

Survival guidelines for Transaction Practitioners

ISSUE 3: APPLICATION OF SURETYSHIP RULES TO RELATIONS INVOLVING A THIRD-PARTY PLEDGOR

Introduction

Pledges are commonplace in the Russian market because of the benefits they provide to creditors, including in the case of a pledgor's bankruptcy. A pledge can be provided by both the principal obligor under the secured obligation and by a third party. In practice, the third party is most often an owner of business, a parent company or a subsidiary. However, a peculiarity of third-party pledges is the possible application of certain rules as to suretyship that are aimed at significantly improving the position of a third-party pledgor. In this regard, it is generally accepted in practice in financial transactions to exclude the application of suretyship rules with respect to a third-party pledgor to the fullest extent permitted by law.

Let us remind you of the fact that the law expressly provides that either a principal obligor itself or a third party can be a pledgor.¹ Regardless of what assets are pledged, if the pledgor

is a third party, the relations between the pledgor, the principal obligor and the pledgee are by *default* regulated not only by pledge rules, but also by the suretyship rules set out in articles 364-367 of the Russian Civil Code.

What does it mean to apply suretyship rules to relations involving a third-party pledgor?

Among other things, we note that:

- i. A third-party pledgor is vested with the right to raise objections to the creditor's claim, which the principal obligor is entitled to present. Moreover, this right remains even if the principal obligor has waived such objections or acknowledged its debt.²

¹ Paragraph 2 of clause 1 of article 335 of the Civil Code of the Russian Federation (Russian Civil Code).

² Clause 1 of article 364 of the Russian Civil Code.

- ii. A third-party pledgor has the right to refuse to perform its obligations and not to agree to enforce the property pledged by it, if the pledgee has the opportunity to perform a set-off with the principal obligor.³
- iii. Amendments to the agreement forming the underlying secured obligations require a consent of the third-party pledgor, if such amendments result in an increase in its liability or other adverse consequences for it. Otherwise, the third-party pledgor is liable on the original terms, and only the original amount of secured obligations will continue to be secured by the pledge.⁴
- iv. In case of novation⁵ of an underlying secured obligation, the pledge continues to secure the new novated obligation only if the third-party pledgor expresses its consent to secure the novated obligation, which may be given prior to the entry into a such novation agreement.⁶
- v. A transfer of the debt under a secured obligation will trigger termination of the pledge if the third-party pledgor has not, prior to the transfer of debt or within a reasonable time after notifying it of the transfer of the debt, agreed to secure obligations of such new obligor.⁷
- vi. The pledge will terminate if the term of the pledge is not established in the pledge agreement itself and the pledgee does not enforce the pledge within one year from the date on which the underlying secured obligation becomes due.⁸

Is it possible to rule out the suretyship rules with respect to a third-party pledgor?

Yes, the provisions of the law expressly provide for a contractual exclusion of the application of suretyship rules with respect to a third-party pledgor.⁹ In other words, the application of such suretyship rules is *optional* and is settled by agreement between the parties to the pledge agreement.

The current market standard is to expressly rule out the suretyship rules from a pledge agreement with the third-party pledgor.

Are there any peculiarities to be considered in excluding the application of the suretyship rules to relations involving a third-party pledgor?

As stated above, by *default*, a pledge granted by a third-party pledgor will terminate if *the term of the pledge is not established* in the pledge agreement and the pledgee does not enforce the pledge within *one year* from the date on which the secured obligation became due.¹⁰

We note that the stipulated one-year deadline for submitting a claim against a third-party pledgor is preclusive, and therefore may not be extended or restored.¹¹ The consequences of the expiration of the deadline for submitting a claim against such pledgor, unlike the consequences of missing the limitation period, are applied by the court on its own initiative, regardless of a request of the party to the dispute.¹²

At the same time, **we emphasize** that submitting a prepayment or acceleration notice to the borrower being the principal obligor (or a similar claim for early performance of the secured obligation) does not shorten the validity period of the pledge provided by a third-party pledgor. In this case, the validity period of the pledge is calculated based on the originally scheduled payment terms of the secured obligation.¹³

Here, despite the express exclusion of the application of this rule by the parties, **we still recommend** establishing in a pledge agreement a *specific* term of its validity. Our recommendation is based on the following.

- i. According to the position of the Constitutional Court of the Russian Federation, a third-party pledgor must be given the opportunity to foresee the property consequences of providing the security within reasonable limits. In this regard, there should be a time frame, ie a specific term for satisfying the demand to enforce the pledged property.¹⁴

³ Clause 2 of article 364 of the Russian Civil Code.

⁴ Clause 2 of article 367 of the Russian Civil Code.

⁵ For the avoidance of any doubt, please note that in this survival guideline under a novation we understand a Russian law novation as specified in article 414 of the Russian Civil Code, i.e. the replacement of the original obligation between the parties with another obligation between the same parties.

⁶ Clause 1 of article 367 of the Russian Civil Code, clause 26 of Resolution of the Plenum of the Supreme Court of the Russian Federation No. 6 "On Certain Issues of the Application of Provisions of the Civil Code of the Russian Federation on Termination of Obligations" dated 11 June 2020.

⁷ Clause 3 of article 367 of the Russian Civil Code.

⁸ Clause 6 of article 367 of the Russian Civil Code.

⁹ Paragraph 2 of clause 1 of article 335 of the Russian Civil Code.

¹⁰ Clause 6 of article 367 of the Russian Civil Code.

¹¹ Ruling of the Panel of Judges on Civil Cases of the Supreme Court of the Russian Federation No. 41-KG18-16 dated 29 May 2018, Resolution of the Arbitrazh Court of the Moscow District No. F05-23749/2019 dated 6 February 2020, on case No. A41-81963/2017.

¹² Resolution of the Constitutional Court of the Russian Federation No. 18-P dated 15 April 2020.

¹³ Clause 44 of Resolution of the Plenum of the Supreme Court of the Russian Federation No. 45 "On some issues of dispute resolution related to suretyship" dated 14 December 2020, Ruling of the Panel of Judges on Economic Cases of the Supreme Court of the Russian Federation No. 305-ES20-12714 dated 15 April 2021 on case No. A41-46643/2019.

¹⁴ Ibid.

- ii. Following the Constitutional Court of the Russian Federation, a similar position is supported by other Russian courts, which emphasize the inadmissibility of the existence of third-party pledgor's obligations not limited in time.¹⁵

We note that providing in a pledge agreement that it is valid "until complete performance of the secured obligations" is considered by the courts equivalent to the absence of a pledge term agreed upon by the parties.¹⁶

Thus, in the absence of a specific term of pledge agreed upon by the parties, **we cannot exclude the risk** that the court will apply the rules on termination of suretyship to relations involving a third-party pledgor, even if there is an agreement to the contrary.

In all cases where there is no agreement of the parties to the contrary, do the suretyship rules established by articles 364-367 of the Russian Civil Code apply to relations involving a third-party pledgor?

No, not always. Having analyzed the court practice, we have seen recent cases in which the presence of signs of affiliation¹⁷ between the principal obligor and the third-party pledgor played a decisive role for the court.

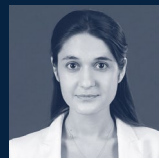
In a number of cases, having established affiliation between the principal obligor under the secured obligation and the third-party pledgor, the court concluded that the suretyship rules set out in articles 364-367 of the Russian Civil Code could not be applied to the relations arising under a pledge agreement. This conclusion is based on the opinion of the court that in these cases the affiliation between the principal obligor of the secured obligation and the third-party pledgor results in the actual coincidence of such entities.¹⁸ We note, however, that this ground for the non-application of articles 364-367 of the Russian Civil Code to the relations involving a third-party pledgor is not established by law.

Therefore, notwithstanding the position of the courts discussed above, **we recommend** that the pledge agreement should expressly rule out articles 364-367 of the Russian Civil Code to relations involving a third-party pledgor, even if the third-party pledgor and the principal obligor under the secured obligation are affiliates. This will eliminate the need to prove affiliation between such entities in court, as well as eliminate the risk of the ground for non-application of these suretyship rules not being supported by court.

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¹⁵ For example, Resolution of the Tenth Arbitrazh Court of Appeal No. 10AP-18330/2020 dated 11 March 2021, No. 10AP-18331/2020 on case No. A41-22138/2020 (the decision was left unchanged by Resolution of the Arbitrazh Court of the Moscow District No. F05-13702/2021 dated 28 June 2021 on case No. A41-22138/2020), Resolution of the Arbitrazh Court of the Povolzhsky District No. F06-61716/2020 dated 28 January 2021 on case No. A55-6016/2019.

¹⁶ Appeal ruling of the Moscow City Court No. 33-11403/2020 dated 2 July 2020, Decision of the Arbitrazh Court of the Novosibirsk Region dated 29 July 2020 on case No. A45-11382/2020.

¹⁷ Signs of affiliation of entities are determined in article 4 of the Law of the RSFSR No. 948-1 "On competition and limitation of monopolistic activity in commodity markets" dated 22 March 1991.

¹⁸ For example, Resolution of the Arbitrazh Court of the Moscow District No. F05-354/2021 dated 11 February 2021 on case No. A40-312635/2019, Resolution of the Arbitrazh Court of the Moscow District No. F05-5747/2021 dated 14 May 2021 on case No. A40-196753/2019.