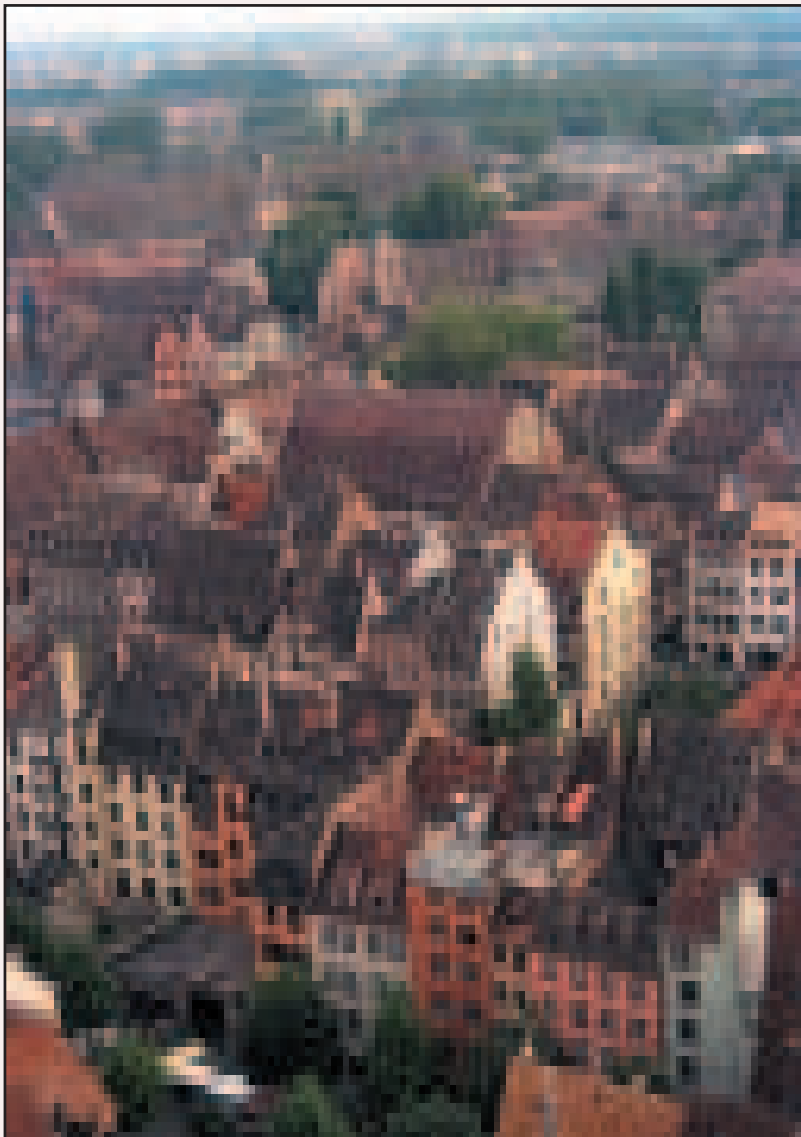


REAL ESTATE INVESTMENT IN RUSSIA



**International
Real Estate
Institute**



By:

*Gene M Burd, Esq.
Marks & Sokolov, LLC
Philadelphia, PA*

*A nastasiya Mamai, Esq.
Marks & Sokolov, LLC
Moscow, Russia*

I. INTRODUCTION

With the memories of the financial crash of 1998 fading away, western businesses increasingly look at Russia as a potential investment opportunity. According to Interfax, accumulated foreign investments in the Russian economy totaled \$53.595 billion by late September 2003, a 34.7% year-to-year rise. Interfax report November 17, 2003, as reported by *Johnson Russia List* #7423, November 17, 2003. While Europe and the United States are still struggling with recessionary pressures, Russia's economic growth of 7.2 percent in the first half of 2003 is attracting foreign investors. Western bankers, even those who suffered major losses in 1998, such as Credit Suisse First Boston and Barclays, are returning. Charles Pretzlik and Arkady Ostrovsky, *Banks Again Booking Seats on Russian Flights of Capitalists. Strong Growth Has Lured Back Even The Losers In The 1998 Crash To Prospect For New Deals*. Financial Times (UK), July 17, 2003.



Investment in real estate, which is relatively new to Russia, is becoming popular, especially in Moscow, where triple net rental rates for prime retail space are reported to be reaching \$150 per square foot per annum, and \$50 per square foot per annum for office space. Both Russian and Western investment funds take positions in the market. In February 2003, First Real Estate Investment Fund, which, as the name says, claims to be the first Russian real estate investment fund based on trust management principles, registered its trust agreement. The fund's stated objective is to profit from Moscow's expanding real estate market. Western asset manager Fleming Family & Partners has \$60 million in Western pension funds it intends to invest in Moscow real estate. The fund's leading investor is the General Electric Pension Trust.² Another Western fund, Brunswick Capital is planning to invest \$100 million in Moscow real estate, primarily, Class "A" office space.³

In addition to the growing economy and high rents, an important reason for growing attention to Russian real estate is the formation and development of the legislative basis that provides investors with an understanding of their property rights. Among these developments are the Land Code, which provides the basic principles of the private ownership of land, laws governing land registration, mortgage law, and local legislations governing and regulating the real estate market.

This article provides a brief overview of various laws applicable to the Russian real estate market, with a primary focus on the potential concerns of foreign investors entering the market. The article also reviews basic issues which are applicable to real estate in Russia and considers major distinctions between Western and Russian approach to real property.

II. BASIC PRINCIPLES APPLICABLE TO REAL PROPERTY IN RUSSIA

Development of Real Estate Legislation

Real estate in today's Russia is a relatively novel investment vehicle. During the Soviet time, private land ownership was tabu. In the 1917, The Land Decree abolished landed proprietorship without any compensation and declared that land "belongs to the whole people."⁴ The land remained common property up until 1993,

¹See ZAO Management Company "Concordya - Asset Managmeent", *Fund Characteristics*. Available at <http://concordya.ru/hf.htm> (last visited July 17, 2003).

² Robin Munro, *Foreign Fund to Buy Real Estate*, The Moscow Times, May 19, 2003.

³ Igor Semenenko, Brunswick Ready to Roll With \$500M The Moscow Times, July 10, 2003.

when the first post Soviet Russian Constitution declared that private ownership can extend to land and natural resources and guaranteed equal treatment to the privately owned property.⁵ Also in 1993, the Decree No. 1767 allowed sale, purchase, and lease of land, as well as creation of security interest in land.⁶

However, up until 2001, the provisions of the Constitution allowing private ownership did not have practical effect because legislation creating and regulating private ownership rights in land either did not exist or had not entered into force. For example, Chapter 17 of the Civil Code dealing with rights in real property, including land,⁷ did not become effective until April 2001.⁸ The Land Code regulating issues of ownership and land use became effective on October 30, 2001. Furthermore, the parts of the Civil Code relevant to dealing with agricultural land did not become effective until January 2003. Thus, until very recently, Russian law simply did not have the provisions permitting prospective investors to understand the rights and responsibilities of landowners with reasonable certainty.

The Land Code, the most important part of the land related legislation, was a product of heated debates concerning privatization of agricultural land, private ownership of land parcels, the right of foreigners to purchase land, establishing the value of land for leasing and selling by the state entities, and the eminent domain provisions.⁹

Laws Applicable to Real Estate Transactions

The most important laws relevant to transactions in real estate are the Land Code, Civil Code, Land Registration Law, and the Mortgage Law. In addition, separate regions of the Russian Federation have the right to adopt their own laws and regulations governing ownership, use, and transfer of land and other real property. These laws are briefly reviewed below.

Land Code

The Land Code was signed into law by President Putin on October 26, 2001, and declares the basic principles of land legislation which including a wide variety of environmental, social and land conservation principles. Among the basic principles is the unity of the land with the attached objects. The Land Code divides land into categories according to its use, which are agricultural, municipal, industrial, specially secured, forest, water, and the reserve. Legal principles applicable to different categories could be different. Generally, it is fairly clear that land conservation and environmental concerns are regarded higher than commercial use of the land. See Article 1 of the Land Code.

The Land Code, federal laws, and the laws of the regions of the Russian Federation comprise land legislation. The scope of land legislation is limited to relationships arising out of the use and conservation of land. The Land Code also defines various types of ownership interests in land, which will be discussed below, and sets forth the rights and obligations of parties with interests in land. It also addresses the issues of land control, categories of land and basic land use principles. However, relationships concerning land as property are generally outside the scope of land legislation and are reserved to civil legislation. See Articles 2 and 3 of the Land Code. Civil

⁴ See Decree on Land, October 26 (November 8), 1917, available at <http://www.marxists.org/archive/lenin/works/1917/oct/25-26/26d.htm> (last visited November 19, 2003)

⁵ See Article 9 (2) and 8 (2) of the Constitution of RF.

⁶ See Decree of the President of the RF of October 27, 1993, No. 1767 "On the regulation of land relationships and the development of the agrarian reform in Russia.", Point 2.

⁷ See *Federal Law # 45-FZ* of April 16, 2001.

⁸ See *Federal Law # 45-FZ* dated April 16, 2001. Further, the relevant provisions of the Chapter 17 of the Civil Code concerning transactions involving agricultural lands became effective as of January 27, 2003. See *Federal Law # 101 -EZ* on Transactions [Oborot] Involving Agricultural Lands of July 24, 2002

legislation includes the Civil Code and federal laws adopted pursuant to the Civil Code. Similarly, the Land Code has limited application to relationships arising out of transactions with improvements attached to the land.

This apparent duality of land as an object and land as property creates an important distinction between the Russian and Western approaches to real property.¹⁰ In the West, land and improvements are generally subject to the same form of ownership as it relates to the highest owner (i.e. not a lessee). For example, if the land is owned in fee simple, the improvements are also owned in fee simple by the same owner. It would be very unusual for one to own a building on land which he or she leases. However, the latter situation is common in Russia. This unusual, from the western point of view, form of ownership is reminiscent of a feudal system in which the state, as the landlord, is at the top. The state normally retains higher ownership rights to a land parcel unless it decides to relinquish them in the process of privatization. For example, municipalities would often retain ownership rights to the land, which would be leased to a developer who would build and own as property a structure attached to the land.

Notably, the Land Code explicitly distinguishes between ownership of land by Russian citizens and by the foreigners and provides certain limitations on the ownership of land by foreign citizens. Such limitations include, *inter alia*, ownership of land within areas adjacent to the Russian national border and near military installations. The Law on Transfer of Agricultural Land, which was adopted pursuant to the Land Code, further limits the rights of foreigners in agricultural lands by prohibiting any form of ownership of agricultural lands by foreigners except leasing.¹¹ Within the meaning of the law, foreigners include legal entities with over 50% interest owned by foreign citizens.¹² The Land Code, however, does not define the term “foreigners,” which may give rise to potential issues in determining whether a certain real property belong to a foreigner.

Civil Code

The Civil Code contains provisions that address property rights in land and real (immovable) property. While provisions dealing with land are contained in Chapter 17 the Civil Code, various provisions dealing with real property are located throughout the Civil Code. For example, definition of real property is placed in Article 130, provisions concerning registration of real property rights are covered in Article 131, and creation of property rights in newly created real property is in Article 219. An *enterprise* as a complex of assets is also treated as real property. See Article 132 of the Civil Code.

Under Russian law, the term real property includes both land and attachments or improvements to it, such as buildings and structures. See Article 130(1). These types of property, however, could be treated differently. While the Civil Code primarily regulates transactions involving improvements attached to land, the Land Code sets out rules for transactions involving land. Sometimes the Civil Code and the Land Code provide for conflicting regulations. For example, Article 21 (2) of the Land Code provides that lifetime inheritable possession cannot be transferred except by inheritance. However, Article 267 of the Civil Code provides that the owner in lifetime inheritable possession of a land plot may transfer the land plot to others pursuant to a lease or a fixed-term use without compensation. While in this situation the general rule of Russian legal doctrine that gives prevalence to a later law could be applied, such situations may result in conflicting legal decisions.

⁹ See e.g. Yevgenia Borisova, *Fists Flys as Duma Approves Land Bill*, Moscow Time, June 18,2001, p.1

¹⁰ The duality of land and improvements seems to be inconsistent with the Land Code itself which generally proclaims that the unity of land and improvements is a basic principle of land legislature. See Article 1. 1 (5) of the Land Code.

¹¹ *Federal Law of July 24,2002 # 101-FZ On Transactions [Oborot] Involving Agricultural Lands*, Article 3.

¹² *id*

Mortgage Law

The Mortgage Law entered into force in July 1998. The law provides basic principles for utilizing real property as security for a debt. In addition to giving important definitions and setting legal principles for securitization of real property, transfer limitations, secondary mortgage, foreclosure, and forced sale, the law describes in great detail the proceedings for the recording of mortgages. The adherence to technical details is extremely important because it is not unusual for Russian courts to invalidate agreements and registration instruments based on technicalities.

Land Cadastre Law

The Law on the State Land Cadastre sets forth procedures for mandatory recording of information about existing land lots. The law was adopted in January 2000. The law generally deals with the general procedures for maintaining and recording information about land and real property. The proper cadastre recording is important because “land plots may only be subject to sale or purchase if they are on record in the state cadastre.”¹³ Moreover, improvements attached to the land are also subject to recording in the cadastre. See Article 14(2) of the Cadastre Law.

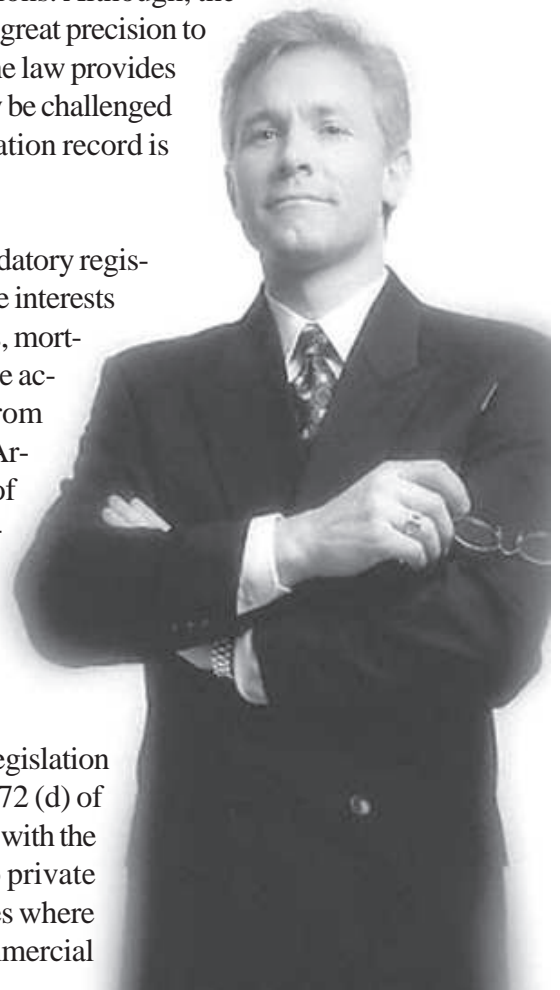
The Law on the State Registration of Real Estate and Real Estate Transactions (“Registration Law”).

The Registration Law was adopted in 1997 and last amended in June 2003. The law provides detailed provisions for the registration of real estate and real estate transactions. Although, the requirements are mostly technical, it is important to follow them with great precision to avoid the invalidation of a transaction for technical reasons. In fact, the law provides that state registration is the only proof of a registered right and can only be challenged through the court. Article 2(1) of the Registration Law. The registration record is public. Article 7 of the Registration Law.

The Registration Law, as well as the Land Code require mandatory registration of ownership rights and other estate interests in real estate. The interests subject to registration include various types of ownership, easements, mortgages, trust management arrangements and leases. Interests that were acquired prior to the adoption of the Registration Law are exempt from registration unless the interest holder desires to transfer the interest. Article 4 of the Registration Law. Short-term leases and sub-leases of structures with duration less than one year are also exempt from registration requirements. Article 25(1) of the Land Code, Article 651(2) of the Civil Code.

Local Laws

The Constitution grants local governments the right to enact legislation on issues related to the ownership, use, and transfer of land. Article 72 (d) of the Constitution. Various laws have been enacted by all regions to deal with the above issues. One of the major issues is the transition from state to private ownership of land. This issue is especially controversial in large cities where local governments own major portions of the income producing commercial



¹³ Article 37 (1) of the Land Code

properties. For example, in Moscow, private ownership of land was prohibited by the 1994 legislation¹⁴ The statute has been challenged in court by Mostranskomplekt, a company attempting to purchase land from the City of Moscow, which petition to purchase a 13.8 hectares parcel was denied. Mostraskomplekt sued the City and won at the trial level in February 2003. The court required the city to sell the land at issue at the bargain price of \$3 00,000¹⁵. In May 2003, the Moscow government adopted the Law on Land Use and Construction in the City of Moscow, which allows land to be privatized through a bidding process. However, it would be up to the City to decide whether to allow the privatization of a particular parcel of land. The adoption of the new law is perhaps an attempt by the City of Moscow to address the mounting pressure to privatize city land.

III. MAJOR ISSUES RELATED TO INVESTMENTS IN REAL ESTATE

This section of the article will address the major issues traditionally considered in an analysis of laws applicable to real estate transactions. These issues include: determining the types of interests that exist, the creation of these interests, and their termination. Since this article is primarily addressed to the Western audience, the issue of the ownership of land by foreigners is also considered.

A. Types of Interests in Land

The Land Code defines six types of interests in land: ownership, perpetual (indefinite) use, lifelong inheritable possession, free fixed term use, leasehold, and easements. Ownership under the Russian civil code system is a bundle of rights that includes the rights of possessing, enjoying and disposing of an object of ownership. Perpetual (indefinite) use, lifehold inheritable possession and easements are referred to as limited estate rights.

Owner ship

Ownership is the highest property interest in land. Both private citizens and legal entities have the right to own land. Article 15 of the Land Code. Owners have the right to use, mortgage, bequeath, lease, sell, or otherwise use the land. Article 260 of the Civil Code. For all practical purposes, ownership is the interest which should attract the most attention from foreign investors because of its flexibility and superiority over the other types of interests in land.

Perpetual or Indefinite Use

Perpetual or indefinite use is only applicable to municipal, state or federal property. Land Code, art 20(1) Private citizens are not permitted to hold land based on a perpetual or indefinite use basis. However, the Land Code contains a grandfather clause that allows those who held the property in use prior to the adoption of the Code to retain a use interest in the property. Land Code, art. 20(3). The land subject to this grandfather clause cannot be alienated. Land Code, art 20(4). However, the holder of the interest has the right to convert his use interest into ownership, with a payment for the land. Land Code, art 20(5). Legal entities are required to re-register and transfer their right to perpetual or indefinite use into a leasehold or ownership by January 1, 2004. Implementing Law of the Land Code, art 3(2). If a building or a structure is located on a land plot which is being held by a legal entity through a right of perpetual or indefinite use, the right must either be re-registered and transferred into a leasehold right or the land plot must be be acquired into ownership, as set forth by the Land Code. Article 3(2) of the Law Implementing the Land Code.

¹⁴ The rights granted by the Constitution belong to the subjects of Russian Federation, most of which are republics and certain regions. Moscow and St. Petersburg are the only cities which are separate subjects of Russian Federation.

¹⁵ The Moscow government has appealed the decision, but at the time of this article, the result of the lawsuit is unavailable

For practical purposes, if an investor is interested in a parcel of land which is held in perpetual and indefinite use by a private citizen, it would be advisable to require the interest holder to convert the use into ownership, prior to transferring the land to the investor. If such a conversion is not accomplished, the transaction could be void. A similar transactional structure may apply when land is purchased from a legal entity, with additional attention to be paid to the re-registration requirements.

Lifetime Inheritable Possession

Lifetime Inheritable Possession is a transitional form of property right, which is only applicable to land which has been held in this form prior to the adoption of the Land Code. Land Code, art. 21 (1). Land held in lifetime inheritable possession cannot be alienated except for through a bequest. However, similar to a perpetual or indefinite use, the holder of the right to lifetime inheritable possession can re-register and convert his interest in the land into ownership without paying the purchase price.

Leasehold

Leasehold interests have the same general structure as leaseholds in the West. The owner has the right to lease land. Land Code, art. 22(2). The term and the rent are generally determined by agreement between the parties. However, if the ownership belongs to the state or municipality, the rent can be set by the Russian Government. Land Code, art 22(4). The lessee has the right to assign, sublease, or pledge the land without consent of the owner unless such consent is required by the lease agreement. Land Code, art. 22(5) and (6). Where the land belongs to the state or a municipality, the assignment is only allowed if the lease is for a term of over five years. Land Code, art. 22(9). In the event of assignment, the assignee becomes liable to the owner on the lease. There is no similar provision for a sublease, so it appears that in the event of a sublease, the main lessee remains liable to the owner.

The statute provides that a lessee of a state- or municipally-owned land has preemptive rights to acquire the land subject to the lease if the land is being sold. Land Code, art. 22(8). The right is mandatory and cannot be contracted out. Consequently, it is important for the validity of title that during the privatization sale, the lessee be offered the parcel and reject it. Otherwise, there is the potential that the lessee or the assignee would later claim that the privatized title is invalid because the lessee did not have the opportunity to exercise his preemptive rights. Additionally, the lessee has preemptive rights to renew the lease. Land Code, art. 22(3).



As discussed above, leasing, and especially long-term leasing, is frequently used for real estate investments. Due to the reluctance of local governments to part with the control of land, most of the commercial buildings in such cities as Moscow and St. Petersburg are leased on a long-term basis rather than owned outright. It could be anticipated that with time, long-term leases will be converted to outright ownership. However, one can only guess when this conversion will take place.

Easements

The Russian law provides for easements (servitudes), which are the rights of third parties or the public in the land. Land Code, art. 23, Civil Code, art 274-276. The easements are divided into private and public. To be valid, the easement must be registered. However, they can be created during the owner's possession of the land. The law provides for three basic means for the creation of easements: (i) by necessity, where passage through the neighboring land is required; (ii) for public purposes to install transmission and communication lines; and (iii) for other reasons where ownership rights of the owner of a real property cannot be adequately assured without an easement. Civil Code, art. 274. In the event of private easements, the owner has the right to be compensated for creation of the easement. Land Code, art. 23(6).

An easement is attached to the land, which means that it is transferred to the subsequent owner. Civil Code, art. 275 (1). Easements can be terminated either by the agreement of the parties (at the request of the owner), or by the court.

Public easements are created for a number of specifically defined purposes including passage, drainage, water supply, access to the shore, and others. The owner of the land does not have the right to compensation for the creation of a public easement unless the easement creates significant difficulties in the usage of land. Land Code, art. 23(7). The law does not explain what "significant difficulties" are. Accordingly, the interpretation is left for the courts. In the event it becomes impossible for the owner to use the land burdened by public easement, the owner has the right to demand that the land be transferred through eminent domain to be compensated for his losses or provided an alternative parcel of land.

B. Acquisition of Interests in Real Property

Generally, the rights in real property could be acquired by purchase, public sale, privatization, lease, bequest, or pledge. Due to the difference in the treatment of land and improvements attached to the land, the applicable rights could differ. Therefore, it is important to understand what rights are acquired and in what they are acquired.

Acquisition of Rights in Land

The Land Code distinguishes among the following four basic methods of acquiring rights in land:

- private sale;
- public sale and acquisition from the state for construction purposes;
- lease;
- passing of rights upon transfer of the improvements attached to the land;

Registration of the land parcel in the cadastre is a general requirement for all means of acquisition. An interest acquired in an unregistered parcel could be void or voidable.

Private sale is generally governed by the agreement between buyer and seller and applicable general principles of contracts. However, the law prohibits certain terms in agreements for sale of land. These prohibited terms include (i) a unilateral repurchase right by the seller; (ii) limitations on alienability including limitations on mortgages, leasing, or other transactions with the land; (iii) limitations of seller's liability against the claims of third

parties. Land Code, art. 37(2). Additionally, the law imposes liability on the seller for knowingly providing false information on restrictions related to the use or enjoyment of land. The buyer has the right to invalidate the sale or to have the purchase price decreased and to compensation of applicable losses if seller provided such knowingly false information. Land Code, art. 37(3). The same liability for providing knowingly false information applies to leases.



The Land Code provides detailed regulations for the transfer of land from public to private ownership. See Land Code, arts. 30-34. While a detailed review of these regulations is beyond the scope of this article, the main features are as follows. The land parcel subject to transfer needs to be surveyed and its use must be defined. Consent of various state authorities must be obtained and the parcel must then be registered in the cadastre. In some instances, the sale needs to be advertised. The transfer of the right to the parcel must be registered in the cadastre, which is not the same as registering the parcel itself. In each specific case, it is important to follow the applicable procedures to avoid potential title claims and reversal of privatization.

The main features of leasing and transfer of the applicable rights have been reviewed above. Generally, the leases are treated as contracts and the freedom of contracts applies. The owner, however, is liable for knowingly providing false information to the lessee on various restrictions relating to the use of the land. In the event such information has been provided, the lessee has the right to invalidate the lease or to lower the rent and to have his losses compensated.

Interests in land can also be obtained by acquiring the ownership to real property located upon the land. Land Code, art. 35. Generally, upon acquiring the ownership rights to an improvement, the new owner acquires a right to use the portion of the property beneath the improvement on the same terms and conditions as the previous owner. This transfer of rights relating to land is governed by the Land Code, the Civil Code governs transfer of rights relating to the real property attached to the land.

Once the rights to land and the attached improvement are merged into one person or legal entity, the land generally cannot be alienated separately from the improvement and improvement cannot be alienated separately from the land¹⁶. However, the improvement can be transferred separately if the land is categorized as non-transferable or of a limited transferability. A portion of the improvement can be sold separately if it cannot be separated together with the portion of the land beneath the improvement”, Land Code, art. 35(4). This provision is important from the point of view of the eventual diminishing of the distinction between the ownership of land and that of the attached improvements, which is one of the stated goals of the Land Code.

Acquisition of Rights in the Improvements

The rights in improvements may be acquired in a similar manner to the rights in land. The major difference, however, is that the law primarily applicable to transactions with improvements is the Civil Code and not Land Code, which is primarily applicable to transactions with land. Accordingly, the general principles applicable to contracts are also applicable to transactions with improvements. For instance, an agreement for sale of real property must contain terms and conditions relating to the subject matter of the transactions and the price, otherwise the agreement will be treated as unconcluded. However, in addition to conventional contractual norms, agreements for transfer of rights in real property are subject to mandatory registration. Once again, adherence to registration formalities is extremely important to avoid potential invalidation of the transaction.

C. Termination of Interests In Real Property

Provisions relating to the termination of interests in real property are contained in both the Civil Code (as to the land plots and other real property) and the Land Code (as to the land plots). As it would be expected, termination of ownership interests in real property comes with voluntary or involuntary transfers. Leasehold interests can be terminated by their own terms and upon default of the lessee. As to the non-ownership interests, they can be terminated if the holder improperly uses the land.

Real property can be transferred to the state by confiscation and eminent domain. In both cases, a court decision relating to the termination of the ownership interests is required. In the event of eminent domain, the owner has to be compensated with the value equal to the value of the land prior to the transfer of the land to the state.

D. Ownership of Real Property by Foreigners

Foreigners¹⁸ are generally treated equally with respect to ownership and leaseholds interests. As noted above, the main limitation is that foreigners are not allowed to hold interests in land located in the federal border areas and in areas specifically designated as such by federal laws. Land Code, art. 15(3). Foreigners are also not permitted to hold perpetual or indefinite use and lifetime inheritable possession interests. The latter limitations, however, are of a little practical meaning since both of these interests could be converted to the ownership and the land can be sold to new owners. Additionally, foreigners can only have leasehold interest in land designated as agricultural¹⁹. Within the meaning of the law, the term “foreigners” also includes legal entities, in which foreign citizens have over 50% interest²⁰.

Foreigners are on equal footing with Russian citizens in their right to acquire the ownership to land plots underneath buildings, which they own. Land Code, art. 36(9). This right is subject to general limitations applicable to the rights of foreigners in Russia and national security interests limitations set forth in the Land Code. Similarly, foreigners can lease land on the same basis as Russian citizens, subject to the same limitations as applicable to the ownership. Land Code, art 22.



B. Real Estate Financing

Development of the real estate market requires that the law provide ways to secure the interests of creditors in real property. The Law on Mortgages adopted on July 22, 1998 addresses this concern. While mortgages are still uncommon in Russia, the tendency to make loans secured by real property is growing. According to the media report, portfolio of Delta Credit, one of the first mortgage banks in Russia, already exceeds \$80 million²¹. Considering the significant growth of the commercial real estate market discussed in the

¹⁶ Land Code, art. 35(4). This provision of the Land Code appears to contradict Civil Code, which permits parties to determine themselves whether the land is transferred together with the improvement. See Civil Code, art. 273.

¹⁷ This provision apparently envisages a condominium form of ownership where multiple owners own units in a structure and each unit cannot be meaningfully separated with the corresponding land parcel.

¹⁸ The term “foreigner” is not defined by the Land Code. Therefore, it is unclear whether a Russian registered company controlled by citizens of other countries would be considered a domestic or foreign company.

beginning of this article, it is not inconceivable that the residential mortgage development will be followed by development in commercial mortgage market.

Mortgage

Mortgage [*ipoteka*], or pledge of real estate, is governed by the Mortgage Law and corresponding provisions of the Civil Code. A mortgage is a secured transaction that allows a creditor preference over other creditors in satisfying his claims from the mortgaged real estate. Mortgage Law, art 1. The following property could be mortgaged:

- land;
- commercial real property including entire enterprises;
- residential property;
- personal use property such as summer houses, garden houses, and garages;
- and
- aircrafts, ships and spaceships.

Mortgage Law, art 5(1). General rules of mortgages are applicable to unfinished construction and leasehold interests. Mortgage Law, art. 5(2) and (5).

Mortgage law regulates the following aspects of mortgage obligations:

- the form and content of mortgage agreements;
- issuance of pledge certificates;
- registration of mortgages;
- obligations of mortgagors to care of the mortgaged property;
- transfer of mortgaged property;
- secondary mortgages;
- transfer of obligations secured by mortgages-
- foreclosure and forced sale; and
- special consideration for mortgages on land, commercial, and residential realty.

Mortgage law is a comprehensive document and its detailed review is beyond the scope of this article. Accordingly, only certain basic points will be addressed here.

Mortgage agreements are subject to the general contract principles of the Civil Code and to additional requirements imposed by the Mortgage Law. For example, in addition to a conventional requirement that a contract contain a subject and purchase price, the mortgage agreement must specify the object of the mortgage, its value, nature, amount and term of the obligation secured by the mortgage. Additionally, the object of the mortgage has to be identified by name, location and a description which is sufficient to identify the object. The law contains additional requirements, which should be followed with precision to avoid invalidation of the mortgage agreement for technical reasons. Mortgage Law, art. 9. Obviously, a mortgage agreement must be in writing. A mortgage agreement must be notarized and registered, and the underlying interest in real property should be recorded in the register of interests in real property. A mortgage agreement is considered in force after it has been registered.

¹⁹ Federal Law of July 24, 2002 # 101-F-Z On Transactions [*Oborot*] Involving Agricultural Lands, Article 3

²⁰ *id.*

²¹ Robin Muro, *Would-Be Homeowners Shop for Financing*, The St. Petersburg Times, October 23, 2003

Mortgage Law not only regulates mortgage agreements but also pledge certificates [*zakladnaya*] which are commercial papers derivative to mortgages. Pledge certificates serve to prove the rights of mortgagees in the obligations secured by the mortgage and the mortgage agreement. The law imposes a number of specific requirements to the form and the content of the pledge certificate. These requirements must be followed closely because if they are not met, the pledge certificate is invalid.

Chapter V of the Mortgage Law provides a number of default provisions relating to a mortgagor's responsibilities for the maintenance and care of the property. These provisions can be modified by the parties to the mortgage agreement. Most of these provisions are similar to those usually found in mortgage agreements used in the United States. For example, mortgagor is obligated to care for the mortgaged property and maintain it in good order; to maintain insurance on the property; to comply with the laws related to the prevention of loss to the property. The mortgagor has the right to step in the shoes of the mortgagee if the mortgagee's interest in the property has been challenged by third parties; the right to inspect the mortgaged property. In some cases, mortgagee's failure to comply with non-monetary requirements may lead to the mortgagor's right to accelerate the obligation secured by the mortgage and to commence foreclosure proceedings.

Chapter IX deals with foreclosure. The mortgagor has the right to commence foreclosure proceedings if the mortgagee fails to make timely payments more than three times in twelve months. This provision can be changed by agreement of the parties. The law provides a numbers of specific issues to be resolved by the court as follows:

- the amount to be repaid to the mortgagee;
- the property subject to the mortgage;
- the means of sale of the property to satisfy mortgaged obligations;
- the initial public sale price; and
- the measures required to safeguard the mortgaged property.

In the event that the mortgagor is an individual and the mortgaged property is not used in business, foreclosure proceeding can be postponed for a period of up to a year, However, such a postponement is not allowed if it leads to significant deterioration of the financial condition of the creditor or if the mortgagee is insolvent or bankrupt.

A property can be foreclosed without court proceedings with consent of the mortgagor. However such consent is only valid if given after the event of default took place. Thus, a tool such as confession of judgment authority given by the debtor at the execution of debt and mortgage instruments is unavailable.

Chapter X of the Mortgage Law provides detailed regulation of forced sale of property. There is an important difference between approach taken by the Russian law and the practice often used in the United States. The law does not explicitly allow the mortgagee to use the value of the mortgage obligation owed to him as a bid at public sale. Thus, technically, mortgagee if he desires to take part in the public sale needs to be prepared to come with the entire amount of the bid in actual funds without a deduction of the value of the obligation owed to him. However, the creditor has the right to acquire the property at the initial price if the public sale was invalidated. In such case, the creditor may use the amount of the debt owed to him as a set off against the purchase price.

Title Insurance

According to a number of private sources, title insurance is available in Russia to cover interests in residential and commercial properties. Title insurance covers the loss of ownership rights as a result of invalida-

tion of the real estate transaction for various reasons including transaction under duress or fraud, transactions violating the rights of minors or incapacitated persons, failure to comply with legal requirements, unauthorized transactions, and other reasons giving the rise to potential third-party rights. Title insurance normally compensates the value of the lost property right and legal expenses including attorney fees.

The premium will vary depending on (i) the term of the policy, which could be from one to ten years, where ten years is the statute of limitation for potential claims of third parties; (ii) the risk factor which is determined by a legal audit of the title prior to the issuance of the insurance, and (iii) the value of the property. Quoted rates vary from 0.5 to 4.5 percent of the value of the interest in the property.

IV. DISPUTE RESOLUTION

The resolution of commercial disputes involving foreign companies in emerging markets has always been one of the important issues for investment in many countries, including Russia. While the government and judicial authorities appear to be taking certain measures to fight such abuses, many Western investors still remain concerned with whether they can protect their legitimate interests in the Russian courts. For this and a number of other business reasons, many Westerners prefer to include in agreements with their Russian counterparts arbitration provisions that require arbitration in neutral countries.

Arbitration provisions are generally valid and enforceable under Russian law. Furthermore, Land Code specifically provides for the right of the parties to refer their land related disputes to arbitration. Land Code, art. 64(2). However, certain types of real estate disputes lie within the exclusive jurisdiction of the Russian arbitrazh courts. For instance, disputes involving a foreign party, and related to real estate located on the territory of the Russian Federation can be only decided by the Russian arbitrazh courts²². Arbitrazh Procedural Code, art. 248. The law is unclear, however, as to whether a domestic Russian company wholly owned by foreigners is considered as Russian or foreign.



V. CONCLUSION

While Russia is still considered to be a high-risk region, it slowly but surely adopts basic principles which could be understood by Western investors. This tendency was, for instance, expressed by Moody's, which recently upgraded Russia's sovereign rating to the investment grade of Baa3. The essential building blocks for real estate investment in today's Russia do exist. However, the peculiarities of Russian law must be carefully considered prior to engaging in real estate transactions and the use of "standard" mortgage financing terms should be done with great caution to avoid potential issues in the future.

²² See Article 248 of the 2002 Arbitrazh Procedure Code of Russia

RIM

Registered International Member

RPM

Registered Property Manager

SCV

Senior Certified Valuer

CTS

Certified Trade Specialist



**International
Real Estate
Institute**

International Real Estate Institute

P.O. Box 879 Palm Springs, California 92263 USA

Tel: (877) 743-6799 Fax: (760) 327-5631

E-mail: info@irei-assoc.org Website: www.irei-assoc.org