

Articles

Real Estate Transactions in Russia: New Land Code Gives Green Light to Foreign Investment

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I. INTRODUCTION

One should not be intimidated by the printed news, by the risks, or by the history of Russia. Rather, one should view Russia as an exciting market that is developing and will provide opportunities for cautious investors to enrich their businesses.¹

Until very recently, the concepts of private ownership of land and the use of real estate as collateral for debt were unknown to a majority of Russian people. The laws of the Soviet Union did not recognize the concept of private land.² The first significant step in the direction of creating land ownership rights was the enactment of the Land Code of the Russian Soviet Federated Socialist Republic (“RSFSR”) in April 1991.³ However, under the Land Code of the RSFSR, the rights bestowed upon Russian citizens were severely limited when compared to the Western concept of property rights.⁴

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¹ Kenneth A. Cutshaw, *Russian Roulette*, 43-JAN. FED. LAW. 30, 35 (1996) (quoting statement of U.S. Ambassador in Moscow), available in WESTLAW.

² See Andrei A. Baev, *The Privatization of Land in Russia: Reforms and Impediments*, 17 LOY. L.A. INT’L & COMP. L.J. 1, 2 (1994).

³ See Olga Floroff & Susan W. Tiefenbrun, *Land Ownership in the Russian Federation: Laws and Obstacles*, 27 ST. LOUIS U. L.J. 235, 246 (1993).

⁴ See *id.* at 248 (stating that “[t]he Land Code [of RSFSR] does not provide the right of land ownership for the purposes of engaging in entrepreneurial activity”).

President Yeltsin's Edict No. 1767, signed on October 27, 1993, was the first truly revolutionary measure that did away with the communist legacy by allowing "citizens and legal persons . . . to sell, bequeath, donate, mortgage, lease and exchange" land.⁵ These rights were later legitimized by the Constitution of the Russian Federation of 1993⁶ and by the Civil Code of the Russian Federation of 1994 (the "Civil Code")⁷ and further expanded by the presidential decrees of 1994 and 1996.⁸ However, the real breakthrough in the way of creating a truly competitive real estate market came with the enactment of the long-awaited Land Code of the Russian Federation (the "Land Code") on October 30, 2001.⁹

The foundation for the law of secured transactions was first laid by the Russian legislature when it enacted the Law of Pledge of 1992,¹⁰ which, together with the subsequently-enacted Civil Code, set up a framework for the law of obligations, including various ways

This limitation of the Land Code of RSFSR had a stagnating effect on the development of a market economy system in Russia. *See id.*

⁵ Ukaz Prezidenta RF o regulirovanii zemel'nykh otnoshenii i razvitiu agrarnoi reformy v Rossii [President's Decree No. 1767, Regulation of Land Relations and Development of the Agrarian Reform in Russia], [Ross. Gazeta 29 Oct. 1993] [hereinafter Decree No. 1767], *translation available at* 1993 WL 10409647. This decree was necessary for the establishment of a mortgage system, since commercial banks did not lend money to farmers who could not secure it with collateral. Leyla Boulton, *Yeltsin to Open Way for Sale of Land*, THE FIN. TIMES LTD., October 26, 1993, at 2.

⁶ KONSTITUTSIIA ROSSIISKOI FEDERATSII [Constitution of the Russian Federation] [KONST. RF (1993)] (Russ.).

⁷ Grazhdanskii Kodeks RF (Civil Code) [GK RF] (Russ.) [hereinafter Civil Code].

⁸ *See, e.g., Investment Climate in Russia*, RUSSIA EXPRESS BRIEFING, Sept. 30, 1996, 1996 WL 8618978.

⁹ Zemel'nyi Kodeks RF (Land Code) [ZK RF] (Russ.) [hereinafter Land Code]. *See* Robin Munro, *A Good Year for a Maturing Real Estate Market*, MOSCOW TIMES, Jan. 30, 2002, LEXIS News Library; *Putin Signs Land Code into Law*, UNITED PRESS INT'L, Oct. 26, 2001, LEXIS News Library.

¹⁰ Zakon RF O Zaloge [Law on Pledge], [Ross. Gazeta 6 June 1992] [hereinafter Law on Pledge], *available in translation in* 1992 WL 472476.

of securing the performance of obligations.¹¹ The law of secured transactions was later further enhanced by the enactment of the Federal Act on Mortgage of July 9, 1998 (the “Mortgage Act”).¹² Today, the Civil Code and the Mortgage Act provide the framework for the law of mortgages, which, to a large extent, has been modeled after the Western laws on mortgages. The purpose behind these enactments was to develop a system for secured transactions capable of encouraging and facilitating real estate finance and attracting foreign investors.¹³

The purpose of this article is to introduce a foreign investor, who may be interested in engaging in real estate transactions in Russia, to the current legal environment in which the investor will have to operate. The article demonstrates the structure of the legal framework and the progress that has been made in the areas of real estate and secured credit in order to create a competitive real estate market. It also identifies the inherent risks and uncertainties that foreign, as well as domestic investors may be facing when engaging in real estate transactions in Russia. Finally, it argues that in light of the

¹¹ See Jason J. Kilborn, Note, *Securing Russia's Future: A Plea for Reform in Russian Secured Transactions Law*, 95 MICH. L. REV. 255 (1996). The enactment of the Civil Code was long awaited in Russia where most of the reform measures undertaken had been in the nature of “decrees” and of sporadic character. Lane H. Blumenfeld, *Russia's New Civil Code: The Legal Foundation for Russia's Emerging Market Economy*, 30 INT'L. LAW 477 (1996) (Civil Code replaced the “ill-designed patchwork” of post-Soviet laws and decrees). Often these new laws contradicted each other and failed to provide for the mechanisms needed in order for Russia to become a market economy. See *id.* For instance, no significant measures had been launched in order to create a law of obligations. See E. A. Sukhanov, *Russia's New Civil Code*, 1 PARKER SCH. J. E. EUR. L. 619, 622 (1994).

¹² Federal'nyi zakon ob ipoteke (zaloge nedvizhimosti), S izmeneniamina 11 fevralia 2002 [Federal Law on Mortgage (Pledge of Real Estate), as amended February 11, 2002], [hereinafter Mortgage Act], available in LEGAL MATERIALS: RUSSIA 5TH REPORTER, BINDER ** (2002).

¹³ See *Investment Climate*, supra note 8. See also Thomas de Waal, *Chernomyrdin Ready for Poll on Land Reform*, THE LONDON TIMES, Sept. 1, 1995, available in 1995 WL 7694140 (quoting Russian Prime Minister Chernomyrdin's statement that land reform was necessary to attract foreign investment). See also Brandon Bennett, *Secured Financing on Russia: Risks, Legal Incentives, and Policy Concerns*, 77 TEX. L. REV. 1443, 1446 (May, 1999) (“... enactment of the Civil Code prompted further confidence and optimism for business in general, and secured financing in particular”).

unprecedented series of legal reforms that have been implemented in Russia in recent years, including, most importantly, the enactment of the Land Code, and the current investment climate, Russia's current real estate market presents many lucrative opportunities in the form of actual acquisitions of real estate, as well as real estate finance.

Part II of this article discusses the forms of property rights that exist in Russia. Land ownership is a very new concept to Russian citizens. An understanding of the existing property rights is important in order to know how these rights can be used by a foreign investor. This part provides a historical overview of the developments undertaken to create the concept of real estate ownership in Russia and introduces the present laws governing property rights, including the new Land Code. It warns foreign investors of the existing risks in the area of real estate acquisitions that may affect a foreign investor interested in acquiring real property in Russia.¹⁴

Part III identifies and analyzes the ways in which real estate can be used as collateral for debt. The Russian legal framework governing secured credit provides that any property, whether real or personal, can constitute collateral for debt. However, the relevant laws provide for different treatment of security interests in real property vis-a-vis security interests in personalty.¹⁵ Because the focus of this article is on real estate transactions, this article deals primarily with those aspects of Russian law on secured transactions that have a bearing on real estate finance. Further, Part III makes a potential foreign lender aware of certain existing uncertainties and impediments that may affect mortgage finance in Russia.

Finally, Part IV introduces a foreign investor to the current economic climate in Russia. In Part IV, the author, while acknowledging that certain existing risks may complicate the real estate transactions in Russia, argues that despite the existing

¹⁴ See Adrian Moore, *Brick by Brick: The Land Code's Devil Will Lie in the Details*, MOSCOW TIMES, Feb. 5, 2002, LEXIS News Library (noting that under the new Land Code, foreign individuals and companies will be subject to certain restrictions as applicable to land in border areas and beneath certain sensitive buildings).

¹⁵ See generally *infra* text accompanying note 157.

uncertainties, the real estate market in Russia is ripe for foreign investment.

II. ACQUISITION OF REAL ESTATE IN RUSSIA

A. Historical Background

Private ownership of land in Russia has emerged very recently.¹⁶ In 1990, the Soviet Union adopted the USSR Fundamentals of Law on Land Ownership (the “Fundamentals”) which granted the citizens of the former Soviet Union a “limited right to use, possess, lease and dispose of land.”¹⁷ The Fundamentals was a very conservative law that explicitly banned “buying, selling, donating and mortgaging or the unauthorized exchange of parcels of land.”¹⁸

Soon after Russia became an independent state on June 12, 1990, the Russian lawmakers passed the Land Reform Law, which ended the state’s exclusive right of land ownership.¹⁹ The Land Reform Law provided for “use, possession and ownership” of farm land in narrowly defined circumstances, while retaining certain restrictions on the use, transferability and disposition of land.²⁰ The Land Reform Law explicitly excluded foreign citizens from the category of

¹⁶ Russian people have never had unlimited access to ownership of land. See William G. Frenkel, *Private Land Ownership in Russia: An Overview of Legal Developments to Date*, 3 PARKER SCH. J.E. EUR L. 257 (1996). In imperial Russia, for the most part, land ownership was the domain of the royal family, the nobility, and some wealthy merchants. During the Soviet years, the land was nationalized and belonged to the government. See *id.*

¹⁷ Floroff & Tiefenbrun, *supra* note 3, at 237.

¹⁸ *Id.* (citing Fundamentals, art. 53).

¹⁹ See Baev, *supra* note 2, at 17.

²⁰ Floroff & Tiefenbrun, *supra* note 3, at 238. See also Baev, *supra* note 2, at 17 (arguing that under the Land Reform Law, the concept of land ownership was strictly limited to ownership of farmland). Among other restrictions, the Land Reform Law authorized the state to regulate the size of a land plot that could be owned by an individual and specified that owners could sell their land only back to the state. See *id.* at 17-18.

natural and legal persons that could own land, despite the right of foreign citizens to own property in Russia.²¹

The Land Code of the RSFSR provided Russian citizens with broader property rights by allowing individuals and legal entities to resell land.²² However, the right to resell land remained subject to the same restrictions as it did under the Land Reform Law.²³ The major significance of the Land Code of the RSFSR was its novel principle that “rights to an underlying land plot attach to the rights to buildings or other structures on the land plot.”²⁴ Yet, under the Land Code of the RSFSR, foreign citizens could neither own nor possess inheritable land.²⁵ President Yeltsin’s Decree of December 27, 1991 abolished some of the limitations on the sale of land by permitting landowners to resell land to Russian individuals.²⁶ However, land owners could only engage in expressly specified activities on the land.²⁷

²¹ See Floroff & Tiefenbrun, *supra* note 3, at 239 (noting that on the face of the RSFSR Ownership and Property Law, foreigners had the same property rights as Russian citizens).

²² See *id.* at 250.

²³ See *id.* at 249-50.

²⁴ Frenkel, *supra* note 16, at 260. According to one of the principles of Russian property law, which is drastically different from the common law of property, historically a distinction had been made between ownership of land and other immovable property such as buildings. See *id.* This has presented various problems in dealing with transfers of real property. See *id.* The Land Code of the RSFSR was also important because it provided a framework for other property rights in land such as permanent possession, temporary possession, and lease, which are still recognized in Russian law. See Floroff & Tiefenbrun, *supra* note 3, at 251-52.

²⁵ See Floroff & Tiefenbrun, *supra* note 3, at 251.

²⁶ See Baev, *supra* note 2, at 19.

²⁷ See *id.*

President Yeltsin's Decree No. 1767 issued in 1993 became the first major step toward creating a free real estate market.²⁸ It allowed for the free sale, purchase and lease of land.²⁹ By abolishing the last legal limitations on buying and selling land, this decree finally enabled farmers to obtain necessary loans by using land as security for debt.³⁰ Therefore, land finally became "a commodity and an object of capital investment."³¹ It is noteworthy, however, that the decree did not explicitly give foreigners the right to buy and sell land.³² Although land could be sold to "joint-stock companies, partnerships and cooperatives, including those with foreign investments," it remained unclear whether foreign investors that were not part of a joint-stock company or partnership could buy and sell land in Russia.³³ While President Yeltsin tried persuading foreign entrepreneurs that the decrees he signed in 1992 and 1993 made them

²⁸ See generally, Andrei Sizov, *Will the Land Market Work?*, MOSCOW NEWS, Nov. 3, 1993, 1993 WL 10473716 (discussing the decree's potential impact on the Russian economy through the elimination of impediments to land ownership).

²⁹ See Boulton, *supra* note 5; Semyon Reznik, *Yeltsin's Risky Land Reform*, WASH. TIMES, Nov. 8, 1993, at A21.

³⁰ See Baev, *supra* note 2, at 21-22.

³¹ *Id.* at 22. Unlike the earlier legislation and presidential decrees, Decree No. 1767 allowed for use and sale of land for nonagricultural purposes. See *id.* However, the primary use of this decree was to promote the privatization of farm lands. See *id.* at 26. Thus it did not address the regulation of the privatization of urban lands. See *id.*

³² See Decree No. 1767.

³³ Decree No. 1767; see also James J. Ammeen, Jr., Comment, *Modern Russian Secured Transaction Law and Foreign Investors' Rights Thereunder*, 4 IND. INT'L & COMP. L. REV. 371, 405-6 (1994).

legitimate landowners,³⁴ at best, Decree No. 1767 left the issue of foreign land ownership unclear.³⁵

These property rights were later affirmed when the citizens of the Russian Federation ratified the new Constitution of the Russian Federation (“Constitution”) by a majority vote in December 1993.³⁶ Article 35 of the Constitution explicitly gives Russian citizens the right to “own and alienate land.”³⁷ However, the Constitution is silent on the issue of the ability of foreign nationals and corporations to own and alienate land, thus failing to provide much-needed guidance on the issue.³⁸

Drawing on the earlier legislation and presidential decrees, the Civil Code was a significant effort on the part of Russian lawmakers to create a mechanism that would conform to Western standards of real estate transactions, by allowing greater flexibility in land alienation.³⁹ The Civil Code provides, among other things, for rights of individuals and legal entities in real and personal property and

³⁴ See *Yeltsin's Speech to American Business Circles*, BBC SUMMARY OF WORLD BROADCASTS, June 19, 1992, LEXIS News Library. President Yeltsin told a conference of Russian and American businessmen, “. . . I signed a decree on the sale of plots of land to foreign private investors as private property during the privatization of state enterprises In this way rights to real estate are being transferred to the new private owners. . . , and it is unimportant whether they are foreign citizens or our own.” *Id.* See also Richard C. Schneider, Jr., *Property and Small-Scale Privatization in Russia*, 24 ST. MARY'S L.J. 507, 518-19 (1993) (stating that in 1992 Yeltsin signed two decrees that authorized foreigners purchasing privatized assets or enterprises to acquire land appurtenant to buildings).

³⁵ See Ammeen, *supra* note 33, at 406.

³⁶ See Patricia G. Woods, Comment, *From Feudal to Modern: The Evolution of Real Estate Finance in Russia*, 8 EMORY INT'L L. REV. 749, 753 (1994).

³⁷ KONST. RF, art. 35.

³⁸ See De Waal, *supra* note 13; Frenkel, *supra* note 16, at 259. Not specific with respect to real property ownership, the Russian Constitution simply states in Article 9 that land may be held in private ownership. KONST. RF, art. 9; Frenkel, *supra* note 16, at 259.

³⁹ See Joe Fuisz, Note, *Land Ownership in the Russian Civil Code*, 2 PARKER SCH. J. E. EUR. L. 127 (1995); Frenkel, *supra* note 16, at 261.

regulation of contractual obligations.⁴⁰ The Civil Code lays out the basic principles of land ownership by setting forth that persons that own non-agricultural land in Russia may sell, bequeath, mortgage, lease or otherwise use such land.⁴¹ While adopted as an attempt to create a competitive market for real estate, the Civil Code has been criticized for its limited ability to carry out the reform effort.⁴² The Civil Code does not regulate the privatization of land; it governs only those real estate transactions where the land in question is already owned by individuals or legal persons.⁴³ Most importantly, Chapter 17 of Part I of the Civil Code, dealing with land ownership rights, and Part II of the Civil Code, dealing with lease transactions, did not take effect until the adoption of the new Land Code.⁴⁴

The Land Code came into effect after several years of fierce opposition between the proponents of land reform, former President Yeltsin and President Vladimir Putin, and the hard-line communist and agrarian factions in the Russian Parliament, who had been opposed to the idea of freedom of buying and selling land.⁴⁵ The Land Code seeks to clarify the confusion and perplexity created by a myriad of local and federal regulations affecting transactions in real estate and helps to create favorable conditions for the development of

⁴⁰ See generally Civil Code. See also Victor B. Kozlov, *The New Russian Civil Code of 1994*, at 2-3, Feb. 19, 2002, available at <http://www.cnr.it/CRDCS/kozlov.htm>.

⁴¹ Civil Code, ch. 17. See also James T. Hitch & Maxim Kalinin, *Kremlin's New Land Laws Have Civil-Code Ancestry*, ST. PETERSBURG TIMES, July 17, 2001, LEXIS News Library.

⁴² See Frenkel, *supra* note 16, at 261-62.

⁴³ Civil Code, ch. 17; Hitch & Kalinin, *supra* note 41 (Civil Code applies only to land already in "civil circulation").

⁴⁴ See Fuisz, *supra* note 39, at 129; Frenkel, *supra* note 16, at 262.

⁴⁵ See Sergei Blagov, *Russian Privatization: The Code Has Landed*, Jan. 15, 2002, ASIA TIMES ONLINE, available at <http://www.atimes.com/c-asia/DA15Ag02.html> (left-wing opposition had argued that freedom to buy and sell land will lead to large-scale purchases of land by speculators from impoverished farmers).

a competitive real estate market.⁴⁶ In addition to affirming the rights in land in Chapter 17 of the Civil Code, the Land Code introduces the following changes: it provides that individuals and legal entities can acquire industrial and urban land⁴⁷ from the state or a municipality and establishes procedures for the purchase and sale of land; it legalizes ownership of land that has been sold over the past decade under the presidential decrees of former President Yeltsin; and it provides that, subject to certain restrictions discussed below, foreign citizens and legal entities have the same right to own land as their Russian counterparts.⁴⁸

Together with the Civil Code, the Land Code provides for the following property rights: 1) ownership; 2) inheritable lifetime possession; 3) permanent use; 4) servitudes; 5) land lease; and 6) gratuitous temporary use.⁴⁹ A foreign investor must have a clear understanding of these rights, as well as the procedures for selling and purchasing real property before engaging in any entrepreneurial activity related to real estate transactions in Russia.

B. Property Rights and Their Impact on Real Estate Transactions

1. Ownership

Full ownership is the highest form of property rights in Russia. It is as close to absolute control of land as a private citizen may obtain

⁴⁶ See Yevgenia Borisova, *Land Code Approved in Final Reading*, MOSCOW TIMES, Sept. 21, 2001, LEXIS News Library.

⁴⁷ The Land Code does not apply to agricultural land and, as such, regulates transactions in urban and industrial land, which represents about two percent of the country's territory. See Borisova, *supra* note 47; Blagov, *supra* note 45.

⁴⁸ See generally Land Code. See also Yury Lebedev & Konstantine Kouzine, *Brick by Brick: Land Code Introduces Much-Needed Change*, Oct. 16, 2001, MOSCOW TIMES, LEXIS News Library (describing changes introduced by Land Code); Blagov, *supra* note 45.

⁴⁹ See Land Code, arts. 15, 20; Civil Code, arts. 260, 262, 265, 268, and 274; A. Ivanov, *The Next in Turn Attempt to Solve the Land Problem*, Feb. 19, 2002, available at <http://balfort.com/landcode.html>. See also, Woods, *supra* note 36, at 753-62; Fuisz, *supra* note 39, at 129.

and can be analogized to fee simple estates in the United States.⁵⁰ An owner of a land parcel may sell, bequeath, mortgage, lease or otherwise use it.⁵¹ To maintain their right of ownership, owners must comply with the purpose for which a land parcel is designated, which may be either for agricultural use or for housing or other construction.⁵²

In a ground-breaking measure, the Land Code provides that Russian citizens, legal entities, *as well as foreign individuals and legal entities*, and stateless persons, may qualify to own land in Russia.⁵³ The Land Code contains one limitation on the right of foreigners to own land in Russia: foreigners cannot own plots close to federal borders and in certain other areas, as provided by federal law.⁵⁴ By allowing foreigners to become owners of land, the Land Code has eliminated the most significant obstacle to foreign investment in the real estate market in Russia, thereby giving foreign investors an incentive both to buy real property and to finance acquisitions of real estate in Russia.

An ownership interest can also come in the form of “common joint” or “common share” property, which American lawyers may recognize as tenancy in common.⁵⁵ Common joint owners can

⁵⁰ Civil Code, arts. 260, 284; Woods, *supra* note 36, at 753. In the U.S., a fee simple estate gives its holder full ownership of land by allowing for inheritance by lineal or collateral heirs and for alienation either during the holder’s life or by will. See ROGER A. CUNNINGHAM, WILLIAM B. STOEBUCK & DALE A. WHITMAN, *THE LAW OF PROPERTY* 29 (1993). Since, unlike the defeasible estates, it does not terminate upon the happening of a specific event, a fee simple estate can have an infinite duration. *See id.*

⁵¹ *See* Civil Code, art. 260.

⁵² *See* Civil Code, art. 284; Ivanov, *supra* note 49; Woods, *supra* note 36, at 754.

⁵³ *See* Land Code, art. 15.

⁵⁴ *See id.*, art. 15; Blagov, *supra* note 45.

⁵⁵ Woods, *supra* note 36, at 754.

partition their land parcel in order to mortgage, lease, sell or bequeath their individual interests.⁵⁶

To prove ownership of land, individuals and legal entities must present a title deed issued by a local committee for land resources and land management upon the showing of a contract of sale or other documents proving transfer of land.⁵⁷ In addition to serving the recording and authentication functions, the title deed is required for transactions involving land, such as sales, mortgages, and leases.⁵⁸ When selling a land parcel, the owner must report any existing liens against the land and any usage restrictions.⁵⁹

Ownership of land terminates when the owner voluntarily relinquishes his or her rights to the state, sells the parcel or defaults on a mortgage.⁶⁰ In addition, the state may confiscate land by eminent domain.⁶¹ If the federal government appropriates a land parcel based on the owner's failure to comply with its designated purpose or the owner's engaging in an ecologically damaging activity, the government need not compensate the owner.⁶² If, on the other hand, the government seizes land for none of those reasons, then the government must compensate the owner for the fair market value of the parcel.⁶³ It is important to understand that only holders of ownership, as opposed to other property rights such as life-long

⁵⁶ *Id.*

⁵⁷ *See id.* at 754-55; *see generally* Oksana M. Kozyr, *The Legal Treatment of Immovables Under the Civil Code of the Russian Federation*, 44 MCGILL L. J. 327, 346-49 (1999).

⁵⁸ *See* Woods, *supra* note 36, at 755.

⁵⁹ *See id.* at 755-56.

⁶⁰ *See id.* at 756.

⁶¹ *See id.* at 757.

⁶² *See id.* at 756-57.

⁶³ *Id.* *See also* Sonni Efron, *Yeltsin Signs Guarantees of Private Land Ownership; Russia: His Landmark Decree Tackles a Key Barrier to Free Market*, L.A. TIMES, Oct. 28, 1993, at 1 (commenting on the RF President's Decree No. 1767).

possession or permanent use, are entitled to compensation for the value of the confiscated land.⁶⁴

In addressing the concept of ownership of real property in Russia, it is important to note that prior to the enactment of the Land Code, Russian statutes treated land parcels separately from the structures and buildings erected upon such land parcels.⁶⁵ In other words, under the pre-Land Code statutes, an owner of a building did not necessarily own the land underneath the building. Thus, it was possible for one person to own land and for another to own the buildings constructed on such land. As a result of this legal distinction, which is often seen as an oddity by foreign investors, prior to the passage of the Land Code, transfers of real property, which quite naturally often involved transfers of both buildings and structures and the underlying land parcels, usually gave rise to a number of theoretical as well as practical problems.⁶⁶ The Civil Code contemplated that the party who owned the building would enter into an agreement with the owner of the land allowing the building owner to use the land.⁶⁷ In the event the parties failed to resolve the problem contractually, their only resort was to litigate the dispute.⁶⁸

The Land Code continues to treat the land and the objects on it as separate objects. However, the Land Code seeks to close the gap by giving owners of the buildings and structures an automatic right to use the adjoining land and by providing them with a priority right to buy the adjoining land.⁶⁹ Thus, the owner of a building or a structure can finally acquire an undisputed right of ownership to the underlying land.

⁶⁴ Woods, *supra* note 36, at 757.

⁶⁵ See Kozyr, *supra* note 57, at 349-50.

⁶⁶ See Hitch & Kalinin, *supra* note 41.

⁶⁷ See *id.*

⁶⁸ See *id.*

⁶⁹ See Land Code, art. 35(1), (3).

There are several important reasons why a person or a legal entity planning to purchase real estate either for personal use or for entrepreneurial activity may prefer full ownership to other rights in land. First, only the holder of a full ownership interest in land has an unrestricted right to sell, lease or mortgage its land.⁷⁰ Also, the Civil Code explicitly says that “the ‘quantity and value of property’ in full ownership shall not be limited,” whereas it does not provide a similar guarantee with respect to the other forms of ownership.⁷¹ Companies have additional incentives to purchase the land under their enterprises, as opposed to leasing the land from the state, as they have been doing thus far. As further discussed below, the Land Code, together with related legislation, provides a dependable way to determine the price of land, whereas rents tend to fluctuate. In addition, as is always true, upon disposal of an enterprise, the company owning it recovers a return on its investment by selling the land, whereas rent is an expense that cannot be recovered. Finally, as discussed in greater detail in Part III of this article, given Russia’s positive economic forecast, land will likely appreciate over time, thereby enabling buyers of land to turn a profit on their real estate investments.

2. Lifetime Inheritable Possession

Lifetime inheritable possession originates in the Land Code of the RSFSR and is a transitional step from state to private ownership.⁷² This property right is comparable to the common law fee-tail in that land held in inheritable lifetime possession can be alienated by succession upon the possessor’s death;⁷³ however, alienation during the holder’s life is restricted.⁷⁴ This property right entitles its holder

⁷⁰ See Fuisz, *supra* note 39, at 129.

⁷¹ See *id.*

⁷² Woods, *supra* note 36, at 757.

⁷³ In U.S. jurisdictions, a fee tail estate could last as long as each successive holder died leaving issue. See CUNNINGHAM, *supra* note 50, at 59-61. In its original form, which has been abolished in most states, a fee tail estate could not be conveyed by deed. See *id.*

⁷⁴ Woods, *supra* note 36, at 757.

to possess and use land that is owned by a municipal or state government. The right of lifetime inheritable possession may be transferred only to the holder's heirs.⁷⁵ A holder of land in inheritable lifetime possession cannot sell, mortgage or lease the land.⁷⁶ The holder may, however, mortgage or sell the building or structures on the land.⁷⁷ The right of inheritable lifetime possession was reinstated by the Civil Code and the Land Code.⁷⁸ The Land Code also provides that holders of land in lifetime inheritable possession may acquire ownership rights to such land subject to the provisions of the Land Code.⁷⁹ Under the Land Code, the right of lifetime inheritable possession appears to be limited to Russian citizens.⁸⁰ However, due to the limited rights that this interest gives to its holder, it is unlikely that a foreign entrepreneur would be interested in becoming a life-long holder.⁸¹

Inheritable lifetime possession terminates upon 1) the possessor's voluntary surrender of the land; 2) failure to comply with the purpose for which the land was granted; 3) inefficient farming on the land; 4) ecological maltreatment; 5) failure to pay real estate taxes; or 6) alienation of lifetime possession of a building or structure on the land.⁸² If the government confiscates the land owned in inheritable lifetime possession by eminent domain, and not for the reason of non-designated use, ecologically harmful activity, or failure to pay

⁷⁵ See Ivanov, *supra* note 49.

⁷⁶ See Fuisz, *supra* note 39, at 130.

⁷⁷ Woods, *supra* note 36, at 757.

⁷⁸ See Sukhanov, *supra* note 11, at 633.

⁷⁹ See Land Code, art. 21.

⁸⁰ See Floroff & Tiefenbrun, *supra* note 3, at 251. See also, Ivanov, *supra* note 50.

⁸¹ See generally Fuisz, *supra* note 39, at 130 (warning that limitations imposed on holders of inheritable possession of land deprive them of access to real estate and real estate finance markets); Frenkel, *supra* note 17, at 262 (criticizing inheritable life-long possession as being an "antiquated" right).

⁸² Woods, *supra* note 36, at 758.

taxes, then the lifetime holder can be compensated only to the extent of any expenditures made to improve the land.⁸³

3. Permanent Use

The right to permanent use or possession of land has undergone significant change as a result of the enactment of the Land Code. Under the Civil Code, the right to permanent (i.e., unlimited in time) use of land could be granted to citizens as well as legal entities that owned immovable property such as buildings or structures upon land owned by another.⁸⁴ This right is defined as “a grant, indefinite in duration, of a limited amount of land for the purpose of entrepreneurial activity.”⁸⁵

The Land Code has drastically modified the right to permanent use of land, providing that this right may be granted to federal, state and municipal government branches, but never to individuals.⁸⁶ However, citizens or legal entities who had a right to permanent use with respect to a land parcel owned by the federal or municipal government prior to the enactment of the Land Code remain entitled to such a right. Further, citizens who have a right to permanent use with respect to a land parcel have a right to privatize such land parcel by acquiring ownership rights to it.⁸⁷

Land held in permanent use cannot be alienated or leased for compensation.⁸⁸ It can, however, be transferred, together with the property interests held in the buildings or structures located on the land.⁸⁹ Yet, the holder of this property right may not mortgage its

⁸³ *Id.* at 758-59. This is different from the full ownership right which, in analogous situations, entitles its holder to be compensated for the fair market value of the confiscated parcel. *See id.* at 757.

⁸⁴ *See* Fuisz, *supra* note 39, at 130.

⁸⁵ Woods, *supra* note 36, at 759 (citing the Civil Code).

⁸⁶ Land Code, art. 20.

⁸⁷ *Id.*

⁸⁸ *See* Woods, *supra* note 36, at 759; Fuisz, *supra* note 39, at 130.

⁸⁹ *See* Fuisz, *supra* note 39, at 130.

permanent possession interest in land and may only mortgage the buildings located on the land.⁹⁰ If land held in permanent possession is confiscated by eminent domain, the holder of the interest can only be compensated to the extent of its expenditures on land improvements.⁹¹

4. Servitudes

The right of limited use, also known as servitude, may be granted to any person and may concern any land parcel. The right provides for the limited use of land without a right to ownership based on need and according to particular patterns.⁹² Servitudes may be private (established contractually and governed by the Civil Code) or public (established by a local or other government act, based on public interests).⁹³ The right of servitude is employed in situations where there is a necessity to use someone else's—not necessarily adjacent—land parcel, for example, for the purposes of laying a pipeline or telephone wire.⁹⁴ Finally, the right of servitude may be of limited or permanent duration.⁹⁵

5. Land Lease

One of the least possessory rights in land, land lease, embraces a broad range of eligible holders, and it includes, *inter alia*, foreigners and stateless persons.⁹⁶ The terms of a land lease, such as its duration and the amount of lease payments, are established contractually in accordance with the Civil Code. It is noteworthy that under the Land Code, a tenant may assign its rights in the

⁹⁰ See Woods, *supra* note 36, at 759.

⁹¹ *Id.* at 760.

⁹² See Ivanov, *supra* note 49; Fuisz, *supra* note 39, at 130.

⁹³ Land Code, art. 23.

⁹⁴ See *id.*; Fuisz, *supra* note 39, at 130.

⁹⁵ See Land Code, art. 23.

⁹⁶ See *id.*, art. 22.

underlying lease to a third party without notifying the landlord. Where the term of a land lease is greater than five years, the tenant may sublease the land to a third party without notifying the landlord, unless the lease agreement expressly provides otherwise.⁹⁷ Termination of a land lease with a term exceeding five years is possible only by a court order, based on a significant breach by the tenant.⁹⁸

6. Gratuitous Temporary Use of Land

Finally, the right of gratuitous temporary use of land is a limited possessory right, which has little, if any significance, to potential foreign investors. This right entitles the holders—including governmental entities and citizens employed in certain industries, such as employees of national forest reserves—to use a land parcel free of charge for a limited period of time.⁹⁹

Not only is full ownership the most desirable form of property rights from an individual's standpoint, but also it is the one most capable of facilitating the Russian real estate and real estate credit markets.¹⁰⁰ Thus, to be able to take advantage of the new opportunities available to foreign investors in the Russian real estate market, a potential purchaser of real estate in Russia must be familiar with the procedures governing acquisitions of land in Russia.

C. Acquisition of Ownership Rights in Land

The Land Code establishes that for any property right in land to be valid and enforceable, that property right must be created in accordance with the provisions of the Civil Code, as well as other federal laws, and be recorded in the national registration system in

⁹⁷ *See id.*

⁹⁸ *See id.*

⁹⁹ *Id.*, art. 24.

¹⁰⁰ *See generally* Fuisz, *supra* note 39, at 132 (concluding that only full ownership can enable farmers to sell their land and/or use it as collateral); Frenkel, *supra* note 17, at 294 (discussing numerous ways in which an enterprise can benefit from becoming a full owner of the land it occupies).

accordance with the provisions of the Federal Law on the State Registration of Rights in Real Property of July 21, 1997 (the "Registration Law").¹⁰¹ All transactions dealing with land must be documented in accordance with the requirements of the Registration Law.¹⁰² The only property rights that need not be registered in the national registration system are those of lease and sublease.¹⁰³

In a ground-breaking measure, the Land Code unequivocally provides that Russian citizens and legal entities, as well as foreign nationals and legal entities, may acquire ownership rights to land currently owned by the federal or municipal government. To acquire ownership of a land parcel, an individual or a legal entity must submit an application to the federal or local authorities, requesting a turnover of the ownership of the land parcel from the state or local government to the applicant.¹⁰⁴ The decision whether a request will be granted must be made within two weeks following the submission of the application.¹⁰⁵ Owners of buildings and other structures on a land parcel owned by the government have priority in acquiring ownership rights to that land parcel.¹⁰⁶ Finally, individuals and legal entities that own structures or buildings on land parcels owned by the federal or municipal government have the exclusive right to privatize or acquire ownership rights to the land situated under such buildings and structures.¹⁰⁷

¹⁰¹ Land Code, art. 25; see generally William R. Siegel, *The Law "On the State Registration of Rights in Real Property": Encouraging or Deterring Foreign Investment in the Russian Federation?*, 19 NW. J. INT'L. L. & BUS. 195 (1998) (providing explanation of various provisions of Registration Law and significance thereof to development of real property rights).

¹⁰² Land Code, art. 26.

¹⁰³ *Id.*

¹⁰⁴ *Id.*, art. 28.

¹⁰⁵ *Id.*

¹⁰⁶ *Id.*, art. 35, § 3.

¹⁰⁷ *Id.*, art. 36, § 1.

It is worth noting that the Land Code provides that the local or state authorities may not refuse to grant ownership to individual or legal entities for the purpose of construction, except when the land parcel in question has been explicitly excluded from the turnover provision of the Land Code or where the privatization of the land parcel has been prohibited by federal law, or the land parcel is reserved for federal or municipal needs.¹⁰⁸ However, the Land Code sets forth different parameters for acquisitions of land for the purpose of construction, based on the potential owner's choice of land parcel. Where an individual or a legal entity wants to purchase a specified land parcel for the purpose of construction, the individual or legal entity's options appear to be limited to leasing the desired land parcel.¹⁰⁹ In contrast, individuals and legal entities may acquire ownership rights to land parcels that they have not specifically requested for the same purpose.¹¹⁰ The procedure for acquiring an unspecified land parcel is through an auction.¹¹¹ It is also possible to purchase an unspecified land parcel without going through an auction, provided that there is no other application for the purchase in that tender or auction.¹¹²

Finally, the final version of the Land Code omits the originally proposed guidelines for the determining of prices for land parcels beneath buildings and structures.¹¹³ Instead, the formula for determining the price of land parcels beneath buildings and structures now appears in a separate law, titled "On the Introduction of the Land Code," ("Introduction Law"), and it is based on the applicable

¹⁰⁸ *Id.*, art. 28, § 4.

¹⁰⁹ *See id.*, art. 30, § 3; Yevgenia Borisova, *So, Think You Want to Buy Some Land?*, MOSCOW TIMES, Jan. 28, 2002, LEXIS News Library.

¹¹⁰ Land Code, art. 30.

¹¹¹ *See id.*

¹¹² *See id.*, art. 30, § 4; Borisova, *supra* note 109.

¹¹³ The third reading of the bill proposed by the Duma contemplated that the price for land parcels beneath buildings or structures would be set at five to ten times the real property tax imposed on the parcel. *See Zemel'nyi Kodeks Rossiiskoi Federatsii (RF) Proekt No. 85788-3* [Land Code of the Russian Federation, Bill No. 85788-3], art. 37(9).

real property tax rate and the population of the municipality in which the land in question is located.¹¹⁴ Based on the population of any given municipality, the law sets upper and lower price limits within which local authorities may set the land prices.¹¹⁵ Thus, the lower limit is three times the annual real estate land tax, whereas the upper limit, for highly populated municipalities, such as Moscow or St. Petersburg, is thirty times the annual property tax.¹¹⁶

D. Benefits of Land Ownership

Within the realm of the existing legal framework, tremendously enhanced by the enactment of the Land Code, there are many reasons why ownership of land is preferable generally to all other property rights in land in general and particularly to leases. First, the Land Code contemplates that there will be open tenders for purchases of undeveloped land. Thus, given the fact that the market prices for land in Russia are still relatively low, investors have an opportunity to buy undeveloped land at a rather cheap cost. Also, with respect to land parcels underlying buildings and structures, the price will be developed according to the guidelines set forth in the Introduction Law, which also provides for relatively low prices by the standards of other developed countries.¹¹⁷

Second, land ownership allows the owner additional financial leverage through the ability to mortgage the land and the building, whereas, in the case of a land lease, the tenant would be required to obtain the landlord's consent to a mortgage of the tenant's rights in

¹¹⁴ Maxim Popov, *With the New Land Code, the Time to Buy Land Is Now*, ST. PETERSBURG TIMES, Jan. 22, 2002, LEXIS News Library. For instance, in Moscow and St. Petersburg, the price of land is set between five and thirty times the applicable annual land tax, this figure being further multiplied by a coefficient of between 0.7 and 1.3, depending on the use of the land. Robin Munro, *Sales Held Up As Holes Are Filled In Land Code*, MOSCOW TIMES, Nov. 27, 2001, LEXIS News Library.

¹¹⁵ Popov, *supra* note 114.

¹¹⁶ See Munro, *supra* note 114.

¹¹⁷ See *Russia: Happy Hunting Ground*, EUI BUSINESS RUSSIA, Dec. 10, 2001 (copy on file with author); Popov, *supra* note 114.

land.¹¹⁸ Further, purchasing land is a one-time expense, whereas rent rates may fluctuate. Finally, Russia's promising economic outlook indicates that land will appreciate over time. Thus, on disposal of an enterprise or other property, the company will not only return its investment by selling the land, but will in all likelihood also earn a profit on its initial investment.¹¹⁹

E. Existing Uncertainties Affecting Land Acquisitions

Notwithstanding the benefits of land ownership, a potential investor must be aware of the existing uncertainties surrounding acquisitions of land. First, as stated above, the Land Code does impose certain limitations on foreign ownership of land by providing that foreigners may not own land in areas close to federal borders and in other special areas, as provided by federal law. The list of such excluded areas is to be provided later in time by the President of the Russian Federation. This uncertainty inevitably complicates the decision-making of foreign investors. However, experts predict that that this limitation will not apply to many areas and will primarily include lands near the Chinese border.¹²⁰ Further, once the list is available, foreign investors may be able to find creative ways to avoid the prohibition on the ownership of land in the excluded areas.¹²¹

Second, there seem to be a number of discrepancies between the Land Code and certain other Russian legislation, such as the Civil Code, which affect various property rights in land. By way of example, the regulation of the right to permanent use under the Land Code is strikingly different from that under the Civil Code. The Civil Code provides, *inter alia*, that in the absence of any other claim to

¹¹⁸ Popov, *supra* note 114.

¹¹⁹ *Id.*

¹²⁰ See Moore, *supra* note 14.

¹²¹ For example, since the Land Code does not provide a definition of either a Russian or a foreign company, it is possible for Russian-registered but 100% foreign-owned companies to buy land in restricted areas. See Robin Munro, *Land Code Won't Solve Everything Overnight*, MOSCOW TIMES, July 24, 2001, LEXIS News Library.

the land underneath a building, the building's owner has a statutory right to permanent use with respect to such land.¹²² In contrast, the Land Code merely provides that the right to permanent use may be granted to state or municipal authorities, as well as to other governmental entities, without providing a statutory ground for the creation of such a right.¹²³ Under the Land Code, the right to permanent use cannot be granted to individuals.¹²⁴ Instead, the Land Code provides that existing holders of the right to permanent use with respect to a land parcel may acquire the land in ownership.¹²⁵

Further, commentators have noted a number of internal inconsistencies in the Land Code, which will have to be further clarified by way of official commentaries or legal decisions. For instance, Article 30 of the Land Code provides that an individual or legal entity may not purchase a specified parcel of land for the purpose of construction, thus being left with the sole option of leasing the parcel. Yet, Article 28 of the Land Code indicates that state or municipal governments may not refuse to grant ownership of land to individuals or legal entities for the purposes of construction.¹²⁶ Local land committees vested with the authority to consider applications for land turnover have expressed confusion over the provisions of Article 30.¹²⁷ Legal commentators have conflicting opinions whether the Land Code allows purchases of designated parcels for the purpose of construction.¹²⁸

Another aspect of the legal framework that will require certain modification involves the national system of registration of interests in real estate, known as the "cadastre" system, which is covered by a

¹²² See Civil Code, arts. 268, 271.

¹²³ See Land Code, art. 20(1).

¹²⁴ See *id.*, art. 20(2), (3).

¹²⁵ See *id.*, art. 20, § 5.

¹²⁶ See *id.*, art. 28.

¹²⁷ See Borisova, *supra* note 109.

¹²⁸ See *id.*

separate law.¹²⁹ While the cadastre system has been praised as an important step in the creation of a title assurance system comparable to Western title registration systems and generally promoting foreign investment by giving foreign actors an ability to ensure the security of title for their real estate investments, it has also been criticized for its many shortcomings.

Although the cadastre system appears to be accessible to any person who submits a written request and identification documents to receive information about real property, any registered rights thereto, or any limitations on these rights, the registrar may refuse to grant the request (though he must do this within five days) without providing an explanation for its refusal.¹³⁰ Further, access to documents contained in the files is even more restricted than access to the register, as it is only open to holders of rights in real estate, or persons who have received a power of attorney from a right-holder, and various government actors.¹³¹ Another seriously problematic aspect of the cadastre system appears to be its failure to establish a dispute resolution mechanism for title disputes.¹³² The law also fails to clearly allocate areas of authority for registration of interests in real estate between federal and subfederal governmental bodies, which may ultimately lead to a clash between federal and local

¹²⁹ Pursuant to the Registration Law, all “owners of immovable property and holders of other rights” therein, including “citizens of the Russian Federation, foreign nationals and stateless persons, Russian and foreign legal entities, . . . foreign states” and Russian federal and municipal bodies must record their rights in real property created after the enactment of the Registration Law in the national registration system (i.e., cadastre system). See Siegel, *supra* note 101, at 201 (quoting Article 5 of the Registration Law) (internal quotes omitted). Each object of realty is then assigned a unique cadastre number and entered into a state register of rights, containing the following information about any object of real property: 1) a brief description of the real property; 2) the names of persons who have registered their rights with respect to the property; and 3) information about any encumbrances on the property. *Id.* at 201-02.

¹³⁰ See Lev S. Batalov, *The Russian Title Registration System for Realty and Its Effect on Foreign Investors*, 73 WASH. L. REV. 989, 1002 (1998) (noting that the registrar exercises broad discretion in granting or refusing to grant requests for information).

¹³¹ See Siegel, *supra* note 101, at 204.

¹³² See *id.* at 206.

bureaucracies.¹³³ Finally, the Registration Law recognizes all interests in real estate which were created prior to the enactment of the Registration Law, as “legally valid in the absence of their state registration.”¹³⁴ Thus, in order to create a title assurance system capable of facilitating the types of transactions contemplated in the Land Code, additional legislation is needed to address the deficiencies in the Registration Law. Additionally, from a technical standpoint, the cadastre system in its current form may not be capable of handling the highly challenging task presented by the passage of the Land Code, which includes determining and recording the owner and the value of every plot of land in Russia.¹³⁵

Local governments have yet to review local laws and procedures for sales of land to ensure that they are in accord with the Land Code.¹³⁶ Certain commentators have suggested that some, if not many, local officials opposed to the change in ownership of land to private ownership, especially foreign ownership, may frustrate the implementation of the Land Code on the local level by delaying the enactment of local procedures necessary to fill in the gaps left by the Land Code.¹³⁷

Nonetheless, while the uncertainties currently present in the area of real estate acquisitions are undoubtedly significant, the positive effect of the enactment of the Land Code is so great that it should outweigh the existing risks in persuading investors, including foreign ones, to invest in the real estate market.

¹³³ A related problem has arisen as a result of the enactment of the Land Code. In order to proceed with the privatization, Russia needs to determine which of the lands available for turnover are federal and which are sub-federal. Yevgenia Borisova, *Land Reform: The Race Is On*, MOSCOW TIMES, Feb. 4, 2002, LEXIS News Library (commenting that in Moscow alone the process of identifying the owner of every parcel of land could take years).

¹³⁴ See Siegel, *supra* note 101, at 208 (quoting Registration Law, art. 6(1)).

¹³⁵ See Borisova, *supra* note 133.

¹³⁶ Moore, *supra* note 14.

¹³⁷ See *id.* In Moscow, the price rates for purchases of developed land and the procedures for processing applications have yet to be established. *Id.*

III. REAL ESTATE FINANCE

A. *Overview of Existing Law*

Secured credit plays an important role in any market economy. During the time of the Soviet Union, Russian, or more accurately Soviet law did not have a concept of secured transactions similar to what has long existed in the West.¹³⁸ In a centrally-planned economy like that of the former Soviet Union, if a state-regulated entity failed to comply with its obligations, it would be sanctioned by a penalty.¹³⁹ The penalty would later be subtracted from the entity's budget, which in turn was also subsidized by the state.¹⁴⁰ Private citizens were protected by a codified list of items that could not be foreclosed upon.¹⁴¹

Until the enactment of the Law on Pledge, the law on mortgages in all the former Soviet republics, including Russia, emulated the mortgage law of the Soviet Union, which was profoundly inadequate to create an efficient system for secured transactions.¹⁴² As a result, foreign lenders were unwilling to invest in Russia.¹⁴³ The Law on Pledge was one of the first attempts by the Russian Federation to lay a codified foundation for a law of secured transactions.¹⁴⁴ The Law on Pledge seems to be modeled after the mortgage laws of Western

¹³⁸ See Wim A. Timmermans, *Secured Transactions in Russian Civil Law*, in *THE REVIVAL OF PRIVATE LAW IN CENTRAL AND EASTERN EUROPE* 339 (George Ginsburgs et al. eds., 1996).

¹³⁹ *See id.*

¹⁴⁰ *See id.*

¹⁴¹ *See id.*

¹⁴² See Christopher Osakwe, *Modern Russian Law of Banking and Security Transactions: A Biopsy of Post-Soviet Russian Commercial Law*, 14 *WHITTIER L. REV.* 301, 354-55 (1993).

¹⁴³ *See id.*, at 354-55.

¹⁴⁴ *See* Law on Pledge; Kilborn, *supra* note 11, at 258-60 (commenting that the Law on Pledge and the Civil Code were the first two statutory enactments designed to regulate the area of secured transactions and the use of personal property as collateral).

countries, seeking to give Western investors certain protections that they would have when engaging in similar transactions in their home countries.¹⁴⁵

The Law on Pledge defined “the basic provisions on mortgage,”¹⁴⁶ requiring that “[m]ortgage . . . be a way of creating security for [an] obligation under which the mortgagee (creditor) acquires the right, in the event of nonperformance by [the] debtor of [the] obligation, to receive satisfaction out of the mortgaged property in preference to [an]other creditor.”¹⁴⁷ A mortgage can be either contractual or created by operation of law.¹⁴⁸ Under the Law on Pledge, a mortgagor can pledge as collateral any property which the mortgagor is “free to alienate,” including “buildings[s], structure[s] or other object[s] directly connected with land, together with the land parcel or right to the use thereof,” as well as “chattels, securities, other property and property rights.”¹⁴⁹

The law of secured transactions was greatly strengthened when the Russian Parliament passed the Civil Code, which inspired greater confidence for the way business in general and secured transactions in particular would be conducted in Russia.¹⁵⁰ Until the enactment of the Civil Code, no effective mechanism for enforcing commercial transactions had existed in Russia.¹⁵¹ The Civil Code governs a broad range of topics including contractual obligations and secured

¹⁴⁵ See Osakwe, *supra* note 142, at 355 (stating that the Law on Pledge moved “Russian law of secured transactions into the family of Western law,” and assuring Western investors and lenders that “it is safe to lend money in Russia”).

¹⁴⁶ Law on Pledge, art. 2.

¹⁴⁷ *Id.*, art. 1.

¹⁴⁸ *See id.*, art. 3.

¹⁴⁹ *Id.*, arts. 4, 6, 42.

¹⁵⁰ See Kilborn, *supra* note 11, at 255; Bennett, *supra* note 13, at 1446. The Civil Code codified many of the provisions of the Law on Pledge without change. *See id.*

¹⁵¹ See Sukhanov, *supra* note 11, at 621, 622.

credit.¹⁵² The Civil Code promulgates a set of rules that are intended to guide the Russian economy in its struggle to become a free market economy.¹⁵³ In addition to codification, the Civil Code strives to assist in the development of commercial practices by offering gap-filling rules for conducting commercial transactions.¹⁵⁴ The Civil Code contains a relatively sophisticated section on obligations, which addresses secured transactions in great detail.¹⁵⁵

The law of secured transactions was further improved with the enactment of the Mortgage Act, which pertains to security interests in immovable property.¹⁵⁶ Among other things, the Mortgage Act provides what types of real property may be mortgaged and what limitations apply.

The present legal framework governing secured obligations, and comprised of the Law on Pledge, the Civil Code, and the Mortgage Act, provides for two types of consensual secured obligations: (1) pledge (*zalog*), which is a consensual lien on personal property; and (2) hypothecation (*ipoteka*), which is a mortgage on real property.¹⁵⁷ Since the purpose of this article is to explain the risks and opportunities of a foreign investor involved in real estate transactions, this section will focus on the law pertaining to hypothecation.

¹⁵² *See id.*

¹⁵³ *See* David Hoffman, *Russia Gets New Laws for Free Market; Impact of Civil Code May Top Constitution*, WASH. POST, Mar. 1, 1996, at A01.

¹⁵⁴ *See* Alexander S. Komarov, *The Uniform Commercial Code: A Russian Point of View*, 29 LOY. L.A. L. REV. 1085, 1091 (1996).

¹⁵⁵ *See* Kilborn, *supra* note 11, at 255 (noting the significance of the Civil Code to the law of secured transactions).

¹⁵⁶ *See* Mortgage Act; Bennett, *supra* note 13, at 1448-49 (giving overview of provisions of the Law on Mortgage).

¹⁵⁷ Civil Code, art. 334 (stating that security interests in real property are governed by the law on hypothecation); Mortgage Act, art. 1 (hypothecation is a lien on real property).

1. Requirements for Hypothecation

The Law on Pledge defines hypothecation as the “mortgage of [an] enterprise, building, structure or other object directly connected with land, together with the land parcel or right to the use thereof.”¹⁵⁸ To hypothecate an obligation means to secure it with collateral without turning over possession of the collateral to the creditor.¹⁵⁹ Where the borrower has defaulted on a mortgage, the secured creditor may enforce its rights after the borrower has exhausted its redemptive rights and the collateral has been foreclosed upon.¹⁶⁰ Prior to the enactment of the Land Code, due to the then-existing uncertainty regarding the right of foreigners to own land in Russia, some commentators had expressed a view that the inability to take the mortgaged land in satisfaction of a secured obligation put a foreign lender at risk, which naturally made real estate finance less desirable for foreign investors.¹⁶¹ The enactment of the Land Code has removed this obstacle by enabling, subject to certain limitations, foreign lenders to take title to the foreclosed-upon property.¹⁶² The Mortgage Act sets forth the formal requirements for a mortgage contract, which include, among other things, that the contract must be in writing and must contain the terms of the secured obligation, a description of the mortgage property sufficient to identify such

¹⁵⁸ Law on Pledge, art. 42.

¹⁵⁹ See Osakwe, *supra* note 142, at 373; Mortgage Act, art. 1(1) (secured creditor may satisfy debtor’s obligations from the immovable property securing such obligations, with a priority over all other creditors of debtor).

¹⁶⁰ See Ammeen, *supra* note 33, at 379.

¹⁶¹ See, e.g., *id.* at 406.

¹⁶² Under the Mortgage Act, a lender appears to be prohibited from taking title to a mortgaged property by means of making a credit bid on the property at a judicial foreclosure. See Mortgage Act, art. 57 (contemplating that bidders at foreclosure auctions must tender payment in the amount of the winning bid to take title to the foreclosed property). The law does not contain a provision allowing the foreclosing lender to bid against the debt of the mortgagor. However, the law contemplates that the debtor may agree, in a written post-default agreement similar to a deed in lieu of foreclosure used in many states in the U.S., to deed the property over to the lender, thus relieving the lender of the burden of going through the hurdles of judicial foreclosure. See *id.*, art. 55.

property, and, the value of the mortgaged property.¹⁶³ A mortgage contract must be notarized and duly recorded in the state registration system.¹⁶⁴

2. Foreclosure Proceedings

The Law on Pledge provides that a secured creditor has the right to satisfy its claim out of the pledged property.¹⁶⁵ The right of foreclosure can be exercised only after the time accorded for redemption either by statute or by contract has lapsed.¹⁶⁶ One of the features of the Law on Pledge is its guarantee that the mortgagor retains the right to redeem its obligations until the moment of the foreclosure sale.¹⁶⁷ Any attempt to limit this right by contract is void.¹⁶⁸ To be able to make educated decisions about entering the Russian real estate market, foreign lenders should also know that under current law, where the foreclosed collateral is in the form of residential real estate, the foreclosure sale may also be challenged on constitutional grounds, and the inhabitants of the mortgaged residential real estate may not be forcefully evicted.¹⁶⁹

¹⁶³ *See id.*, art. 9.

¹⁶⁴ *See id.*, art. 10. The Civil Code also provides that real estate mortgages must be registered. However, under the Civil Code there is no registration requirement with respect to security interests in personal property. *See Bennett, supra* note 13, at 1452. The Civil Code itself does not provide for a recording system for security interests in immovables. *Id.* at 1456.

¹⁶⁵ Law on Pledge, art. 23.

¹⁶⁶ *Id.*, art. 24.

¹⁶⁷ *See id.*, art. 31.

¹⁶⁸ *See Timmermans, supra* note 138, at 360.

¹⁶⁹ *See Lena Berezanskaya, Draft Law on Mortgages Lies in Limbo*, MOSCOW TIMES, Sept. 2, 1997, LEXIS News Library (stating that since the Russian Constitution recognizes a right to housing, where defaulting borrower has no other place to live, courts can reverse foreclosure sale); Igor Iassenovets, *Russian Mortgage Law – Success, Failure and the Road Ahead*, available at <http://www.rupron.com/static/a00/386.asp>.

The Law on Pledge fails to define the rules that should govern the foreclosure procedure, providing that a “[s]ale of mortgaged property under foreclosure shall be made” in accordance with the Russian Federation Code of Civil Procedure (the “Civil Procedure Code”), unless the Law on Pledge or contract provides otherwise.¹⁷⁰ Under the Civil Procedure Code, when a borrower defaults on a mortgage secured by real estate, the collateral must be sold at a public auction.¹⁷¹

For the most part, the Civil Code and the Mortgage Act mirror the provisions of the Law on Pledge pertaining to the enforcement of security interests in real property. Yet, there is a discrepancy between the Mortgage Act and the Civil Code with respect to the definition of default. While the Mortgage Act defines “default” primarily as a payment default, the Civil Code uses a broader concept of default, leaving it to the parties to further define what constitutes default in the security agreement.¹⁷²

Upon default, a secured creditor may enforce its rights by foreclosing on the property.¹⁷³ In most cases, a mortgage foreclosure involves a judicial proceeding.¹⁷⁴ The Mortgage Act provides for one limited exception, which allows the secured creditor to foreclose upon the mortgaged property without commencing judicial foreclosure proceedings where the creditor and the debtor enter into a post-default notarized agreement authorizing the creditor to foreclose on the mortgaged property out of court.¹⁷⁵

¹⁷⁰ Law on Pledge, art. 28.

¹⁷¹ See Timmermans, *supra* note 138, at 359 (citing Article 399ff of Code of Civil Procedure of Russian Soviet Federated Social Republic).

¹⁷² See Mortgage Act, art. 50; Bennett, *supra* note 13, at 1461 (citing Civil Code, art. 348(1)).

¹⁷³ See Mortgage Act, art. 50(1).

¹⁷⁴ See *id.*, arts. 51, 54; Bennett, *supra* note 13, at 1465 (citing Civil Code, art. 349(3)).

¹⁷⁵ See Mortgage Act, art. 51. However, a court may invalidate such agreement upon the commencement of a suit “by the person whose rights were violated by such agreement.” See *id.*, art. 55(5).

The Mortgage Act and the Civil Code provide for various ways in which the debtor may prevent the secured creditor from seizing the collateral in the event of the debtor's default on the underlying obligation. Under the Civil Code, the debtor may petition the court for an order postponing the actual foreclosure for one year, provided that the debtor remains liable for the underlying obligation as well as for any losses suffered by the creditor as a result of the delay.¹⁷⁶

Another safeguard that the debtor has under the current law is the redemption provision contained in the Civil Code, which allows the debtor to redeem the mortgaged property at any time prior to the actual sale by either performing its obligation in full or merely tendering the amount of the arrears.¹⁷⁷

Both the Mortgage Act and the Civil Code require that the mortgaged property against which execution is levied be disposed of by public auction, unless a different procedure has been established by law.¹⁷⁸ The creditor has the right to receive any deficiency from the debtor's other assets.¹⁷⁹

A significant shortcoming of the Mortgage Act, the Law on Pledge and the Civil Code, is their failure to provide for a scenario where the mortgagee participates in the bidding and acquires ownership of the collateral. This oversight fails to address the realities of the marketplace where the true value of the collateral is often much greater than the proceeds of a foreclosure sale. In such situations, both the mortgagee and the mortgagor will benefit if the mortgagee is able to buy the collateral because: 1) the mortgagee ends with ownership of the collateral, which can later be sold on the open market for a fair market price, thus, hopefully, returning a profit to the mortgagee; and 2) the mortgagee and mortgagor are spared from the mortgagee later needing to sue the mortgagor for the

¹⁷⁶ Civil Code, art. 350(2).

¹⁷⁷ *Id.*, art. 350(7).

¹⁷⁸ See Mortgage Act, art. 56(1); Bennett, *supra* note 13, at 1471 (citing Civil Code, art. 350(1)).

¹⁷⁹ See Civil Code, art. 350(6).

deficiency judgment, which is also especially advantageous to the mortgagee since the deficiency claim is an unsecured one.¹⁸⁰

The Mortgage Act provides that if fewer than two bidders are present at a public auction, such auction shall be deemed not to have taken place, which suggests that credit bids, often employed by foreclosing lenders in the United States, are not contemplated under current Russian law.¹⁸¹ The Civil Code allows lenders to obtain the collateral where two consecutive public sales are ruled as not having taken place. However, it does not require creditors to take ownership of the foreclosed collateral, and indeed, the mortgagee is *entitled* to keep the collateral.¹⁸²

B. Existing Risks Affecting Mortgage Finance

The Russian law governing mortgage finance in general and mortgage foreclosure in particular leans heavily in the direction of protecting debtors, often resulting in greater risk exposure for secured lenders. Undoubtedly, the provisions of the Mortgage Act and the Civil Code, which allow the debtor to defer the foreclosure proceedings and redeem the mortgage property by tendering merely the amount of the arrears, greatly benefit the debtor, while seriously inhibiting the lender's ability to return its investment. Further, under current law, a foreclosing creditor seems to be prohibited from taking title to a mortgaged property at a judicial sale where the foreclosing creditor is the only bidder. Thus, both the Mortgage Act and the Civil Code fail to provide lenders with any mechanism for taking possession of the mortgaged property and realizing its fair market value by selling the property at a private sale.

Finally, a secured creditor must be aware of the effect that Russian bankruptcy law may have on the secured creditor's ability to

¹⁸⁰ See generally Law on Pledge, art. 29 (explaining when a creditor is entitled to a deficiency judgment).

¹⁸¹ See Mortgage Act, art. 58(1). In the United States, in the absence of active bidding at a judicial foreclosure sale, the foreclosing creditor will typically bid in an amount up to the amount of the debt owed to such creditor, take title to the foreclosed property and later resell it at the fair market value.

¹⁸² Timmermans, *supra* note 138, at 371.

recover its investment. Although this article does not aim to provide an overview of the Russian Bankruptcy Law,¹⁸³ some of its provisions are noteworthy, as they may appear less than intuitive to a Western investor. Thus, under the Bankruptcy Law, secured claims are subordinate in priority to those of tort claimants and unpaid wages.¹⁸⁴ Further, secured creditors are not entitled to their particular collateral, but rather, have a secured claim to the extent of the debtor's remaining assets.¹⁸⁵ While this provision is similar to the treatment of secured claims under the United States Bankruptcy Code, unlike its American counterpart, the Bankruptcy Law does not appear to allow a secured creditor to be relieved from the moratorium (i.e., the Russian equivalent of the automatic stay) in situations where such collateral is not necessary to the debtor's reorganization efforts or the debtor's estate is subject to liquidation.¹⁸⁶

While the impediments discussed above will certainly affect potential lenders' decision-making, the overall positive impact of the legal reforms made in the area of mortgage finance seems to have made the legal environment sufficiently predictable for a foreign lender to make an educated business judgment. The most likely result of the existing risks is that secured lenders will insist on more stringent terms, such as collateral well in excess of the amount of the loan, higher interest rates or some other form of protection.

¹⁸³ Federal'nyi Zakon RF O Nesostoyatel'nosti (Bankrotstve) (Federal Law on Insolvency (Bankruptcy)), [Ross. Gazeta Jan. 20, 21 1998] [hereinafter Bankruptcy Law].

¹⁸⁴ See Bankruptcy Law, art. 106.

¹⁸⁵ See *id.*, arts. 109(3), 112, and 114.

¹⁸⁶ By comparison, under the United States Bankruptcy Code, a secured creditor is entitled to adequate protection in the form of, *inter alia*, cash payments and/or replacement liens, to compensate the creditor for the debtor's use of the creditor's collateral during the course of the bankruptcy case. See 11 U.S.C. §§ 361, 363. If the debtor fails to adequately protect the creditor's interest in the debtor's assets, the creditor may be entitled to relief from the automatic stay, whereby the creditor may exercise its rights against the collateral, including, without limitation, seizing and disposing of the collateral. See 11 U.S.C. § 362(d)(1). In the alternative, the creditor may be entitled to exercise its rights with respect to the collateral if the debtor has no equity in the collateral and the collateral is not necessary to the debtor's reorganization. See *id.* § 362(d)(2).

IV. CURRENT ECONOMIC CLIMATE

Western investors should be mindful of the existing inconsistencies in the Russian legislation governing real estate transactions and mortgage finance. However, these uncertainties should not discourage potential investors from investing in the Russian real estate sector, which, due largely to the legal reforms undertaken over the past few years, as well as Russia's promising economic outlook, presents a number of attractive investment opportunities.

2001 proved to be a year of solid economic achievements for the Russian economy, including the real estate sector.¹⁸⁷ Russia's economic recovery from the financial crisis of 1998 has been largely attributed to a strict monetary policy and the passage of the long-awaited legal and economic reforms, which so far have been the top priorities of the Putin administration.¹⁸⁸ Such unprecedented economic growth has made Russia potentially the world's most attractive place for foreign investment.¹⁸⁹

The economic growth, coupled with the enactment of the Land Code, which finally removed the legal and other barriers to investment in Russia, has revitalized the Russian real estate market and brought about a tremendous construction boom. With companies rushing to take advantage of the favorable legal environment and

¹⁸⁷ At the end of 2001, Russia's economic growth was anticipated to be approximately five percent, while the European Union's growth was not expected to exceed one percent, and the United States' economy began to shrink in March 2001. Victoria Lavrentieva, *2001: When The Economy Picked Up*, ST. PETERSBURG TIMES, Dec. 28, 2001, LEXIS News Library.

¹⁸⁸ *See id.*; Ken Hoover, *Putin's Leadership Lifts Russia Funds But Will This Really Last? Alliance with Bush Sparks Confidence That Economy Is Tilting Toward The West*, INVESTOR'S BUS. DAILY, Nov. 13, 2001, LEXIS News Library.

¹⁸⁹ *See Investments in Russia: Economic Growth Lures Foreign Investments*, THE RUSSIA JOURNAL, Issue No. 4 (147), Feb. 8, 2002, (discussing various forms of foreign investments in Russia), available at <http://www.russiajournal.ru/weekly/article.shtml?ad=5747/>.

affordable prices, demand for prime office, retail, warehouse and recreational space, as well as residential housing, has skyrocketed.¹⁹⁰

Some foreign companies have already jumped at the opportunity to make a profitable real estate acquisition in the rapidly developing market. For instance, the Swedish furniture retailer, IKEA, is planning to open a giant warehouse near Moscow, seeking eventually to use Russia as a production center for the corporation.¹⁹¹ IKEA wishes to take advantage of the newly enacted Land Code by first leasing the site, building the warehouse and then buying the land. Other Western retailers are beginning to follow IKEA's example and have been inspired to similarly attempt to capture the market's momentum.¹⁹²

The opportunities for investment in the mortgage finance segment of the Russian economy are similarly abundant. At present, Russia presents unique advantages in the area of mortgage finance. While Russian banks have been slowly getting involved in the real estate finance sector, real estate loans nonetheless comprise a small share of their total portfolio.¹⁹³ In fact, currently not more than 100 banks are active on the commercial real estate market.¹⁹⁴ The shortage of real estate financing is a result, at least in part, of the lenders' pre-Land Code uncertainty in their ability to return their investments. The few lenders that offer real estate loans usually insist on very stringent

¹⁹⁰ See Robin Munro, *A Good Year for a Maturing Real Estate Market*, *supra* note 9; *Commercial Real Estate: Dancing in the Factories, Trading in the Outskirts*, ST. PETERSBURG REAL ESTATE BULLETIN, available in <http://www.rupron.com/static/a00/156.asp>.

¹⁹¹ See Robin Munro, *IKEA to Use Russia as a Network Hub*, MOSCOW TIMES, Feb. 12, 2002, LEXIS News Library.

¹⁹² *See id.*

¹⁹³ See Maxim Dovgyallo & Andrey Tkachenko, *Russian Banks Lending for Commercial Real Estate and Construction*, available at <http://www.urbaneconomics.ru/eng/activity/estate/part01.html> (copy on file with the Journal of East European Law).

¹⁹⁴ *Id.*

loan terms.¹⁹⁵ Terms for construction loans have, in the past, been even more stringent, which has had a very inhibiting effect on real estate development despite the growing demand for both commercial and residential properties.¹⁹⁶ Before the passage of the Land Code, lenders—contrary to the worldwide custom—could not take a mortgage on the land parcel and the project being constructed on it. Instead, they insisted on liquid collateral with a market value 1.4 times the loan amount.¹⁹⁷ With the legal barriers to free transferability of land finally eliminated, the construction loan practices are bound to change.

Finally, investors should be aware that it is only a matter of time before lenders, domestic and foreign alike, realize that Russia presents unique opportunities in the area of mortgage finance. In the early 1990s most Russians were able to privatize their residences for a nominal fee and therefore, at present, most of the residential real estate in Russia is debt-free.¹⁹⁸ Also, due to the very substantial tax advantages available to individuals taking out a mortgage to finance the acquisition of a new home, Russia should expect a substantial rise in the demand for residential mortgages.¹⁹⁹ One thing that investors should remember, however, is that to take maximum advantage of the opportunities that are available, they must act swiftly, before the market has lost its current momentum.

V. CONCLUSION

During the past seven to ten years, Russia has made tremendous progress in creating a system of law allowing for a free-market economy and intended to attract foreign investment. With the enactment of the Land Code in October 2001, Russia has finally

¹⁹⁵ *See id.* (stating that in 2000, Russian banks charged an annual interest rate between forty and fifty percent for short-term loans).

¹⁹⁶ *See id.*

¹⁹⁷ *See id.*

¹⁹⁸ James Cook, *Brick by Brick: Tax Breaks Take Sting Out of Mortgage Loans*, MOSCOW TIMES, Feb. 13, 2001, LEXIS News Library.

¹⁹⁹ *See id.*

created a viable legal framework for real estate transactions, which, coupled with the existing law of contractual and secured obligations, should help the country in establishing a competitive real estate market. While Russia today is faced with the somewhat daunting task of implementing the legislative reforms that were enacted during 2001, the investment opportunities for foreign investors in real estate acquisition and mortgage lending are abundant. A prudent investor is advised to obtain a good understanding of his legal rights under the current Russian law before making a business decision concerning whether to invest in the Russian real estate market.