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Creating and enforcing security interests in Kazakhstan

Ways of taking security interests are becoming increasingly sophisticated. Here is a guide, by James E Hogan, Aigoul Kenjebayeva, Gary Sullivan, Robert Starr and Karen Widess of Salans Hertzfeld & Heilbronn, Paris, Almaty and London

Under the law of the Republic of Kazakhstan there are various means of securing the performance of obligations. While all of these structures are set out in the Kazakhstan Civil Code (penalty, pledge, withholding of property from the debtor, suretyship, guarantee, deposit and "other means provided for by legislation or by contract"), the one that is likely to interest many lenders and investors is the pledge or the taking of security in assets such as property and rights.

This article concentrates on the various mechanisms which can be used to secure obligations under Kazakhstan law, and provides a general summary of the procedures required to perfect and enforce such security interests. It also discusses pledges on natural resources.

Pledges of immovable property

Immovable property is defined in the Civil Code to include buildings, structures, perennial plantings, and other property connected with the land which cannot be removed without commensurate damage to the purpose thereof. Also included in the definition of immovable property are aircraft and sea-going vessels subject to state registration, vessels of internal water navigation and 'river-sea' navigation and space objects. Everything not defined as immovable property is deemed to be movable property.

Kazakhstan law on the securing of transactions in and with immovable property has been substantially updated with the enactment by the president of Kazakhstan of a trio of edicts having the force of law: On Land, December 22 1995 (the Land Law); On the Hypothecation of Immovable Property, December 23 1995 (the Mortgage Law); and On State Registration of Rights in Real Property and Dealings with Them, December 25 1995 (the Real Property Registration Law).

The Land Law provided for the first time that land may be privately owned in many, but not all, circumstances. Both individuals and non-governmental legal entities may own land with certain restrictions. Foreign companies generally have the same rights as Kazakh legal entities and may own land underlying commercial buildings (either industrial or non-industrial), residential buildings, other structures and their complexes, attached for servicing of the structures.

Land can still be held by right of use, either permanent or temporary, alienable or inalienable, paid or unpaid. Foreign citizens and legal entities may have the right to use land, in certain circumstances, and are classified as 'foreign' land

users. However, enterprises with foreign participation are classified as 'national' (as opposed to 'foreign') land users, along with citizens of Kazakhstan and Kazakh legal entities.

The right to use land can arise from a government *akt*, from a civil law transaction, such as a lease, or from other bases envisioned in the law. Certain uses of land must be licensed (for example, oil and gas exploration and extraction and mining) and the necessary licence must be obtained before obtaining the right to use the land. Use rights in certain types of land are not transferable.

The right to permanent use cannot be granted to 'foreign' land users. Therefore, for a foreign investor to obtain such permanent use rights, it would either have to be a participant in a Kazakh enterprise and so be considered a 'national' land user, or purchase the land, if outright ownership is permitted.

Mortgages must be supported by a written agreement, and the right in the pledged property arises from the moment of registration of the agreement

There are no restrictions on the possession by foreign land users of temporary land use rights, up to 99 years, usually by lease or sublease. Rights to buildings will automatically confer rights (either of ownership or use) of the underlying land, and such rights are not severable from the building rights.

Land held in private ownership or by right of use can be pledged (mortgaged) with certain exceptions, including land held by right of temporary, short-term (under three years) use. In the case of land held under joint ownership, all owners must agree in writing to the pledge of the land. Buildings can also be pledged, together with the land use rights for the underlying land. Pledge agreements, like virtually all other interests in real property, must be registered in the government register for operations with land.

A mortgage (or hypothecation) is specifically defined in the new law as a type of pledge, whereby the pledged property or share in it remains in the ownership and use of the pledgor or a third party. Mortgages must be supported by a written agreement, and the right in the pledged property arises from the moment of registration of the agreement. Until a new registration agency is launched at the Ministry of Justice, registration continues at local Land Committees. No notarization is required.

The mortgage agreement must contain information on the name and address of the parties and any agents, the existence and description of the underlying obligation which the pledge supports, a description and the location of the pledged property, the type of rights in the property which the pledgor possesses plus any other provisions desired by the parties which do not contradict Kazakhstan law.

No official public registry or other independent source for verification yet exists which would allow a prospective pledgee to verify that there are no pre-existing pledges on particular property

The pledgor is obliged to inform the pledgee on concluding the pledge contract, before its registration, of all rights of third parties in the pledged property, including unregistered interests. Failure to so inform the pledgee will give the pledgee the right to demand early fulfilment of the underlying obligation or changes in the conditions of the pledge agreement.

A mortgage can also be memorialized in a transferable

security instrument called a Mortgage Certificate (*ipotechnoe svidetel'stvo*). The issuing of a Mortgage Certificate and all transfers of it must be registered in the same registry as other transactions in real property, that is, the registry of the Kazakhstan Ministry of Justice. The Mortgage Certificate can, in turn, be pledged to support a debt or other obligation.

Mortgages may be foreclosed either by court order, by non-judicial procedure (if agreed by the parties either in the mortgage agreement or subsequently), or by the mortgagee taking the pledged property in lieu of the debt, in case the auction procedure provided for in the law is not successfully conducted.

A very limited number of types of pledged property are not subject to foreclosure without a court order, such as real estate owned in common with persons other than the pledgor or having historical or other cultural value.

Pledges of movable property

The general Kazakhstan legislation concerning the pledging of movable property is limited and underdeveloped. An earlier Kazakhstan Law, On Pledges, December 23 1991, was repealed on the entry into effect of the Civil Code. Following its repeal, the only rules in force for pledges of movable property are certain provisions of the Civil Code. Eventually we would expect that a new

Pledges relating to natural resources

Under the Petroleum Law

Petroleum in its underground state belongs to the Republic of Kazakhstan. Ownership of petroleum which has been brought to the surface and the right of disposal thereof is determined by the contract for the conduct of petroleum operations concluded between the contractor and the government.

Under the Law on Petroleum, the contractor has the right to dispose of its share of petroleum production, both in Kazakhstan and abroad, including that received during the course of experimental industrial work and trial use of individual wells, with the exception of that petroleum acquired or requisitioned by Kazakhstan under Articles 35 and 36 of the Petroleum Law. Presumably, the contractor is free to pledge its share of petroleum, both within Kazakhstan and abroad.

However, there is no specific procedure set out for pledges of natural resource production, and therefore the procedure for such a pledge would be under the general civil law provisions for pledges of movable property (although, here again, it is uncertain whether natural resource production would be considered as movable or immovable property).

The petroleum law contains a provision, Article 53, concerning the 'Transfer of Rights and Obligations' which could apply to pledges involving oil and gas.

Under the Subsoil Code

The Presidential Edict On the Subsoil and Subsoil Use, of January 27 1996 (the Subsoil Code) became effective from its date of publication, January 29 1996.

The Subsoil Code establishes the basic Subsoil Use Right which is defined as "a right to possess and use the subsoil within the limits of the Contract Territory granted to a Subsoil

User in accordance with the procedure established by the present Edict" (Article 1(21)), and may be created by grant from the state, transfer (assignment) from one subsoil user to another, or succession, in case of the reorganization of a legal entity.

The Subsoil Code contains a special provision on the transfer (assignment) of Subsoil Use Rights (Article 14). Subsoil Use Rights based on a licence may be transferred only with the permission of the government. Provided permission is given, the Subsoil Use Rights are transferred through a civil law transaction and the licence is re-issued by the government. As is the case under the Petroleum Law, a transfer of only part of the rights by the transferor would result in the transferor and the transferee bearing joint liability under such rights.

Under the Subsoil Code, Subsoil Use Rights may be pledged to secure an obligation. However, a loan secured by such a pledge must be used only for the purposes stated in the licence. Subsoil Use Rights for petroleum operations are transferable, including by way of pledge, although there is no mention of pledge in the Petroleum Law. The Petroleum Law is to be read in conjunction with the Subsoil Code and in case of conflict, the Petroleum Law will control petroleum operations.

The Minister for the Oil Industry has unofficially expressed the view that the pledge provision in the Subsoil Code was intended to allow producers to pledge their rights in petroleum products, although the Subsoil Code speaks only of a pledge of Subsoil Use Rights.

It is questionable whether Subsoil Use Rights may be transferable (including by way of pledge) unless the transferor possesses both a valid licence and contract.

detailed law on pledges would be enacted in Kazakhstan. In the meantime, the lack of legal regulation on this subject has complicated efforts by local and foreign investors in Kazakhstan to raise capital through secured financing.

Participation interests (*doli*) in limited liability partnerships are proprietary rights which may be pledged under Kazakhstan legislation, unless otherwise prohibited by legislative acts or by the partnership's foundation document. However, there are no regulations or instructions specifically relating to the pledging of these interests. Presumably the general rules set out in the Civil Code for the creation of pledges in property rights apply, and the creation of the pledge and the relations between the pledgor and pledgee are governed by the pledge agreement.

Under Kazakhstan legislation, pledge agreements must be in writing, and must indicate the subject of the pledge, a valuation of the pledged property, as well as the nature, the amount and time period corresponding to the obligation being secured by the pledge. Failure to include these elements will render the pledge invalid.

Generally, where the pledge is of property not subject to registration, such a pledge would be effective as from the moment of signature of the pledge agreement.

Pledge registration requirements

Under the literal language of the Civil Code, in instances where the pledged property is subject to state registration, the pledge itself must also be registered with the same bodies. The pledgor has the right to demand (on presentation of supporting documents and written notice) that the registration of the pledge be annulled on satisfaction in full of the obligations secured by the pledge.

With certain exceptions (see discussion of securities below), there is no requirement at present to register movable property and hence no way to register a pledge in movables.

Creation and continuity of pledges

The basic principle in the Civil Code concerning the creation of pledge rights is that they come into effect on the basis of the pledge agreement.

The Civil Code also provides that the creation of pledge rights over property, the pledging of which is subject to registration, occurs from the moment of such registration "to the extent that is not otherwise provided by the pledge agreement". This provision seems to indicate that the time of the creation of the pledge may be defined in the pledge agreement as a date other than the date of state registration. Until the enactment of a new law on pledges of movable property, or the promulgation of regulations, the precise time of the creation of pledge rights will remain unsettled under Kazakhstan legislation.

Under the general Civil Code provisions on the transfer of pledged property, if such property is transferred to a third party before satisfaction of the obligations secured, the new recipient takes the property subject to the pledge, and, if registration is required, registration must be amended to reflect the transfer of the pledge obligation to the new owner.

Secondary pledges of property are allowed under the Civil Code, unless prohibited by prior pledge agreements on the same property. The pledgor has an obligation to advise all prospective pledgees of the existence and priority rights of pre-existing pledges with respect to the property. However, no official public registry or other independent source for verification yet exists which would allow a prospective pledgee to verify that there are no pre-existing pledges on particular property. The Civil Code provides that the pledgor is to be "liable for any losses resulting from its failure to inform of pre-existing pledges". However, this liability would be useless if the pledgor were insolvent or otherwise unable to make good on its obligations.

Execution against pledged property

In general, execution against pledged property may be taken only under a court order, unless the pledge agreement or legislative acts provide otherwise. If the agreement or other legislative acts provide for the seizure of the property by means other than a court procedure, the pledgee would have the right independently to seize pledged property and sell it by public auction. Given the wording of the relevant Civil Code provisions, there is no apparent right of a pledgee to avoid this public auction requirement. The right of strict foreclosure does not exist, and the auction may not take place by private sale. In addition, at the request of the pledgor, a court may have the right to delay the auction for up to one year.

Company Law provides that general information concerning parties that have pledge rights over securities must be recorded in the Company share register

Any physical person or legal entity (including the pledgor and the pledgee) may participate in the auction. In the event that fewer than two potential purchasers participate in the auction, the pledgee would have the right either to take ownership of the pledged property for the price established by a decision of the court or on the basis of a decision of the relevant government body charged with appraisals of property, or to demand the holding of a new auction.

If the amount realized from the sale of the pledged property is insufficient to satisfy the obligation secured by the pledge, the pledgee would have the right to bring a claim against the pledgor. Should the pledgor have insufficient assets from which to pay such a claim as a result of bankruptcy, the pledgee would be treated with respect to the deficiency as an unsecured creditor. Under the Kazakhstan Civil Code, the priority of creditors' claims to the assets of a legal entity undergoing liquidation is:

- citizens who have suffered harm to life and health;
- persons entitled to payment for labour (wages) or intellectual property; (secured creditors);
- payment to state budgetary and non-budgetary funds; and
- other creditors.

Dispute resolution

From the foreign investor's point of view, there is still no entirely reliable mechanism for the enforcement of laws and contracts in Kazakhstan in an acceptable and timely manner. This being said, recent developments show that a substantial degree of progress has been made.

Court procedures

Certain legislation, such as the Land Law, requires that disputes arising thereunder be resolved in the Kazakhstan courts. While steps to reorganize the judiciary are being taken with a view to creating a court system suitable for a market economy by, among other things, eliminating the old Soviet-style arbitration courts and establish arbitrazh panels within the regular courts, the training of judges in market economy legal transactions continues. Therefore, most foreign investors, where possible, will choose to have disputes resolved by international arbitration.

International arbitration options

Both the conduct of international arbitration and the enforcement of arbitral awards are addressed in Kazakhstan under various laws and bilateral and multilateral agreements.

Article 27 of the Law on Foreign Investment dated December 27, 1992, provides for the settlement by international arbitration of disputes that arise in connection with foreign investment before various arbitral bodies which are expressly listed, including most of the arbitration bodies most commonly used in international transactions.

Kazakhstan recently ratified a number of international treaties on the subject of the enforcement of arbitral awards, including the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards, 1958. In view of the ratification by Kazakhstan of the New York Convention, arbitral awards made in any country party to the New York Convention must be recognized by Kazakhstan courts, subject, of course, to certain exceptions set out in the Convention.

Under the Convention, a court can refuse to recognize and enforce an arbitral award if a competent authority in the country finds the subject matter of the dispute is not capable of settlement by arbitration under its legislation or is contrary to public policy. There is no reported practice that would indicate the manner in which these exceptions to enforcement would be applied by Kazakhstan courts, and Kazakhstan has not yet adopted a law on international arbitration.

Securities — specific provisions

The Civil Code provides that the pledge of securities of joint stock companies and banks is carried out "bearing in mind" applicable legislation on securities. However, we are aware of no published or unpublished regulations or instructions in force which relate to the mechanisms or requirements for the pledging of securities, including certificated or uncertificated shares.

The only direct reference to pledges of securities in the Civil Code is a provision which states that, for a pledge of proprietary rights represented by securities, the security is transferred to the pledgee by deposit either with a bank or

with a notary office, unless the pledge agreement provides otherwise. This procedure would apply only to pledges of certificated securities, since an uncertificated security has no material form capable of being physically deposited with the bank or notary office.

Presumably, the parties would be free to provide in their pledge agreement any other mutually satisfactory means for carrying out a pledge of securities, and the depository responsible for recording transactions with such securities would be requested to note such pledge rights.

Subsoil Use Rights for petroleum operations are transferable, including by way of pledge, although there is no mention of pledge in the Petroleum Law

Because the issuing of and the carrying out of transactions with securities must be registered, all pledges of securities are subject to state registration. In addition, Company Law provides that general information concerning parties that have pledge rights over securities must be recorded in the Company share register or with the depository. The Company Law provides that such information must be accessible to shareholders and pledgees of shares for inspection. However, specific procedures in this regard have not yet been developed, and it is not clear to what extent the provisions of the Company Law are followed.

Article 26 of the Securities Law sets forth the principle that ownership rights to securities come into effect at the time of registration in the share register. It is conceivable that the same rule would apply by analogy to pledge rights as well. However, under a literal reading of this Article, together with the general provisions on pledges set forth in the Civil Code, a pledge of securities would arise at the moment of the signing of the pledge agreement, unless otherwise provided by the agreement.

A securities tax must be paid on all transfers of ownership rights to securities. Securities taxes would be deemed due and owing on execution of pledges of securities at the moment that ownership of securities is transferred to the pledgee.

Choice of law

The question of choice of law in foreign economic transactions (those where one party is a foreign person or legal entity) is governed in Kazakhstan by those parts of the Fundamental Principles of Civil Legislation of the USSR and the Republics (the Fundamentals) which are still in effect in Kazakhstan. Article 166 of the Fundamentals provides that the law to be applied in a foreign economic transaction shall be the law selected by the parties.

In the absence of such a selection, Article 166 sets out certain tests for determining the applicable law. In the case of a pledge agreement, the applicable law would be that of the country where the pledgor "is located, has its place of residence or has its basic place of activity" unless otherwise established by the parties. □