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# Independent Security Rights under Russian Legislation

## 1. Introduction

Russian legislator places great emphasis on the development of security instruments. The primary trend for a legal regulation involves gradual rejection of the strong link between the underlying and security obligations (the process of weakening of accessory).

This process is accompanied by using of non-accessory (independent) security rights in the economic turnover.

Is accessory the essential feature of security instruments? How does that concept correlate with the concept of independence? What are the differences between the regulation of independent obligations and abstract ones? Experts argue about all of these questions, whose answers form the subject of this paper. In addition, the reader may become familiar with features of independent security rights regulation under Russian law.

### 1.1. The types of security instruments

Under clause 329 of the Civil Code of the Russian Federation (*Гражданский кодекс Российской Федерации*<sup>\*1</sup>), security instruments include the forfeit, the advance, the pledge, the right of retention of possession, the suretyship, the bank guarantee, and other security instruments established by the rule of law or by agreement.

It should be emphasised that the forfeit and advance are not supposed to serve security purposes. This idea is not new in the doctrine. For example, G.F. Shershenevich (Г.Ф. Шершеневич), one of the classic voices in Russian civil law, wrote about the ephemeral nature of the forfeit's security function: while the fear of the forfeit encourages the performance, the effect of the forfeit depends essentially on the debtor's ability to perform the obligation *per se*.<sup>\*2</sup> M. Plyaniol (М. Пляниоль) claimed that the advance is now seen rather more as a departure from a contract than as a remedy assisting in the fulfilment of its terms.<sup>\*3</sup>

Regardless, a tradition seems to have established itself in Russian law of classifying the forfeit (clause 330 of the Civil Code) and advance (clause 380 of the Civil Code) both as security instruments and as types of remedies (liabilities arising from non-performance of the obligation), simultaneously. Meanwhile, in practice, these instruments are unambiguously considered only as remedies. Nobody would think of

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<sup>1</sup> Hereinafter 'the Civil Code'.

<sup>2</sup> Г.Ф. Шершеневич. Курс гражданского права. Тула 2001, pp. 384 ff.

<sup>3</sup> М. Пляниоль. *Курс гражданского права*, Ч. 2: Договоры. Петроков: Изд. тип. С. Панского 1911, pp. 519 ff. The notions of the advance under French law and Russian law coincide.

assuring his right to performance of the obligation by means of the forfeit or advance. Nor is the forfeit or advance among the means considered by the Bank of Russia to be collateral for the repayment of loans.\*<sup>4</sup> This is easily explained by the nature of security rights. The effect of the security mechanism is clear: if the debtor fails to fulfil the obligation, the creditor has an opportunity to employ an additional (a reserve) source for this purpose.

## 1.2. Personal security instruments

Suretyship, the most traditional personal security instrument, is well known in the Russian legal tradition. Suretyship arises from a contract of surety\*<sup>5</sup>, according to which the surety (security provider) shall be obliged to the creditor (secured creditor) of the other person (the main debtor) to perform the latter's obligation (the underlying obligation) if the main debtor has not duly fulfilled the obligation (clause 361 of the Civil Code). Suretyship is a dependent personal security. Its legal nature is similar to that of the security instrument, described in Article IV. G.-1:101 of *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of Reference*\*<sup>6</sup>: '(a) a "dependent personal security" is an obligation by a security provider which is assumed in favour of a creditor in order to secure a right to performance of a present or future obligation of the debtor owed to the creditor and performance of which is due only if, and to the extent that, performance of the latter obligation is due'.

The norms addressing the independent personal security appeared in Russian law when Part 1 of the active Civil Code came into force, on 1 January 1995. This security instrument was termed a 'bank guarantee' instead of a 'demand guarantee' (although the International Chamber of Commerce's\*<sup>7</sup> Uniform Rules for Demand Guarantees constituted a prototype for the Russian legislator). The key point here is that only banks and insurance companies were granted legal capacity to issue independent guarantees (clause 368 of the Civil Code).

A non-typical personal security instrument such as co-debtorship with a security function is not used in practice; a comfort letter is not binding under Russian law.

## 1.3. Proprietary security instruments

A pledge should be treated as a traditional proprietary security instrument under Russian law. It is a security right in a movable or immovable asset that entitles the secured creditor to preferential satisfaction of the secured right\*<sup>8</sup> from the encumbered asset (clause 334 of the Civil Code). Both possessory and non-possessory security rights are considered under Russian law to be a pledge; a pledge in immovables is traditionally called 'ипотека' (from the Latin 'hypotheca')—i.e., a mortgage.

Another security right that should be associated with proprietary security instruments is the right of retention of possession. The opportunities this right creates for the secured creditor are similar to the consequences of a pledge. The claims of the creditor who is retaining the thing shall be satisfied from its value in the amount and by the procedure stipulated for the satisfaction of the claims secured by the pledge (clause 360 of the Civil Code). This type of security has been part of practice for a long time, but it was only in the active Civil Code (clause 359) that it came to be specified through a statutory rule.

Russian law is familiar with devices for retention of ownership. Retention of ownership by a seller under a contract of sale, stipulated in clause 491 of the Civil Code, can be considered to be a security instrument. Retention of ownership by a lessor under a contract of financial leasing (clause 665 of the Civil Code)

<sup>4</sup> See, for example, Положение Центрального банка Российской Федерации от №254-П от 26 марта 2004 «О порядке формирования кредитными организациями резервов на возможные потери по ссудам, по ссудной и приравненной к ней задолженности» [‘Provision of the Central Bank of the Russian Federation N 254-P of 26 March 2004 ‘On forming the reserves for possible losses on loans and similar debts by credit organisations’]. — *Бюллетень Банка России* 2004/28.

<sup>5</sup> As a general rule, any kind of security right may arise from a contract. When a special clause exists, a security right may arise by the functioning of the law.

<sup>6</sup> C. von Bar, E. Clive, H. Schulte-Nölke (eds). *Principles, Definitions and Model Rules of European Private Law: Draft Common Frame of reference (DCFR)*. Outline edition. 2009. Hereinafter ‘the DCFR’.

<sup>7</sup> Hereinafter ‘the ICC’.

<sup>8</sup> To describe the notion of a secured right in Russian civil-law parlance, the term ‘обеспеченное обязательство’ (literally ‘secured obligation’) is commonly used. The two expressions have the same meaning.

also has a security purpose. There are other examples wherein parties to a contract attempt to construct a security instrument by using a title of ownership. However, rules of law for these instruments have not yet been developed and feature mainly at the level of doctrine.<sup>9</sup>

## 2. Bank (independent) guarantee

### 2.1. The ICC Uniform Rules for Demand Guarantees— the model for the Russian law

The bank guarantee is the only independent security used in Russian law.<sup>10</sup> The norms governing this guarantee coincide in essence with the ICC Uniform Rules for Demand Guarantees, publication 458 (1992).<sup>11</sup> The main differences are the following:

- 1) As was mentioned above, only banks and insurance companies are authorised to issue independent guarantees. An independent security is a risky instrument, especially when a form unfamiliar to the participants in the economic relations as was the case in Russia. This is why only financial institutions (banks and insurance companies) as professional ‘merchants of money’ were given legal capacity to be guarantors under an independent-security arrangement. In fact, only banks issue guarantees, because the structure of insurance companies’ assets is not well suited to such transactions.
- 2) In accordance with UR N 458, a so-called first demand guarantee (this is a guarantee that must be paid on demand without indication as to the principal’s violation of the underlying obligation) was allowed as an exception to the general rule under the condition expressly set forth by the parties involved (Article 20 (c) of UR N 458).<sup>12</sup> Outside highly confidential relationships, a guarantee of such a type turns into a ‘suicide letter’, as bankers put it. To protect the principal’s interests, practising this type of guarantee has been prohibited by Russian law. In accordance with clause 374 of the Civil Code, a demand under a guarantee shall be supported in any event by a statement indicating in what respect the principal is in breach of the underlying obligation.
- 3) To prevent abuses by beneficiaries, the Russian legislator introduced an additional stage to the procedure for satisfying the beneficiary’s demand (not provided for by UR N 458<sup>13</sup>). If the guarantor comes to know that the underlying obligation has already been performed or has been terminated on some other grounds or been invalidated, he shall be obliged to notify the beneficiary and the principal about this immediately, and the guarantor shall be liable to pay upon receiving a second demand from the beneficiary (clause 376 of the Civil Code).

The provisions of paragraph 6, ‘Bank guarantee’ (Chapter 23 of the Civil Code), are brief. The parties involved may stipulate that the ICC Uniform Rules for Demand Guarantees are applicable to their relationship in full or in part when they are not in contradiction with the mandatory rules set forth by law.<sup>14</sup> Moreover, judges and experts with the Supreme Arbitration Court of the Russian Federation<sup>15</sup> take into account approaches employed in the ICC Uniform Rules (as a part of *lex mercatoria*) in the course of preparing documents issued by the Supreme Arbitration Court in order to create uniform judicial practice.<sup>16</sup>

<sup>9</sup> For details, see С. Сарбаш. Обеспечительная передача правового титула. – *Вестник гражданского права* 2008/1, pp. 7ff.

<sup>10</sup> Aval with respect to the bill of exchange should be considered separately. See the Convention Providing a Uniform Law for Bills of Exchange and Promissory Notes (Geneva, 7 June 1930), Article 30 (hereinafter ‘the Geneva Convention on Bills of Exchange’). Russia is a party to this convention.

<sup>11</sup> Hereinafter ‘UR N 458’.

<sup>12</sup> Now see Article 15 ICC of the Uniform Rules for Demand Guarantees, publication 758 (2010), hereinafter ‘UR N 758’.

<sup>13</sup> Also in UR N 758.

<sup>14</sup> See, for example, определение Высшего Арбитражного Суда Российской Федерации № ВАС-11455/10 от 23 августа 2010 [‘Resolution of the Supreme Arbitration Court of the Russian Federation N ВАС-11455/10 of 23 August 2010’] and постановление Президиума Высшего Арбитражного Суда Российской Федерации № 6040/12 от 2 октября 2012 [‘Decision of the Presidium of the Supreme Arbitration Court of the Russian Federation N 6040/12 of 2 October 2012’].

<sup>15</sup> Arbitration courts in the Russian Federation are part of the state court system and deal with economic litigation.

<sup>16</sup> The most important forms are the Plenum of the Supreme Arbitration Court’s Rulings and the Presidium of the Supreme Arbitration Court’s Information Letters. See Информационное письмо Президиума Высшего Арбитражного Суда РФ от 15.01.1998 N 27 «Обзор практики разрешения поров, связанных с применением норм Гражданского кодекса Российской Федерации о банковской гарантии» [‘Information letter of the Presidium of the Supreme Arbitration Court of

## 2.2. The future of bank guarantees in Russian civil law

In accordance with an order from the President of the Russian Federation, the concept for development of the civil legislation of the Russian Federation was elaborated upon in 2009.<sup>17</sup> The Draft Federal Law on amendments to the Civil Code<sup>18</sup> was prepared on the basis of the Concept. The Draft Amendments are now under discussion in the State Duma of the Russian Federation.

Considerably more detailed regulation of relations under a bank guarantee than that in the active Civil Code is to be found in the Draft Amendments. The new norms were developed in consideration of UR N 758, but the specific features inherent to Russian practice have been retained. All of the novel elements can be classified into one of three groups:

- 1) Changes related to the fact that Russian participants in economic relations are already familiar with the bank guarantee as it stands. In accordance with the Draft Amendments, not only banks but also any commercial organisation shall be authorised to issue a guarantee. Accordingly, instead of 'bank guarantee', the name of the instrument shall be 'independent guarantee', which reflects the nature of the instrument more accurately.
- 2) Changes that are aimed at diminishing the impact of the mistaken notion that private law is, similarly to public law, imperative in nature.

Socialism was based on a planned economy and administrative methods of management, so several generations of Russian lawyers were brought up with the idea that any permitted deviation from the norms must be stated in a normative act *expressis verbis*. The impact of this idea on Russian jurisprudence is still noticeable. There are more than a few judgements that are based on the assertion that everything not expressly provided for in normative acts is considered to be in contradiction with the legislation. And this persists notwithstanding the fact that the private-law principle 'everything is permitted that is not forbidden' is formulated in clause 1 of the Civil Code as follows: natural persons and legal entities 'shall be free to establish their rights and duties on the basis of an agreement and to define any terms of the agreement, that are not in contradiction with legislation'. It is clear that a formal approach to the interpretation of the law should be set aside in favour of proper education of the lawyers, and that this will take time. As a quick way to rid ourselves of the limitations that affect freedom of contract in practice, the drafters are forced to include in the Draft Amendments rules confirming authorisation of what is not prohibited.

A good illustration is the requirement to issue a bank guarantee in written form. Issuing a guarantee is a unilateral juridical act. The standard written form of any juridical act is a paper document with the hand-written signature of the authorised person. But it is not prohibited to use any other technical means that still allows one to read, record, and reproduce information in tangible form (clauses 156, 160, and 434 of the Civil Code). However, there is no direct reference in the Civil Code to such an opportunity with regard to the bank guarantee. As a result, courts have often decided that a guarantee was not 'in writing' if it was issued by means of electronic communication, including the standard SWIFT transmission. To overcome this approach, the Supreme Arbitration Court was forced to issue a special instruction regarding electronic transmissions.<sup>19</sup> For the same reason, direct reference to a guarantee given in any written form that enables determination of the identity of the guarantor and the conditions of the guarantee is included in the Draft Amendments (in the new language of clause 368 of the Civil Code).

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the Russian Federation N 27 of 15 January 1998, "Review of the practice of settlement of disputes related to the application of provisions of the Civil Code on bank guarantee norms" (hereinafter 'Letter of the Supreme Arbitration Court N 27'), and Постановление Пленума Высшего Арбитражного Суда РФ от 23.03.2012 N 14 «Об отдельных вопросах практики разрешения споров, связанных с оспариванием банковских гарантий» [The ruling of the Plenum of the Supreme Arbitration Court of the Russian Federation N 14 of 23 March 2012 "On some issues of the practice of settlement of disputes related to challenged bank guarantees" (hereinafter 'The Plenum's Ruling N 14')].

<sup>17</sup> Концепция развития гражданского законодательства Российской Федерации. Москва, 2009 [The Concept of Development of Civil Legislation of the Russian Federation. Moscow, 2009], hereinafter 'the Concept'.

<sup>18</sup> Проект Федерального закона «О внесении изменений в части первую, вторую, третью и четвертую Гражданского кодекса Российской Федерации, а также в отдельные законодательные акты Российской Федерации» N 47538-6 [Draft Federal Law "On amendments to the first, second, third and fourth parts of the Civil Code and to some legislative acts of the Russian Federation", N 47538-6]. Available at <http://www.consultant.ru/law/doc/gk/>. Hereinafter 'the Draft Amendments'.

<sup>19</sup> The Plenum's Ruling N 14', item 3.

- 3) Changes aimed at reducing the risk of abuse by beneficiaries. The norms of clause 376 of the Civil Code<sup>\*20</sup> are detailed in the Draft Amendments. The concept remains the same: if the demand meets the conditions of the guarantee but the guarantor has reasonable doubt as to whether it is justified, the latter may suspend payment (for not more than seven calendar days following receipt of the demand) upon notification of the other parties involved. It is important to emphasise that the guarantee is not converted into a dependent security instrument. The situation involves just a delay of payment, nothing more. Such suspension is possible only in the following cases:
- a) Any document submitted is unreliable (contains inaccuracies in the facts)
  - b) The circumstances or the risk under which the beneficiary's claim for payment shall be presented did not arise
  - c) The secured obligation is invalid
  - d) The secured obligation has been performed in favour of the beneficiary

In all of these cases, the bank **needs** to verify the circumstances beyond the documents submitted. That contravenes the documentary nature of the guarantee (see Article 7 UR N 758). To fulfil its documentary obligation (such as payment under an independent guarantee and letter of credit), the bank need only check the apparent indicators of the documents and is not liable for any discrepancies between the contents of the documents and the facts (delivery of goods, their quality, etc.). But in fact the specified contradiction does not exist. The guarantor has no the obligation to check outside circumstances, it has a **right** to do so. But the main thing is that after seven days the payment shall be made on the basis of the due documents having been submitted in due time regardless of any other circumstances. The balance of interests of the parties involved is also supported by the rule that a guarantor is obliged to pay damages in the event of unjustified suspension of payment.

As we can see, the new norms do not affect the independent nature of the guarantee, and at the same time they emphasise the security function of the instrument. It is also important that they aid in achieving one of the main purposes of civil law—to protect *bona fides* as the basis of civil turnover.

Two other provisions of the Draft Amendments that are not in line with UR N 758 attract attention.

First, the norms related to independent guarantees should be applied in cases wherein the obligation of the grantor is to transfer shares, bonds, or generic things. It is recognised in practice that suretyship may secure an underlying obligation to deliver generic assets. In this case, the security provider's obligation consists of transferring a similar asset (e.g., shares traded on the organised market). To apply this approach to the independent personal security may appear theoretically appropriate. The problem is whether it is at all practical. We have no knowledge of the extent to which the financial market is in need of such transactions. Therefore, the forecast related to this unknown instrument can be based on legal logic alone. The independent guarantee makes it possible to eliminate, with the aid of a legal mechanism, such specific risks as cannot be avoided by means of other security instruments: for the beneficiary (the risk of the principal's late performance of the underlying obligation) and for the guarantor (the risk associated with checking whether the beneficiary has a right to claim the performance). To reach a fair balance of interests, the principal is entitled to recover damages for any losses in case of the beneficiary's unjustified demand. When an underlying obligation is the obligation to pay money, all relationships between the parties involved are similar in nature, amounting to an obligation to pay. This renders sufficient protection to the principal.

The situation is different when the guarantor delivers under the beneficiary's demand any securities or equivalent negotiable instruments. If such a demand was unjustified, the negative consequences for the principal may be irreversible (e.g., loss of control over the business), so it would be impossible to render complete protection. In other words, the legal mechanism of independent security may fail in the relationships between the principal and the beneficiary. But it is only in these relationships that the security function of an independent guarantee is manifested.<sup>\*21</sup> Except for these relationships, the whole structure converts into a sale transaction between the principal and the guarantor with a performance in favour of the beneficiary. It is subject to doubt whether the guarantee 'payable' through generic assets is eligible as a genuine security instrument. Meanwhile, suretyship in such cases enables maintaining the balance of interests and protecting the principal.

<sup>20</sup> See Subsection 2.1 of this paper, above.

<sup>21</sup> See Section 5, below.

Secondly, it is stipulated in the Draft Amendments that instead of showing a fixed amount the guarantee may suggest a manner of its calculation. This may be more convenient for the parties to the underlying obligation, as they can synchronise the terms of this obligation and the guarantee. However, it is not convenient for the guarantor, since the amount of the guarantee is the basis for calculating the fees for the guarantor (e.g., bank charges), the total risk accepted by the guarantor, and the amount that the principal is due to give the guarantor if a payment under the guarantee is made. Therefore, it is recommended in UR N 758 to issue a guarantee with indication of the amount or maximum amount payable (Article 8).

### 3. Independent mortgage in the Draft Amendments

The drafters suggest two types of mortgage: the accessory mortgage and independent mortgage (new clause 303.1 of the Civil Code under the Draft Amendments). In a contract for accessory mortgage, the underlying obligation must be specified in every detail (including its substance, its amount, and the time of performance of the obligation). For independent mortgage, it is sufficient to indicate in the contract the maximum amount that can be due to the pledgee from sale of the encumbered immovable and the expiry time of the security right.

What is the meaning of the term ‘independent mortgage’? Is it a genuinely independent security right, which (similar to the independent guarantee) can be implemented regardless of whether the underlying obligation exists? Independent proprietary security is unknown in Russia. Introducing to the law any untested instruments would be dangerous *per se*, to say nothing of such a high-risk instrument as an independent security. It is necessary to take into account the peculiarities of the Russian market. Its participants frequently suffer through lack of professionalism and sometimes do not show reasonable caution, and, regrettably, there have been many abuses in business relations. In spite of the fact that independent proprietary security instruments had been in use there for over a century, Germany was forced to reform its legislation in 2008. In particular, the famous *Grundschuld* was turned into an accessory security right to counteract the abuse of mortgage securities holders.<sup>\*22</sup> From the perspective of Russian realities, it would be too radical a solution to allow for a genuine independent mortgage.

Detailed study of the Draft Amendments shows that an independent mortgage cannot be qualified as a truly independent security. It is an accessory instrument, but its accessory is extremely weak. The parties may agree that, regardless of the performance of the underlying obligation, the mortgage remains in force to secure other, existing or future, obligations. The security right is not linked to a specific underlying obligation. It is obvious that this type of mortgage greatly facilitates access to credit. But to retain the mortgage after the termination of the underlying obligation is not equal to being satisfied from the cost of the encumbered immovable after the termination of the obligation. In terms of law, the accessory of a security instrument is a general rule while any independence of the security right (as an exception) is to be set out in the law *expressis verbis*.<sup>\*23</sup> Such provision is not made in the Draft Amendments.

The independent mortgage under the Draft Amendments has something in common with the German *Höchstbetragshypothek* (a mortgage with a maximum upper limit). The *Höchstbetragshypothek* is used to secure loans with an indefinite amount of debt. Therefore, in the land register the maximum amount the pledgee can receive is indicated instead of the underlying obligation being specified. However, to exercise a security right, the pledgee will have to prove the existence of this obligation and the amount of the secured debt<sup>\*24</sup>, which means that this instrument is accessory in nature.

<sup>22</sup> For details, see L. van Vliet. The German Grundschuld. – *The Edinburgh Law Review* 2012 (16), p. 2.

<sup>23</sup> See, for example, clause 329 of the Civil Code and the new version of this clause in the Draft Amendments.

<sup>24</sup> В.М. Будилов. *Залоговое право России и ФПГ*. СПб 1993, pp. 45 ff.

## 4. Independence of security rights as an alternative to their accessory

All security rights always fulfil a security function. To present the problem in the simplest way, one can describe a security function as follows. Firstly, by using a security instrument the creditor acquires an additional (to the initial claim against the debtor) source for performance of the underlying obligation. Secondly, the creditor is entitled to use only one of the sources (either initial or additional). Thirdly, this additional facility gives privilege against non-secured creditors of the debtor. The mechanism of such privilege varies, depending on whether the case involves a personal, proprietary, accessory, or independent security, but in any case the position of a secured creditor is more advantageous.

Therefore, to analyse the security function, it is necessary to describe the connection between the underlying obligation and the security instrument. For this purpose, the doctrine traditionally resorts to the categories of accessory and independence. To create an internally consistent system of regulation, one should treat these two categories as mutually exclusive: a security instrument is either accessory or non-accessory—i.e., independent. The absence of accessory means independence, and vice versa.

There are varying degrees of accessory: from very strict (in which case the underlying obligation must be given a detailed description in the security contract—e.g., the contract under which a security right is created—and the security right is terminated with any change of the underlying obligation) to extremely weak (in which case the underlying obligation is described in the security contract in very general terms or not described at all, because it has not yet arisen). But no matter whether the connection between the underlying obligation and the security instrument is strong or weak, it does exist and, consequently, the security right is accessory. Accessory always has two attributes: 1) exercise of a security right is possible if the secured right exists, and 2) the secured creditor is entitled to receive not more than the amount of debt under the underlying obligation at the time of collection.

The independence of the security right has no degrees: either it exists or it does not. On receiving the secured creditor's claim, the independent security provider has no right to declare that the secured right does not exist or exists only in part. This is equally true for the independent personal security<sup>\*25</sup> and for independent proprietary security instruments.<sup>\*26</sup>

It may be difficult to distinguish between accessory security instruments and independent ones, because of terminological confusion. Security rights with extremely weak accessory are sometimes referred to as non-accessory or independent. Accordingly, the classification of mortgages drawn up by experts with the European Bank for Reconstruction and Development includes a mortgage that can be created in the absence of the underlying obligation. The authors of the document refer to such a mortgage as a **mortgage without accessory**. But they explain in brackets that it is impossible to enforce the security right under a 'mortgage without accessory' in the absence of the underlying obligation.<sup>\*27</sup> This means that the accessory of the security, while it may be extremely weak, still exists, and the security provider may put forward objections against the secured creditor's right with respect to the underlying obligation.

The contents of contracts and unilateral juridical acts, along with the rights and obligations arising from them, are to be interpreted in terms of the fundamental difference between accessory and independent security instruments. In Russian practice, the following forms for the text of bank guarantees can be found: 'We undertake to pay on your demand in the amount of [...], provided that the principal is in breach of its obligations under the underlying contract' and 'We undertake to pay on your demand in the amount of [...]. This guarantee is issued in case of violation of the underlying obligation by the principal.' At first sight, it may appear that the details of such documents (the title and the specific language of the document) indicate an intention to issue an independent guarantee (or bank guarantee, as it is referred to in the active Civil Code). However, closer consideration can lead us to a question: what obligations arise from such juridical acts? How should the words 'to pay, provided that the principal is in breach' and 'to pay in the event of violation of the obligation' be treated? The literal meaning of these phrases is that the guarantor undertakes to pay, with

<sup>25</sup> Clause 329 of the Civil Code, Article 5 of UR N 758; A. Pierce. *Demand Guarantees in International Trade*. London: Sweet & Maxwell 1993, pp. 45 ff.

<sup>26</sup> В.М. Будилов (see Note 24), pp. 48 ff; L. van Vliet (see Note 22), pp. 162 ff.

<sup>27</sup> *Ипотека в странах с переходной экономикой. Режим правового регулирования ипотеки и ипотечных ценных бумаг* ['Mortgage in transition economies. The legal framework for mortgages and mortgage securities']. 2008, p. 24. Available at <http://www.ebrd.com/>.

this depending on the factual state of matters with the underlying relationship. This, in turn, means that the guarantor's obligation should be treated as accessory. Insofar as it is accessory that distinguishes an independent guarantee from suretyship—in other words, an independent personal security instrument is a dependent personal security less accessory—obligations arising out of the documents mentioned above can be interpreted as involving suretyships. In this case, the bank, as a security provider, is liable to pay the beneficiary on condition that the underlying obligation has been violated. Unless the bank verifies the existence of violation, the debtor shall not be obliged to reimburse the bank. When one takes into account all the circumstances, the litigation that may arise could be resolved in favour of the principal.

## 5. Can a genuine security be truly independent?

It must be admitted that it was not easy for Russian jurisprudence to adopt the concept of independent security. The idea that it is impossible to combine the security function and genuine independence was developing in two directions.

1. Some lawyers, trying to create a strictly symmetrical legal system, took a simple approach to the problem: independent security is anything but security. Indeed, from the point of view of the civil law, an obligation under an independent guarantee is an obligation to pay. Yet anyone familiar with practice will confirm that an independent guarantee is a security, often a very reliable one. To explain this contradiction, one must consider the whole structure of relations, not only the independent guarantee. The structure always consists of more than two relationships.<sup>\*28</sup> The most common structure includes relations between 1) the parties to the underlying obligation (the debtor and the secured creditor), 2) the debtor and the security provider, and 3) the security provider and the secured creditor. The security function manifests itself not in the relations between the security provider and the secured creditor (as in the case of an accessory security) but in the relations between the parties to the underlying obligation.<sup>\*29</sup> This idea finds support in the law: 'The obligation of the guarantor to the beneficiary **in the relationships between them** shall not depend upon the underlying obligation' (clause 370 of the Civil Code) (emphasis added). The beneficiary's right to demand payment under the guarantee is in no way connected with, or bound by, the underlying obligation under the relationship to the guarantor. But in relations with the principal, the beneficiary has no right to refer to the independence of the guarantee and is bound by the security purpose of the latter. This fact predetermines the final reimbursement to be rendered between the principal and the beneficiary.

2. The line of thought proceeding from the idea that security cannot be entirely independent has found more proponents. For a long time after the Civil Code came into force (in 1995), a reference to the underlying obligation incorporated into the guarantee was often treated as evidence of a legal connection between the two obligations (underlying and guarantor's). This entailed two practical consequences.

Firstly, guarantees may contain conditions that can be complied with only on the basis of full understanding of the relations between the principal and the beneficiary. An example is use of 'the guarantor shall pay under the condition that the underlying obligation has been violated' instead of 'the beneficiary's demand shall be supported by a statement indicating in what respect the underlying obligation is violated'. In UR N 758, this problem is considered in terms of distinguishing non-documentary conditions from documentary ones.<sup>\*30</sup>

<sup>28</sup> If a security instrument is granted by the debtor (for an obvious reason, it involves proprietary security alone) and the framework covers only the underlying contract and the contract for proprietary security, the secured creditor in any event is unable to cite independence as a legal attribute. The creditor's unjust claim shall be blocked by the debtor's reference to the principle of good faith and fair dealing.

<sup>29</sup> Independent proprietary security instruments may be included in another framework, which requires special consideration. It can be assumed that the conclusion (i.e., that the security function manifests itself not in the relations between the security provider and the secured creditor but in other relations) from the analysis of personal security instruments can be applied also to the independent proprietary security, if any.

<sup>30</sup> UR N 758, Article 7, 'Non-documentary conditions': 'A guarantee should not contain a condition other than a date or the lapse of a period without specifying a document to indicate compliance with that condition. If the guarantee does not specify any such document and the fulfillment of the condition cannot be determined from the guarantor's own records or from an index specified in the guarantee, then the guarantor will deem such condition as not stated and will disregard it except for the purpose of determining whether data that may appear in a document specified in and presented under the guarantee do not conflict with data in the guarantee.'



Secondly, guarantors, encouraged by their principals, may refuse to pay on the pretext of the absence of violation of the underlying obligation. For a long time after the appearance in our civil law of norms regulating bank guarantees, courts actively defended the principal's interests. If the beneficiary filed claim against the guarantor with the court and the latter (usually after a lengthy examination) found out that at the time of the beneficiary's demand there was no violation as stated in the demand, the court would reject the claim of the beneficiary on grounds of abuse of the right by the latter.<sup>\*31</sup> In fact, in such cases independent guarantees were treated as dependent—i.e., as suretyship—with the only difference being that in making their judgements the courts addressed rules of good faith and fair dealing rather than norms on suretyship.

Recently, the practice has changed. Decision of the Supreme Arbitration Court of the Russian Federation N 6040/12, of 2.10.2012, may be seen as exemplary.<sup>\*32</sup> The bank (the guarantor) refused to pay on the client's (beneficiary) demand, stating that the contractor (the principal) had not violated the contract and was not liable to return the advance payment to the client. With reference to clause 370 of the Civil Code and UR N 758, the court obliged the guarantor to pay, emphasising that: 'only circumstances connected with failure to meet the terms of the guarantee *per se* can be recognised as grounds for refusal to satisfy the claim of the beneficiary.'

So, in following of the legislators' lead, the existence of independent personal security has been accepted by the courts.<sup>\*33</sup>

## 6. Independence versus abstraction

Semantically, independence and abstraction are concepts that are close in their meanings. There is something in common between the legal concepts 'independent obligation' and 'abstract obligation', since both of them describe the absence of any essential link between an obligation and a particular legal phenomenon.<sup>\*34</sup> Independent and abstract obligations are both exceptions to the general rule. Their existence is possible only by force of an express provision in the law.

Russian legal tradition employs the term 'independence' for analysing security structures, with accessory seen as an alternative to independence, whereas the term 'abstraction' is used for describing the relationship between an obligation and the grounds from which it arose, with 'causality' as its alternative.

In the theory, there are differences in the regulation of independent obligations and abstract ones. But whatever the differences, the ultimate result will be the same: a debtor shall be bound to lose the right of objection to the demand of a creditor. Thus, a debtor under an independent obligation is not entitled to raise an objection with regard to the underlying obligation<sup>\*35</sup>, while a debtor under an abstract obligation has no right to raise an objection with respect to the grounds for such obligation.<sup>\*36</sup>

Clause 370 of the Civil Code contains a direct provision referring to the independence of a bank guarantee. There is no reference to the abstraction of the latter in the Civil Code. A bank guarantee would be abstract if its force did not depend on the grounds for its issue. The grounds for issuing a guarantee lie in an agreement between the principal and the guarantor. The Civil Code does not contain an express statement that the guarantee is not connected with the agreement. Therefore, *de lege lata* the obligation of a guarantor to pay on demand depends on whether the agreement is valid.

<sup>31</sup> See Letter of the Supreme Arbitration Court N 27's item 4 and Information Letter of the Presidium of the Supreme Arbitration Court N 29 (of 16 February 1998), 'Review of the practice of settlement of disputes involving foreign persons', item 3.

<sup>32</sup> This decision gives special notice that earlier judgements of courts of arbitration on similar cases may be reconsidered on grounds of new findings.

<sup>33</sup> In addition, the decision contains the important conclusion that the terms of a bank guarantee should be interpreted in favour of the creditor (beneficiary) in order to preserve security. The Court emphasised the priority of a creditor's interests. This is especially important for Russian law since it has long been oriented toward protecting the debtor as the weaker party to an obligation.

<sup>34</sup> The concept of the abstract obligation formed in Russian law under the influence of the German pandectic doctrine. See, for example, А.С. Кривцов. *Абстрактные и материальные обязательства в римском и в современном гражданском праве* [Abstract and material obligations in Roman and modern civil law]. Москва: Статут 2003, pp. 124 ff.; Ю.С. Гамбаров. *Гражданское право: Общая часть* [Civil law: General part]. Москва: Зерцало 2003, pp. 709 ff.; В.М. Хвостов. *Система римского права* [System of Roman law]. Москва: Спарк 1996, pp. 170 ff.

<sup>35</sup> Clauses 370 and 376 of the Civil Code, Article 20 of UR N 758.

<sup>36</sup> See, for instance, the Geneva Convention on Bills of Exchange, Annex 2, Article 16.

To strengthen a beneficiary's position, the authors included in the Draft Amendments clause 370 of the Civil Code in a new wording: 'An obligation of the guarantor to the beneficiary, stipulated by the bank guarantee, shall not depend in the relationships between them on the underlying obligation, on the relationships between the principal and the guarantor or on any other obligations, even if the guarantee contains references to them.'

When and if this new rule finds its way into the Civil Code, a bank guarantee will be not only an independent but also an abstract obligation under Russian law.

## 7. Conclusions

The bank (independent) guarantee is the only independent security right known under Russian law. It follows the model of the ICC Uniform Rules for Demand Guarantees with one significant distinction, arising from the intention of the legislator to create additional obstacles to abuse by beneficiaries. The independent mortgage envisaged by the Draft Amendments cannot be qualified as a truly independent security. It is a security instrument with weak accessory.

When there are varying degrees of accessory (from very strict to extremely weak), the independence of the security right has no degrees (it either exists or does not). To create a coherent regulatory system, the categories 'accessory' and 'independence' should be treated as incompatible. The absence of accessory means non-accessory—i.e., independence. And vice versa.

The independent security instruments should be considered genuine security. Their specificity is that the security function manifests itself not in the relations between the security provider and the secured creditor (as is the case with an accessory security) but in the relations between the parties to the underlying obligation.

In theoretical terms, there are differences between the regulation of independent obligations and abstract ones, but, from a practical point of view, the ultimate result will be the same: the debtor has to lose the right of objection against the creditor.