



Lloyd's Shipping Economist's Inaugural Developments in Russian Shipping

Russian Ship Registration and other recent developments in Russian Shipbuilding and Merchant Shipping

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1. INTRODUCTION AND BASIS OF INFORMATION

1.1. Background

The present report is dedicated to certain matters concerned with Russian merchant shipping and represents a general overview of shipping and shipbuilding industries in Russia. The primary purpose of this examination has been to identify the current state, potential perspectives and problems of the above industries nowadays. The information contained in this report is intended for the use on the Lloyd's Shipping Economist Inaugural Conference which shall take place 10th – 11th September 2007 at Corinthia Nevskij Palace, St Petersburg.

The findings set out below are based on independent research of current Russian legislation, official news and announcements made by the Russian state authorities.

This report is not intended to be relied on in any specific set of circumstances nor to be used as a basis for any management decision.

2. THE CURRENT STATUS OF THE RUSSIAN INTERNATIONAL SHIP REGISTRY

2.1. Russian Ship Registries

Pursuant to merchant shipping legislation a vessel in Russian Federation is subject to registration in one of the following ship registries:

- State Ship Registry;
- Ships Book;
- Bareboat Charter Registry; and
- Russian International Ship Registry ("RISR").

State ship registry includes all motor vessels with main engines power not less than 55 kilowatts and non-self-propelled crafts with tonnage not less than 80 tons.

Ships book includes all sports and voyage vessels and all other vessels not covered by State ship registry.

Bare-boat registry includes foreign vessels bareboat-chartered to Russian entities which vessels therefore obtain the right to fly Russian flag.

Russian International Ship Registry is quite a new ship registry in Russian merchant shipping practice and requires more detailed description.

2.2. General Information on RISR

A Russian law № 168-FZ "On amendments to particular legal acts of the Russian Federation in connection with formation of the Russian International Ship Registry" has come into legal effect (the official date of publication being on 23 December 2005).

This law amends several Russian legal acts including the Commercial Shipping Code (the most essential act regarding Russian shipping activity) and the Tax Code. It provides a legal base for the creation of the Russian International Ship Registry as well as some benefits for the use of this new Register.

Once a vessel is brought into the RISR structure it acquires the right of sailing under the flag of Russian Federation.

Only vessels that are to be used in international carriage of cargos, passengers and luggage and in other kinds of international trade can be entered on the RISR. In such a way as a general rule transportation and towage between ports located within the borders of the Russian Federation cannot be carried out by vessels registered in the RISR except for cases expressly provided by international treaties or by the regulations of Russian Federation Government.

RISR represents a unified database which consists of all essential information about the vessels included, but the registration of the vessels in RISR may take place only in the following Russian harbours:

- Arkhangelsk
- Astrakhan
- Vladivostok
- Kaliningrad
- Korsakov
- Murmansk
- Nakhodka
- Novorossisk
- Saint Petersburg
- Taganrog
- Tuapse
- Holmsk

2.3. Purpose of RISR Establishment

The main purpose for the creation of RISR is to increase number and quality of the Russian merchant fleet. It is envisaged that RISR shall provide more favorable conditions for Russian ship-owners presently holding their vessels under foreign flags that shall allow part of vessels to return from foreign registries and also to attract newly-built vessels into Russia.

2.4. Benefits of RISR

Using of the RISR makes available certain benefits for ship-owners:

- import of vessels liable to the registration in RISR is exempt from import VAT;
- VAT rate of 0% applies to sale transactions of newly built vessels liable to the registration in RISR;
- incomes acquired from the use of vessels registered in RISR are exempt from profit taxation (on condition that port of departure and/(or) port of destination are located outside of the Russian Federation's border);
- vessels liable to registration in RISR are also exempted from customs duty;
- vessels registered in RISR are exempted from transport tax and property tax.

Instead of above taxes and duties the ship-owners shall pay only registration duty for initial vessels registration and annual duty for prolongation of vessel's registration in RISR.

2.5. Difficulties Arisen

As at March 2007 over 140 vessels were registered in RISR. All these vessels were transferred into RISR from Russian ship registries. Transfer of the vessels from under foreign flags into RISR could not take place since the Governmental resolution which would regulate procedures for the use by the ship-owners of customs duty exemption was not yet in force.

The relevant Resolution (N 448) was adopted by the Government only on 16 July 2007. But the procedures and terms of inclusion into RISR of the vessels from under foreign flags are still unclear.

RISR is devoid of entire "internationality" which presents in and implied by its denomination. Only vessels owned by Russian entities by right of ownership and/or foreign vessels bareboat-chartered by Russian entities can be registered in RISR. The merchant legislation does not state direct prohibition for vessels owned by foreign entities to be included into RISR. Nevertheless articles 15 and 47 provide general rule under which a vessel shall be excluded from RISR since it ceases to be in ownership of the Russian entity.

Any vessel subject to registration in RISR shall be produced to customs authorities for inspection. This fact may create additional difficulties for ship-owners especially if the vessel is used only outside Russian borders. Transportation of the vessel to the place of inspection may entail expenses disproportionate to the prospective benefits that finally may prevent a ship-owner from RISR registration.

Incomes of ship-owners acquired from the use of vessels registered in RISR are exempt from profit taxation on condition that port of departure and/or port of destination are located outside of the Russian Federation's border. The use of the vessels in such a case means cargo, passenger and luggage carriage, provision of other services concerned with such carriage as well as leasing of such vessels. In practice it is not entirely clear whether profit exemption can be used by only one entity for example by the ship-owner alone or by several entities including ship-owner, bareboat-charterer and time-charterer

(in case of bareboat charter and subsequent time charter). We understand that all entities involved in the use of the vessel registered in RISR are entitled to the profit exemption especially bearing in mind that MSC includes into the notion "ship-owner" all entities exploit the vessel on any legal ground not only by right of ownership. Our main concern with this regard is that Russian Tax Authorities may use a different approach and restrict the use of the profit exemption.

Another doubt concerned with the use of profit exemption arises in case when such exemption shall be used by foreign ship-owner. If a foreign ship-owner bareboat-charters a vessel to a Russian entity this vessel may be registered in RISR. In this case the foreign ship-owner may exempt its income (charter hire) from taxation in the Russian Federation. On the other hand in accordance with Russian tax legislation income of the foreign company acquired from such kind of activity is subject to withholding taxation at the rate of 10% and special provisions dedicated to tax withholding procedures adopted by the Tax Authorities have no reference to the possibility of profit exemption due to the registration of the vessel in RISR. In that way we envisage practical difficulties concerned with the use of profit exemption by foreign companies.

3. SHIPBUILDING DEVELOPMENTS

3.1. General Information on United Shipbuilding Corporation

In accordance with the presidential decree N 394 dated 21 March 2007, the United Shipbuilding Corporation (“USC”) was established as an open joint stock company with its headquarter in St. Petersburg.

USC shall be a fully state-owned company. The share capital of USC will be formed by transferring of monetary assets and shares of several shipbuilding entities to the company.

The establishment of USC envisages number of measures which shall be effected in several stages. Such measures include reorganization of existing, establishment of new shipbuilding, repair and scientific-research entities which will be interrelated in order to create unified shipbuilding holding.

The process of establishment of USC may be provisionally divided into 6 stages.

3.2. Stage 1 – Establishment of USC

First constitutive contribution to share capital of USC includes 60 % shares of OJSC Planning and design bureau Nevskoe (St Petersburg) and monetary assets in the amount of RUR 25 million.

3.3. Stage 2 – Establishment of three Shipbuilding Centers

Three fully state-owned Open Joint Stock Companies shall be created as subsidiary companies of USC. Such companies are:

- OJSC West Shipbuilding Center (with its headquarter in St Petersburg)
First constitutive contribution to share capital of OJSC West Shipbuilding Center includes 100% - 1 share of OJSC Svetlovskoe enterprise ERA (Svetly) and monetary assets in the amount of RUR 25 million.
- OJSC North Shipbuilding and repair Center (with its headquarters in Severodvinsk)
First constitutive contribution to share capital of OJSC North Shipbuilding and repair Center includes 100% - 1 share of OJSC Design bureau Rubin-North (Severodvinsk) and monetary assets in the amount of RUR 25 million.
- OJSC Far East Shipbuilding and repair Center (with its headquarters in Vladivostok)
First constitutive contribution to share capital of OJSC Far East Shipbuilding and repair Center includes 100% - 1 share of OJSC Scientific-research institute Bereg (Vladivostok) and monetary assets in the amount of RUR 25 million.

3.4. Stage 3 – Integration of State Enterprises

State Machine-building enterprise Zvezdochka (Severodvinsk) was renamed into State enterprise Center or ship repair Zvezdochka and the following enterprises were merged into this Center:

- State enterprise Shipyard NERPA (Sneznogorsk)
- State enterprise Research-and-production union VINT (Moscow)
- State enterprise Shipyard of Ministry of defense N 10 (Polyarny)
- State enterprise Shipyard of Ministry of defense N 35 (Murmansk)
- State enterprise Shipyard of Ministry of defense N 82 (Roslyakovo)
- State enterprise Yard of Ministry of defense N 1 (Sochi)
- State enterprise Shipyard of Frontier Service N 5 (Temruk)
- State enterprise Astrakhan Shipyard of Ministry of defense

3.5. Stage 4 – Extension of USC

The following State enterprises shall be reorganized (transformed) into fully state-owned Open Joint Stock Companies:

- State enterprise North planning and design bureau (St. Petersburg)
- State enterprise Central maritime design bureau Almaz (St. Petersburg)
- State enterprise Central design bureau of maritime equipment Rubin (St. Petersburg)
- State enterprise Saint Petersburg maritime bureau of machine-building Malahit
- State scientific-research and design-technological bureau Onega (Severodvinsk)

Then 100% - 1 share of these companies shall be contributed into share capital of USC in return for the additional shares to be issued and distributed by USC in order to increase share capital of USC.

In addition, the following state owned assets:

- 24,49 % shares of OJSC Central design bureau Iceberg (St. Petersburg)
 - 14,99 % shares of OJSC Central design bureau for hydrofoil crafts (Nizhni Novgorod)
- shall be contributed into share capital of USC in return for the additional shares to be issued and distributed by USC in order to increase share capital of USC.

3.6. Stage 5 – Extension of Three Shipbuilding Centres

OJSC West Shipbuilding Center

The following State enterprises shall be reorganized (transformed) into fully state-owned Open Joint Stock Companies:

- State enterprise Admiralty yards (St. Petersburg)
- State enterprise Middle-Neva shipyard (St. Petersburg)
- State enterprise Kronshtadt maritime shipyard (Kronshtadt)
- State enterprise Yard of Ministry of defense N 33 (Baltisk)

Then 100% - 1 share of these companies shall be contributed into share capital of OJSC West Shipbuilding Center in return for the additional shares to be issued and distributed by OJSC West Shipbuilding Center in order to increase its share capital.

In addition, the following state owned assets:

- 20,96 % shares of OJSC Shipyard North Yard (St. Petersburg)
- 33,53 % shares of OJSC Plant Krasnoe Sormovo (Nizhni Novgorod)
- 51 % shares of OJSC Baltic shipyard Yantar' (Kaliningrad)

shall be contributed into share capital of OJSC West Shipbuilding Center in return for the additional shares to be issued and distributed by OJSC West Shipbuilding Center in order to increase its share capital.

OJSC North Shipbuilding and repair Center

The following State enterprises shall be reorganized (transformed) into fully state-owned Open Joint Stock Companies:

- State enterprise Center or ship repair Zvezdochka (Severodvinsk)
- State enterprise North production union Arctic (Severodvinsk)
- State enterprise Special design bureau for electro chemistry with pilot plant (Moscow)
- State enterprise Production union North machine-building enterprise (Severodvinsk)

Then 100% - 1 share of these companies shall be contributed into share capital of OJSC North Shipbuilding and repair Center in return for the additional shares to be issued and distributed by OJSC North Shipbuilding and repair Center in order to increase its share capital.

OJSC Far East Shipbuilding and repair Center

The following State enterprises shall be reorganized (transformed) into fully state-owned Open Joint Stock Companies:

- State enterprise Far East plant Zvezda (Bolshoy Kamen')
- State enterprise Khabarovsk shipyard
- State enterprise Yard of Ministry of defense N 30 (Dunai)
- State enterprise Yard of Ministry of defense N 92 (Vladivostok)

- State enterprise Yard of Ministry of defense N 178 (Vladivostok)
 - State enterprise Yard of Ministry of defense N 179 (Khabarovsk)
 - State enterprise North-East Ministry of defense regional center for repair and utilisation of weapons and defense equipment (Viluchinsk)
- Then 100% - 1 share of these companies shall be contributed into share capital of OJSC Far East Shipbuilding and repair Center in return for the additional shares to be issued and distributed by OJSC Far East Shipbuilding and repair Center in order to increase its share capital.

In addition, the following state owned assets:

- 20 % shares of OJSC Holding company Dalzavod (Vladivostok)
- 10 % shares of OJSC Nikolaevsk-na-Amure shipyard.

shall be contributed into share capital of OJSC Far East Shipbuilding and repair Center in return for the additional shares to be issued and distributed by OJSC Far East Shipbuilding and repair Center in order to increase its share capital.

3.7. Stage 6 – Joining of the Corporation

When all above stages are successfully accomplished 100% -1 share of each Shipbuilding Center shall be transferred into share capital of USC in return for the additional shares to be issued and distributed by USC in order to increase share capital of USC. This sixth stage shall be accomplished not later than 1 January 2009

3.8. Purposes of USC

As a whole overall measures for establishment of United Shipbuilding Corporation shall be completed by 1 April 2009 and as a result Russia shall obtain unified and centralized but at the same time very diversified structure owned by the State for special shipbuilding purposes.

According to the Decrees USC as well as its subsidiaries and related companies shall conduct as priority the following kinds of activity: development, designing, production, supply, warranty and after-sale service, modernization, repair, utilization of shipbuilding equipment for military and civil purposes and installations for continental shelf exploitation for the sake of state and other customers including foreign customers as well as application of new technologies and developments in the shipbuilding field.

Please see below a diagrammatic representation of the proposed structure of USC:

4. STATE SUPPORT OF SHIPBUILDING INDUSTRY

4.1. General Information

Pursuant to Resolution of Federal Soviet at Federal Assembly (upper chamber of Russian Parliament) N 406 SF dated 24 November 2006 in spite of certain measures undertaken by the Russian state authorities for enhancement of domestic shipbuilding this industry suffers from a deep system crisis.

Absence of complex strategy for development of shipbuilding industry and its legislative support negatively affected production, technological, organizational, financial and economic state of the industry.

Main production facilities of most companies have not been renovated for last 20 years their wear-and-tear amounts to 65-70 %. Production and technological bases of shipbuilding companies do not comply with the requirements of modern shipbuilding and cannot ensure production of competitive output.

River, fishing, scientific-research and salvage fleets have exhausted their technical feasibility and subject to replacement for 80 %.

Accumulated indebtedness to federal budget and off-budget funds significantly restrains attraction of the investments, increases costs, decreases profitability and entails financial instability of the industry.

Based on this situation stabilization efforts were recommended to the Government of the Russian Federation. Inter alia it was recommended the following:

- to elaborate the draft law On State support of shipbuilding industry in the Russian Federation as well as to amend current legislation in order to ensure State support for shipbuilding industry;
- to elaborate the perspective plan for strategic development of shipbuilding industry;
- to elaborate federal program "Development of civil shipbuilding in Russian Federation for the years 2008-2016";
- to consider possibility for restructuring of past-due indebtedness of shipbuilding companies to federal budget and off-budget funds;
- to consider possibility for exemption from VAT for import shipbuilding components and technological equipment which are not produced in Russia;
- to consider possibility for establishment of special tax regime for shipbuilding companies;
- to elaborate regulations simplifying financial leasing of domestic river and fishing vessels.

4.2. State and Private Business Collaboration

The State shall support efforts of business directed to application of new effective technologies and production output with high degree of processing. Necessary resources shall be concentrated to directions where Russia has real preconditions for successful competition. Shipbuilding industry is exactly such competitive direction.

In order to ensure competitiveness of civil shipbuilding production in conditions of rapid development of shipbuilding industry throughout the world Ministry of Energy and Industry of the Russian Federation ("*Minpromenergo*") intends to organize and support partnership between the State and private business (so-called VIP projects) for modernization of productive capacities. The State is ready to share all risks related with such projects.

By 2015 output of civil production shall be equal to 34% in total volume of goods output. At that growth in production volume of shipbuilding industry shall be 220 per cent.

For competitive shipbuilding of large-capacity vessels in Russia (tankers, bulkers, and gas-carriers) Russia needs modernization and building of new shipyards in regions with highly developed shipbuilding industry.

26 February 2007 Minpromenergo adopted Order N 50 "On development of productive capacities in shipbuilding industry". This order has initiated collection of projects prepared by private companies for the creation of modern shipbuilding complexes in main shipbuilding regions: West Shipbuilding Center; North Shipbuilding and repair Center; Far East Shipbuilding and repair Center.

4.3. Measures for Development of Shipbuilding Industry

Minpromenergo intends to insert in current Russian legislation series of amendments directed at the development of the shipbuilding industry in the Russian Federation. These amendments provide improvement measures which may be divided into system measures i.e. general measures applicable in many fields of industry and special measures i.e. directed to development of exactly shipbuilding industry. Both kinds of measures bear long-term character and shall be adopted at the earliest possible time.

System measures include:

- Tax exemption from VAT for import equipment analogs of which are not produced in Russia.
- Financing of interest rates for loans of domestic banks as well as financing of expenses concerned with the use of other financial instruments for shipbuilding in Russia.
- Co-financing of investment projects concerned with modernization of productive capacities.

Special measures include:

- elaboration of measures for securing legal priority for development of maritime shelf by Russian industry;
- gradual limitation of the use in coastwise navigation and on internal waterways of foreign vessels and vessels built overseas;
- stimulation of fishing vessels building on domestic shipyards;
- development of financial leasing system for shipping companies acquiring Russian river vessels.

4.4. State Financial Leasing Company

In March 2007 State maritime and river transport agency ("Rosmorrechflot") approved proposal of Association of shipping companies to establish State financial leasing company which shall provide financing for building of new river cargo vessels.

There is a critical lack of new river vessels in the Russian Federation. Nowadays Russian river fleet has more than 29 thousand vessels of various functions. Among them more than 27 thousands (more than 90%) had been built during previous 30 years by more than 100 shipbuilding and ship repair companies in times of Russian Soviet Federative Socialist Republic.

River vessels can work only during navigation season, in Russia that is about 5-6 months per year. The rest of the time vessels are lying idle and in that way pay-back period for such vessels may be equal to the period of exploitation. This creates certain difficulties in financing of river vessels. That is why the idea of establishing of State leasing company has arisen. It is assumed that State leasing company shall built new vessels at its own expense and then provide them on a financial leasing basis to shipping companies.

This scheme has several advantages. Financial leasing doesn't request one-time derivation of significant amount for financing of fixed assets, besides leasing fee is 15 - 25% of total cost of new vessel during its building. In addition tax legislation in respect of financial leasing allows the use of accelerated depreciation that in its turn allows to increase expenses and to reduce amount of property tax.

4.5. State Support of the Financial Leasing Scheme

Minpromenergo has elaborated a strategy on development of shipbuilding industry for the period up to the year 2020. Within the scope of this work a tender for leasing projects in the area of civil shipbuilding shall take place. For this purposes on 9 March 2007 Order of Minpromenergo N 64 was adopted. This document regulates the procedures for the above tender and among others provides that:

- **leasing company** shall be profitable and have satisfactory structure of the balance sheets;
- **objects** of the tender are financial leasing projects which envisage provision on the financial leasing basis of the vessels build in Russia to domestic shipping companies;
- **purpose** of the tender is to make a selection of projects which shall be supported at the expense of federal budget;
- **criteria** for selection are:
 - share of leasing company's own funds in total volume of investments necessary for the project;
 - share of the Russian Federation in the share capital of leasing company;
 - economic effect of the project;
 - number and type of the vessels to be acquired and provided to Russian shipping company on financial leasing basis.

Government's priority is building of river vessels, river-sea vessels, speed cargo-and-passenger vessels, fishing vessels and all kinds of sea vessels. These kinds of water transport will receive the financial aid in the first place.

The use of leasing scheme shall improve financial situation for both shipbuilding companies and ship-owners, moreover it is envisaged that such measures shall allow to bring back into Russian shipyards significant part of shipbuilding orders.

5. PLEDGES (MORTGAGES) IN RUSSIA – BASIC PROVISIONS

5.1. Concept of Pledge

Under the Russian law pledge (mortgage) is a mean of securing the performance of obligations. Pledge represents obligation dependent on principal obligation i.e. to be secured by the pledge. Under general rule the invalidity of pledge obligation shall not entail the invalidity of principal obligation but on the other hand the invalidity of the principal obligation shall entail the invalidity of the pledge obligation.

Pledge (mortgage) relationships in Russia are governed by the following legal acts:

- Civil Code of the Russian Federation (CC of RF);
- Federal law “On mortgage (pledge of immovable property) (Law on mortgage)”;
- Law of Russian Federation “On pledge”;
- Merchant Shipping Code of the Russian Federation (MSC of RF) as regard to ship mortgages.

Pursuant to article 334 of CC of RF by virtue of a pledge the creditor with regard to an obligation secured by pledge (pledgeholder) shall have the right, in the event of the failure of the debtor to perform this obligation, to receive satisfaction from the value of the pledged property preferentially before other creditors of the person to whom this property (pledgor) belongs with the exceptions established by a law.

[Note: For example pursuant to MSC of RF obligations secured by maritime mortgage over the vessel liable to preferential satisfaction before demands following from obligations secured by registered mortgage over the vessel]

The pledgeholder shall have the right to receive on the same principles satisfaction from insurance compensation for loss or damage of the pledged property irrespective of to whose benefit it was insured unless the loss or damage occurred for reasons for which the pledgeholder is liable.

5.2. Grounds for Arising of Pledge

- A pledge shall arise by virtue of a contract.
- Pledge also shall arise on the basis of a law when the circumstances specified therein ensue.

5.3. Object of Pledge

Any property including things and property right (or demands) may be the object of pledge except for property withdrawn from turnover, demands inextricably connected with the person of the creditor, in particular, demands concerning alimony, compensation for harm caused to life or health, and other rights whose assignment to another person has been prohibited by a law.

[Note: In Russian Federation money can not be an object of pledge].

5.4. Demand Secured by Pledge

Unless provided otherwise by a contract, a pledge shall secure a demand in that amount which it has at the moment of satisfaction, in particular, interest, penalty, compensation of losses caused by the delay of performance, and also compensation of necessary expenses of the pledgeholder for maintenance of the pledged thing and expenses relating to recovery.

5.5. Mortgage as a Kind of Pledge

A pledge of land plots, enterprises, buildings, installations, apartments and other immovable property (mortgage) shall be regulated by Law on mortgage.

The general rules on pledge contained in the CC of RF shall apply to mortgage in the instances when other rules have not been established by the CC of RF or by the law on mortgage.

5.6. Mortgage Over the Vessel

According to article 130 of the CC of RF to immovable things (immovable property) also shall be relegated aircraft and seagoing vessels subject to State registration, vessels of internal navigation, and space objects.

Moreover article 5 of the Law on mortgage expressly relegates aircraft and seagoing vessels, vessels of internal navigation to the kinds of property which can be object of mortgage governed by the Law on mortgage.

But also the MSC of RF has entire Chapter XXII "Maritime mortgage over the vessel and Mortgage over the vessel or over the vessel under construction" which dedicated to the matters of mortgages over the vessels.

The MSC of RF consist of a provision under which all relationships including property relationships originated from merchant shipping shall be governed by the MSC of RF. And only property relationships not regulated by the MSC of RF directly are subject to the regulations of the CC of RF and other civil law provisions.

Since the MSC of RF is a special act purported to govern relationship originated from merchant shipping it has legal priority for governing overall merchant shipping relationships including matters of mortgages over the vessels.

5.7. Maritime Mortgage Over the Vessel

By means of maritime mortgage over the vessel only the following demands to the ship-owner can be secured:

- in respect of salary and other amounts due to ship master and the other members of the crew for their work aboard the ship including costs on repatriation and social insurance payments to be paid on behalf of ship master and the other members of the crew;
- in respect of compensation for harm caused to life or health on land or on water in direct connection with the exploitation of the ship;
- in respect remuneration for the salvation of the ship;
- in respect of harbor and channel duties, duties on the other navigational routes and pilot fees;
- in respect of compensation for real loss caused during exploitation of the vessel as a result of loss or damage of the property other than cargoes, containers and passengers' stuff carried on that vessel.

These claims cease to be secured by maritime mortgage and lose priority if the vessel is not arrested within one year of the accrual of the claim.

5.8. Preferential Satisfaction of Demands Secured by Maritime Mortgage

Demands secured by maritime mortgage over the vessel are liable to preferential satisfaction before demands following from obligations secured by registered mortgage over the vessel. None of demands is liable to preferential satisfaction before demands secured by the maritime mortgage over the vessel except for demands concerning compulsory sale of sunken vessel.

In case of compulsory sale of sunk vessel salvaging of which has been performed by harbor authorities in efforts to ensure safe navigation or prevent environment pollution the vessels salvaging expenses shall be paid at the account of the facilities gained from her sale prior to satisfaction of any demands secured by sea mortgage over the vessel.

5.9. Language of a Contract in the Russian Federation

In accordance with the Law of RF “On official language of Russian Federation” Russian language is liable to compulsory use in relationships between companies of all form of ownership.

In addition pursuant to the Law of RF “On languages of Russian Federation nations” Russian language shall be used:

- in work of state authorities, organizations, enterprises and institutions;
- in official paper work;
- in official correspondence.

But nevertheless Law of RF “On languages of Russian Federation nations” also provides that paper work in field of commercial activity can be carried out in any languages provided by contracts between business partners.

Regulations on accounting and accounting statements preparation in Russian federation provide that documentation of property, liabilities and other facts of economic activity, keeping of accounting registers and accounting statements preparation shall be carried out in Russian language. All basic accounting documents compiled in other languages must have Russian translation per line.

Following from the above provisions it appears that contract between Russian entity and foreign partner can be executed in foreign language, but anyway it has to be supplied with Russian translation. In business practice in the purposes of convenience it is usually used to issue documents between Russian and foreign companies in dual language in the same document.

5.10. Currency of Monetary Obligation in the Russian Federation

Pledge (mortgage) is a secondary obligation which follows for and has no power without principal obligation. Usually pledge (mortgage) secures monetary obligations.

Under general rule monetary obligations in the Russian Federation must be expressed in Russian Roubles. Nevertheless it may be provided in a monetary obligation that it shall be subject to payment in roubles in an amount equivalent to a determined amount in foreign currency. The above rule is compulsory applicable to Russian residents (Russian entities) in other words settlements in foreign currency between Russian entities are not permitted.

The use of foreign currency when effectuating the settlements on the territory of the Russian Federation shall be permitted in the instances and on the conditions determined by Law “On currency regulation and currency control”. This law prohibits the use of foreign currency in settlements between Russian residents. Settlements in foreign currency between Russian residents and Non-resident as well as settlements between Non-residents on the territory of the Russian Federation are permitted.

In such a way principal obligation as well as securing obligation (pledge or mortgage) can be denominated in foreign currency.

Theoretically Russian law allows debts denominated in foreign currency to be enforced and collected in that foreign currency (subject to compliance with currency control regulations). However, this rule is unlikely to apply to a public sale of the vessel in Russia which is an internal sale and therefore the sale proceeds have to be collected in roubles. The case may be different when the mortgaged vessel is purchased by foreign entity. In such a case foreign purchaser will have a right to transfer foreign currency into Russia in

return for the vessel with no restriction. Then foreign mortgagee will be able to receive sale proceeds in foreign currency at once. Anyway a foreign mortgagee should bear in mind the above possibilities when the bailiffs distribute the sale proceeds and insist that the proceeds be distributed to him in the foreign currency. If this is not done the foreign mortgagee will have to accept the sale proceeds in roubles for which purpose it will have to open a special rouble bank account with a Russian bank. At present such rouble sales proceeds remitted to such Russian bank account are freely convertible into foreign currency and the foreign currency proceeds are freely transferable abroad. Under new legislation the Central Bank retains certain powers to impose restrictions on convertibility of Roubles into foreign currency and, potentially, on the transferability of foreign currency abroad.

5.11. Registration of the Mortgage Over the Vessel

Pursuant to CC of RF (art. 339) a contract of pledge must be concluded in written form. According to article 10 of Law on mortgage mortgage contract shall also be concluded in written form and subject to state registration.

A contract on mortgage must be registered in the procedure established for the registration of transactions with the respective property.

[Note: In accordance with art. 131 of CC of RF the right of ownership and other rights to a thing in immovable things, limitations of these rights (including mortgage) the origin thereof, transfer, and termination shall be subject to State registration in a unified State register by justice institution].

But the Law "On state registration of rights to an immovable property and transaction therewith" excludes vessels from the property to be registered in accordance with its provisions.

Therefore mortgage registration over the vessels shall be carried out based on provisions of MSC of RF. In accordance with the above code the vessel shall be registered in one of the following registers:

- State Ship Registry;
- Ships Book;
- Bareboat Charter Registry; or
- Russian International Ship Registry

Mortgage over the vessel shall be registered in the registry of basic vessel's registration.

Right of ownership and other rights to immovable property, as well as limitations (encumbrances) of these rights (mortgage, trust management, etc.) shall be registered in State Ship Register or Ship Book.

Right of ownership and other property rights to a vessel registered in Russian International Ship Register as well as limitations (encumbrances) of these rights (mortgage, trust management, etc.) shall be registered in Russian International Ship Register except for such rights, limitations (encumbrances) of these rights to a vessel chartered under bareboat charter.

A vessel under construction also can be the object of the mortgage. Mortgage over the vessel under construction shall be registered in the registry of the vessels under construction where initially the vessel under construction was registered.

Mortgage over the foreign vessels which is temporarily provided with the right to sail under the Russian flag as well as mortgage over the vessel under construction is being built for foreign recipient can not be registered in the Russian Federation by way of primary registration but these mortgages can be noted in respective Russian registry. Such secondary registration constitutes public notice of the existence of such mortgage.

Registration of the vessel shall be carried out by the master of Maritime Merchant Harbour or by the master of Maritime Fishing Harbour (for fishing vessels).

The state registration duty at the moment amounts to RUR 7500.

The failure to comply with the form and registration rules shall entail the invalidity of the mortgage contract.

5.12. Enforcement of a Russian Ship Mortgage

In order to enforce a mortgage in Russia the vessel must be arrested first. Arrest is any detention of the vessel or movement limitations imposed onto the vessel while the vessel is within jurisdiction of the Russian Federation. Arrest is ordered by the court (arbitration court or commercial arbitration court) on the basis of a claim giving rise to a right of arrest, which includes claims arising out of the mortgage (as well as claims of suppliers, charterers and a broad range of further claims).

In accordance with CC of RF (art. 348, 349) execution may be levied on mortgaged property in order to satisfy the demands of the mortgagee in the event of failure to perform of the improper performance by the debtor of an obligation secured by the pledge for which he is liable.

The demand of the mortgagee shall be satisfied from the value of pledged immovable property by decision of a court.

The satisfaction of the demand of a mortgagee at the expense of the mortgaged immovable property without recourse to a court shall be permitted on the basis of a notarially certified agreement of the mortgagee with the mortgagor concluded after the grounds arise to levy execution on the object of pledge. In this case the mortgaged property shall be sold out on the auction organized by the mortgagee or mortgagee may acquire mortgaged property and set-off purchase price against principal obligation.

[Note: Russian law provides one more opportunity for satisfaction of the demand of a mortgagee without recourse to a court. By agreement of the parties principal obligation may be terminated by granting "release-money" in place of performance (this may be transfer of the mortgaged property to the mortgagee instead of performance of principal obligation)].

Mortgaged property on which execution is levied by decision of a court shall be sold by means of public sale. Public sale shall be organized and carried out by the state authorities that are in charge of enforcement of court decisions. Public sale shall take place at the whereabouts of the mortgaged property.

Organizer of public sale shall advertise on date, time and place of public sale in official periodical press not later than 30 days and not earlier than 60 days up to public sale.

Entities intend to participate in public sale shall pay deposit in amount which can not exceed 5% of initial sale price. The deposit shall be returned if an entity does not win public sale. The entity won public sale shall within five days pay the rest of purchase price and then within another ten days a purchase sale contract shall be concluded.

If a public sale fails a repeated public sale take place within one month after initial public sale. Initial sale price shall be decreased by 15%. If repeated public sale also fails a mortgagee obtains a right to purchase pledged property at the price 25% lower than initial sale price and to set-off this sale price against principal obligation. If a mortgagee ignores this right a mortgage shall cease.

Thus in order to levy execution on mortgaged property an entity shall pass through the following stages:

- **obtaining court decision.** Statutory deadline for arbitration court cases in the Russian federation is three months. State duty amounts based on the amount of claim. If claim amount exceeds RUR 1 000 000 state duty shall amounts to RUR 16 500 plus 0,5% of amount exceeding RUR 1 000 000 but always subject to a

minimum of RUR 100 000. A court decision comes into effect in one month and after this period a writ of execution shall be issued.

- **organization of public sale.** Public sale shall be organized and carried out by state authorities in charge of enforcement of court decisions based on writ of execution. Any writ of execution shall be executed within two months.

In such a way theoretically deadline for enforcement of a Russian ship mortgage shall be equal to six months. On practice this deadline may be much longer because of the following:

- in Russia procedural deadlines are often violated and no assurance can be obtained with this regard. Besides procedural deadlines may be extended in case a court case involves foreign entities;
- a court case may be subject to commercial arbitration which decision must be approved by state arbitration court – it takes one month more. Statutory deadline for commercial arbitration court cases is different and may be equal up to six months;
- a court case may be subject to non-Russian jurisdiction. In this case foreign court decision shall be acknowledged by state arbitration court – it also takes one month more.

5.13. Priority of Claims Against the Vessel

In regard to the treatment of the priority of various claims against the Vessel upon enforcement, Russian law is favourable to the mortgagee. The mortgagee ranks ahead of all claims except:

- Claims by port authorities for salvage where the vessel is a sunk wreck;
- Claims secured by maritime mortgage;
- Claims secured by a shipbuilder's lien or ship repairer's lien.

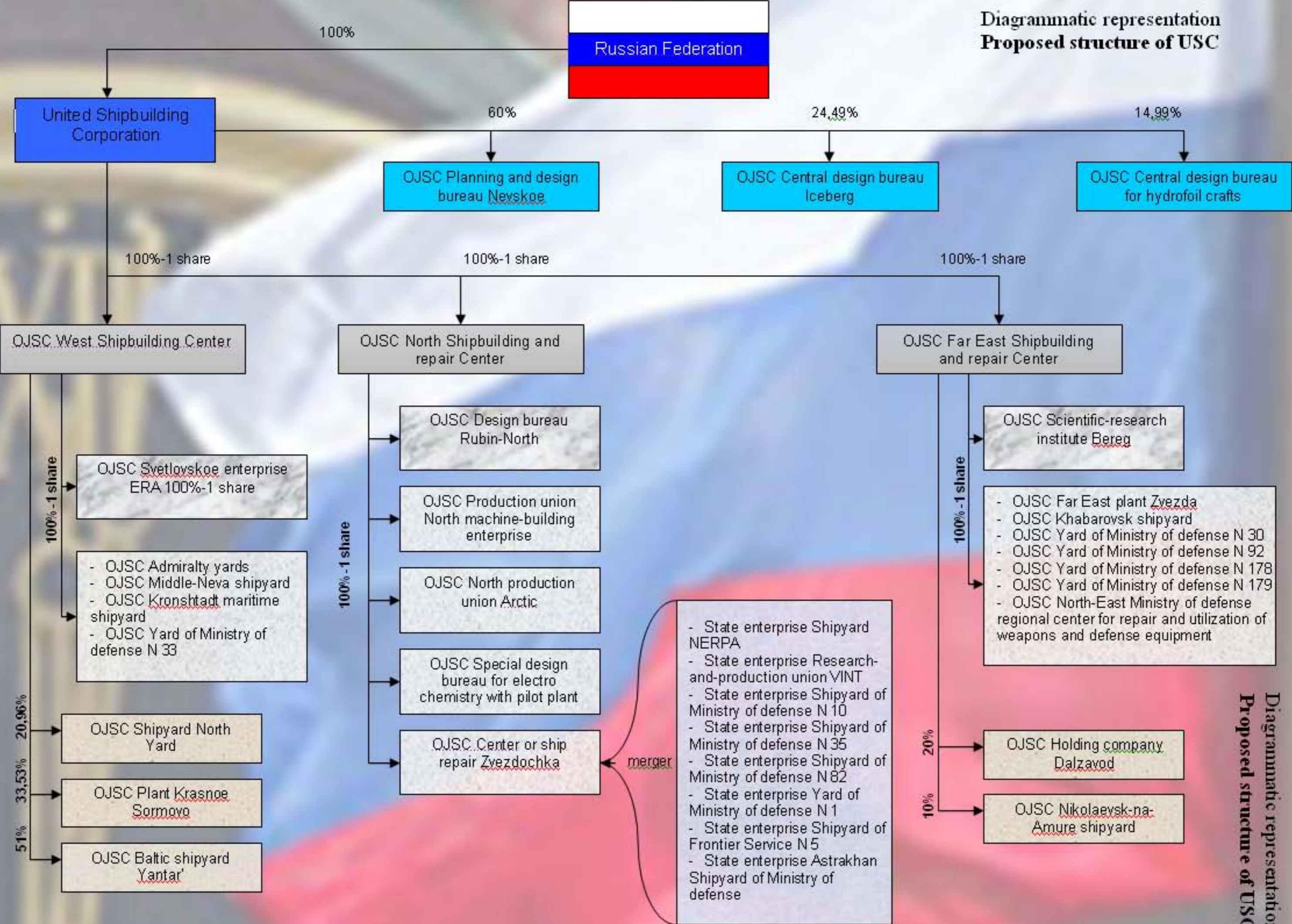
5.14. Levying Execution on the Mortgaged Property Under Insolvency of the Mortgagor

When liquidating a legal entity the demands of its creditors shall be satisfied in the following priority:

- in first priority the demands of citizens to whom the legal entity being liquidated bears responsibility for the causing of harm to life or health by means of capitalizing the respective time payments shall be satisfied;
- in second priority accounts shall be settled with regard to the payment of severance benefits and the payment for labour with persons who work under a labour contract, and with regards to the payment of remuneration under authors' contracts;
- in third priority the indebtedness relating to obligatory payments to the budget and extra-budgetary fund shall be paid;
- in fourth priority the indebtedness relating accounts shall be settled with other creditors.

Demands of creditors relating to obligations secured by the mortgage of property of the legal entity being liquidated shall be satisfied at the account of monetary assets acquired from the sale of mortgaged property preferentially before the other creditors, except for obligations to first and second priority creditors whose rights of demands has arisen before mortgage origin.

**Diagrammatic representation
Proposed structure of USC**



Diagrammatic representation
Proposed structure of USC