

AMERICAN UNIVERSITY OF CENTRAL ASIA  
INTERNATIONAL AND BUSINESS LAW DEPARTMENT

Legal aspects of foreclosure upon immovable pledged property and sale  
of the pledge in the Kyrgyz Republic

Written by: Takhmina Lolakova

Supervisor: Omuraliev S

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**Abstract**

In this paper will be discussed issues and challenges of foreclosure of the real estate (apartments, houses) under credit contract in the Kyrgyz Republic. The legislative base that regulates this type of relationship does not provide sufficient protection of parties from the risks. Moreover, the laws that regulate pledge relations contradict to each other and those contradictions can cause invalidation of the auction proceedings. There is no distinction between the assessment, preparation and procedure for public auction in case of foreclosure of the collateral. The economic position of the Kyrgyz Republic requires improvement, and this can be reached by providing credits to the citizens. And one of the efficient types of providing credit is securing it with the pledge. This type of securing becomes more demandable from year to year; therefore pledge institution needs amendments to work efficiently.

## Introduction

Micro-financing is a part of the global financial sector as it provides credit to people who need money for their business. Usually the easiest way to get money for one's business is to get it from banks. Banks have different systems for providing loans, but one of the most guaranteed is secured loans under the pledge. The bank provides credit and it takes as a pledge the property of the debtor. The pledge is one of the ways to guarantee the performance of obligations. The client transfers the ownership right to bank and if the client does not fulfill its obligation, the bank becomes the true owner of the client's property. These types of loans are very safe because in any circumstances banks will be able to take the sum of given credit back through judicial and extrajudicial ways.

Obtaining credit as a secured loan is one of the safest transaction, however not all of the debtors realize consequences of that transaction. The problem is that many debtors do not realize that in case of not returning credit they will lose their property and clients who pledged their only property will suffer a lot. As the only way to return their property, debtors try to find violations in the documents, foreclosure proceedings and sale of the pledge to stretch the time. Reviewed cases showed that there are many violations in pledge institution, which is illustrated in the following table:

Courts	Number of cases	Violations		
		Civil procedural code	terms	Civil code, law "on pledge", law "mortgage"
Bishkek city	130	101	23	94
Chuy region	77	31	14	46
Osh region	94	250	2	200
Jalal-Abad region	106	290	1	241
Batken region	18	54	1	46
Issyk-kul region	16	14	-	4
Naryn oblast	17	27	1	22
Talas oblast	9	10	-	16
Overall	467	777	42	669

\*Reviewed cases of the Supreme Court of the Kyrgyz Republic in 2001.<sup>1</sup>

Within this thesis work, my goal is to explain the concept of the pledge institution including its benefits and potential dangers to both creditors and banks. Also, during my research I will give practical recommendations as how to avoid risky consequences with signing credit and pledge agreements.

While writing this research was used following methods: analysis, synthesis, comparative law, case review. The work became a result of deep analysis and study of foreclosure and sale of the pledge of the Kyrgyz Republic. Moreover, the work compares foreclosure proceedings of the Kyrgyz Republic with Russian Federation and Republic of Kazakhstan. In order to illustrate the weaknesses of the pledge institution was used and analyzed famous cases on foreclosure of immovable property in Kyrgyzstan.

This work consists of two chapters. The first Chapter focuses mainly on the history of the establishment of the pledge institution. The core of Chapter 1 is to give definitions and nature of the pledge. Moreover, this Chapter will discuss the process of issuing credit, signing credit pledge contracts and the consequences of taking those obligations. This section will explain not only the essential conditions of the credit pledge contract, but also the process of foreclosure upon immovable pledged property in the Kyrgyz Republic both for judicial and extrajudicial ways.

Chapter 2 includes an identification of problems related to the implementation of the institute of a pledge, judicial and extrajudicial foreclosure. In the process of identifying issues in the pledge institution, the paper will examine cases focusing on the problems of foreclosure.

The purpose of this work is that based on comprehensive analysis of existing legal approaches to loan, analysis of state regulations on pledge and judicial review to offer legal

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<sup>1</sup> Postanovlenie Plenuma Verkhovnogo Suda KR “ Razreshenie sporov, svyazannih s zalogovimi obyazatelstvami ” of 25 sentyabria, 2001g., abz.7 p.2 [Part 2, Section 7 of the Kyrgyz Republic Supreme Court Plenary Ruling on Selected Issues of Pledge Relations of Sep. 25,2001], Biulleten’ Verkhovnogo Suda KR[BVS] [Bulletin of the Supreme Court of the Kyrgyz Republic] 2001, p.1.

advice to improve pledge institution, because the laws that regulate pledge relations are in contrary to the Law “On pledge” that leads to the invalidation of foreclosure upon pledged property.

## **Chapter I. Loan, pledge and the process fulfillment of obligation by pledged property**

### **1.1. Credit relations and Secured agreement.**

According to the Article 296 of the Civil Code of the Kyrgyz Republic “By means of an obligation, one person (obligor) shall be obliged to commit a certain action in favor of the other person (obligee) such as: to transfer property, to perform work, to pay money and so on, or to restrain from a certain action, and the obligee shall have the right to demand performance from the obligor.”<sup>2</sup> There are different grounds for emerging obligation. It can emerge from contract; as a result of creating works of science, art or other results of intellectual activity; as result of damage to another person and etc.<sup>3</sup> In case of providing credit, obligation emerges from contract relations between bank and a client.

This kind of contract concluded between parties is named a secured transaction. Generally, “a secured transaction is a credit transaction in which the lender acquires a security interest in collateral owned by the borrower and is entitled to foreclose on or repossess the collateral in the event of the borrower's default.”<sup>4</sup> Consider the example, when a borrower purchases a car on issued credit. If the borrower fails to return the taken credit on time, the lender will resell car using foreclosure procedure.

According to the Article 319 of the Civil Code of Kyrgyz Republic there are several types of secure obligation such as: penalty, pledge, retention of the debtor's property, surety, bank

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<sup>2</sup> Grazhdanskii Kodeks Kirgizskoi Respubliki [GK KR] [Civil Code], art. 296 (Russ.), translation took from <http://www.toktom.kg>. (Official online versions of legislation).

<sup>3</sup> Id, at Art.297

<sup>4</sup> "Creditors' Rights and Secured Transactions." National Paralegal College. [nationalparalegal.edu/public\\_documents/courseware\\_asp\\_files/businessLaw/Bankruptcy/CreditorsRights.asp.html](http://nationalparalegal.edu/public_documents/courseware_asp_files/businessLaw/Bankruptcy/CreditorsRights.asp.html) (accessed March 5, 2013).

guarantee, deposit and other methods.<sup>5</sup> These types of fulfilling obligation guarantee performance of the principal obligation and encourage the debtor to conduct properly.<sup>6</sup> This research will review the obligation secured by a pledge. The important aspect of the pledge as securing obligation is that the creditor-pledgee acquires the rights to get satisfaction through the pledged property prior to other creditors when the debtor fails to perform obligation under the contract.<sup>7</sup> Before providing the credit, the bank signs a credit contract with a potential debtor. Credit contract is one of the types of contract of loan. "Under a credit agreement, a bank or any other lending organization (creditor) shall grant funds (credit) to the borrower in the amount and based on the terms provided by the agreement, and the borrower shall return the amount of money lent and pay interest thereon."<sup>8</sup>

"One of the characteristic features of an effective financial system is that the lender provides a loan secured on a lower interest rate than in the case of an unsecured loan, as collateral (pledged assets) creates a sense of security to the lender. The interest rate of a loan requested by the pledgor, depends in part on their assessment of the risks of granting the loan. If the type of the collateral reduces the risk of non-repayment of the loan, the lender can reduce the rate of interest in the provision of this loan. In other words, the goal is to create a two-level system of interest rates, which implies a lower interest rate in the case of a secured loan, and higher if the loan is not secured. Alternatively, the lender may grant a loan for a larger amount in the event that this loan is secured, compared with an unsecured loan, again because of the sense of security that gives the lender collateral (security). In the world there are quite inefficient systems of secured financing system under which the lender takes the borrower's collateral, but still do not feel secure in the deal at the expense of the said deposit. In terms of inefficient

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<sup>5</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 319 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>6</sup> Hametov, R, and O Mirnova. "Securing of fulfillment of obligation: Contractual Means." In *Contracts*. 5 ed. Moscow: Russian justice, 1996. 18-20.

<sup>7</sup> Fadeeva, T. "Types of securing obligation." In *Civil law*. 5 ed. Moscow: Prospekt, 2001. 570.

<sup>8</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 734 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

systems of secured financing pledgor establishes the same interest rate loan, and provides the same amount of the loan as if it were an unsecured loan.”<sup>9</sup> Therefore bank secures contract and one of the best way is taking the collateral.

In banking practice it is used to name credit contract as loan agreement that is equivalent to the terms “credit” and “loan”. However, it contradicts to the nature of the loan agreement. Under Article 610 of the Civil Code of the Kyrgyz Republic “under loan agreement or a contract on gratuitous use, the lender undertakes an obligation to transfer or shall transfer a thing for gratuitous temporary use to the borrower and latter undertakes an obligation to return the said thing in the same condition as received.”<sup>10</sup> As can be seen from the given definition, a loan agreement has two essential characteristics which are gratuitousness and assignment of things, but not money. On the other side, the object of transfer in a credit contract can be only cash assets on onerous basis. Professor and PhD in law Bulateskiy U. states that in the economic literature the terms "loan", "credit" and "loan under contract on gratuitous use" are treated as synonyms, which however flaws and distorts the essence of civil law.<sup>11</sup>

The main feature of credit relations is that only banks and any other lending organization have right to issue credit based on the license that permits to practice such kind of banking operations.<sup>12</sup> Credit relations take shape only after conclusion of credit agreement. However, before concluding a contract, bank or other lending organization checks creditability of the client.

Potential borrower provides documented application which includes earmarked credit, amount of asked credit and credit payment term. After accepting application on providing credit supported by documents, the bank carefully reviews the credit worthiness of the borrower, determines his ability and willingness to return a requested loan. In other words, banks check

<sup>9</sup> Pravo I Predprinimatelsto, #2-3, 1998.

<sup>10</sup> Grazhdanskii Kodeks Kirgizskoi Respubliki [GK KR] [Civil Code], art. 610 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>11</sup> Bulateskiy, U, and V Yazev. "Credit Contract." In *Commercial (Trade) Law*. Moscow: ID FBK-PRESS, 2002. 487.

<sup>12</sup> Zakon KR “O Bankakh i Bankovskoy Deyatelnosti” [Law of the Kyrgyz Republic “On banks and banking activity”], art.18 (Russ).



legal capacity, reputation of the borrower, asset ownership (property and property rights of the borrower) and possibility to provide a requested loan in the economic conditions of the state.<sup>13</sup>

When providing credit, banks strive for reliable clients who would be able to fulfill their obligations under credit contract. The legal capacity of the borrower (for example, for physical person age is over 18, for legal entity registration and etc.) is determined not only to define whether borrower is able to repay requested loan but also to confirm his capacity to receive credit. The credit history plays a big role in providing a credit by bank. The credit history means not only the capacity to return a loan, but also the desire to fulfill all obligations of credit contract by debtor willfully. Before providing a credit banks check potential borrower in database; it checks whether the potential client has a good history.

As time comes to conclusion of credit contract certain requirement to the form of agreement is prescribed by law. The contract must have written form and failure to comply with the written form of agreement shall entail its invalidity.<sup>14</sup> Consequently, an oral loan agreement will have no legal consequences upon the parties. Such a contract is void from the time of its conclusion therefore each party shall return to the other everything acquired in the transaction.<sup>15</sup> The structure of the credit contract is not regulated by law but in practice it usually contains of the following sections: introduction, general provisions, the subject of the contract, the terms of the loan, the payment terms, the rights and obligations of the parties, other conditions, legal addresses, details and signatures of the parties.<sup>16</sup> Essential conditions of the credit contract are the amount of requested money issued as credit, terms of fulfilling obligation and amount of credit interest rate.

As a credit contract is a consensual agreement, it is considered to be concluded from the time when the parties agree with all essential conditions of the contract. Another essential trait of

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<sup>13</sup> “Pravo I Predprinematelstvo”, №6, 2004

<sup>14</sup> Grazhdanskii Kodeks Kirgizskoi Respubliki [GK KR] [Civil Code], art. 735 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>15</sup> Id., at Art.184.

<sup>16</sup> Bulateskiy, U, and V Yazev. "Credit Contract." In *Commercial (Trade) Law*. Moscow: ID FBK-PRESS, 2002. 488.

contract agreement is that it is reciprocal. From one side a creditor is obliged to provide credit under conditions of credit agreement, from the other, borrower has right to demand fulfillment of obligation and he bears obligation to return credit as well as credit interest rate. The peculiarity of the credit contract is that there is the possibility of a one sided refusal to fulfill obligations under the contract.<sup>17</sup> The creditor may refuse to grant to the borrower credit provided by an agreement, in full or in part if there are some circumstances that certifies that the credit will not be returned.<sup>18</sup> The same right is guaranteed to creditor when the borrower breaches his obligation to use a credit for certain purpose, provided by the credit agreement.<sup>19</sup> These reasons for refusal to extend are legal, therefore creditor does not bear any liability before the borrower in case of refusing providing credit upon reasonable grounds.

On the other side, the borrower has the right to refuse to receive the credit. He has right to waive the credit, in part or in full, by notifying the creditor before the date, which has been scheduled in the agreement for granting the credit. However, the credit contract can contain provisions on the prohibition of refusal of the loan or the borrower has to reimburse the lender damages arose from the termination of the credit contract.<sup>20</sup>

Finally, the borrower is obligated to provide security for its obligations under the security agreement and maintain the quality of the provided property. A common example of fulfilling obligation by security agreement can be pledge of securities, goods, car, property rights and etc. This work will discuss the fulfillment of obligation by immovable pledged property. After signing credit contract, parties simultaneously sign pledge agreement. Pledge agreement becomes a part of credit contract and moreover parties include in credit contract the type of security, date and number of the pledge agreement.

## **1.2 Concept, essence and essential conditions of pledge contract**

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<sup>17</sup> Grazhdanskii Kodeks Kirgizskoi Respubliki [GK KR] [Civil Code], art. 736 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>18</sup> Id..

<sup>19</sup> Id..

<sup>20</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 736 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

Banks seek reliable borrowers and the safest type of a credit contract is when the credit is given under pledge. Pledge relations are regulated by the Civil Code of the Kyrgyz Republic and Law “On pledge.”<sup>21</sup> Moreover, commercial banks, independently on the basis of existing laws and regulations, are able to develop regulations, instructions, and recommendations for the use of pledge agreements for repayment of loans up to the value of the property collateral, etc.<sup>22</sup>

### *Defining the pledge*

Article 324 of the Civil Code of the Kyrgyz Republic defines pledge as:

*“By virtue of law, the obligee of a guaranteed obligation (pledgeholder) shall, in the event of the obligor’s failure to perform the obligation, have the right to satisfaction from the pledged property prior to all other obligees of the person who owns the pledged property (pledgor), except as otherwise established by law. The pledgeholder shall have the right to obtain full satisfaction from the value of the pledged property irrespective of whose benefit it is insured for, provided that the loss or damage did not occur by reasons for which the pledgeholder is responsible.”<sup>23</sup>*

The same definition is given in the Law on Pledge of the Kyrgyz Republic, that

*“a pledge is a means of securing monetary obligation or obligation expressed in a monetary form by way of security of the ownership right or any other real right in the property.”<sup>24</sup>*

In other words, the pledgee can obtain satisfaction up to the value of the pledged property under secured obligation. A pledge is a means of securing obligation of primary obligation. Primary obligation is the performance of obligation timely and fully, notably repaying the debt. Pledging the property of the debtor is one of the common forms of securing the repayment of bank loans. Pledge of property is made by conclusion of the pledge agreement, signed by the two

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<sup>21</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,” [Law “On Pledge”], art.2(Russ).

<sup>22</sup> Id., at Art.2.

<sup>23</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 324(Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>24</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,” [KR] [Law “On Pledge”], art.1 (Russ).

parties. The agreement provides the creditor the right to obtain preferential claims up to the value of the pledged property upon default or improper performance by the debtor of the obligation.

Usage of security transactions commenced recently after the formation of pledge institution. Legislative regulation of pledge as an instrument of fulfilling of various civil obligations of the Kyrgyz Republic started to develop in recent times. This is explained by the events that took place in Kyrgyzstan after the Soviet collapse. During this period, the general atmosphere of mistrust and a wave of bankruptcies among business organizations, caused strong demand to develop the institution of pledge.

During Soviet times, pledge relations were regulated by Soviet civil law. However, the economy of the Kyrgyz SSR did not particularly need mechanisms of enforcing those obligations. Citizens infrequently used this kind of secure transaction and the pledge was not widely used. Since the development of economy, parties increasingly started to use various ways to ensure the fulfillment of obligations, and currently pledge is one of the preferred methods. Practice has also shown that the pledge is a means of protection against unfair debtor practices and allows the borrower to fulfill his/her obligation according to the contract.

When a bank provides loans, it realizes that it is a big risk to provide financial facility without any assurance, that is why it needs a guarantee that the loan will be paid. The property of borrower can become a tool of guarantee. Hence, banks should realize risks of providing credit under the given property and further possibility to sell that pledged property in the changing economy with variety rates of inflation. The recoverability of the loan is one of the main principles of lending, otherwise a loan will simply lose its meaning.

As it comes to credit transactions, there are two objects of the law: creditor and borrower; the mechanism of repayment of the loan should take into account the interests of both and keep balance of these interests. When a lending organization provides credit, it becomes the organizer of the credit process and ipso facto protects its interests. The creditor determines the areas of

investing the loans, quantitative parameters of the loan, conditions of credit transaction, methods of the repayment of credit to create better possibility for full and timely repayment of loan.

*Parties to the pledge agreement*

When concluding credit contract, bank or any other lending organization at the same time concludes pledge agreement with borrower. The parties under pledge contract are pledgor and pledgee. A pledgor is a person (legal or physical) holding the right of ownership, or any other real right, to the collateral.<sup>25</sup> It can be the owner or a legal holder and the user of the pledged property or property rights that has the right to dispose property or property rights. Pledgor may be a debtor himself or a third party.<sup>26</sup> Pledgee - is the person who takes the property as collateral and whose claims are secured by pledge under the principal obligation.<sup>27</sup> Article 6 of the Law “On the pledge” does not limit parties of the contract. Subjects of pledge agreement can be physical persons, legal entities, Kyrgyz Republic as well as local governmental bodies.

Any person who has legal capacity has right to sign pledge agreement. One who has full legal capacity can do it independently or by the help of representatives, limited or partially capable persons can avail his/her rights through legal representatives (parents, guardians, trustees).<sup>28</sup>

Concerning legal entities, in order to become a pledgor, the entity does not need any specific legal capacity. It is sufficient if first, the law does not prohibit providing loans to legal entities of the category to which the borrower belongs, the second, the charter of the association does not contain an explicit prohibition to obtain loans and thirdly, the loan is used for statutory purposes of the organization. The charter is the founding agreement of the legal entity signed by

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<sup>25</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], art.6 (Russ).

<sup>26</sup> Id.

<sup>27</sup> Id., at art.3.

<sup>28</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 63(Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

its founders (participants).<sup>29</sup> As it was defined by law, any legal entity can become a pledgor as well as non-commercial organizations.

#### *Object of the contract*

Under a pledge agreement, a pledged property can be any kind of property or proprietary rights, securities, the certificates of shares and etc., except the property, which is prohibited in accordance with the law which cannot be alienated.<sup>30</sup> However, personal rights, including right to receive salary, pension and etc. cannot be pledged as collateral.<sup>31</sup> The assets that can be pledged as collateral can be any object that has a monetary value, in other words any material object on which could made levy of execution. Furthermore, a pledgor may pledge only his property and only actual holder of the pledge right may be a pledgor.<sup>32</sup>

The value of collateral must be higher than the given credit. Collateral must cover principal debt, the lender costs associated with the maintenance of the property, interest, the organization of public auction and other creditors' losses.<sup>33</sup> Thus, could be said that the pledged property must meet two criteria: acceptability and adequacy.<sup>34</sup> Acceptability of collateral objects is determined by the following: right of ownership on the pledged property; pledge should have monetary value; possibility of selling of the pledge. Adequacy of the pledged property means that the price of pledged property must be higher compared to debt obligations so that it will cover all amounts of debt and possible percents for delay in performance of principal obligation.<sup>35</sup> These above mentioned criteria identify possibility to obtain credit under certain property, otherwise bank will not be able to conclude contract with pledgor.

#### *Form of the contract*

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<sup>29</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 87(Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>30</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], art.4 (Russ).

<sup>31</sup> Id.,.

<sup>32</sup> Id., at art.7.

<sup>33</sup> Fadeeva, T. "Types of securing obligation." In *Civil law* . 5 ed. Moscow: Prospekt, 2001. 570.

<sup>34</sup> "Nalogi i Pravo", N 10, 2005.

<sup>35</sup>Pravo I Predprinimatelstvo, №6, 2004.

Legal relations based on pledge usually arise under the contract. A pledge contract must be concluded in a written form and signed by both sides.<sup>36</sup> Moreover, a pledge contract should be notarized if it secures borrower's obligation under the contract.<sup>37</sup> When there is a pledge contract on real estate, it can be considered to be concluded in case of state registration according to the law of the Kyrgyz Republic on state registration on rights on immovable property.<sup>38</sup> In case of not fulfilling those requirements, the contract will be considered void.

A pledge is derived from the nature of the secured obligation. The pledge agreement must include: the nature of the secured claims, the size and duration of the obligation, and a description of the collateral, and any other conditions which parties agreed to include.<sup>39</sup> A pledge agreement can be independent, i.e. separate from the main agreement under which arose secured obligation, however main agreement may consist of conditions of pledge.

Essential conditions of the pledge agreement consist of the object of the pledge and its price, essence, size and terms of fulfilling obligation.<sup>40</sup> And if parties cannot come to agreement upon any of these issues or did not stipulate above mentioned provisions agreement is considered to be void.<sup>41</sup> However, if main agreement (credit contract) stipulates essence of the pledge, size and terms of fulfilling obligation, agreement is valid if pledge agreement makes reference to the main agreement. In case of absence of primary obligation, the lender has no right to preferential satisfaction of his claims from the pledged property. The pledge contract does not have an independent character, hence it follows that it only provides the performance of the principal obligation under the credit contract. Pledge agreement tied with the credit contract. At the

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<sup>36</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 328(Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>37</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], art.10 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>38</sup> Id..

<sup>39</sup> Id..

<sup>40</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 328(Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>41</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], art.10 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

discretion of the parties, the contract may include other conditions which, after their inclusion in the agreement, can become essential conditions.

When the issue comes to the price of the pledge it is very important to determine the assessed value of the pledged property, that the given property will be sufficient enough to meet the obligations.<sup>42</sup> Estimated value of the collateral should reflect the actual market price prevailing in the market at the moment of collateral.<sup>43</sup> To determine the assessed value of the real estate, lender evaluates itself or in its sole discretion, engage independent experts who are certified to carry out activities in the field of evaluation.<sup>44</sup> After establishing the fair market value of the collateral, in order to determine the estimated selling price, lending organizations take into the account the term of the loan agreements coefficients: demand factor of 0.3 to 1.0, and the risk ratio 0.7.<sup>45</sup>

The main economic definition of the efficient financing is that the collateral (pledge) must have sufficient economic value to potential secured lender, in order to either (1) make a provision of a loan to a low interest loan rates, or (2) to provide a greater amount of the loan than if you would have this loan was not secured by the pledge.<sup>46</sup> In many jurisdictions, lenders take security (collateral) for all loans granted, but at the same time considering the collateral as having no practical economic value.<sup>47</sup> In these loans the interest rate is the same as in the case of an unsecured loan, although in theory should be less, and the amount provided by the secured loan is not different from that if the loan was unsecured, thus providing collateral mortgagor does not give him any advantage.<sup>48</sup>

### *Types of pledges*

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<sup>42</sup> Polojenie o rabote s zalogom, utverjdjeno prikazom Ministerstva Finansov Kyrgyzskoy Respubliki ot 2 Aprelya 2002g. N 96-P,[Regulation on business with pledge, adopted by the Ministry of Finance, April 2, 2002](Russ).

<sup>43</sup> Id..

<sup>44</sup> Id..

<sup>45</sup> Id..

<sup>46</sup> Pravo I Predprinimatelstvo, N 2-3, 1998

<sup>47</sup> Id..

<sup>48</sup> Id.



According to the Law “On pledge” there are two types of pledge: (1) pledge with delivery of the pledged property to the pledgee (pawn) and (2) pledge with the collateral remaining with a pledger.<sup>49</sup>

Under Article 24 of Law “On pledge,” “a pawn is a type of pledge upon which the pledger delivers the pledged property to the pledgee under a pledge agreement.”<sup>50</sup> This norm is very useful for creditor, because in this case, the collateral will be secured and be under control of the creditor. However, on the other side, a pledgee can make the pledger to refund all expenses on preserving the pledged property by including this provision in the pledged agreement.<sup>51</sup> If it is not included in the contract then the obligation of physically preserving the pledged property lies on the shoulders of pledger. He should notify the pledgee of any damages or destruction of the pledged property. Moreover, the pledgee should regularly report to the pledger about the use of the pledged property. In case of damaging of the pledged property, the pledgee is liable for that forfeiture, unless the he proves that this damage was not his fault.<sup>52</sup>

In case of pawn, pledgee possesses the pledged property and can use collateral at his/her disposal if it was stipulated by agreement. When pledgee uses the pledge as well gains some profit, all that is acquired by this way should cover the cost of maintaining the pledged property or the loan itself.<sup>53</sup> Pledger’s rights related to disposal of the pledge are limited in pawn because collateral is possessed by pledgee or it is under the lock, seal of the pledgee (hard pawn) or other signs indicating that the property is pledged.<sup>54</sup>

Practice shows that when the collateral is immovable property, in most cases the pledger has access to the property and uses it. A common example of collateral of this type of pledge can

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<sup>49</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], art.24 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>50</sup> Id..

<sup>51</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 331 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>52</sup> Id..

<sup>53</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], art.31 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>54</sup> Id., at Art.24.

be buildings, structures, apartment in a multi-flat house, land parcels. In this case pledgee has right to obtain physical access to the property as well to documentations concerning pledged property. Moreover, the pledge is able to claim cessation of any encroachment on the collateral threatening with the destruction, damage or depreciation, and ask pledger to take actions to safeguard the pledged property.<sup>55</sup> The difference of this type of pledge in comparison with the pawn is that the pledger possesses and uses the collateral according to its character and exercises other rights under the pledge agreement.

No matter who gains the right of using collateral, this right must be exercised without deterioration of the pledged property. If under the agreement, pledgee is entitled to use the collateral then the right of observing and controlling the use of property is retained by the pledgor. This right of mutual control over the use of the collateral is regulated by law to maintain the value of the property during the period when it is under the pledge and to satisfy the claims of creditors in full amount.

*The costs of registration of the pledge*

Different jurisdictions have different types of registered rights that are secured by the collateral. In America it is called "a receipt for the loan," ending with the modern "lien" in the UK.<sup>56</sup> The basis of all these systems is the creation of secured funding mechanism under the provision providing for public notice about the specified financing, so that the creditors are aware of the current financial condition of potential borrowers before granting a loan given to the borrower.<sup>57</sup> To ensure that these mechanisms are applicable from a legal point of view, it is necessary to use the concept of "constructive notice" rather than "actual knowledge" in respect of all secured lenders who provide loans to any particular borrower.<sup>58</sup> Otherwise, any lender may declare that he is "in good faith" to lend collateral, even not looking at the pledge registry, and

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<sup>55</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], art.31 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>56</sup> Pravo I predprinimatelstvo, N 2-3, 1998.

<sup>57</sup> Id..

<sup>58</sup> Id.

not knowing thus encumbrances against the property.<sup>59</sup> The concept of "constructive notice" imputes knowledge of the information contained in the public register, to all persons without exception, including junior creditors (ie, those who designed the pledge after its predecessor, which has a priority right), whether known whether they are actually about past encumbrances or not.<sup>60</sup>

Commercial use of these funding mechanisms usually depends on the following three subordinate concepts: they should allow a general description of the collateral (security) for after-acquired property should also apply provided the right of the pledgee, and a promissory note must include the following amounts provided by the lender.<sup>61</sup> “Thus, commercially effective financial mechanism in addition to what he has to ensure that the requirements of registration and the proposed concepts of awareness, should allow a secured lender to exercise its lien against the changing stock of goods described by their common characteristics, without having to calculate the daily balance. Registered secured right established by the new Law "On Pledge" of the Kyrgyz Republic is committed to meet all these requirements. In most cases, the law requires the registration of the pledge. Registration document may differ from the contract between the parties for the provision of credit.”<sup>62</sup> This is an important factor that allows the parties to give public notice of the products produced by them secured transactions, without revealing at the same time all the details of the transaction. However, the registration document must carry the information about the actual existence of the secured transaction, on the parties which concluded the deal, the security and the amount of the debt obligation that is covered by this provision. Such security may be described in detail but the common or signs.<sup>63</sup> “If the description is given on the general grounds, it may include after-acquired property that meets these most common features of such property. Collateralized debt obligations may also be

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<sup>59</sup> Pravo I predprinimatelstvo, N 2-3, 1998.

<sup>60</sup> Id..

<sup>61</sup> Id..

<sup>62</sup> Id..

<sup>63</sup> Id..

defined as detailed and descriptive, and debt, given in general terms includes the projected future to grant the lender to the borrower money in a loan up to a certain maximum amount of the loan.”<sup>64</sup>

The system of registration of mortgages exhaustively described and regulated in detail by the new law "On pledge." There were the attempts to solve the problems associated with the loss of time at check-in, common in Eastern and Central Europe and the other former Soviet republics, by: 1) limiting the number and types of questions that may be considered registrar limited time available for such a review, and 2) the requirement that the recorded and used to determine the priority of the time of submission of the application for registration, and no time permit the registration by the Registrar.<sup>65</sup> Registrar may refuse to accept an application for registration if it does not meet the requirements of Article 16 of the Law "On pledge" of the Kyrgyz Republic and the developers of the new Law "On pledge" of the Kyrgyz Republic have tried to make these requirements clear and simple for everyone.<sup>66</sup> These requirements are reduced mainly to the fact that they are clearly defined by the transaction, information was provided in respect of the secured promissory note and a brief description of collateral (security). Article 16 of the Law "On pledge" of the Kyrgyz Republic simplifies the requirements for registration, but we should bear in mind that the employees of the registration in countries with inefficient registration system for secured transactions shown a remarkable ability to find the most unexpected reasons for delaying consideration of the registration.<sup>67</sup>

For lenders this issue is resolved fairly well. Lender must obtain from the borrower signed the pledge agreement and signed the application for registration. Each of these documents is quite simple in its form and registration is not particularly difficult. In addition, the law provides for a simple and clear scheme of registration fees.<sup>68</sup>

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<sup>64</sup> Pravo I predprinimatelstvo, N 2-3, 1998.

<sup>65</sup> Id..

<sup>66</sup> Id..

<sup>67</sup> Id..

<sup>68</sup> Id..

Unfortunately until now there are many uncertainties regarding the role of notaries, although it should be noted that the developers of the new Law “On pledge” of the Kyrgyz Republic included provisions that exclude most of the existing unnecessary and burdensome requirements for notarization in the project of developing the Law.<sup>69</sup> These, unfortunately, were removed from the final text of the law in the course of the discussion in the legislature. In the course of this workshop, we will examine some of the conflicts associated with existing requirements for notarization, with whom you can meet in practice.

### **1.3 Fulfillment of obligation by pledgor**

The unstable market situation of the Kyrgyz Republic is exacerbated by the global financial crisis that led to an increase in defaults. As a result, creditors more often use the procedure of foreclosure upon pledged property to fulfill obligation under the contract. Creditors face regulatory issues related to the foreclosure upon pledged property, mainly in its implementation.

Foreclosure on the security to satisfy the creditor’s claims may be applied upon default or improper performance by the debtor of the obligation by the pledge, in particular if (1) pledger missed the due date for the obligation repayment and/or (2) he fails to satisfy the pledgee’s claims on early performance of the obligation secured by the pledge in the cases provided by Article 56 of the Law “On pledge.”<sup>70</sup> Under Article 56 of the Law “On pledge”, the pledgee may claim early performance of the obligation secured by pledge and commence foreclosure proceedings, when:

- The pledger violates the rules on handling the collateral or the pledgor no longer possesses the collateral;

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<sup>69</sup> Pravo I predprinimatelstvo, N 2-3, 1998.

<sup>70</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], art.55 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

- The pledger violates the rules of substitution or reinstatement of the collateral;<sup>71</sup>
- The collateral is forfeited under the circumstances beyond the pledger's scope, if the pledger waived his right to substitute or reinstate the collateral;
- The pledgor violates the rules on subsequent pledge;<sup>72</sup>
- The pledger violates the duties on maintenance and safekeeping of the collateral;
- The pledger violates the duties on notification of the pledge of the third parties claims to the collateral;
- Other cases as provided by law or pledge agreement.<sup>73</sup>

The legislation provides for both judicial (public) and non-judicial processes (contractual) of foreclosure upon pledged property.<sup>74</sup> Public foreclosure requires the decision of a court. Contractual foreclosure is based on an agreement on fulfilling obligations of a pledgee signed by pledger that is notarized - with a pledge clause in a contract or a separate agreement to the satisfaction of the creditor. Parties are able to conclude that agreement of fulfilling obligation under the contract after occurring grounds for reclaiming the debt.<sup>75</sup>

#### *Foreclosure procedure*

When there is a default, or improper performance, by the debtor the pledgee may institute foreclosure procedure. First, the pledgee draws up a notice about the institution of the foreclosure procedure. This notice should be made in a written form and indicate the description of the pledge agreement, obligation, the offer to comply voluntary the obligation within 15 days

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<sup>71</sup> "Replacement of the subject of pledge shall be allowed only with the consent of the pledgeholder. If the subject of pledge was destroyed or damaged, or the ownership right or the right of economic management to the same was terminated on grounds established by law, the pledgor shall have the right to restore or to replace the subject of pledge within a reasonable time period by any other property of equal value," taken from *Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code]*, art. 331 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>72</sup> "A subsequent pledge shall be allowed, unless it is prohibited by the prior pledge contracts. If the pledged property becomes a subject of another pledge to secure other claims (subsequent pledge), claims of the subsequent pledgeholder shall be satisfied from the value of the subject of the pledge after the claims of the prior Pledgeholders," taken from *Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code]*, art. 329 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>73</sup> *Zakon Kyrgyzskoi Respubliki "O Zaloge," [KR] [Law "On Pledge"]*, art.56 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>74</sup> *Id.*, at Art.55.

<sup>75</sup> *Id.*, at Art.59.

from the moment of serving the notice to the debtor, the warning about possible launching of the foreclosure procedure and registration number and date if pledge is registered.<sup>76</sup> The pledgee then serves this notice to the debtor directly, or by registered mail to the addresses indicated or by fax.

When a pledgor receives a notice under Article 59 of the Law “On pledge,” he has several options. First, he can satisfy the pledgee’s claims indicated in the notice by settling the dispute in the non-judicial procedure. Pledgor signs an agreement on satisfaction of the pledgee’s claims in non-judicial procedure.<sup>77</sup> Second, the pledgor then can file a claim with the court for foreclosure if non-judicial foreclosure was not stipulated in the pledge agreement or arbitration agreement. Third, he may take measures to settle the dispute in any non-judicial ways or file the claim to the court for withdrawal of the notice by the pledgee.<sup>78</sup>

If the contract between the pledgor and the pledgee provides for non-judicial foreclosure then none of the parties may change the foreclosure procedure unilaterally or refuse to comply with the foreclosure procedure identified in the contract.<sup>79</sup> However, if grounds for foreclosure on the collateral exist, parties are able to conclude an additional agreement concerning foreclosure procedure and make it different from the earlier established one if they choose.

In the case, when the pledgor signed agreement on satisfaction of the pledgee’s claims in non-judicial procedure, the pledgor must transfer collateral to the pledgee otherwise the pledgee may undertake legal actions necessary to transfer the collateral. From the moment of transfer, the pledgee obtains the collateral until he sells it and under law or agreement has the right to make some improvements to the collateral.<sup>80</sup>

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<sup>76</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], art.58 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>77</sup> Model agreement on satisfaction of the pledgee’s claims in non-judicial procedure, approved by Ministry of Justice of KR, April 28, 2005 (Russ).

<sup>78</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.59 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>79</sup> Id., at Art.60.

<sup>80</sup> Id., at Art. 60.

If the parties did not include in their agreement any type of foreclosure procedure than judicial foreclosure will take place. Pledgee sends the notice to the pledger of the coercive foreclosure and immediately acquires the right to charge the collateral.<sup>81</sup> The term “immediately” means within 3 business days, unless the pledgee gives a valid reason for delay.<sup>82</sup>

#### *Judicial foreclosure on the collateral*

Judicial foreclosure on the collateral may be made on the basis of the court decision, unless the pledge agreement provides for non-judicial foreclosure procedure on the collateral.<sup>83</sup> The pledgee is required to submit to the court the notice on the foreclosure procedure that was sent to the pledger and approval that the pledger refused to willfully repay the debt during given 15 days.<sup>84</sup> Further, the court identify, and indicate in its decision, all the sums due to the pledgee from the value of the collateral, interest-bearing sums, the method of the sale, starting price and etc..<sup>85</sup>

In the case of foreclosure and sale of a residential house or apartment, members living in the mortgaged property must vacate the occupied premises within 30 days at the request of the owner.<sup>86</sup> If this requirement is ignored by the pledger, the owner of the collateral has right to exercise his right by evicting the pledger and any other living with him through administrative or judicial procedure.<sup>87</sup>

#### *Collateral of the pledged agreement*

The meaning of the collateral as a security liability is that the lender in case of default of the debtor has right of preferential satisfaction of his claims in comparison with the other creditors. But not all improper performance or/and non-performance provides the creditor the right to start

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<sup>81</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.60 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>82</sup> Id..

<sup>83</sup> Id., at Art. 62.

<sup>84</sup> Id., at Art. 63.

<sup>85</sup> Id..

<sup>86</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.65 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>87</sup> Id..



foreclosure procedure. For instance, foreclosure of agricultural land parcels mortgaged under a pledged agreement may be denied because of incommensurability of obligation and the value of the pledge. The denial is explained by the fact that the principal obligation is insignificant and the pledgee's claims are explicitly incommensurate with the normative value of the mortgaged pledge.<sup>88</sup> In the event that the proceeds of the sale of the secured property will not cover the full amount of the pledgee's claims, the debtor has to recover the lacking amount from the other property that he has, however if the price of the sale of the secured property will be higher than the amount of debt, the pledgee has to return the excess sums.

*Sale of the foreclosed secured property*

One of the main differences between the judicial and non-judicial foreclosure is a manner of sale of pledged property. In the event of judicial foreclosure, the court identifies the type of foreclosure. In most cases, the court chooses public auction. In the public auction, the property is sold to the highest bidder. If there is an agreement on non-judicial foreclosure then the bank or other lending organization identifies to sell the pledge or keep it.

As it is regulated under Article 67 of the Law "On Pledge" the foreclosure procedure can be started only after 15 days, unless otherwise established by the decision of the court.<sup>89</sup> Both parties (pledger and pledgee) should act in good faith in order to sell the security in a manner most beneficial for them. The pledgee has the right to sell secured property by any method that is convenient to him. Moreover, he may appoint a manager of the collateral who will act on his behalf and settle any relevant issue.<sup>90</sup>

If it is proven by the decision of the court that the property was sold at an unreasonable price, the winner of auction should return the property to the owner (pledger), and the owner (pledger)

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<sup>88</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge," [KR] [Law "On Pledge"], Mar. 12, 2005, art.66 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>89</sup> Id., at Art.67.

<sup>90</sup> Id., at Art.68.

should return money, in other words parties will be restituted by the decision of the court.<sup>91</sup>

Each party shall return to the other everything acquired in transaction and those rights commenced from the transaction will entail no legal consequences. In the case of illegal sale of the collateral, the pledger has right to demand from pledgee to recover damages caused by illegal actions of lender.

### *Sale methods*

As we have discussed, when the borrower does not make repayment of money on time, creditor commences foreclosure process. The collateral after foreclosure is sold at the public auction or by other methods stipulated in the agreement.<sup>92</sup> The public auction can be conducted in two ways: (1) open auction and (2) competition (tender). The winner of the sales by auction shall be deemed to be the highest bidder, and the winner by competition shall be the person who proposes the best conditions as decided by the Competition Committee established by the organizer.<sup>93</sup> Upon judicial foreclosure, bidding is determined by the decision of the court, and upon non-judicial foreclosure by the pledge agreement or agreement on satisfaction of the pledge's claims.

Thus, foreclosure involves selling the property by public auction or competition, and the pledger satisfies its obligations from the amount of money received as a result of the auction. If the money received from the public auction will not cover the amount of credit and penalty, the pledgee has the right to demand additional foreclosure on another property of the pledgee to repay the obligation under credit contract. Despite that fact, one of the positive aspects of foreclosure sale is the fact that its procedure is clearly written out by the legislator.<sup>94</sup>

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<sup>91</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.69 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>92</sup> Id., at art.72.

<sup>93</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 408(Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>94</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.72 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

When the method of foreclosure sale is decided, parties appoint auction members by mutual agreement or on the basis of agreement on the satisfaction of the pledgee's claims. Upon judicial foreclosure, a public auction parties (conductors of the auction) are defined by the decision of the court. However, court, on the motion of the parties, may define auction party recommended by pledge/ pledger who should be independent and unbiased.<sup>95</sup> The auction party may be any legal entity or individual of the Kyrgyz Republic, as well as foreign legal entity or an individual. However, upon judicial foreclosure auction party cannot be officials of state agencies, local government institutions, the judiciary of the Kyrgyz Republic, a person charged with the enforcement of judgments or the one who has priority interest such as pledger's/ pledgee's relatives, their creditor, debtor and etc..<sup>96</sup>

As a common rule, an auction for immovable pledged property takes place at the location of the immovable property unless otherwise provided by law.<sup>97</sup> The executive officer (judicial foreclosure) or the auction party should notify of the forthcoming auction no less than 30 calendar days prior to the auction through publication of the announcement in newspapers.<sup>98</sup> The auction should be announced through periodical press and published once in national and local newspapers. The Civil Code of the Kyrgyz Republic as well regulates conditions of announcing auction. The notice must contain the information about the time, place and the form of sales, their subject matter and the procedure for conducting the same, including information about registration for the sales, identification of the winner, and the information about the starting price.<sup>99</sup> However, Law "On pledge" gives more detailed information on provisions that should be included in announcement. The auction announcement must indicate:

- 1) The name, description and characteristics of the secured property being auctioned;

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<sup>95</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.73 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>96</sup> Id., at Art.74.

<sup>97</sup> Id., at Art.75.

<sup>98</sup> Id.

<sup>99</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 409 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

- 2) The exact location of the secured property
- 3) The initial (starting) sale price of the secured property;
- 4) The size, terms and the order of depositing a warranty fee by the bidder;
- 5) The procedure and time frame for payment of the purchase price;
- 6) Time and place of auction;
- 7) The name and residence (location) of the auction party, his telephone number for inquiry and payment particulars.<sup>100</sup>

Moreover, a copy of the auction announcement shall be posted, if it is possible, on a visible place on the property no later than one month prior to the date of auction.<sup>101</sup> The Article gives exhaustive list of provisions that the announcement must indicate and the phrase “announcement must indicate” explicitly shows that those provisions are essential. If the requirements set forth in that article are not met, the auction shall fail. The result of cancellation the second auction will be more deplorable for both sides. The creditor, automatically becomes the owner of a real estate, moreover it purchases it with essential discount from the initial price. However, lending organizations do not need that property, the main goal is to gain profit and return the money.

Before beginning the auction, persons who are willing to participate in auction shall deposit indemnity payment (warranty fee) higher than 5 percent of the starting sale price of the secured property.<sup>102</sup> The person who participated in auction and further won the auction, his indemnity payment shall be credited to the purchase price, in other words indemnity payment becomes a part of money that he should pay for the pledged property. The indemnity payment of other participants who did not win auction, failed to participate in auction or consequently auction was recognized failed, the auction is returned back. However, if the winner of the sale evades entering into the contract, he loses his deposit. If the organizer of the sale refuses to sign

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<sup>100</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.75 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>101</sup> Id..

<sup>102</sup> Id..

the protocol on the result of auction, he shall return double the amount of the deposit. Moreover, he compensates the winner for losses, caused by taking part in the sales, in the event this amount exceeds the deposit.<sup>103</sup>

As stated above, the person who offered the highest price at the auction for the property is considered to be the winner of the open auction, the one who offered the best conditions is the winner of competition.<sup>104</sup> On the same day the winner of the auction and auction party sign a protocol of the results of the sales which later will have the force of the agreement. The winner shall pay the purchase price during the time frame established by the auction party, but no more than one week after signing the protocol on the results of the auction.<sup>105</sup>

In some cases a public auction can be announced as failed and invalid. The auction is failed when less than two bidders participated in public auction, no one offered the price higher than the initial price of the collateral and the winner failed to pay purchase price of the collateral within established time frame.<sup>106</sup> A public auction is announced as failed at the same day of public auction if less than two participants appeared at the auction and no higher price than the initial price of the collateral was offered. The public auction is announced failed the very next day, when the winner failed to pay the purchase price within established time frame. In this case, pledger has right to purchase pledged property as its initial price. However, if pledger refuses of this right, the repeated auction will be announced. The auction party is entitled to identify the initial price of the collateral at the repeated auction.<sup>107</sup> Auction party may maintain the initial price of the previous auction or establish new appraisal. If the repeated auction is announced

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<sup>103</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 409 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>104</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge," [KR] [Law "On Pledge"], Mar. 12, 2005, art.75 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>105</sup> Id..

<sup>106</sup> Id., at Art.76.

<sup>107</sup> Id..

failed then pledge has right to purchase secured property at the amount no more than 10% lower than the initial price of the collateral.<sup>108</sup>

An auction can be invalidated by the decision of the court if the auction was organized by violation of procedures; the collateral was sold not eligible bidder; and if auction party, pledger, pledge committed administrative or criminal infringement.<sup>109</sup> The invalidation of the sales leads to the invalidation of the protocol on the results of the sales and the agreement consequently. If the pledger does not agree with the invalidation of the auction, he may contest the results in the court of the district where the auction took place.<sup>110</sup>

If the auction took place successfully, the auction party should submit a report. This report has a written form and has to be submitted to the court (upon judicial foreclosure) or to the parties (upon non-judicial foreclosure) within 10 days of the final distribution of the proceeds received from auction or of the date when the pledgee decides to acquire the secured property.<sup>111</sup> The report contains information on secured property, time and place of conducted auction, data on buyer, the purchase price and distribution of auction proceeds.<sup>112</sup> Even if the auction was declared invalid, the auction party still has to submit report on the results of the public auction. The report should contain the same data concerning the secured property, auction itself and grounds for its invalidation, price at which pledge purchased the collateral.

Money obtained after selling the secured property is distributed within 10 days from the moment of receipt.<sup>113</sup> Part of received money after auction of the secured property is used to cover expenses and costs of holding an auction, the rest repays debt to satisfy the pledgee's claims.

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<sup>108</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge," [KR] [Law "On Pledge"], Mar. 12, 2005, art.76 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>109</sup> Id., at Art.77.

<sup>110</sup> Id., at Art.75.

<sup>111</sup> Id., at Art.81.

<sup>112</sup> Id..

<sup>113</sup> Id., at Art.80.

When the distribution of auction proceeds is finished and the principal obligation is fulfilled, the pledge is ceased. Upon the cessation of the pledge, the pledgee has to make a notice of the cessation of the pledge and register this notice with the agency for the state registration of pledges.<sup>114</sup>

## **Chapter II. Issues, challenges and recommendations**

### **2.1 Changes in the Law “On pledge”**

The new Law of the Kyrgyz Republic "On Pledge" was adopted just in time because the last legislation of the Kyrgyz Republic that regulated the pledge relations, established a highly complicated procedure of foreclosure on collateral. The foreclosure proceedings could be initiated only in courts and was a very expensive and time-consuming procedure. As Sarnaeva, a senior lawyer in USAID project in developing commercial law, states such procedure created a situation in a State where the credit market was not fully responsive to the needs of the economy (low and short terms of loans, high interest rates, complex, lengthy, costly procedures for obtaining loans, etc). According to USAID research, the realities of life, followed by a poorly developed financial and credit system, inadequate financing of the economy and the lack of pledge lending system strongly dictates the need to change pledge legislation especially in terms of simplifying the foreclosure of the pledged property. A contradictory collateral laws prevented the creation of a favorable investment climate in Kyrgyzstan and the establishment of the Institute of pledge lending.<sup>115</sup>

The first Laws "On pledge" from 1992 to 1997 and the Law of the Kyrgyz Republic "On mortgage" from 1999 were more or less balanced in terms of equality of legal protection of the interests of both pledgee and pledgor. However, the norms the new Law of the Kyrgyz Republic "On Pledge" from 12 March 2005 to a greater extent defends the interests of the creditors

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<sup>114</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.73 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>115</sup> Pravo I Predprinimatelstvo, #2, 2005.

(pledgee), at the same time giving the parties of the pledge agreement legal greater autonomy and the right of discretion in establishing the pledge.<sup>116</sup>

The purpose of the adoption of the new Law "On pledge" of the Kyrgyz Republic was the creation of secured financing (pledge) system that would be applicable to commercial activities. The working group for the development of the law considered that there was no need to create a perfect system of secured financing, since the creation of such a system can last indefinitely. It is important to create a system applicable to commercial activities in order to gain experience of its practical application and to understand what benefits can provide the system with time. Later, this system could be improved, based on the experience gained and the positive momentum gained in the initial phase by the initial success.<sup>117</sup>

The concept of the new Law of the Kyrgyz Republic "On Pledge" from March 12, 2005 N 49 was directed to solve the key issue in foreclosure process. The Law performed more simplified non-judicial foreclosure on the collateral and the elimination of the contradictions that exist in the legislation of the Kyrgyz Republic, which regulates pledge relationship.<sup>118</sup> In principle, the legislator in the new law completed the task, though, some provisions of the new law require further development to ensure a clear mechanisms for implementation of the foreclosure process upon pledged real estate.<sup>119</sup> For example, the rules that determine the order of foreclosure and sale of collateral, should be supplemented by the rules providing for the implementation of the pledged real property only through public auction. This way of sale of the pledged property would eliminate the possibility of a transition of the collateral in foreclosure through the institution of compensation, thus ensuring, first, the principles of the inviolability of the Institute of collateral relations, and second, would yield him the highest bidder, thus protecting the interests of the pledgor.<sup>120</sup>

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<sup>116</sup> Pravo I Predprinimatelstvo, #2, 2005.

<sup>117</sup> Pravo I Predprinimatelstvo, N 2-3, 1998

<sup>118</sup> Pravo I Predprinimatelstvo, #2, 2005.

<sup>119</sup> Id..

<sup>120</sup> Id..



The very positive aspect of the new Law was an alternative way of resolving the dispute. For the first time, appeared a legal possibility to include in the pledge agreement the arbitration clause.<sup>121</sup> Arbitration clause permits to solve any dispute and controversy in Arbitration Court. Another way was drawing of the arbitration agreement to refer a dispute arising between the parties pledge (mortgage) relations, to an arbitral tribunal.<sup>122</sup>

In paragraph 5 of paragraph 4 of Article 10 and paragraph 2 of paragraph 2 of Article 59 of the new Act contains a provision that for the first time created a real opportunity for the revival of alternative methods of dispute resolution between the parties pledge (mortgage) by including the legal parties to the contract of pledge (mortgage) in the content of their contract "arbitration clause" or for them to conclude a separate "arbitration agreement" allowing the mortgagor and the mortgagee to transfer incurred on pledge dispute to arbitration that was missing in the Law "on Pledge" (1997) and the Law "on Mortgage" (1999).<sup>123</sup>

Amendments touched the terms of notice the pledgor of the initiation of the foreclosure of the collateral (Articles 58, 67). In sub-paragraph 2 of paragraph 2 of Article 58 of the new law, the term of sending notice to the pledgor on commencing foreclosure on the pledged property had been reduced to the minimum period of notice from 30 to 15 days.<sup>124</sup> The new law has established that a proposal for a voluntary execution of obligations, including the payment of amounts of all debts must be made within a specified period, which may not be less than 15 days from the date of delivery to the debtor (mortgagor) notice. The specific term is defined by the pledgee or by the agreement between the parties themselves.<sup>125</sup>

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<sup>121</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.10, 59 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>122</sup> Id.

<sup>123</sup> Id.

<sup>124</sup> Id.

<sup>125</sup> Id.

Radically had been changed the concept of extra-judicial foreclosure on the collateral.<sup>126</sup> Clerks want to have a working mechanism for foreclosure of collateral, and therefore took an active part in the discussion of the above-mentioned new Law “On Pledge” of the Kyrgyz Republic. In the framework of the working group, which included representatives of international financial institutions, members of the Secretariat of the President of the Special Representative of the Kyrgyz Republic on foreign investment, the National Bank and financial institutions, has been developed concept of extra-judicial foreclosure of the mortgaged property.<sup>127</sup> As the old law had a very complicated, complex and lengthy process of foreclosure on the collateral in the case of default by the debtor of the secured obligation, the Article 60 of the Law “On pledge” had been changed effectively.<sup>128</sup> Before, there was no option, banks had to file an action to the court on the recollection of the debt. In most cases, this process was taken a lot of time, often lasted for months, and even years. Moreover, those cases were reviewed in three instances. Such situation was so unfair and uncomfortable to the creditor, and therefore the working group of the Law “On pledge” of the Kyrgyz Republic offered a radically new version of Article 60 of the Law on non-judicial foreclosure.<sup>129</sup> What, ultimately, should contribute not only to ensure the balance of interests of pledge (mortgage) relations, but also a significant reduction in terms of foreclosure on the collateral out of the courts.<sup>130</sup>

In this connection, let us turn to the general rules prescribed in the Article 335 of the Civil Code of the Kyrgyz Republic, based on which the pledgee is entitled to claim satisfaction from the value of the property by the court, unless otherwise provided by law.<sup>131</sup> Overall, the working group worked on the establishment of non-judicial ways of foreclosure upon pledged property that can be classified into three categories:

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<sup>126</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.60 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>127</sup> Pravo I Predprinimatelstvo, #4, 2003.

<sup>128</sup> Pravo I Predprinimatelstvo, #2, 2005.

<sup>129</sup> Id..

<sup>130</sup> Id..

<sup>131</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code] (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

- A pledge agreement or agreements containing provisions on non-judicial foreclosure of the pledged movable property;

- Notarized agreement between the pledgee and the pledgor on the treatment of extra-judicial foreclosure of the pledged real property;

- The executive and the presence of a notary in the pledge agreement pledgee's rights to enforce the collateral out of court in the absence of a dispute between the parties pledge transaction.<sup>132</sup>

It should be noted that the proposed concept of extra-judicial order based on the principle of differentiation of the foreclosure on the pledge depending on the type and status of the pledged property.<sup>133</sup> Moreover, the condition on the satisfaction of the pledgee's claims out of court gives the lender the right without the consent of the pledgor to initiate foreclosure proceeding upon immovable pledged property.<sup>134</sup> By the way, in order to protect the rights of the pledgor, the new law requires that if the subject of the pledge is a real estate, the non-judicial foreclosure agreement must be notarized.<sup>135</sup> Thus, in the final agreement, according to which the foreclosure can be commenced without going to the court is beneficial for both parties as the pledgor and the pledgee, because the lender is able to promptly satisfy its monetary claims, and the borrower (debtor) can avoid useless costs and possible waste of time in litigation. At the same time, it should be noted that there were some concerns about the fact that non-judicial foreclosure law may pose a potential threat to borrowers who extra-judicially can lose ownership on the pledged immovable property.<sup>136</sup> However in my opinion all this claims are unfounded because if everything will be conducted according to law and parties will follow established procedure of foreclosure, parties will only gain more of extra-judicial procedure because they will not spend money on hiring good attorney and "fleeing" through all instances of

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<sup>132</sup> Pravo I Predprinimatelstvo, #2, 2005.

<sup>133</sup> Pravo I Predprinimatelstvo, #2, 2005.

<sup>134</sup> *Id.*

<sup>135</sup> *Id.*

<sup>136</sup> *Id.*

the courts. Moreover, parties have to pay state duty. Judicial foreclosure involves the use of third parties such as the court, the notary, the State Executive, and therefore this time of foreclosure is more labor-intensive and time consuming.

In general, no matter what kind of pledge the bank takes to secure the obligation, the debtor will always be able to engage the lending organization in a lengthy legal process. Moreover, this right is granted to debtor by the Law "On pledge." Article 37 of the Law states that the decision on registration of title to real estate mortgagee may be challenged in court by the mortgagor.<sup>137</sup> After all, from the meaning of paragraph 2 of Article 19 of the Constitution of the Kyrgyz Republic is clear that the property is inviolable, and against the will of the owner no one shall be arbitrarily deprived of his property without a court order.<sup>138</sup> Thus, in fact, to foreclose without going to the courtroom is possible only with the voluntary consent of the debtor. "The settlement of such situations without judicial intervention is possible only if there is an agreement on the transition of the ownership to bank, in case of delay in debt and by the will of the debtor," - says Inna Zavalnaya, Director of the Department of civil Law and the business of the Ministry of Justice of Ukraine.<sup>139</sup> And the concept of extrajudicial foreclosure under article 60 of the new Law "On pledge", originally based on the will of both parties in the contract of pledge, and at the conclusion of other agreements that provide non-judicial foreclosure of the pledged property in case of default by the debtor obligations secured.<sup>140</sup> Thus, the new law established a mechanism that eliminates the non-judicial foreclosure of the pledged property against the will of its owner (pledgor).<sup>141</sup> "Clearly, the law gives the creditor, i.e. a bank to obtain legal ownership or sell the collateral (house) without a court order" - says partner at the law

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<sup>137</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.37 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>138</sup> Konstitutsiia KR [Konst. KR] [Constitution], June 27, 2010, Art.19 (Russ.)

<sup>139</sup> "Attorney's advice: how to protect property from the bank?." Attorneys legal experience. <http://advocat-volodarsky.kiev.ua/covet-yurista-kak-spasti-ot-banka-zalogove-imushhestvo.html> (accessed April 29, 2013).

<sup>140</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.60 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>141</sup> Id..

firm" Master and partners, " Mr. Reznikov. "But to realize this right will be very difficult, if the debtor is mind. He has every right to go to court and delay the proceedings, using the tricks of procedural law. "<sup>142</sup>

Another innovation that was brought to the Law "On pledge" of the Kyrgyz Republic was Article 65. This provision touched the term for eviction from the apartment. In case of foreclosure of residential house (or apartment), the pledgor and living with him members (family, any other third parties) must at the request of the new owner of an apartment (house) evict the premises within 30 days.<sup>143</sup> In case of failure to do so the owner of the house (room), realizing the rights of the owner, has the right to evict the administrative or judicial procedure mortgagor and living together with his family members, as well as third parties of premises occupied by them.<sup>144</sup> As the practice shows, this norm is not really working, it is like a "dead norm." For instance, if the pledgor failed to make payments and the date for commencing auction was announced. However, this auction might fail because the pledgor locked the door and does not let anyone to enter. As the auction on the pledged immovable property is conducted on the place of location of the real estate,<sup>145</sup> then there is no way to conduct the auction.

Overall, the terminology of the Law became more satisfactory in comparison with the previous Laws that regulated the pledge relations. The proposed mechanism was adopted in order to achieve a balance between the interests of the pledgor and the pledgee, to increase the responsibility of the borrower to the lender and make contractual relations more sufficient.<sup>146</sup>

## **2.2 Problematic issues of pledge institution**

The Law "On pledge" of the Kyrgyz Republic provides three types of pledge: pledge with the delivery of the pledged property to the pledgee (pawn), pledge with the collateral

<sup>142</sup> Newspaper "Leviy bereg". "Mortgage-pad?". Tristar, your financial navigator.

[http://tristar.com.ua/2/art/ipotechnyi\\_zalog\\_\\_pustyshka\\_10120.html](http://tristar.com.ua/2/art/ipotechnyi_zalog__pustyshka_10120.html) (accessed April 29, 2013).

<sup>143</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.65 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>144</sup> Pravo I Predprinimatelstvo, #2, 2005.

<sup>145</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.75 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>146</sup> Pravo I Predprinimatelstvo, #2, 2005.

remaining with a pledgor and pledge of rights.<sup>147</sup> However, this classification is different from the one that is given in the Civil Code of the Kyrgyz Republic. Civil Code provides pledge of rights, mortgage, pledge of securities, pawn, pledge of cash assets and etc.<sup>148</sup> According to a qualified judge of the Kyrgyz Republic Rahmonova, the concepts given in the Civil Code of the Kyrgyz Republic does not have the logical classification of types of collateral.<sup>149</sup> She states that under the law, there is a division of collateral by the location of the pledged property (for a mortgage), but on the other hand, there is classification by the object of the pledge (mortgage, pledge of rights, securities and receivables). Consequently, there is an absence of a single criteria of dividing collateral and Law of the Kyrgyz Republic "On Pledge" does not give clear classification on the types of pledge.

The classification of pledge in Russian Federation is made by the location of the collateral. According to Article 5 of the Law of the Russian Federation "On pledge," there is a pledge with the delivery of the pledged property to the pledgee and pledge with the collateral remaining with a pledgor.<sup>150</sup> Simultaneously, Braginskiy and Vitryanskiy, professors in civil law, note that Civil Code of Russian Federation defines three separate types of collateral that require special regulation: mortgage, pledge of goods in turnover and pledge of things in pawnshops.<sup>151</sup> However, Braginskiy and Vitryanskiy also do not define specific classification of collateral. As the classification criteria are not selected, for most of the scientist these types of collateral are somewhat inconsistent. The division of collateral is based on the specifics of the legal regulation of the types of collateral.

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<sup>147</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.24 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>148</sup> Grazhdanskiy Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 325 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>149</sup> Shukurov, N, and L Rahmonova. "Issues of legal regulation of pledge relations in the Republic of Tajikistan." Issues of Pledge. [www.lcg.tj/downloads/p01.zip?PHPSESSID=73968bc142f7f29b53edd5171f541a76](http://www.lcg.tj/downloads/p01.zip?PHPSESSID=73968bc142f7f29b53edd5171f541a76). (accessed March 10, 2013).

<sup>150</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.5 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>151</sup> Braginskiy , M, and V Vitryanskiy. "General Provisions on Pledge." In *Contractual Law*. 1 ed. Moscow: Statut, 2005. 544-545.

It can be noted that each country has its own classification of pledge. The most consistent classification of the pledge is made based upon the location of the pledged property and the object of the pledge.<sup>152</sup> As to the classification of pledge depending on the location of the pledged property, it may be offered such types such as a pledge with delivery of the pledged property to the pledgee (pawn) and pledge with the collateral remaining with a pledgor or the third person. These types of pledges are currently regulated in the legislation of the Kyrgyz Republic and depending upon the type of pledge, there is a specific legal regime for pledged property, rights and obligations of the pledgor and pledgee. However, certain criteria must be defined in the law “On pledge” to identify a type of pledge.

The development of legislation on the pledge in the Kyrgyz Republic started at 12<sup>th</sup> of March, 1992, when the first law "On pledge" was enacted. Currently, pledge relations are regulated by the law "On pledge" adopted in 2005, and the Civil Code of the Kyrgyz Republic of 1996, which contains of 19 norms than governs pledge relations. Before between the provisions of Civil Code and law on pledge had contradictions, but in 2007 the Civil Code has been amended and brought to the compliance with norms of law “On pledge.”

#### *Nature of the pledge disputes*

Pledge has accessory (optional) nature and the main purpose is to secure obligation.<sup>153</sup> The judge of the Supreme Court of the Kyrgyz Republic, Gutnichenko L. states that pledge is a secured obligation to repay the loan because most of the lawsuits presented to the court consist of two issues: the recovery of principal obligation and interest for its use, and reimbursement of foreclosure expenditures.<sup>154</sup>

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<sup>152</sup> Shukurov, N, and L Rahmonova. "Issues of legal regulation of pledge relations in the Republic of Tajikistan." Issues of Pledge. [www.lcg.tj/downloads/p01.zip?PHPSESSID=73968bc142f7f29b53edd5171f541a76](http://www.lcg.tj/downloads/p01.zip?PHPSESSID=73968bc142f7f29b53edd5171f541a76). (accessed March 10, 2013).

<sup>153</sup> Gutnichenko , L. "Judicial practice on issues of pledge agreement." Pledge agreement. [www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko\\_kirg\\_ru.rtf](http://www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko_kirg_ru.rtf) (accessed March 10, 2013).

<sup>154</sup> Id..

The law requires written and notarized form of pledge agreement,<sup>155</sup> and registration at authorized state agency (State Agency for Registration of Real Estate).<sup>156</sup> Despite this fact, judicial practice showed that in cases on recollection of debt, parties failed to get required registration.<sup>157</sup> Norm on requirements on the form of the pledge agreement is peremptory and failure to comply with the rules on the form of the pledge agreement leads to the invalidity of the pledge agreement.<sup>158</sup> In such cases, pledgee bears all risks. This mandatory norm cannot be changed by agreement of the parties. The strict requirement of the law to the form the pledge agreement is justified, since it disciplines the participants of civil legal relations, and guarantees the protection of the legitimate rights and interests of the parties in court.<sup>159</sup>

Moreover, judicial practice has shown that while providing loans, lending organizations do not check legal documents on the pledged property. In such cases, inattentive lender suffers. Appellate and Supreme judicial reviews show that in most cases, legal documents on the immovable property are checked at the stage of foreclosure.<sup>160</sup> In such cases, members of the common property have to be invited to the court as co-respondent, and if they were not notified about the time and place of the hearing, the decision of the court will be cancelled and returned to the a new trial.<sup>161</sup> The pledgee will not be able to start foreclosure proceedings unless all members of common property present in the hearing.

According to the legislation of the Kyrgyz Republic there is a pre-trial procedure for settling a dispute upon pledged property. Therefore, before filing a lawsuit against a borrower, a lender should (1) make notification of commencing the process of foreclosure, (2) register that

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<sup>155</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.10 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>156</sup> Id., at Art. 20.

<sup>157</sup> Gutnichenko , L. "Judicial practice on issues of pledge agreement." Pledge agreement. [www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko\\_kirg\\_ru.rtf](http://www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko_kirg_ru.rtf) (accessed March 10, 2013).

<sup>158</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.10 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>159</sup> Gutnichenko , L. "Judicial practice on issues of pledge agreement." Pledge agreement. [www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko\\_kirg\\_ru.rtf](http://www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko_kirg_ru.rtf) (accessed March 10, 2013).

<sup>160</sup> Id..

<sup>161</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 736 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).



notice in the State Register and (3) give this notice to borrower.<sup>162</sup> It is possible that the pledger will fulfill his/her obligation and the parties will not waste time in litigation. However, if the debtor fails to perform his obligation under the contract, the pledgee (lender) has the right to start judicial foreclosure if he attempted to use a pre-trial procedure for settling disputes. The court dismisses a motion if pledgee failed the pre-trial procedure.<sup>163</sup> The pledgee can appeal the decision after fulfilling the pre-trial procedure of dispute resolution. Analysis of court practice shows that the courts of first instance satisfy 80% of claims, the appellate body almost every 10% case, and supreme courts every 5%.<sup>164</sup>

Appealed decisions of the first instances were dismissed because of procedural violations as well as improper application of material law. According to the cases submitted to the court, following can be observed:

Courts	Appellate			Supreme			Average of cancelled/changed decisions
	appealed	cancelled/changed	%	appealed	cancelled/changed	%	
Bishkek city	14	5/5	71,4	27	22	81,4	78,0
Chuy region	3	3	100	12	2	58,3	66,6
Osh region	19	3	15,7	37	27	73,0	65,2
Jalal-Abad region	6	4	66,6	12	10	83,3	77,7
Batken region	2	-	-	3	3	100	60,0
Issyk-kul region	-	-	-	1	1	100	100
Naryn oblast	1	-	-	2	1	50,0	33,3
Talas oblast	2	1	50,0	1	1	100	66,6
Overall	47	16	44,6	95	73	76,8	66,1

\*Reviewed cases of the Supreme Court of the Kyrgyz Republic in 2001.<sup>165</sup>

From the given data could be seen that at the Supreme instance decisions are appealed

<sup>162</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 58 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>163</sup> Grazdanskii Processualniy Kodeks Kyrgyzskoi Respubliki [GPK KR] [Civil Procedural Code], art. 221 (Russ.)

<sup>164</sup> Gutnichenko, L. "Judicial practice on issues of pledge agreement." Pledge agreement. [www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko\\_kirg\\_ru.rtf](http://www.cac-civillaw.org/konferenzen/apr08/Gutnitschenko_kirg_ru.rtf) (accessed March 10, 2013).

<sup>165</sup> Postanovlenie Plenuma Verkhovnogo Suda KR "Razreshenie sporov, svyazannih s zalogovimi obyazatelstvami" ot 25 sentyabria, 2001g., abz.7 p.2 [Part 2, Section 7 of the Kyrgyz Republic Supreme Court Plenary Ruling on Selected Issues of Pledge Relations of Sep. 25,2001], Biulleten' Verkhovnogo Suda KR[BVS] [Bulletin of the Supreme Court of the Kyrgyz Republic] 2001, p.5.

twice more and canceled three times more frequent. Most of the violations happen in the courts of Jalal-Abad and Batken regions.<sup>166</sup>

Some courts underestimate the preparation of cases for trial and do not follow procedures provided in Articles 134-137, 148-150 Civil Procedural Code. As a result, hearings are delayed, and the terms for hearing the case prescribed by Article 155 of the Civil Procedural Code are violated. There were resolved 42 cases with violation of the terms for hearing, or every tenth case of this category.<sup>167</sup> For example, the Oktyabrskii and Pervomaiskii Bishkek district courts considered 23 cases on collateral with the violation of the procedural terms, and in Leninskii district court, on the contrary, cases of this category were left without movement.<sup>168</sup>

Overall, these numbers had decreased recent years upon qualified hearing of cases and changes that had been brought to the Civil Code and the Law “On pledge” of the Kyrgyz Republic. These amendments brought into compliance these two normative legal acts that regulate pledge relations, consequently quality of hearing had raised, moreover prior grounds for taking legal proceedings had been resolved outside of the courtrooms.

#### *Foreclosure upon the pledge*

Foreclosure on the collateral out of court can be made on the basis of:

- 1) the pledge agreement containing the terms of foreclosure on the collateral out of court;
- 2) a notarized agreement between the pledgee and the pledgor, concluded after occurring grounds of foreclosure on the collateral;
- 3) The executive notary.<sup>169</sup>

The general rule laid down in Article 335 Civil Code of the Kyrgyz Republic that regulates the procedure of foreclosure of the pledged real estate is a provision under which the pledgee's

<sup>166</sup> Postanovlenie Plenuma Verkhovnogo Suda KR “ Razreshenie sporov, svyazannih s zalogovimi obyazatelstvami” ot 25 sentyabria, 2001g., abz.7 p.2 [Part 2, Section 7 of the Kyrgyz Republic Supreme Court Plenary Ruling on Selected Issues of Pledge Relations of Sep. 25,2001], Biulleten’ Verkhovnogo Suda KR[BVS] [Bulletin of the Supreme Court of the Kyrgyz Republic] 2001, p.5.

<sup>167</sup> Id., p.5

<sup>168</sup> Id., p.6

<sup>169</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Mar. 12, 2005, art.60 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

claims are satisfied from the value of such property by the decision of the court.<sup>170</sup> However, pledgee can foreclose pledged property without bringing an action to the court. Satisfaction of pledgee's demands outside of the courtroom is possible on the basis of a notarized agreement between pledgee and the pledgor concluded after occurring the grounds for repossession of the collateral. We should pay attention to two factors, first, the moment of conclusion of the agreement and second, the form of agreement that requires notarization.<sup>171</sup> The agreement will enter into force only if it was concluded after occurring grounds for pledgee to start foreclosure proceedings, in other words if debtor violated the terms of the repayment of the credit. Consequently, we can conclude that any provision included in the pledged agreement that pledgee is entitled with the right to commence foreclosure upon pledged real estate in non-judicial way contradicts to the Civil Code and the Law "On pledge." Such agreements are void if they were concluded before hand, when the pledgor did not violate the primary obligation. Concerning the form of the agreement, if there is an absence of notarization, it leads to the invalidation of the contract, it also becomes void.<sup>172</sup>

Of course, foreclosure the pledge in non-judicial way under such agreement is beneficial for both parties, if all requirements are met. Parties can avoid litigation costs and the pledgee is able to efficiently return the credit from the borrower. In most cases pledgor sees the violation from pledgee's side, but he does not prevent foreclosure because "his hands are tied up."

In addition, Article 27 of the Law "On pledge" allowed the foreclosure of the pledged property in indisputable manner on the basis of executive notary.<sup>173</sup> However, such type of foreclosure had a significant drawback. Pledgee is entitled to demand fulfillment of obligation and commence foreclosure proceedings any time without verification grounds for foreclosure.

The new code prescribes that the pledgee's claims are satisfied from the value of the

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<sup>170</sup> Pravo i Predprinimatelstvo, N 4, 2003

<sup>171</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.60 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>172</sup> Id., at Art.10.

<sup>173</sup> Id., at Art. 27.

pledged property by the decision of the court in accordance with the procedural legislation.<sup>174</sup> Thus, indisputable foreclosure on the collateral on the basis of the executive notary is not allowed. There is only one exception to the rule when the pledgee can foreclose pledged property without bringing an action to the court on the basis of a notarized agreement between pledgee and the pledgor, if the agreement was concluded after occurring the grounds for repossession of collateral.<sup>175</sup> In this case, two conditions must be met: 1) the pledgor within the prescribed time did not fulfill or improperly executed pledge obligation, 2) the notarization of the agreement on non-judicial foreclosure on the collateral.<sup>176</sup>

*The institution of reclamation of property from bona fide purchaser*

The Constitution of the Kyrgyz Republic protects the ownership rights of a right holder and declares that no one can be deprived of property against his or her will unless by the decision of the court.<sup>177</sup> Recent amendments to the Civil Code of the Kyrgyz Republic removed contradictions between the Civil Code and the Law "On pledge," mainly on such a key issue, as foreclosure of pledged property. However, amendments did not touch the institution of reclamation of property from bona fide purchaser. This problem is rising and yet had not been resolved.

According to the Law of the Kyrgyz Republic "On pledge" the sale of the pledged property is made through public auction.<sup>178</sup> And here we will address to the institution of reclamation of property from bona fide purchaser. A common example in practice, when the pledger claims to return pledged property which was sold at auction to a bidder, who did not know that the auction was conducted with the violations of law or auction procedures. For example, in the invitation to public auction, an executive officer identified the improper location

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<sup>174</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 335 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>175</sup> Pravo i Predprinimatelstvo, N 1, 1996

<sup>176</sup> Id..

<sup>177</sup> Konstitutsiia KR [Konst. KR] [Constitution], June 27, 2010, art.4 (Russ.)

<sup>178</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge," [KR] [Law "On Pledge"], Mar. 12, 2005, art.71 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

of the place of auction of the immovable pledged property.<sup>179</sup> One of the grounds of disposal of property is violation of auction proceedings.<sup>180</sup> In case of revealing any grounds for invalidation of auction, pledger asks bona fide purchaser to return the pledged property. But after purchasing immovable property, the owner registers purchased property. In such cases, the rights of bona fide purchaser are not secured. Because the auction is invalid then its consequences have no legal force, thus, a person who has bought the pledged property from the auction and registered the transaction in the State Register will start disputing with initial owner-pledger. The bailiff stands aside and bona fide purchaser resolves this issue by himself. As a result, interests of the owner of the property who won the auction remain unprotected. Therefore, Civil Code of the Kyrgyz Republic needs some revision norms of reclamation of property from bona fide purchaser.

As it was noted above, the law requires mandatory notarization and registration of pledge agreement on real estate. Such contracts are considered to be concluded from the moment of registration, and failure to comply with the requirements for notarization and registration leads to invalidity of the pledge agreement.<sup>181</sup>

Buildings and facilities directly related to the land, are registered at the local public administration, specifically in Bishkek Bureau of Technical Inventory, the right to land - in the land registry, administered by local authorities and the State Land Cadastre, the right to natural resources - in the State inventory of minerals, and registration of enterprises as legal entities are administered by the National Statistics Committee.<sup>182</sup>

In practice the requirement on registration is not fulfilled by parties. They only hold the notarized pledge agreement. Article 60 of the Law of the Kyrgyz Republic "On pledge" establishes the undisputed foreclosure of the pledged property on the basis of executive

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<sup>179</sup> Slovo Kyrgyzstana, October 2, 2009

<sup>180</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.77 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>181</sup> Id., at Art. 20.

<sup>182</sup> Pravo i Predprinimatelstvo, N 1, 1996

notary.<sup>183</sup> Such procedure is provided by the Law "On the State Notary" and the debt collection is made indisputably under executive inscriptions of notary bodies.<sup>184</sup> According to this norm, foreclosure could be commenced on the basis of executive notary of notarized transaction. At the same time, according to the law of pledge, pledge agreements of property shall be notarized and registered. Thus, for repossession of the property secured by the pledge, notarization of the pledge agreement is not enough. In practice, notaries in fact violate law on the pledge by applying law on the notaries only, ignoring requirement on state registration of the pledge agreement.

Article 61 paragraph 4 of the Law "On pledge" states that after the pledge sends the notice to the pledger of coercive foreclosure, he acquires right to seize the collateral immediately.<sup>185</sup> However, in practice this not is not working. A pledge cannot become the owner of the immobile property within 3 days because he cannot evict people who occupy that property.<sup>186</sup> Moreover, the pledge cannot sell that property in auction because he does not access to the property at all.

Another issue is the announcement of auction in newspapers. As it was mentioned, the notice must be published once in national newspaper and once in local newspaper.<sup>187</sup> However, law says nothing upon regional newspapers. Whether auction based on publication of announcement in regional newspaper will be invalidated or it will be in compliance with the auction procedures, is not clear.

#### *Contradictions in the Law "On executive production"*

The Law of the Kyrgyz Republic "On executive production and about the status of legal executives," defines the time of the sale organized by legal executive within two months from

<sup>183</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.60 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>184</sup> Pravo i Predprinimatelstvo, N 1, 1996

<sup>185</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.61 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>186</sup> Id..

<sup>187</sup> Id., at art.75.

the day of initiation of foreclosure proceedings in specialized organizations, as well as auctions.<sup>188</sup> About the upcoming auction legal executive informs by mass media not later than ten days prior to the auction.<sup>189</sup> The announcement of auction must indicate the general information about the auctioned property, owner of the property, initial price and the date of auction.<sup>190</sup> However, Article 409 of the Civil Code of the Kyrgyz Republic provides different criteria, stating that announcement must include and that this announcement must be done no later than 30 days earlier to the upcoming auction.<sup>191</sup> The same time frame for establishing auction is given in the Law of the Kyrgyz Republic "On pledge."<sup>192</sup> These contradictions in the legislation lead to the cancellation of legal executive's action when applying to the court on validity and recognition of the sales.

Furthermore, as discussed, before taking part in auction, bidders have to pay indemnity payment in amount of 5 percent of the initial purchase price.<sup>193</sup> The law "On executive production and about the status of legal executives" requires a narrower provisions that announcement of auction, and an indemnity payment is 10 percent of the appraised value of the property.<sup>194</sup>

On the other hand, another problem legal executives' face is the passive attitude of the debtor to the sale of the pledged property. In most cases the legal executive himself seeks funds for storage, transportation, and establishment of the sale on the pledged property. For example, the legal executive arrested (real) property and commenced foreclosure proceedings. Even if the choice of a press agency is made, the costs of publication of a notice containing all the necessary

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<sup>188</sup> Zakon Kyrgyzskoi Respubliki "O Sudebnom Proizvodstve i Statuse Sudebnikh Ispolniteley" [Law of the KR "On executive production and about the status of legal executives"], Nov. 20, 2006, art.33 (Russ)

<sup>189</sup> Id., at art.67.

<sup>190</sup> Id..

<sup>191</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], art. 409 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>192</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005, art.37 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>193</sup> Id., at art.75.

<sup>194</sup> Zakon Kyrgyzskoi Respubliki "O Sudebnom Proizvodstve i Statuse Sudebnikh Ispolniteley" [Law of the KR "On executive production and about the status of legal executives"], Nov. 20, 2006, art.91 (Russ).

information will be difficult to continue obtain. In practice, the price of the ads range from 1200 to 2500 soms. It is unlikely that the debtor will be unable to pay the price of ads, and the creditor will refuse to lend him extra money, consequently the performance of the court decision is delayed. Statistics show that 60% of the executive documents of such claimants returned without execution.<sup>195</sup>

Tilekeeva A., the head of the Judicial Department of the Ministry of Justice of the Kyrgyz Republic, believes that the debtor does not have to wait for the beginning of the sale of the said property, and may actively participate in the sale process from the beginning, to prevent any kind of fraudulent activity in sale of the pledged property.<sup>196</sup> It is better if the debtor or his attorney would be interested in a activity of legal executive, and carry out the sale, offer the newspaper in which to advertise the upcoming auction, and if the court's decision does not set the starting price, then determine the market value of the property, provided the legal executive expert opinion about the real value of the property.<sup>197</sup>

In summary, it can be noted that the problem non-compliance of the Law "On executive production and about the status of legal executives," the Civil Code and the Law "On pledge" is completely solvable, since the Civil Code has higher status of legal force.<sup>198</sup> In order to eliminate contradicts, all laws that regulate pledge relations shall be revised and brought to conformity.

#### *Law "On Notary"*

Another Law that regulates pledge relations is Law "On Notary." It mainly regulates the process of foreclosure based on the notarization of the agreement. Article 83 of the Law "On Notary" states that in order to initiate foreclosure proceedings upon the pledged property, the agreement should be notarized.<sup>199</sup> However, Law "On Pledge" prescribes that in order to

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<sup>195</sup> Pravo i Predprinimatelstvo, #1, 2003

<sup>196</sup> Id..

<sup>197</sup> Id..

<sup>198</sup> Zakon Kyrgyzskoi Respubliki "O Normativnih Pravovih Aktakh" [Law of the KR "On normative legal acts"], May 13, 2011, art.4

<sup>199</sup> Zakon Kyrgyzskoi Respubliki "O Notariate" [Law "On Notary of the KR"], Art. 83



commence foreclosure upon collateral, the agreement shall be registered and notarized.<sup>200</sup> These contradictions in laws can cause misunderstandings and unending litigations of the parties. Therefore, Laws shall be bring into complies to work effectively.

*Case study and recommendations*

The problems that were discussed above might look small, but they have big impact on the difficulties that parties face while concluding pledge credit contract. These difficulties will be illustrated through cases. One of such famous cases is the dispute between “AsiaUniversalBank” JSC. v. “A&A World Trade Company” LLC., “Razzak” LLC.. In 2006 “A&A World Trade Company” LLC. took a credit in amount of \$300000 from “AUB.” The credit contract was secured with the pledge- the three stories building that belonged to “Razzak” LLC. However, the borrower could not fulfill its obligation and missed the term for repayment of money. In 2008 “AUB” filled a motion against “A&A World Trade Company” LLC. to recollect the debt and forfeit. First and the second instances issued the decision in favor of “AUB” and started the judicial foreclosure. The public auction on the building was announced, but no purchaser was willing to buy the real estate. According to the law, the second auction was announced; however it also failed because there were no purchasers. Based on it, property rights on the building were transferred to the “AUB.” “AUB” could not sell that building, and after several attempts of selling the property, it made the three stories building its branch.

In 2011, the pledgor commenced court proceedings based on the newly discovered circumstances. As it was found out, in 2008 Erkin Torobaev and Aziz Kachybekov granted guarantee fee to participate in an auction, but they allegedly were not able to enter to the building and participate in public auction.

According to the Article 361 of the Civil Procedural Code of the Kyrgyz Republic, one of the grounds for judicial review of acts of the newly discovered evidence is essential

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<sup>200</sup> Zakon Kyrgyzskoi Respubliki “O Zaloge,”[KR] [Law “On Pledge”], Art.10 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

circumstances of the case that were not and could not be known to the applicant.<sup>201</sup> Toronbaev and Kachybekov granted indemnity payment in November, 2008, however the guarantee fee was returned only in April 2009. Therefore, the peremptory day was in April 2010, but “A&A World Trade Company” LLC. filed an action in April 2011. Moreover, the pledgor was claiming that the executive officer was absent in a place of conducting the second auction in 14<sup>th</sup> of April, 2008. Those claims were not proved by any evidences.

The court analyzed evidences and found out that in fact executive officer was in a place of conducting auction from 9.00 until 10-15, moreover the law itself does not obliges the executive officer to wait the participants of the auction for several hours.<sup>202</sup> Nevertheless, the court on the given grounds assumed the auction invalid and took a decision to conduct another public auction.

“A&A World Trade Company” LLC. repaired the building and invested almost millions of soms. The market price of the building became 100 million soms. At a time when the former owner pledged the building to secure credit contract with bank, it was valued as 12 million soms.

If the Supreme Court will affirm the previous decisions of the first and the second instances, then new auction should be conducted. In 14<sup>th</sup> of November, 2013, The Supreme Court will hear the case. The petitioner already won two instances of the courts even in the absence of the evidences and lapse of time. The Inter-District and City Courts revised their three year decision and held new one.

The decision of annulling previous auction was based on doubtful evidences, or in other words there were no grounds for invalidation of the auction. If the Supreme Court of the Kyrgyz

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<sup>201</sup> Grazhdanskiy Prosessualniy Kodeks Kyrgyzskoy Respubliki [GPK RK][Civil Procedural Code of the KR], Ar. 361 (Russ).

<sup>202</sup> Postanovlenie Sudebnoy Kollegii po Administrativnim I Ekonomicheskim delam Verkhovnogo suda Kyrgyzskoy Respubliki, Delo N ED-1198/07 MBc8, ot 6 Noyabrya, 2008 g. [ Decision of the Board on Administrative and Economic Affairs of The Supreme Court Of The Kyrgyz Republic of Nov. 6, 2008, case N ED-1198/07 MBc8].

Republic will affirm previous decisions then the former owner (pledgor) is entitled to purchase pledged three stories building at first, as a granted priority. As it was stated above, the building was evaluated at a price of 12 million soms, but its actual market price is 100 million soms. If “A&A World Trade Company” LLC will find money to buy the building, he will have to pay only 12 million soms instead of 100 million soms. And those expenses that made “AUB” will not be returned.

Here in this case we can explicitly observe weakness of pledge institution concerning good faith purchaser. Even though, “AUB” became a true owner of the building by established procedure of foreclosure upon pledged property, his rights to the immovable property can be terminated in any moment. It will be very useful to use norms of the Russian Federation that it practices in such cases that provides certain exceptions for such termination of property rights. The Decree of the Plenum of the Supreme Commercial Court dated February 17, 2011 No. 10 “On some issues concerning application of legislative provisions regarding pledge” (hereinafter – the “SAC Decree on Pledge”) prescribes the approach that Russian courts use in cases concerning pledge. A lot of attention is given in this field in Russian Federation because it is one of the main types of securing the obligation. The SAC Decree on Pledge establishes grounds and sets limits of foreclosure of pledged property purchased by a good-faith purchaser. “Practically, it introduced a legal analogy to the rules of vindication by the legal owner from a good-faith acquirer.”<sup>203</sup> “The object of pledge may not be foreclosed upon if it is currently held by a good-faith acquirer, who was not informed (was not reasonably supposed to be informed) about the existence of the pledge and acquired the object on a commercial (i.e. non-gratuitous) basis. On the other hand, if the object of pledge used to be in possession of the pledge holder and was taken away against its will (e. g. stolen), it may be foreclosed regardless whether its current

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<sup>203</sup> "KPMG: Interpretation and Enforcement of Russian Laws on Pledge | Russian Law Online." Russian Law Online | Russia Through Lawyers' Eyes. <http://www.russianlawonline.com/content/kpmg-interpretation-enforcement-russian-laws-pledge> (accessed April 25, 2013).

possessor is a good-faith acquirer.”<sup>204</sup> Such kind of vindication rules and exception should be imposed to the legislation of the Kyrgyz Republic to protect vulnerable rights of a good-faith purchaser.

There are some cases in which the person who was indicated as borrower in the pledged credit contract had never received any money and against whom commenced court proceedings. The plaintiff (the lender) confirmed at the hearing of the case that the credit was received by another person, and a pledged property was provided by the defendant. The court, however, fully satisfied the creditor's claim to recover the debt and commence foreclosure proceedings on the collateral. Moreover, the Court of Appeal affirmed the decision of the first instance and left that violation without any notice. An example of such case can be a dispute between A. Imangazieva v. Beyshenova. This case was reviewed in Leninsky District Court in Bishkek in 11.08.2002. The subject of the dispute was the recovery of 508800 soms and foreclosure of the house. In this case, the defendant was the improper person. The court had to listen to the person who actually received the credit from the lender and then to decide to commence foreclose on the collateral. As one of the grounds for non-performance or improper performance of the pledge agreement, a lot depends on the resolution of the dispute on the primary obligation. The pledgor could not give an explanation to the court about the primary obligation under the credit contract, as he never participated in it. The Supreme Court reversed the Appellate decision of the Bishkek City Court stating that the pledge agreement is not a contract of loan, it can be accepted by the court as one of the written evidence together with other materials of the case.<sup>205</sup>

The pledge itself has accessory character and many disputes are reviewed simultaneously with the action on primary obligation. Inattentiveness and inaccurate decisions of the lower courts makes the “innocent” people being involved in a routine of litigation.

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<sup>204</sup> Grazhdanskii Kodeks Rossiyskoi Federasii [Civil Code of the RF], Art. 302..

<sup>205</sup> Postanovlenie Plenuma Verkhovnogo Suda KR “ Razreshenie sporov, svyazannih s zalogovimi obyazatelstvami ” ot sentyabria, 2003g., [Kyrgyz Republic Supreme Court Plenary Ruling on Selected Issues of Pledge Relations of Sep,2003], Biulleten' Verkhovnogo Suda KR[BVS] [Bulletin of the Supreme Court of the Kyrgyz Republic] 2003.

Another interesting dispute was resolved in District Court of Bishkek decision in 26<sup>th</sup> of April 2001. The Court dismissed the claims of KAFC to commence foreclosure proceedings upon pledged property, mainly apartment and two houses, valued at a price- 100 thousand soms and 450 thousand. The property was in possession of the pledgor Sharshenbaev E.. He had to repay the other part of the debt under the credit contract that was left. This debt was equal to 54013 soms. This amount was disproportionate to the value of the mortgaged property.<sup>206</sup>

According to the paragraph 2 of Article 1 of the Law "On pledge," "A pledge may arise by operations of law or by an agreement committed with the Civil Code and this Law."<sup>207</sup> Therefore, before fulfilling a secured obligation (principal), it must be expressed in monetary claim. An action for foreclosure of the pledged property usually is considered in a single proceeding along with the monetary claim on the obligation secured by this pledge in courts. Practice shows that when this issue is resolved in two different actions, the judgment sometimes is remained unsettled or the court's order or writ of monetary recovery of the secured obligation is not executed.<sup>208</sup> As the study of cases shows, this requirement of the law is not always respected, in particular, in certain cases on actions for recovery of the loan.

From the above examples, we can conclude that the decision to foreclose the collateral, approval of the court to commence the foreclosure proceedings or refusal definitely depends on the performance of the primary obligation. The pledge agreement is a tool to fulfill obligation, it is like a guarantee that in any circumstances, lender is able to return its money back. Therefore, pledge agreement has accessory character and the destiny of the pledged property depends on the performance or non-performance of the primary obligation (credit contract). If the court refuses to meet the claim of the creditor (lending organization) under the principal obligation then,

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<sup>206</sup> Razreshenie sporov svyazannih s zalogovimi obyazatelstvami [Resolution of disputes related to the pledged obligations], toktom.kg (official online version of legislation).

<sup>207</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Mar. 12, 2005 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>208</sup> Razreshenie sporov svyazannih s zalogovimi obyazatelstvami [Resolution of disputes related to the pledged obligations], toktom.kg (official online version of legislation).

accordingly, the court denies satisfaction of the demands of the creditor by pledged property and discharges the contract. In case of cancellation of decisions of the first and second instances, the cancellation of the foreclosure proceedings happen.

If the pledge agreement contains some violations that are contrary to the rules of the Article 328 of the Civil Code of the Kyrgyz Republic and Article 11 of the Law "On Mortgage," the agreement is considered to be not concluded.<sup>209</sup> This happens when the parties did not identify in the agreement the collateral that is going to be sized and period of performance of the principal obligation secured by the pledge agreement. These provisions are the essential conditions of the pledge contract to be valid.<sup>210</sup> Accordingly, the pledgee does not have right to dispose of the collateral before acquiring the right of ownership to the immovable real estate.

The ability to transfer the collateral to the pledgee only occurs if the auction does not give the results.<sup>211</sup> As long as the pledge is not ceased, its transmission prior to the date of the establishment of public auction violates the law and causes its invalidation.

Meanwhile, disputes concerning the pledge relations, mainly foreclosure upon the collateral, that were heard in a court were resolved with the violation of the substantive law, misunderstanding of the nature and purpose of the pledge.

Lending organization "Bishkek" filed an action against the Madiyarov to collect the amount of money under the credit contract and foreclose the collateral. Alamudun Court decided the decision in favor of "Bishkek," and collected payment in amount of 115603 soms without foreclosure upon pledged house. It is a big doubt how the decision will be fulfilled in part of monetary fine by executive officer if under Article 335 of the Civil Code of the Kyrgyz

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<sup>209</sup> Grazhdanskiy Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], Art. 393 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>210</sup> Id..

<sup>211</sup> Zakon Kyrgyzskoi Respubliki "O Zaloge,"[KR] [Law "On Pledge"], Art, 76 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

Republic, the satisfaction of the creditor's monetary claims can be fulfilled from the value of the pledged property.<sup>212</sup>

As practice shows, most of the debtors pledge their only property (apartment, house) obtained as a result of privatization from which pledgor is evicted with his family members without providing future place of residence. According to the statistic reports such cases with eviction of pledgor, were reviewed by courts in 2000 – 595 cases, 2001- 632 cases, 2002- 770, and these numbers increase from year to year.<sup>213</sup>

The person who acquires pledged house (apartment) at the public auction according to the procedure stipulated in the Civil Code of the Kyrgyz Republic without verifying compliance with these conditions does have right to evict the pledgor and his family, or in other words he cannot simply use the house (apartment).<sup>214</sup>

Special attention should be given in cases of foreclosure of the pledged property to the rights of minor (minors) who is entitled to the property rights, as well as minor family members of the pledgor when he is concluding the pledge credit agreements.<sup>215</sup> Analysis of court cases shows that the parent are not always exercises their civil rights in a good faith and reasonable, providing as collateral for a single-family house (apartment), at the risk of losing it.<sup>216</sup> According to Article 26 of the Constitution of the Kyrgyz Republic, parents are obliged to take care of their children. In accordance with the Articles 69, 70 of the Family Code (2003), parental rights may not be exercised contrary to the interests of children.<sup>217</sup> Parents are the legal representatives of their minor children only when advocating for their rights and interests, and the abuse of parental

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<sup>212</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], Art. 335 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>213</sup> <sup>213</sup> Razreshenie sporov svyazannih s zalgovimi obyazatelstvami [Resolution of disputes related to the pledged obligations], toktom.kg (official online version of legislation).

<sup>214</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], Art. 336 (Russ.), translation took from <http://www.toktom.kg>. (official online versions of legislation).

<sup>215</sup> Konstitutsiia KR [Konst. KR] [Constitution], art.26 (Russ.)

<sup>216</sup> <sup>216</sup> Razreshenie sporov svyazannih s zalgovimi obyazatelstvami [Resolution of disputes related to the pledged obligations], toktom.kg (official online version of legislation).

<sup>217</sup> Semeyniy Kodeks Kyrgyzskoy Respubliki, [Family Code of the KR], Art. 69-70.

rights, children's interests are protected by the guardianship authorities. Parents are guardians or trustees of their minor children without special purpose.<sup>218</sup> Within the meaning of Article 72 of the Civil Code limits the guardians' rights to dispose of their property without the prior permission of the guardianship authority<sup>219</sup> and all other transaction that established, terminates or changes property rights of the minor. The results of the reviewed cases show that the courts did not check the compliance with the above mentioned provisions of the law. All cases of foreclosure of the pledged residential premises were considered without the participation of the guardianship authority, no evidences of given permission were claimed. Therefore, the law should protect rights of vulnerable population, minors who cannot protect their rights by themselves.

In accordance with the Articles 27, 28, 32 of the Law "On Mortgage" mortgagee (lender) can commence foreclosure proceedings upon the pledge after sending to the debtor (mortgagor) "notice of default," that states that the debtor could not fulfill his obligation on time, therefore lender proposes for voluntary execution obligations within a period not less than 30 days.<sup>220</sup> Failure to meet the requirements stipulated in the notice and within the specified period gives the mortgagor right to commence foreclosure procedure. The study of cases revealed that in the courts these procedure of substantive law generally is not followed. In courts of Jalal-Abad the number of violations is 136, in Osh region - 79, Bishkek - 46, Batken oblast - 17, Naryn - 15 (Suzak District Court - 72, Osh City Court - 38 October District Court - 29, Bazar-Kurgan District Court - 26, Jalal-Abad City Court - 19, Nookan District Court - 16, Aravan District Court - 16, Uzgen - 11).<sup>221</sup>

The violations in these regions are mostly procedural and material. Day by day,

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<sup>218</sup> Razreshenie sporov svyazannih s zalogovimi obyazatelstvami [Resolution of disputes related to the pledged obligations], toktom.kg (official online version of legislation).

<sup>219</sup> Grazhdanskii Kodeks Kyrgyzskoi Respubliki [GK KR] [Civil Code], Art. 72 (Russ.), translation taken from <http://www.toktom.kg>. (official online versions of legislation).

<sup>220</sup> Zakon Kirgizskoi Respubliki "Ob Ipoteke" [Law "On Mortgage" of the KR], Art. 27 (Russ), translation taken from <http://www.toktom.kg>. (official online versions of legislation).

<sup>221</sup> Razreshenie sporov svyazannih s zalogovimi obyazatelstvami [Resolution of disputes related to the pledged obligations], toktom.kg (official online version of legislation).



improvements are made. Judges are tested on the level of knowledge of the jurisprudence, and better conditions are made to review the cases.

*The cession of right to claim to return the debt*

Under Article 19 of the Law “On Pledge” “a pledgee may cede his rights under the pledge agreement to another person, unless otherwise provided by law.”<sup>222</sup> It means that a senior pledgee has a right to cede his rights of claim to return the credit to another person. This type of cession is now developing, because lending organizations do not want to deal with borrowers, who do not return money on time.

There is a tendency of establishing “Collection Agency” which “knocks out” money from the debtor. The phrase “knock out” was used to illustrate how the collection agencies return money. It uses physical force, threat and other illegal ways to frighten the borrower and make him to return the credit in any ways. Such kinds of agencies are widely used in the Russian Federation. However, law-enforcement agencies sometimes cannot control activity of such agencies. Collection Agencies, definitely, exceed their power by using illegal ways of making the debtor to return money. Russian is still fighting with such agencies that use illegal ways, but such agencies have positive aspects too. If the activity of these agencies will be prescribed by law, the powers of collectors will be limited in legal grounds, and then these agencies can become a good tool for fulfilling obligations. Banks will not deal anymore with clients, the only thing that they will do is issuing credit.

The legislation of the Kyrgyz Republic does not provide such kind of agencies, but there it would be very useful to establish such kind of legal entities that will work on collection of the debts. These agencies will remind about the creditor’s delay and in the case of need they will initiate court proceedings. Interests of banks will be more protected, because it will not participate in a routine disputes, but work on managing financial crisis of the country.

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<sup>222</sup> Закон Кыргызской Республики “О Залоге,”[KR] [Law “On Pledge”], Ar.19 (Russ), translation took from <http://www.toktom.kg>. (official online versions of legislation).

## **Conclusion**

Commercial banks and different lending organizations are the main link in developing market conditions in a country. They become an intermediary for development and involvement of ordinary people into the commercial activity. The development of the finance-credit system directly influences the economic situation of the Kyrgyz Republic, therefore harmonized system of laws in crediting system will acceleration the economic growth of the State.

The crediting operations bare potential risk of losses and damages and an important aspect of further development of bank crediting is to make improvements in the legislation that regulated pledge relations. If commercial banks and credit institutions, as major lenders in the market, will not have a real mechanism of foreclosure on the pledged property without filing a lawsuit in court, by evaluating all risks, they will reduce the issuance of credit. Therefore, the legislation bodies should take all necessary steps to protect rights of the both sides and minimizes the risks of not fulfilling obligations.

The pledge institution of the Kyrgyz Republic had increasingly developed with the growth of credit relations. At the resolution of pledge obligation disputes, courts should ensure accurate compliance with procedural laws, in particular, to clarify the rights and obligations of the parties. The data I the tables showed that most of the cases were resolved even without following procedural rules. Of course, there are some shortcomings in judicial practice but they all are solvable. Certain laws should be revised and harmonized in order to protect the rights and legitimate interests of members of civil relations. Mainly Law “On notary” and Law “On executive production” should be bring into compliance to the Law “On pledge.” These small nuances might look insignificant, but small things can cause big problems. As it was mentioned above, if even one small procedural rule was not fulfilled in auction (judicial foreclosure), the whole foreclosure proceeding can be terminated. We can say, it has a domino effect. If there is a row of dominoes set up, and when you hit the first one, and certainty the other rest will go over very quickly. If a tiny thing contradicts to what prescribed by law, then the whole process will

contradict to the legislation. Therefore, pledge institution needs some amendments to avoid such kind of problems that parties now do.

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