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**Client briefing**
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# What creditors should know about Russian insolvency regime – Q&As on Russian insolvency

## Introduction

This client briefing provides answers to the questions most frequently raised by Russian and foreign investors in connection with the insolvency of their Russian corporate counterparties and gives an overview of the most provisions of the Russian insolvency regime applicable to companies.

In particular, this briefing provides a general description of the insolvency proceedings that can be commenced against a Russian company, insolvency tests which may result in the commencement of insolvency proceedings, the procedure for the initiation of insolvency proceedings and the restrictions on the debtor and its activity which are triggered by the commencement of insolvency proceedings. The briefing also explains what rights creditors generally have in a debtor's insolvency and how creditors can exercise their rights and satisfy their secured and unsecured claims in the debtor's insolvency. It also gives a general understanding of transactions that may be vulnerable in the Russian debtor's insolvency as well as outlining general principles dealing with the potential liability of the management of the debtor and its controlling persons for the debts of insolvent entities.

Most of the legislation regulating the insolvency of corporate entities in Russia is contained in the Federal Law No. 127-FZ "On insolvency (bankruptcy)" of 26 October 2002 (the "**Insolvency Law**") which was significantly amended at the end of 2008 and in the middle of 2009. This briefing does not discuss the insolvency of banks and other credit institutions which are subject to a special regime.

### To what companies can Russian insolvency proceedings apply?

Russian insolvency proceedings can generally be commenced only in relation to a Russian registered company. It is also possible that a Russian court would recognise decisions on insolvency proceedings in relation to a foreign entity issued by a foreign court (e.g. a decision of a foreign court restricting the disposal of property located in Russia and owned by a foreign entity against which bankruptcy proceedings had been commenced outside Russia). Recognition by the Russian court of a decision of a foreign court could be either on the basis of an international treaty (although at present there are no treaties relating to insolvency to which Russia is a party) or, in the absence of such a treaty, on the basis of the principle of reciprocity (although there is no established court practice on this point).

Bankruptcy hearings take place before the local arbitrazh court (the "**insolvency court**") in the area where the company is registered, but decisions of that court may be appealed in courts of higher instance.

**Key Issues**




If you would like to know more about the subjects covered in this publication or our services, please contact:

Victoria Bortkevicha +7 495 725 6406
Logan Wright +7 495 725 6430
Vladimir Barbolin +7 495 258 5071

To email one of the above, please use firstname.lastname@cliffordchance.com

Clifford Chance CIS Limited,
Ul. Gasheka 6, 125047 Moscow, Russia
www.cliffordchance.com

## What are the measures to prevent bankruptcy?

If a company encounters "signs of bankruptcy" (see "*Substantive tests*"), the founders (participants) are to take measures (upon agreement with the company) to restore the company's solvency. The only measure specified by law is rehabilitation by way of provision of financial assistance in an amount sufficient to satisfy the payment obligations of the company to prevent its bankruptcy and restore its solvency.

The regime of rehabilitation is not sufficiently developed and is not usually used in practice.

In Russia there is no concept of a sale of a distressed business to a "newco" on a pre-agreed basis, free of residual liabilities which are left behind in the old structure prior to the commencement of bankruptcy proceedings (generally known in other jurisdictions as a "pre-pack"). A sale of a company's assets prior to instigation of bankruptcy proceedings may be challenged as a "suspicious" or "preferential" transaction.

### *Is a standstill agreement available outside bankruptcy?*

Under Russian law so called standstill agreements, which may be available in other jurisdictions for the purposes of efficient restructuring, or any similar arrangements entered into outside bankruptcy proceedings and introducing a moratorium on enforcement of creditors' claims and security against a Russian company suffering financial difficulties most likely would not be enforceable, unless the terms of each relevant agreement under which the relevant debt obligations have arisen are amended.

## What are the main stages of Russian insolvency proceedings?

There are generally five possible stages of insolvency proceedings that may be applied against a Russian company:

### *Supervision*

- Supervision is the first compulsory insolvency proceeding which involves the appointment by the insolvency court of an interim administrator whose primary aim is to preserve the company's assets while conducting a financial audit of the company to determine whether the company may be restored to solvency. It includes an initial registration of creditors' claims.
- The interim administrator is approved by the insolvency court following nomination by the petitioner or by selection from a list of candidates presented by the self-regulatory organisation of insolvency administrators (the "**SRO**") proposed by the petitioner in its bankruptcy petition.
- During the supervision stage the company's management remains in place (although with restricted authority).
- During the supervision stage the first creditors' meeting must be held which, among other things, should decide on the next stage of insolvency to which the company will move upon the direction of the court after completion of supervision.
- Upon commencement of supervision, discharge of creditors' claims which arose before opening of the insolvency proceedings, and actions or transactions aimed at satisfaction of such claims, are subject to restrictions most of which are extended to further stages of insolvency (see "*What impact does commencement of insolvency proceedings have on creditors' rights?*").
- The supervision stage can last up to 7 months.

### *Financial rehabilitation*

- Financial rehabilitation is not a compulsory insolvency proceeding and is instigated by the insolvency court (i) at the petition of the first creditors' meeting, and, in the absence of such petition (ii) at the petition of the company's shareholders or other persons willing to put up collateral for the company's debts.
- In the course of rehabilitation a debt repayment schedule must be drawn up under which (i) all registered claims are to be satisfied according to the statutory order of priority no later than 1 month prior to the end of the stage, and (ii) first and second priority claims are to be satisfied within six months from the date of commencement of rehabilitation.
- Financial rehabilitation is primarily aimed at restoring the company's solvency and the satisfaction of creditors' claims in accordance with a debt repayment schedule.
- If financial rehabilitation is successful, the company emerges from the insolvency proceedings; if not, the insolvency court will move to liquidation unless, to the extent the length of financial rehabilitation allows, there are grounds to move to external administration (see "*External Administration*").
- If the debt on the debt repayment schedule was satisfied out of security provided by third parties, the claims of such security providers against the

debtor may only be satisfied after termination of the bankruptcy proceedings (in the event the debtor's solvency is restored) or at the liquidation stage as a third priority claim (i.e. *pari passu* with other unsecured claims of creditors).

- Implementation of the debt repayment schedule and the plan for financial rehabilitation (which is drawn up if collateral supporting the debt repayment schedule was not provided) is supervised by an administrator.
- The administrator is approved by the insolvency court following nomination by the creditors' committee or selection from a list of candidates presented by the SRO proposed by the creditors' committee, but again, the company's management remains in place (although its authority is more restricted than at the supervision stage).
- Financial rehabilitation can last no more than 2 years.

***External administration***

- External administration is not a compulsory insolvency proceeding and is generally instigated by the insolvency court at the petition of the creditors' meeting. It involves the appointment of an external administrator to collect in debt, make an inventory of assets and prepare a plan for restoring solvency (to be approved by a majority of creditors voting at a creditors' meeting).
- The external administration commences if there is a real possibility of restoring the company's solvency within the set time limits, and when it succeeds the financial rehabilitation stage it may be commenced only if not more than 18 months have passed since the commencement of financial rehabilitation.
- The company's management is removed by the insolvency court and management power is vested in the external administrator.
- An external administrator is approved by the insolvency court by the same procedure as that applicable to financial rehabilitation.
- Subject to the limitation of the aggregate duration of financial rehabilitation and external administration mentioned below, external administration can last up to 18 months but may be extended by a further 6 months on the petition of the majority of registered creditors voting at a creditors' meeting.
- The aggregate term of the financial rehabilitation and external administration may not exceed 2 years.

***Liquidation***

- Liquidation is the last stage of insolvency proceedings.
- The company may generally enter into liquidation if the insolvency court determines that the company shows "signs of bankruptcy" and there are no grounds to (i) instigate any recovery stages of bankruptcy (i.e. financial rehabilitation and external administration); (ii) approve a voluntary arrangement; or (iii) terminate bankruptcy proceedings or dismiss a bankruptcy petition.
- In addition, the company may enter into liquidation if the creditors' meeting:
  - (i) petitions at any stage of insolvency to have the company declared bankrupt and for the commencement of liquidation;
  - (ii) fails to approve the solvency plan within 4 months from the date of commencement of external administration;
  - (iii) rejects the solvency plan and petitions for liquidation; or
  - (iv) on the basis of the report of the external administrator, fails to take either a decision resulting in termination of insolvency proceedings or a decision on commencement of liquidation, if (a) the insolvency court was petitioned for commencement of liquidation and (b) the maximum term for which the external administration can last has expired.
- Liquidation starts by declaring the company bankrupt and involves the appointment by the insolvency court of a liquidator to realise the company's assets and satisfy its debts in accordance with the statutory order of priorities.
- The liquidator is approved by the insolvency court by the same procedure as that applicable to the administrator in financial rehabilitation and replaces the management of the company.
- Upon commencement of liquidation, all debts are deemed due, all assets are consolidated in a pool comprising the bankrupt estate (although secured assets are accounted for separately within the pool) and all bank accounts are consolidated into a single account save for a "special account" which is to be established for the purposes of collecting proceeds from the sale of secured property;

- Upon commencement of liquidation, monetary claims and other claims on enforcement of the debtor's assets can be presented only in the course of bankruptcy proceedings (save for creditors' current claims and claims on recognition of ownership rights, on compensation for moral damages (mental suffering), on recovery of property from unlawful possession of the debtor and on invalidation of transactions and application of the consequences of such invalidation which are to be presented outside bankruptcy proceedings).
- Liquidation lasts for up to 6 months, although it may be extended by a further 6 months.

***A voluntary arrangement***

- A voluntary arrangement can be entered into at any stage of insolvency proceedings.
- The creditors' meeting can petition for a voluntary arrangement upon approval by a majority of creditors whose claims are included in the register of creditors, and with the unanimous consent of those creditors whose claims are secured by pledge or mortgage over the debtor's assets.
- To be legally binding a voluntary arrangement must be approved by the insolvency court and the court may approve it only if the unsecured claims of the first and second priority creditors and current claims are being satisfied.
- A voluntary arrangement binds the company and the creditors whose claims were included in the register of creditors (irrespective of whether they voted against such arrangement or did not vote).
- From the date of court approval of the voluntary arrangement, the insolvency proceedings terminate and the debtor is obliged to start repayment of creditors' claims in accordance with the repayment schedule set out in the voluntary arrangement.
- Existing security (in fact, only pledges or mortgages) over the debtor's assets is retained to secure claims of secured creditors under the voluntary arrangement, unless otherwise provided in the voluntary arrangement.
- The voluntary arrangement can be terminated only with respect to all creditors bound by the arrangement and arguably only in the case of the debtor's failure to perform, or a material breach, affecting creditors whose claims constituted at least 25 percent of all the registered creditors' claims as of the date of approval of the voluntary arrangement.
- If new insolvency proceedings are subsequently brought against the company, the creditors that entered into the voluntary arrangement will have the right to claim only for the amounts provided for under the voluntary arrangement.

***Shortened insolvency proceedings***

In certain cases (such as commencement of insolvency proceedings against a company during the process of its voluntary liquidation) the shortened insolvency proceedings apply.

If during voluntary liquidation of a company it appears that the value of the company's assets is not sufficient to settle its creditors' claims, the company's liquidator must file for its bankruptcy. In such circumstances the earlier stages of insolvency will not apply and the company is declared bankrupt and the liquidation stage of insolvency is commenced immediately after filing the bankruptcy petition, which significantly reduces the duration of the insolvency process.

As a result, in order to participate in the debtor's insolvency proceedings creditors should file their claims with the insolvency court within 1 month of public announcement that the company was declared bankrupt, and in order to be included in the register of creditors' claims, arguably within 2 months of such announcement. If creditors fail to file within the respective periods, they may not vote at creditors' meetings and the claims outside the register of creditors' claims will be satisfied after discharge of all registered claims.

## How can insolvency proceedings be initiated and commenced?

Insolvency proceedings can be commenced at the petition of:

(i) a third party creditor having a monetary claim against the company confirmed by a court decision;

(ii) a government agency in respect of debts owed to the state budget (e.g., the tax and customs authorities); or

(iii) the company itself (based on the decision of its directors or shareholders).

***Signs of bankruptcy***

The company is treated as not being able to satisfy the monetary claims of its creditors (i.e. as showing "signs of bankruptcy") if the unpaid debt is overdue for at least three months from the date when it must be repaid.

***Substantive tests***

Generally, for the commencement of insolvency proceedings by a creditor or a government agency, the unpaid debt should be equal to or exceed RUR 100,000, be overdue by at least 3 months and the unpaid debt must have been confirmed by the court as well founded.

***Petition by creditors***

A creditor may petition for the debtor's bankruptcy from the date a court decision to recover debt owed by the debtor enters into force.

***Petition by foreign creditors***

For a foreign creditor the following ways of confirming its claim against a Russian debtor for the purposes of filing a bankruptcy petition are available (i) obtaining a foreign court judgment; (ii) obtaining a foreign arbitral award; or (iii) obtaining a Russian court judgment by initiating proceedings directly in a Russian court.

If foreign creditors obtain a foreign court judgment or a foreign arbitral award confirming the claim against a Russian debtor, a bankruptcy petition against the debtor can be filed with a Russian insolvency court only upon recognition and enforcement of such judgment or award.

***A foreign court judgement:*** as no international treaty on recognition and enforcement of foreign judgments exists between Russia and most foreign jurisdictions (such as the UK, for example), a foreign court judgement can be recognised only on the basis of the principle of reciprocity on a case by case basis. Although there are a few cases when Russian courts have recognised foreign court judgments on the grounds of reciprocity, this practice is far from being considered established.

***A foreign arbitral award:*** to initiate bankruptcy proceedings on the basis of a foreign arbitral award confirming the claim, such award will need and to be, if granted in the territory of a contracting state, recognised and enforced in the Russian courts on the basis of the 1958 New York Convention on Recognition and Enforcement of Foreign Arbitral Awards.

***A Russian court judgement:*** as an alternative, foreign creditors may take proceedings against a Russian debtor in the Russian courts (provided that a Russian court has jurisdiction to consider such dispute) and a Russian court should accept jurisdiction unless a foreign court has already passed a judgement in a dispute between the same parties where the resolved claim concerned the same subject matter and the judgement had already entered into force. The Russian court also should dismiss a claim without a hearing on the merits (without prejudice) if a foreign court is already considering a dispute between the same parties on the claim concerning the same subject matter. If a Russian court has jurisdiction to hear a claim against the debtor, it would consider the claim on the merits and once the judgment enters into force, a bankruptcy petition may be filed by a foreign creditor with the Russian insolvency court.

***Petition by government agencies***

There is a separate regime for dealing with petitions by government agencies. An agency may petition for a company's bankruptcy:

(i) with respect to debts owed to the state budget or otherwise to the Russian Federation ("**Mandatory Payments**"), when 30 days have passed after (i) a relevant tax or customs authority took a decision to recover a Mandatory Payment by seizing the debtor's funds or other assets (when a claim is subject to uncontested proceedings); or (ii) a court decision to recover Mandatory Payments entered into force (when a claim is subject to court proceedings); or

(ii) with respect to any other claims, when a court decision to recover the debt enters into force.

***Petition by the company***

Generally, the company **must** petition for bankruptcy within 1 month of it becoming evident that:

(i) the satisfaction of the claims of one or more creditors results in the company's inability to perform its payment obligations in full to other creditors;

(ii) the enforcement of claims against the company's assets will create significant difficulties or make it impossible for the company to continue operations;

(iii) the company (a) ceases to pay any part of its debts as they fall due on account of insufficiency of funds ("inability to pay ") or (b) has insufficient assets in terms of value to satisfy its monetary liabilities ("insufficiency of assets "); or

(iv) in the course of a solvent liquidation of the company, either of the tests referred to in (iii) above is met (in which case a bankruptcy petition must be filed with an insolvency court within ten days of either of the test being met).

If the relevant persons fail to file a bankruptcy petition in the cases provided above, they may be subject to an administrative and/or civil liability (see "*Liability of "controlling persons" for the insolvent company's debts*").

In addition, the company **may** petition for bankruptcy if bankruptcy is anticipated because of circumstances clearly evidencing its inability to perform its payment obligations to its creditors in accordance with their terms.

## How long could it take to commence insolvency proceedings?

Within 5 (five) business days[1] of filing a bankruptcy petition with an insolvency court, the court should decide on whether to accept such petition and instigate insolvency proceedings, or refuse or defer the acceptance of the petition. The insolvency court must accept the creditor's petition if the claim on its face satisfies the substantive tests referred to in "*Substantive tests*".[2] Acceptance of a bankruptcy petition does not inevitably mean that substantive insolvency proceedings will be instigated against the company as the insolvency court should first hold hearings to verify whether the grounds for commencement of substantive insolvency proceedings are well founded.

Within 10 (ten) business days of receipt of the ruling on acceptance of a bankruptcy petition, the debtor must send to the insolvency court and the petitioner a statement of defence. [3]

Not earlier than 15 (fifteen) business days and not later than 30 (thirty) business days after acceptance of the bankruptcy petition, the insolvency court should hold hearings to verify whether the petitioner's claim is well founded. [4]

If the insolvency court confirms that:

- in case of a creditor's claim, the claim is well founded, continues to meet the test referred to in "*Substantive tests*" and as of the date of court hearings remains outstanding; and
- in case of a debtor's claim, any of the tests referred to in "*Petition by the company*" are met,[5]

it must rule on the commencement of substantive insolvency proceedings and instigate supervision (the first compulsory insolvency stage).

[1] Art. 42(2) of the Insolvency Law.

[2] Art. 33(2) of the Insolvency Law.

[3] Art. 47(1) of the Insolvency Law.

[4] Art. 42(6) of the Insolvency Law.

[5] Art. 48(3) of the Insolvency Law.

## How creditors may find out that its Russian debtor has been put in insolvency proceedings?

Information on the commencement of substantive insolvency proceedings against Russian companies (starting from institution of the supervision stage) must be published by the insolvency administrator in a special Saturday edition of the newspaper "Kommersant" which may be viewed online.

In addition, the Unified Federal Register of Information on Bankruptcy (the "**Bankruptcy Register**") which is a publicly available register containing, among other things, information on Russian debtors against which insolvency proceedings have been commenced, was recently established on the basis of the web resources of the news agency *Interfax*[6] and the information contained in such Register is accessible online.

It is also usually recommended to make a search with respect to bankruptcy petitions and/or claims filed against a Russian debtor on the website of the relevant local arbitrazh court in the area where the Russian debtor is registered.

## What impact does commencement of insolvency proceedings have on creditors' rights?

### *Claims of creditors upon commencement of insolvency proceedings*

Once insolvency proceedings are commenced (i.e. the supervision stage is instigated) the insolvent company can only discharge its non-current debts (claims that arose before the opening of insolvency proceedings) in accordance with the statutory order of priorities. In particular, upon institution of supervision:

- Creditors' claims (other than current claims i.e. claims that arose after the opening of insolvency proceedings) may be presented only in accordance with the procedure prescribed by law;
- For the purposes of participation in bankruptcy proceedings and inclusion of creditors' claims in the register, claims which arose on or before the acceptance by the insolvency court of a bankruptcy petition are deemed to be automatically due and payable;
- Any debt recovery proceedings and steps to enforce against the company's assets are suspended (except where enforcement is sought under enforcement orders for employment claims,

[6] Starting from 1 April 2011, information on insolvency proceedings and the auctions for sale of bankrupt debtors' assets must be published in the Bankruptcy Register.

claims for harm inflicted to health or life, claims for moral damages (mental suffering), claims for recovery of property from the debtor's unlawful possession and certain other claims);

- All claims for the purposes of inclusion in the register of creditors' claims are converted into roubles at the exchange rate set by the Central Bank of the Russian Federation (the "**Central Bank**") as at the date of commencement of the insolvency stage following the maturity of such claim. Arguably once the amount of the claim is fixed in roubles and included in the register of claims, it is not subject to further revaluation in any subsequent bankruptcy stage if the exchange rate changes.
- Interest on registered claims during supervision arguably does not accrue at all and during each other stage of insolvency accrues at the Central Bank refinancing rate.
- Enforcement of pledges and mortgages is prohibited at this stage.

***Is set-off available in insolvency proceedings?***

From the date of commencement of the first insolvency stage (supervision), set-off against the debtor's claims is prohibited if it would breach the statutory order of priority, or such discharge results in the preferential satisfaction of claims of one creditor over another. Such prohibition extends to any further insolvency stage.

***Is contractual subordination effective in insolvency?***

Any contractual subordination in respect of a claim against an insolvent Russian company is unlikely to be effective.

***Dividends***

From the date of commencement of the insolvency proceedings, any distribution of profit to participants, the payment of dividends to shareholders and other payments to holders of issued securities is prohibited.

***Are debt to equity swaps available in the company's insolvency?***

Although debt to equity swaps by way of exchanging a company's debts for newly issued shares outside insolvency were recently permitted by amendments to companies laws, such swaps are not available in the course of bankruptcy proceedings against the company. At the insolvency stages where the issue of additional shares by a debtor is allowed, such shares are to be paid for in cash only.

In any case claims of shareholders for the return of equity are repaid after satisfaction of any other creditors' claims.

***Is a creditor allowed to transfer its claim in insolvency?***

Under Russian law there are no restrictions for the transfer of claims against a debtor by its creditor in the debtor's insolvency to any other creditor or person (including when such claims are already included in the register of creditors' claims).

***How security over the debtor's assets can be enforced in insolvency?***

Once insolvency proceedings are commenced, there is a general moratorium on the levying of execution against the property of the insolvent company. Pledged assets are segregated from other assets and may not be sold without the consent of the secured creditor.

Secured creditors can enforce their security at the financial rehabilitation and external administration stages, but only through the insolvency court with a sale of such secured property to be at an auction organised by an insolvency administrator or a specialised organisation.

Enforcement against the secured property will be allowed unless the debtor can prove that enforcement against its secured property would make it impossible to restore the debtor's ability to pay its debts.

Enforcement proceeds from the sale of the secured property are applied against the secured debt as provided in more details in "*Claims of secured creditors*".

***How the sale of the secured property is conducted at the liquidation stage?***

At the liquidation stage the secured property must be sold in the same way as at the early insolvency stages and must be offered for sale at two consecutive auctions with the sale price at the first auction to be approved by the insolvency court and with the sale price at the second auction to be 10% lower than the initial sale price. If the second auction fails, the secured creditor is entitled to appropriate the secured property at a value which is 10% lower than the offered sale price at the second auction. If within 30 days from failure of the second auction the secured creditor fails to appropriate the secured property, the secured property is to be sold by way of a public offer with a gradual decrease of the price.

At the liquidation stage proceeds from the sale of the secured property or the value of the secured property appropriated by the secured creditor are applied

against the secured debt subject to the limitations on allocation of proceeds or value described below in *"Claims of secured creditors"*.

## How can creditors exercise their rights in the company's insolvency?

Creditors have a say on the key matters concerning the insolvency process by participating in the creditors' meetings.

### *What are the powers of the creditors' meeting?*

Generally the creditors' meeting has exclusive competence, among other things, on the following matters:

- to approve additional criteria for nominees for the positions of insolvency administrator at different stages of insolvency;
- to approve a voluntary arrangement to be submitted to the court;
- to determine what would be the next stages of insolvency (i.e. either to petition the court to declare the company bankrupt and commence liquidation or to proceed with pre-liquidation insolvency proceedings that may end up with the restoration of solvency of the company and termination of insolvency proceedings).

### *How to file the claim and include it in the register of creditors' claims*

In order to participate and vote at the creditors' meeting, creditors should file their claims (accompanied with either the court decisions confirming the claim or any other documents confirming the grounds for the claim) with the insolvency court requesting to include their claims in the register of creditors' claims.

In bankruptcy proceedings only monetary claims against the debtor can be filed with the insolvency court and can be included in the register of creditors' claims.

In order to participate in the first creditors' meeting to be held during the supervision stage, creditors' claims should be submitted within 30 calendar days from the date when the commencement of supervision was publicly announced[7]. The claims are included in the register on the basis of an insolvency court's ruling held after the insolvency court verifies the grounds for such claims and confirms that the claim is substantiated. As a result, while a loan granted before commencement of the insolvency process is automatically accelerated, only a debt that has been confirmed by an insolvency court ruling can be recorded in the register of creditors' claims, thereby entitling the relevant creditor to attend and vote at creditors' meetings during that stage. If the claim under a loan is not submitted to the insolvency court within the set period of time, the lender can register its claim (and participate in creditors' meetings, etc.) only at the next stage of insolvency when its claim is included in the register of creditors' claims.

The register is closed to new filings of claims within 2 months of public announcement of the company's bankruptcy and the commencement of liquidation.

### *How do creditors vote at the creditors' meeting?*

Creditors vote at the creditors' meeting in proportion to their registered claims (in each case, excluding the amount of any claim for fines, penalty interest, damages and other financial sanctions). Decisions are generally adopted by a simple majority of votes of creditors attending the meeting (provided that not less than half of the registered creditors by claims were present at such meeting), although decisions on certain matters must be adopted by a majority of the total number of registered votes (e.g. on commencement of further stages of insolvency and extension of the term of such stages, on conclusion of a voluntary arrangement).[8]

The decision of the majority creditors will be binding on the minority creditors and the company cannot influence any such decision and in this sense no true "cram down" is available. The validity of decisions can be challenged in a court.

### *Voting rights of secured creditors*

Under the amended Insolvency Law, secured creditors have been expressly granted a right to vote at a creditors' meeting during:

- supervision; and
- financial rehabilitation and/or external administration if the secured creditor decided against the sale of secured property during these stages or if the insolvency court rejects the sale of secured property on the enforcement of the relevant pledge or mortgage.

Secured creditors that do not have a voting right can still participate in, and speak at creditors' meetings.

Based on the clarifications of the Supreme Arbitrazh Court[9], secured creditors still have voting rights with respect to voluntary arrangements (where unanimous

[7] Art. 71 of the Insolvency Law.

[8] Art. 15 of the Insolvency law.

[9] The order of the Plenum of the Supreme Arbitrazh Court of the RF dated 23 July 2009 No. 58.

vote of all secured creditors is required) at the liquidation stage (where generally secured creditors do not have voting rights) and arguably at the earlier stages of insolvency in cases when the secured creditors generally do not have voting rights (i.e. when their right to enforce security was not rejected or they have not refused to enforce).

## In which order are creditors' claims satisfied in the debtor's insolvency?

### *Claims of unsecured creditors*

At the liquidation stage (where all creditors' claims are subject to satisfaction), the satisfaction of unsecured monetary claims against the insolvent company is generally subject to the following statutory order of priorities:

- *first*, claims for harm inflicted to health or life and claims for moral damages (mental suffering);
- *second*, employment claims (wages and severance payments) and royalty claims under copyright agreements; and
- *third*, all other claims including claims of secured creditors to the extent their claims are not discharged out of the proceeds of sale of secured assets or the value at which the secured assets were appropriated by the secured creditor.

Settlement of claims in the above order of priority is conducted in accordance with the register of creditors' claims.

Claims submitted after the closing of the register of creditors are satisfied only after the discharge of all registered claims.

### *Current claims*

So-called current claims (essentially, monetary claims that have arisen **after** the opening of insolvency proceedings, including court and bankruptcy costs, taxes, payments due to state budget and utilities and operational costs) together with the costs of any measures to prevent industrial or environmental harm, rank ahead of both the statutory order of priorities and claims of all creditors which have arisen **before** the date of acceptance of a petition for the debtor's bankruptcy, and are settled in accordance with the statutory order of priority specifically established for current claims. Within the same order of priority for current claims the claims are discharged in the calendar order of their occurrence.

### *Claims of secured creditors*

The Insolvency Law expressly recognises only a pledge or mortgage as giving the holder the status of a secured creditor and it is therefore unclear what status, if any, would be afforded by other forms of security.

Claims secured by a pledge or mortgage over the company's assets are settled out of the proceeds of sale of such assets in priority to all other claims, subject to a requirement to allocate part of the proceeds to discharge claims with statutory priority of the first and second orders, and certain current claims.

According to the amended Insolvency Law the following rules on allocation of proceeds of sale of secured property at the liquidation stage currently apply:

- 80% (under a credit agreement) or 70% (in all other cases) of the proceeds (in an amount not exceeding the aggregate amount of principal and interest included in the register of creditors' claims) is applied to discharge claims of the secured creditor; and
- the remaining 20% or 30% respectively is to be deposited in a "special account" to be further applied as follows:
  - up to 15% or 20% respectively - for the satisfaction of unsecured claims with statutory priority of the first and second orders, if the unencumbered property of the debtor is insufficient to settle these claims; and
  - the balance - for the satisfaction of court and bankruptcy costs (including costs and fees incurred in connection with the sale of the secured property), payments of fees of the court-appointed administrator and persons retained by such court-appointed administrator for the purposes of administration and any remaining balance, for the satisfaction of other current claims.[10]

If following the failure to sell the secured property at the second auction the secured creditor elects to appropriate the secured property, it must transfer 20% or 30%, as appropriate, of the value of the property at which it was appropriated, to the "special account" for the purposes of satisfaction of the above statutory prioritised claims.

To the extent unsecured claims with statutory priority of the first and second orders are satisfied, the remaining proceeds of sale of the secured property are paid to the secured creditors. If the secured claim is discharged in full, the remaining proceeds are routed to satisfaction of outstanding current claims and the balance is

[10] See the Order of the Plenum of the Supreme Arbitrazh Court of the RF dated 23 July 2009 No. 58.

channelled towards discharge of creditors' claims of the third order of priority.

The Insolvency Law is unclear whether the rules on allocation of proceeds of sale of secured property described above should apply in the case of enforcement of the security by the secured creditor at the early stages of insolvency, and there is an argument that these allocation rules should apply only at the liquidation stage.

***Claims of secured creditors under third party security***

The Insolvency Law does state that claims of creditors under pledge or mortgage agreements that are provided by a debtor as third party security (i.e. not for its own debts) are satisfied in accordance with the procedure of satisfaction of claims of secured creditors. Secured creditors under third party pledges, although not creditors having direct monetary claims against the security provider, now have the same rights as secured creditors of that security provider. However, the following restrictions and distinctions by comparison with the creditors having a direct monetary claim against the debtor apply:

- Creditors under third party pledges are not entitled to file for bankruptcy of the security provider as such secured creditor does not have a direct monetary claim against the security provider.
- Secured creditors under third party pledges may claim enforcement of the security only upon filing an application to the insolvency court asking for their claims to be included into the register of creditors as a secured creditor.[11] The amount of their claims is to be determined on the basis of the value of the secured property provided in the pledge agreement or established by the insolvency court as the starting sale price in the course of enforcement of such security. Although not specified by law, in order to be included in the register of creditors as a secured creditor under a third party pledge, the insolvency court should most likely be provided with evidence that the claim under the secured obligation against the debtor is due and not discharged (although no court decision confirming such claim will be required to be presented to the insolvency court)[12] .

[11] See the Order of the Plenum of the Supreme Arbitrazh Court of the RF dated 23 July 2009 No. 58.

[12] See the Order of the Plenum of the Supreme Arbitrazh Court of the RF dated 23 July 2009 No. 58.

The above will not apply if the security provider gives a guarantee of the primary debt obligation and this guarantee is secured by a pledge or mortgage as in this case the secured creditor will have a direct monetary claim against the security provider under a guarantee secured by the security provider's property.

***Claims of shareholders***

Generally shareholders with shareholder loans are treated as other creditors. However, equity claims of shareholders may not be satisfied in insolvency proceedings and may be satisfied only upon liquidation of a company if any assets remain after all the creditors have been paid in full.

## Which transactions entered into by the company or at the expense of the company may be set aside in the company's insolvency?

In addition to certain transactions that are prohibited or restricted at each stage of insolvency and which if entered into in violation of such restrictions may be challenged by an insolvency administrator, there are specific transactions that may be challenged in insolvency if entered into during suspect periods prior to the opening of insolvency proceedings.

Generally, the following two specific types of transaction can be challenged by an insolvency administrator in the insolvency court at the stage of external administration or liquidation[13]:

(i) so called "suspicious" transactions which include transactions "at an undervalue" and transactions "aimed at defrauding creditors"; and

(ii) preferential transactions.

***Transactions "at an undervalue"*** are transactions where the consideration received or to be received by a debtor is "inadequate" (if, for example, the market value of the transferred assets is significantly higher than the consideration received or to be received, taking into account the circumstances of the transaction, including where the price or other terms of such transaction are materially less favourable than those of comparable transactions concluded in comparable circumstances).

***Suspect period:*** Transactions "at an undervalue" may be challenged if entered into or performed within **1 year** preceding, or at any time after, the opening of insolvency proceedings;

***Transactions aimed at defrauding creditors*** are treated as such if simultaneously the following conditions are to be met:

[13] Chapter III.1 of the Insolvency Law.

(i) the purpose of the transaction was to prejudice the rights of creditors (such purpose is presumed, among other things, if at the time of entry into the transaction the debtor was unable to pay its debts or the liabilities of a debtor exceeded the value of its assets and (a) no consideration was paid to the debtor; or (b) the transaction was with an "interested party"[14]);

(ii) such transaction resulted in infliction of "harm to creditors' rights" (i.e. such transaction or action resulted in (a) a decrease of the value or the size of the debtor's assets; (b) an increase of the value of claims against the debtor or (c) other consequences that entail or could entail the inability of creditors to satisfy their claims (whether in full or part) from the debtor's assets); and

(iii) the counterparty knew or should have known of the above purpose of the transaction at the time of entry into such transaction (an "interested party" is presumed to know of such purpose).

***Suspect period:*** Transactions aimed at defrauding creditors may be challenged if entered into or performed within **3 years** preceding, or at any time after, the opening of insolvency proceedings.

***Preferential transactions*** are transactions that result or may result in preferential satisfaction of a claim of a particular creditor over other creditors, including but not limited to one of the following transactions:

(i) granting of security or guarantees for pre-existing indebtedness;

(ii) transactions that may alter the ranking of creditors' claims which arose before the entry into of such transaction;

(iii) transactions that will or may result in the satisfaction of unmatured claims of creditors where the debtor has failed to satisfy its matured claims; or

(iv) transactions which provide or may provide more priority in satisfaction of a creditor's claims which arose before the entry into of such transaction when compared to the priority to be given to such claims if their settlement was exercised according to the statutory ranking of creditors in insolvency.

***Suspect period:*** Preferential transactions may be challenged if entered into or performed within **1 month** preceding, or at any time after, the opening of insolvency proceedings. However, preferential transactions falling within both (i) and (ii) above, or falling within any of the above where the counterparty knew of the debtor's inability to pay or that the debtor's liabilities exceeded the value of its assets, are subject to a **6 month** suspect period. A counterparty that is an "interested party" is presumed (unless proved otherwise) to have such knowledge.

Any payments made by the debtor or any actions of other persons for the account of the debtor (such as set-off (including as a result of enforcement of the existing security), debiting the debtor's account without consent of a debtor, transfer of a debtor's property, etc.) in or towards discharge of the debtor's obligations (whether scheduled or under voluntary or mandatory prepayment according to the terms of the relevant agreements or, with respect to the transfer of property, in performance of an earlier effected prepayment) within **1 month** prior to the commencement of insolvency proceedings may be challenged on the grounds of preferential satisfaction of claims of a particular creditor over other creditors. Such payments, property transfers and other actions are vulnerable irrespective of whether the recovering creditors knew or did not know of the debtor's inability to pay or insufficiency of the debtor's assets to satisfy its payment obligations at the moment of such payment or action[15].

As the Insolvency Law also expressly provides that security granted after the date on which the debt obligations arose may be challenged, any security granted to support debt rescheduling or mark-to-market payments made by a borrower are potentially vulnerable. It is also clear that novation agreements and settlement agreements (*dogovor ob otstupnom*) are now susceptible to challenge as preferential transactions.

In addition, for the **3 month** period after commencement of external administration, an external administrator may disclaim executory contracts (i.e. contracts where the other party's obligations are contingent on the company first performing its own obligation) if performance of the company's obligations under such contracts will impede restoration of its solvency or will result in losses in comparison with similar transactions entered into in comparable circumstances. The aggrieved party is entitled to claim

[14] Interested parties include, among others, the CEO of the debtor and its directors as well as affiliates and companies comprising the so-called "group of entities" to which the debtor is attributable.

[15] See the Order of the Plenum of the Supreme Arbitrazh Court of the RF dated 23 December 2010 No. 63.

damages caused by the company's refusal to perform.[16] Similar rights are given to a liquidator and similar rules apply at the liquidation stage.[17]

***Is restructuring of a debtor's indebtedness vulnerable in insolvency?***

The provisions of the Insolvency Law on preferential transactions give rise to a risk of challenging the restructuring of the financing of a Russian debtor, irrespective of whether there was an actual flow of funds (i.e. a deemed repayment of the existing loan by the debtor and provision of a new financing by the same creditor on new terms reflected by a book entry could also be vulnerable). As a result, any payments to the creditor under an existing facility effected within the suspect period (even if money was not actually transferred and irrespective of whether the refinanced facility agreement was entered into before the suspect period) may potentially be subject to a clawback to the debtor, while new money provided under a new facility and money clawed back under a refinanced facility would be subject to repayment according to a statutory order of priority in the course of the debtor's bankruptcy. Accordingly, if refinancing is made within the suspect period, the creditor may be exposed to a double risk on the debtor against which bankruptcy proceedings are initiated (i.e. for the amount of the repaid facility to be returned by the creditor to the debtor and the amount of new monies extended to the debtor).

***What cannot be challenged?***

The Insolvency Law specifies certain transactions that cannot be challenged in insolvency. These are:

(i) transactions concluded at an organised auction on the basis of a bid addressed to an unlimited number of participants which cannot be challenged on any of the above grounds;

(ii) transactions entered into in the ordinary course of business if the value of assets disposed of or obligations incurred does not exceed 1 per cent. of the balance sheet value of the debtor's assets, which cannot be challenged as transactions "at an undervalue" or as "preferential transactions"; and

(iii) transactions where the debtor received adequate consideration unless such transactions are treated as "aimed at defrauding creditors".

***Who can challenge?***

A claim for the invalidation of a transaction in insolvency can be brought to the insolvency court by the liquidator or external administrator of a debtor either at his own discretion or when instructed by a creditors' meeting or committee (thus limiting the ability of individual creditors to challenge transactions).

***What are the consequences of successful challenge?***

Everything received under a successfully challenged transaction will be subject to clawback (and all assets disposed of by the debtor under such transactions are to be returned to the bankrupt estate).

In the event the actions of the debtor (such as payment of money, transfer of property or other performance of obligations as well as other transactions discharging a debtor's obligations (by way of set-off (including as a result of enforcement of the existing security), *otstupnoye* (a form of a settlement agreement) or otherwise)) have been set aside as preferential transactions, the obligations of the debtor that have been discharged by such actions are treated as reviving as of the date of performance of the invalidated transaction. Accordingly, the creditor's claim under such revived obligations are considered to continue irrespective of performance of the invalidated transaction.[18]

In turn, counterparties to the challenged transaction will have a claim against the debtor for the value of the returned property, and such claims will generally rank *pari passu* with claims of other unsecured creditors of the debtor. However, in the case of (a) preferential transactions subject to a 6 month risk period (including the revived claims of a creditor referred to in the previous paragraph); or (b) transactions "aimed at defrauding creditors", the counterparty's claim will in each case rank behind the claims of unsecured creditors.

## What is the liability of the management and shareholders of the company in case of the company's insolvency?

Liability of "controlling persons"[19] (including directors) and its shareholders in the case of the company's

[16] Article 102 of the Insolvency Law.

[17] Article 129 of the Insolvency Law.

[18] Article 61.6(4) of the Insolvency Law.

[19] For the purposes of the insolvency legislation a controlling person means a person who, within the two year period prior to the commencement of insolvency proceedings, has or had the right to give binding instructions to the debtor or otherwise is or was able to determine the debtor's actions. The Insolvency Law expressly provides that "controlling persons" include (i) members of the debtor's liquidation commission; (ii) the debtor's authorised representatives (whether authorised by virtue of a power of attorney, regulation or special authorisation); and (iii) persons (entities)

insolvency are regulated by a number of Russian laws. Depending on the type of action and its gravity, a director may be subject to civil, administrative or criminal liability.

***General principles of civil liability***

If bankruptcy of a company is caused by the shareholders (participants) or other persons who have the right to give binding instructions to such company or otherwise are able to determine the actions of the company, such persons can bear subsidiary liability for the company's obligations if the assets of the company are insufficient to discharge the debtor's obligations. Apart from limited liability companies in relation to which the liability of "controlling persons" is not restricted by any subjective test, the scope of the potential liability of "controlling persons" with respect to joint stock companies is restricted to situations where such "controlling persons" have used their right to give binding instructions to, or used their ability to determine the actions of the company with the purpose of the company taking an action knowing in advance that such action would entail the company's insolvency.

***Liability of "controlling persons" for the insolvent company's debts***

In addition to the general liability envisaged by civil legislation, the Insolvency Law sets out the specific grounds and the level of liability of the company's management, shareholders and other "controlling persons" for the company's debts[20].

The shareholder and management as well as other "controlling persons" of a Russian debtor that was declared bankrupt could jointly and severally bear secondary liability for monetary claims of creditors (including current claims) against, and mandatory payments due from, such debtor, when simultaneously:

- the insolvent debtor has acted on instructions from its "controlling persons";
- such actions resulted in a "harm to creditors' rights"; and
- the bankruptcy estate is insufficient to satisfy the creditors' claims, mandatory payments and current claims.

Russian courts may, at their discretion, reduce the liability of a "controlling person" if the loss caused by the debtor acting on the controlling person's instructions was disproportionately lower than the amount claimed by creditors. Furthermore, "controlling persons" are exempt from liability if they can prove that they acted in good faith and reasonably in the interests of the debtor.

In a situation where the accounting or reporting documentation of the debtor that is required to be produced by Russian law appears to be missing, or the relevant information on the assets and liabilities of the debtor and their movement appears to be incomplete or untrue, in each case as of the date of instigation of the supervision stage or declaration of the debtor's bankruptcy, the chief executive officer (the "**CEO**") of the debtor also bears secondary liability for the obligations of the debtor.

In addition to the above, the persons (generally the CEO and a liquidator, as appropriate) who failed to file for the company's bankruptcy when were obliged to do so by law (see "*Petition by the company*" above), may bear secondary liability for new debts of the company arising after the date when the bankruptcy petition should have been filed.

***Criminal liability***

A court may find the CEO of a company or its founders (participants) criminally liable to a fine or imprisonment up to 6 years in cases provided in this section.

The Criminal Code imposes criminal liability for actions taken in anticipation of bankruptcy as well as for the actions taken during insolvency of a company.

In particular, the Criminal Code imposes criminal liability for the following:

(a) deliberate bankruptcy[21] when the CEO or a founder (participant) of the company takes or omits to take actions which he knows will result in the company's inability to satisfy in full its creditors' claims;

(b) fraudulent bankruptcy[22] when the CEO or a founder (participant) of the company knowingly makes a fraudulent public announcement of bankruptcy of that company;

(c) unlawful actions during bankruptcy proceedings[23] that, among other things, contemplate:

(i) concealing property, rights to property or liabilities, withholding information

that had the right "to dispose of 50 per cent. or more" of the voting shares (in the case of a joint stock company) or more than 50 per cent. of participatory interest (in the case of a limited liability company).

[20] Article 10 of the Insolvency Law.

[21] Article 196 of the Criminal Code

[22] Article 197 of the Criminal Code

[23] Article 195 of the Criminal Code

on property, its size, location or any other information on property, rights to property or liabilities, transferring property to others, alienating or destroying property and concealing, destroying or falsifying accounting documents, in each case if such actions have been taken when there were signs of bankruptcy of the company and caused substantial damage;

(ii) unlawful satisfaction by the CEO or a founder (participant) of claims of certain creditors out of the company's assets made with the intention of defrauding other creditors, if such actions have been taken when there were signs of bankruptcy of the company and caused substantial damage;

(iii) unlawful actions aimed at impeding the activity of a court-appointed administrator, including evading transfer of the documents necessary for performance of its duties or the debtor's property or refusal to do so, where the management power of the debtor's CEO is vested in a court-appointed administrator, if such actions (or omission to act) caused substantial damage.

***Administrative liability***

The Administrative Offences Code also imposes liability on the CEO of a company, its founders (participants) or a court-appointed administrator (where appropriate) with respect to bankruptcy[24]. This includes the following administrative offences:

(a) fraudulent bankruptcy;

(b) deliberate bankruptcy;

(c) unlawful actions during bankruptcy, already mentioned in paragraph (c) of the *Criminal liability* section;

(d) acceptance by a creditor of the unlawful satisfaction of its claims out of the debtor's assets knowing of the prejudice of other creditors, if such action was taken when there were signs of bankruptcy of the company;

(e) failure by a court-appointed administrator to perform its obligations under the Insolvency Law; and

(f) failure by the company's CEO to file a bankruptcy petition against a company in the cases provided for in the Insolvency Law.

The offences referred to in paragraphs (a) to (e) will be subject to administrative liability to the extent such offences are not subject to criminal liability (i.e. when the consequences of an offence are less serious than in the case of criminal liability).

The Administrative Offences Code envisages administrative fines of up to RUR 50,000 or disqualification for a period from 6 months up to 3 years as the main sanction on directors.

Disqualification entails depriving an individual of the right to occupy any management position in the executive body of a legal entity, to sit on the board of directors, management (supervisory) board and to carry out entrepreneurial activity involving management of a legal entity.

## Are there any expected amendments to the insolvency legislation?

Despite recent significant amendments to the Insolvency Law regarding the status of secured creditors, which introduced new criteria for challenging transactions in a debtor's insolvency and strengthening liability of debtor's controlling persons, the Insolvency Law continues to develop. At the moment there are proposals from the Russian government on further amendments to the law which, among other things, envisage the following:

- introducing rules on crossborder insolvency aiming (a) to determine cases when the Russian courts have jurisdiction to hear crossborder insolvency proceedings, (b) to identify the law to be applied in the event of crossborder insolvency proceedings, (c) to establish the rules on recognition and enforcement of foreign court judgements on insolvency cases; and (d) to address issues arising in the event of initiation of conflicting insolvency proceedings against the same debtor in different jurisdictions;
- introducing new rules for financial rehabilitation with the purpose of expanding the role and use of such procedure for restoring a debtor's solvency as well as establishing rules on out-of-court settlement of creditors' claims by imposing the institution of standstill agreements.

[24] Articles 14.12 and 14.13 of the Administrative Offences Code

At the moment the above amendments have not been presented to the State Duma and are still in the process of discussion and further development.