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The Commercial Bankruptcy Law of Russia: A Year of Change

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(EDITOR's NOTE: This is part one of a two-part article. Part two will appear in the October 2009 issue.)

Russia's Federal Law No. 127-F3, "On Insolvency (Bankruptcy)," dated 26 October 2002 (the Bankruptcy Law) was amended substantially on 30 December 2008 (the December Amendments) and again on 28 April 2009 (the April Amendments) and further refined on 19 July 2009 (the July Amendments). In addition to the foregoing legislative amendments, on 23 July 2009 the Supreme Arbitration Court of the Russian Federation,[2] the highest bankruptcy court in Russia, issued several resolutions, which for all intents and purposes are binding upon Russia's inferior arbitration courts (hereinafter bankruptcy courts) clarifying various aspects of the recent amendments. Moreover, starting from December 2008 the acts governing the enforcement of security interests in real and personal property in Russia were amended and various bills are circulating that would provide distressed businesses and their creditors with additional restructuring tools, such as debt-equity swaps that are currently prohibited under the law.

At the time of the drafting of this article, the Ministry of Economic Development of the Russian Federation is working on a draft bill (the Bill) of further amendments to the Bankruptcy Law that would, if adopted, fundamentally alter Russia's bankruptcy system and debtor-creditor relations.

The purpose of this article is to provide a brief overview of Russia's modern bankruptcy system (post-1991) and some background to help those unfamiliar with the process gain a sense of the current state of the law; to highlight the significant changes to the Bankruptcy Law introduced in the last year and those that may be introduced if the Bill is adopted; and to point out some areas that could be further improved for the benefit of all stakeholders in the process.

Introduction: The Taint of Bankruptcy and Ghost of Raiders Past

Around the world, bankruptcy traditionally has been regarded as unseemly at best and debtors have been treated with disdain and contempt, if not as criminals. In many Western economies, particularly in the United States, bankruptcy has increasingly come to be viewed as a necessary and appropriate tool for distressed businesses to restructure their debts, preserve value and maintain continued operations of viable businesses.

Russia's bankruptcy system has a similar if particularly unseemly public reputation, which is due to several factors. First, the bankruptcy system is hamstrung by the same factors that impede growth and development in other areas of the law and economy, including Russia's very short history as a market economy and ongoing evolution of the fundamental pillars - legal, structural, financial, social and political - necessary to support such an economy; the lack of transparency in corporate structures; pervasive corruption; and the relative inexperience of the judiciary in commercial and financial matters. Second, in the 1990s the system was viewed as a tool used by "raiders" who engineered dubious involuntary proceedings to snatch plum assets from honest businesspeople. The 2002 amendments to the Bankruptcy Law were primarily designed to combat such abuses with the introduction of greater debtor protections and mechanisms to expeditiously exit involuntary proceedings. At the same time, the system still continues to be perceived as a tool employed by unscrupulous businesspeople to avoid creditors' claims and strip assets from businesses only to set up a new shop under a different name. Both the perception and the reality have shaped the development of the Bankruptcy Law.

All of these factors cannot be cured with a series of amendments to the Bankruptcy Law, but a balanced legislative framework protective of debtor and creditor interests is key to the further development of the law. In the 17 years since the establishment of the Russian Federation and introduction of free market economic principals, Russia has made tremendous advances in restructuring its legal system and continues to make significant strides. Of course, like all governments it struggles to keep pace with the rapid development of commerce. The Bankruptcy Law is no exception.

Since 1992, Russia has experienced three fundamental reforms of its commercial bankruptcy laws. If the principal

concepts of the Bill are adopted, this will represent a fourth fundamental reshaping of the country's commercial bankruptcy laws in less than 20 years. These reforms are occurring in parallel with the development of all legal and commercial institutions and structures to support a dynamic market economy. The scope of the task and the achievements made to date cannot be over emphasized, although much remains to be done to achieve President Medvedev's goal of making Russia an international financial center free of corruption. The establishment of an efficient, predictable and transparent bankruptcy system is a fundamental element of achieving this goal and particularly critical at this moment given the challenges facing the world economy and Russia today.

Overview of Russia's Current Commercial Bankruptcy System

Initiating the Process

A Russia-based company (joint stock company or limited liability company) or sole proprietor cannot become the subject of a bankruptcy proceeding unless it can demonstrate that it meets the following indicators (hereinafter Bankruptcy Indicators):

- It has failed to satisfy a monetary payment judgment - i.e., court ordered judgment for failure to pay a cash claim - within three months of the date such payment was ordered to be performed; or
- It has failed to satisfy an obligatory payment judgment - i.e., a court or agency (e.g., tax inspectorate or customs office) ordered judgment or directive for failure to pay an obligation to the state body, including, but not limited to, tax obligations - within three months of the date such payment was ordered to be performed; and
- The amount of such court ordered judgment(s) is more than 100,000 rubles.

Note that the mere existence of a debt that the debtor is unable to pay is insufficient, there must be a court judgment confirming, or validating the debt, to initiate both voluntary and involuntary proceedings.

Voluntary Proceedings

A debtor's management is required to file a bankruptcy petition as soon as possible if:

- The satisfaction of one or more creditors' claims will result in the debtor's inability to satisfy all of its other creditors' claims in full;
- The authorized body of the debtor has taken a decision to file a bankruptcy petition;
- Enforcement actions against the debtor's property will complicate or preclude the debtor's continued operation; or
- The debtor is insolvent on either a cash flow or a balance sheet basis (See "The April Amendments" below).

A debtor is obligated to file the petition not later than thirty days after the triggering obligation arises. A debtor's management, board of directors (if any), shareholders and "controlling persons" (i.e., persons who within two years of the bankruptcy petition date had the power to direct or determine the debtor's conduct of business) may be held vicariously liable for any losses arising from their failure to timely initiate bankruptcy proceedings. If a debtor, however, initiates proceedings under circumstances when it is able to satisfy the claims of its creditors, it can be held responsible for any damages incurred by its creditors as a result of the improper initiation of bankruptcy proceedings.

In practice, the obligation to file typically has been interpreted to be triggered only after the manifestation of the Bankruptcy Indicators, but it is unclear how to reconcile this with the introduction of cash flow and balance sheet insolvency concepts introduced as part of the April Amendments. Nonetheless, general managers[3] are well advised to keep their board of directors (if any) or shareholders timely informed of collection proceedings, and board members, shareholders and participants should heed those warnings, to minimize risk of personal liability.

Involuntary Proceedings

Commercial creditors - i.e., creditors holding a monetary payment judgment rather than an obligatory payment judgment, excluding claims for unpaid wages, dividends, royalties on copywritten materials or personal injury judgments - may file an involuntary bankruptcy petition on the date their court or arbitral body ordered monetary judgment comes into force.

State agencies holding obligatory payment judgments may file an involuntary bankruptcy petition no sooner than 30 days from the date its court or arbitral body ordered obligatory payment judgment comes into force.

Notice of Filing of Bankruptcy Petition

One of the fundamental shortcomings of the system and the source of great mischief is that notice of the proceeding is only required to be published in one designated paper of national circulation. As a consequence, many creditors are frequently unaware of the initiation of bankruptcy cases and the starting of the clock for filing claims for inclusion in the debtor's claims register.

Venue

Russia's bankruptcy courts have exclusive jurisdiction over bankruptcy proceedings. A significant limitation of the current bankruptcy system is that it does not provide for the administrative consolidation of bankruptcy proceedings of related legal persons. Each debtor is the subject of a discrete bankruptcy proceeding, which can be brought before only a bankruptcy court located where the debtor is registered. As a consequence, a large corporate group's bankruptcy may generate a multitude of bankruptcy proceedings before a multitude of bankruptcy courts scattered across the great expanse

of Russia, generating conflicting court orders. There currently is not a mechanism for effectively coordinating those proceedings.

Acceptance of Bankruptcy Petition

The Bankruptcy Law provides for the following types of insolvency proceedings: supervision, financial rehabilitation, external administration, composition arrangement and liquidation. If a bankruptcy court accepts a bankruptcy petition, the debtor enters a temporary period of supervision. If during the supervision proceedings the case is not dismissed or terminated, at the first creditors' meeting the debtor's registered creditors vote on initiation of financial rehabilitation, external administration or liquidation proceedings depending on the financial condition of the debtor and the goals of the debtor and its creditor body. The debtor also always has the ability to reach a composition arrangement with its creditors and exit its bankruptcy proceedings. However, prior to initiation of any of the three primary proceedings (financial rehabilitation, external administration or liquidation) the debtor, or its petitioning creditor(s), must first prove to the bankruptcy court that the debtor qualifies for bankruptcy (i.e., prove the Bankruptcy Indicators).

Procedurally, upon the filing of a bankruptcy petition, the bankruptcy court has five days to either accept, reject, or return the petition for refiling to correct filing deficiencies. The court's analysis is limited only to whether the petition is presented in the appropriate form and before the appropriate bankruptcy court. The filing of the petition does not automatically stay collection efforts of creditors, but the petitioner may request that the bankruptcy court issue orders to secure the debtor's property pending further rulings of the court.

If the bankruptcy court accepts the petition, it has 30 days to consider the grounds for the petition and whether the petitioner(s) has proven the Bankruptcy Indicators. If the court finds sufficient proof of the Bankruptcy Indicators, the supervision stage of the proceedings is initiated.

Supervision

The initiation of supervision results in a moratorium on collection efforts, including the suspension of enforcement of writs of execution and the setting off of counterclaims in breach of the priority ranking of creditor claims. Further, the debtor is prohibited from repurchasing shares or participatory interests of its founders, shareholders and participants or making distributions to such persons. The debtor's management remains in place, although its powers are sharply curtailed and management is subject to removal for breaching its restricted authority and for other causes. Also, an interim trustee is appointed to manage the supervision process and police and enforce compliance by the debtor and its creditors with the Bankruptcy Law.

The purpose of supervision is to suspend enforcement under writs of execution; analyze the debtor's financial state; identify the debtor's creditors, determine the amounts of their claims and prepare a register of creditor's claims and hold the first creditors' meeting at which registered creditors vote to decide whether the debtor should proceed with financial rehabilitation, external administration or liquidation, or approve a composition arrangement. The creditors' meeting determines the debtor's fate.

Despite the importance of creditors' meetings, particularly the first such meeting, notice of the creditors' meeting is sent by direct mail only to "persons entitled to participate in the creditors meeting" meaning registered creditors and now secured creditors. If the number of registered creditors exceeds 500, notice by publication is acceptable. Consequently, in most cases only a small fraction of creditors holding legitimate unsecured claims receive any notice of creditors' meetings.

Financial Rehabilitation

The financial rehabilitation procedure was introduced in 2002 with the adoption of the Bankruptcy Law and was intended to encourage restructuring, but this never occurred. While the financial rehabilitation procedure is the longest possible procedure (up to 24 months) and allows for the continued service of current management, it is rarely, if ever, employed. The problem is that a condition for concluding financial rehabilitation is the provision of security by a third party to secure the satisfaction of creditors' claims in full accordance with the agreed plan of financial rehabilitation and debt repayment schedule.

External Administration

The goal of external administration is to restore the debtor to solvency pursuant to a plan developed by the court appointed external trustee and approved by a creditors' meeting. External administration must be concluded within 18 months, which period can be extended for an additional six months. The external trustee is responsible for gathering and managing the debtor's property, assessing the debtor's finances, developing a plan of external administration for presentation to the registered creditors for approval and implementing any plan approved by the debtor's registered creditors.

Unlike in financial rehabilitation, the external trustee is primarily responsible for the operation of the debtor's business as most of management powers are terminated. The external trustee has broad discretion, but needs the approval of the debtor's registered creditors that hold a majority of registered claims to:

- Engage in material transactions (i.e., transactions with a value greater than 10 percent of the debtor's net book value per its most recent financial reporting date) and interested party transactions (i.e., transactions parties to which are affiliated to the external trustee, the debtor and/or the creditor(s));
- Borrow or lend money or guarantee obligations, assign claims or debt, or sell equity interests owned

by the debtor; and
- Engage in transactions not approved as part of a plan of external administration, if the debtor has incurred obligations after initiation of external administration in excess of 20 percent of the value of all registered claims.

The external trustee must present a proposed plan of external administration for the vote of the registered creditors at a duly called creditors' meeting within two months of his or her appointment and such plan must be made available to such creditors no less than 14 days prior to the creditors' meeting. Within 5 days of receiving the approval of registered creditors holding a majority of the registered claims, the external trustee must present the plan to the bankruptcy court for approval. The bankruptcy court may approve the plan in whole or in part.

External administration may be terminated by court order upon the motion of a registered creditor or the external trustee; if the external trustee fails to timely submit a plan of external administration or receive approval for the required amount of the debtor's creditors; if it is determined that the debtor cannot be returned to solvency; or for other procedural violations of the Bankruptcy Law.

Liquidation

The purpose of liquidation procedures is to marshal the debtor's assets and delineate and pay all registered claims in accordance with the Bankruptcy Law's priority scheme, with claims of the same priority being paid on a *pro rata* basis if the debtor's assets are insufficient to pay the entire class of registered claim in full. Upon initiation of the liquidation process, all of the debtor's property forms the debtor's estate and the liquidating trustee (liquidator) is appointed. The liquidator has primary responsibility for managing the liquidation of the debtor's assets and the determination and payment of claims. The liquidation process must be concluded in six months from the date of its initiation.

Trustee Powers

The Bankruptcy Law sets forth extensive procedures governing the sale of the debtor's assets, whether in whole or in part, which also apply to sales in liquidation.

Within the terms of financial rehabilitation, external administration and liquidation bankruptcy trustees have the right to refuse to perform any executory contract (contracts not performed or performed only in part by the parties thereto) of the debtor entered into prior to the appointment of the interim trustee or within three months of his or her appointment, if such contracts would hinder the debtor's establishment of solvency or the performance of such transaction would result in a loss to the debtor when compared to analogous market transactions. Such contracts are deemed terminated on the date all parties are notified of the trustee's rejection of the contract.

External and liquidating trustees, on their own initiative, or upon the vote of the creditors' meeting, also have expanded powers to avoid transactions that are not in the interests of the debtor and its creditors pursuant to the April Amendments (see discussion below).

The Debtor's Claims Register and the Priority Ranking of Creditor Claims

For a creditor's claim to be counted it must be registered in the debtor's register of claims. The duly serving trustee is responsible for vetting all claims, which can be registered only with the bankruptcy court's approval.

"Current payments" are monetary or obligatory payment obligations that arise after the acceptance of the debtor's bankruptcy petition and thus are similar in concept to "administrative claims" under the US Bankruptcy Code. These types of payments are not included into the creditors' register and must be paid according to their terms, subject to the following priority scheme:
- First, to satisfy bankruptcy court expenses, including fees of the trustee and its advisors;
- Second, to satisfy wages and salaries of the debtor's employees;
- Third, to satisfy utility and other operational payments necessary for the debtor's day-to-day operations; and
- Last, to satisfy all other current payments, including costs incurred in addressing any threats to health or the environment arising from the cessation of debtor operations.

Registered claims are paid in the following order of priority:
- *First Priority*: claims for damages for personal injury and moral harm;
- *Second Priority*: claims for wages, salary, other employee benefits and royalties payable to authors of copywritten materials; and
- *Third Priority:* all other creditor claims with principal amounts being settled prior to claims for lost profits, interest and penalties on unsecured claims. Secured claims are accorded third priority ranking along with unsecured claims, but the proceeds generated from the sale of a secured creditor's collateral is distributed as follows:

— 70 percent (80 percent if obligation arises under a bank loan) is applied to satisfaction of the secured creditor's claim (principal and interest) and the balance is placed in a segregated bank account as a reserve to pay higher priority claims (if needed);

— 20 percent (15 percent if obligation arises under a bank loan) is applied to pay first and second priority claims, if unencumbered assets are insufficient to satisfy those claims; and

— The balance is applied toward current payments, if unencumbered assets are insufficient to satisfy those claims.

If unencumbered assets are sufficient to satisfy those

higher ranked claims for which a portion of the sale proceeds were reserved and the secured claim was not satisfied in full, the residual amount is applied to such secured claim; otherwise it is made available to all other third priority claims.

The Early Bird Gets the Worm: The Race to the Court House

A couple of key issues warrant highlighting at this point. First, among the elements of a debtor's bankruptcy petition is the identification of a candidate to serve as interim trustee, who in practice is regularly appointed by the bankruptcy court and re-appointed for other stages of the proceedings (e.g., external trustee). Second, the interim trustee is the gatekeeper of the debtor's claims register. Third, only creditor claims that are evidenced by a court judgment (recognized as binding in the Russian Federation), or that have been approved by the bankruptcy court, can be registered in the debtor's claims register. Fourth, the supervision stage of the case cannot under law exceed a period of six months. Fifth, at the creditors' meeting only creditors whose claims are registered in the debtor's claims register have a right to vote. Lastly, the perception, right or wrong, is that the party who appoints the interim trustee exercises *de facto* control over a debtor's bankruptcy proceedings, at least over the supervision stage, because of his or her influence upon which claims are timely registered in the debtor's claims register entitling the creditor to vote.

As a result of these and other facts, creditors currently have a strong incentive to aggressively pursue legal action against distressed businesses and even initiate involuntary bankruptcy proceedings, to secure their vote at creditors' meetings, if not the right to propose their own candidate to serve as interim trustee.

In fact, Russia's largest private bank, Alfa Bank, has been singled out for its aggressive collection efforts, efforts that appear completely rational given the current state of the law and the market. Representatives of other banks have gone on record about their concerns that debtors who file voluntary proceedings use the system to take advantage of their creditors. And state banks reportedly also are taking a more aggressive stance towards debtors. Meanwhile, Russian state authorities, including President Medvedev, have criticized aggressive collection efforts by certain banks as selfish and contrary to public interests.

What is clear is that the Bankruptcy Law currently does not encourage voluntary restructuring of debt in a way designed to preserve the continued operation of business and jobs. Although great strides are being made to improve the system, the interests of debtors and creditors are not appropriately balanced at present to achieve the best results.

1 In preparing this article, the authors have sought to use US and English terms that most closely approximate the concepts presented in the Bankruptcy Law. However, in some instances the Russian concepts may differ in material ways from the common law terms of art. The intent is to provide touchstones for those familiar with common law practices and improve readability.
The contents of this article are not intended to serve as legal advice related to individual situations or as legal opinions concerning such situations. Counsel should be consulted for legal planning and advice. Further, any opinions expressed are those of the authors and not Squire, Sanders & Dempsey L.L.P. or its affiliates.
2 Despite the name, Russia's arbitration courts are state courts with jurisdiction over a wide range of commercial, tax and administrative disputes (including, but not limited to, bankruptcy proceedings). They are not arbitral bodies.
3 In order to avoid confusion, the term "general manager" is used herein to refer to a company's "general director," which in Russian companies is a position similar to the position of chief executive officer in the West, but with broader powers. Every Russian company has a general manager, but may not have a board of directors.

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The December Amendments

The December Amendments were not a reaction to the credit crisis, the impact of which came later to Russia than in the West and really made an impact starting in September of 2008. Rather, the December Amendments were the realization of extended efforts to clarify and improve the Bankruptcy Law, including some of the shortcomings mentioned above. The December Amendments consist of numerous technical amendments and several material clarifications and changes, key of which are highlighted below.

Maintenance of Claims Register

The December Amendments provide that the claims register be maintained by a qualified registrar in accordance with uniform federal standards if the number of creditors included in the claims register exceeds 500. Further, the law now provides that a creditor must reimburse the trustee for the costs of notifying the debtor's other creditors of its asserted claim. Failure to reimburse such costs can result in the striking of the claim from the claims register.

Right to Vote at Creditors Meeting

The December Amendments confirmed past practice limiting the vote at creditors' meetings to only those holding registered claims.

Secured Creditor Rights

The December Amendments clarified that secured creditors are entitled to vote at creditors' meetings conducted during supervision without limitation and during financial rehabilitation and external administration provided such creditor foregoes the right to foreclose on its collateral during such proceedings. If the secured creditor stands on its rights to realize on its collateral, it may attend, but may not vote at, the creditors' meeting. However, its ability to foreclose is not guaranteed. A secured creditor may petition the bankruptcy court to permit it to foreclose on its collateral during financial rehabilitation and external administration procedures. The bankruptcy court may permit execution against collateral if the debtor cannot prove that the loss of such assets will render its efforts to restore its solvency impossible. Finally, the provisions related to the use of proceeds from the sale of collateral to satisfy registered claims discussed above were introduced as part of the December Amendments.

Disclosure Obligation

The December Amendments impose a disclosure obligation on the general manager of the debtor to deliver to the interim trustee and the bankruptcy court within 15 days of the interim trustee's appointment a list of the debtor's assets, rights in property and accounting and other documents reflecting the debtor's economic activities for the three years prior to initiation of supervision proceedings. Thereafter, during the period of supervision the general manager must report to the interim trustee any changes in the debtor's assets.

The introduction of this disclosure obligation is a step in the right direction to avoid the abuses, or at least provide information to permit parties in interest to determine if the trustee should pursue avoidance actions.

Expanded Definition of Interested Parties

The definition of interested parties was expanded to reach back to pick up those serving, or who served, within the three year (rather than one year) period prior to initiation of the bankruptcy proceedings, as the debtor's general manager, a member of any collegial board, a member of any board of directors or supervisory board, the chief accountant and an employee of the debtor.

Regulation of Bankruptcy Trustees' Qualifications, Conduct and Appointment

The December Amendments introduced voluminous changes related to the increasing monitoring of professional standards and conduct of bankruptcy trustees and associations of bankruptcy trustees. In addition, a specific compensation regime for trustees was adopted.

Establishment of a Unified Federal Register of Bankruptcy Information

The December Amendments provide for the creation of an Internet-based register for the publication of certain bankruptcy information subject to otherwise applicable privacy laws. The register is required to be established after promulgation of standards for its maintenance, which

are not expected to be completed before 2010. The level of broad disclosure remains insufficient to allow creditors to make informed decisions and stay informed of developments in the case on a timely basis.

Satisfaction of Creditor Claims by Shareholders or Other Third Parties

The December Amendments set forth the process by which a debtor's shareholder(s) or a third party may satisfy monetary payment claims. The December Amendments also provide a new process by which a debtor's shareholder(s) or a third party may satisfy obligatory payments of the debtor and assume the rights of such obligatory payment as a creditor in the claims register.

Assertions of Deliberate or Fictitious Bankruptcy

The December Amendments provide that a bankruptcy trustee or creditors may file a motion at any time seeking an expert analysis of whether the debtor meets the indicators of a deliberate or fictitious bankruptcy. Such person must pay the costs of the expert analysis if their allegations prove unfounded.

The April Amendments

Unlike the December Amendments, the April Amendments were a direct response to the credit crisis and the financial sector's efforts to cope with the increasing amounts of bad debt on its books. The April Amendments introduced several important new concepts that had the effect of broadening the Bankruptcy Indicators, broadening potential vicarious liability for nondebtor parties and expanding the bases for challenging inequitable transactions of the debtor.

Broadening of Bankruptcy Indicators

Pursuant to the April Amendments, a new filing trigger was added to the Bankruptcy Law, that sets forth circumstances when a debtor must initiate bankruptcy proceedings (see above). Specifically, the law now requires a debtor to file a petition due to "inability to pay" or "insufficient assets." Effectively, the amendments are an adoption of the cash flow insolvency and balance sheet insolvency tests. The term "inability to pay" is defined as "a debtor's cessation of performance of monetary or obligatory payments due to insufficient cash" (i.e., cash flow insolvency - the inability to pay debts as they become due). The term "insufficient assets" is defined as occurring when "the amount of a debtor's monetary and obligatory payments exceeds the value of its assets" (i.e., balance sheet insolvency).

The April Amendments further clarify that a liquidation committee appointed to oversee a voluntary liquidation of a company outside of bankruptcy must cause the company to file a bankruptcy petition within 10 days of determining that the company fails to meet the cash flow insolvency and balance sheet insolvency tests during the course of such liquidation. The introduction of balance sheet insolvency does not appear appropriate as a mandatory filing trigger, because the debtor may still be able to service its debts even if it is balance sheet insolvent. As stated above, however, it remains to be seen if failure to meet these tests themselves will permit the filing of a bankruptcy proceeding.

Broadening of Vicarious Liability

The April Amendments also substantially clarified and broadened the vicarious liability provisions contained in the Bankruptcy Law.

First, the April Amendments make clear that members of a liquidation committee may be found vicariously liable for failing to cause the company to initiate bankruptcy proceedings under the circumstances discussed above.

Further, the April Amendments introduced two new concepts related to vicarious liability - "controlling person" and "damages to creditors' property rights." The term "controlling person" is defined in pertinent part as a person who has, or had within the two years prior to the date of the bankruptcy court's acceptance of a debtor's bankruptcy petition, the right to give the debtor mandatory instructions or otherwise direct the debtor's conduct, including holding more than 50 percent of the debtor's voting shares or participatory interests.

Controlling persons now can be held vicariously liable for "damage to creditors' property rights" incurred by creditors as a result of the debtor's fulfilling instructions of the controlling person or the satisfaction of current obligations when estate assets are insufficient to satisfy creditor claims. The term "damages to creditors' property rights" is defined as "the reduction in the value or size of the debtor's assets or increase in the debtor's liabilities and also any other consequences arising from the debtor's conclusion of transaction or legally binding actions, resulting in creditor's losing, in whole or in part, the ability to satisfy their claims from the debtor's assets."

Claims may be brought against a controlling person as part of the bankruptcy proceeding upon the initiative of the creditors' meeting or creditors' committee or by the trustee upon its own initiative during the liquidation phase of the bankruptcy proceeding. A controlling person can avoid liability if he or she can demonstrate that they acted in good faith and reasonably in the interests of the debtor. If held liable, the controlling person retains subrogation rights against those responsible for causing damages to the creditors' property rights.

The April Amendments now also provide for holding the debtor's management vicariously liable if the statutory accounting records of the company, which it is required under law to maintain prior to the initiation of supervision or the finding of the debtor's bankruptcy are missing or incomplete or misrepresent the facts. Vicarious liability extends to the general manager's reporting obligations during supervision introduced as part of the December Amendments (see above).

Moreover, the April Amendments make clear that

shareholders and participants retain rights of action against members of management for breaches of their duties under the Civil Code to act in good faith and reasonably in the interests of the debtor. All assets recovered from a controlling person are included as part of the debtor's bankruptcy estate.

Expansion of Challengeable Transactions (Avoidance Actions)

The April Amendments also are notable given the introduction of a new chapter on avoidable transactions, which replaces and expands upon the limited number of grounds for avoiding debtor transactions. The Bankruptcy Law now provides for the avoidance of "suspicious" transactions and a much broader and more developed class of "preferential" transactions.

Suspicious Transactions

Suspicious transactions are similar, but not identical, to concepts of constructive fraudulent transfers and intentionally fraudulent transfers under US law.

- Transactions entered into within *one year* of acceptance of the debtor's bankruptcy petition or thereafter may be avoided if made for *unequal consideration*, including situations when the price or other terms of a transaction are substantially worse for the debtor than comparable terms in analogous transactions; and
- Transactions entered into within three years of acceptance of the debtor's bankruptcy petition or thereafter may be avoided if (i) they were made with the intent to inflict *damage to the creditors' property rights;* (ii) they do *damage to the creditors' property rights;* and (iii) the counterparty knew of the debtor's intent prior to the conclusion of the transaction.

Knowledge of the debtor's intent is presumed if the counterparty is found to be an *interested party* (see above) or knew or should have known that the debtor was cash flow insolvent or balance sheet insolvent.

The intent to inflict *damage to the creditors' property rights* is presumed if at the time of entering into the transaction the debtor is cash flow insolvent or balance sheet insolvent and

- The transaction was gratuitous (i.e., a gift) or the counterparty was an *interested party*; or
- The transaction involves the repurchase of shares or participatory interests of shareholders or participants of the debtor; or
- The transaction, or series of transactions, involves the transfer of assets with a value of 20 percent or greater than the net assets of the debtor according to the most recent set of accounts of the debtor prepared before execution of the transaction; or
- The debtor changes its registered address without notifying its creditors immediately prior to or after concluding the transaction; concealed its assets; or destroyed or misrepresented any documents required to be maintained under law, whether deliberately or from the improper maintenance of such documents; or
- After transferring the subject property, the debtor continued to use, possess or control such property.

Preferential Transactions

A transaction may be declared preferential if entered into by the debtor with an individual creditor or third party that involves the granting, or may involve the granting, of a preference to one creditor over other creditors in the satisfaction of claims, including:

- A transaction directed towards the securing of satisfaction of the obligations of the debtor or a third party to a certain creditor arising prior to entry into the challenged transaction;
- A transaction that changes, or may change, the order of priority of satisfaction of creditor claims arising prior to entry into the challenged transaction;
- A transaction that accelerates, or may accelerate, performance of an obligation to a creditor;
- A transaction that changes, or may change, the term of satisfaction of a claim for which the satisfaction has not yet arisen.

The July Amendments

The July Amendments in pertinent part further refine concepts introduced as part of the December and April Amendments, particularly related to the sale of the debtor's property, and conform the law to amendments on pledges introduced in December 2008. The extensive rules governing sales of the debtor's assets are beyond the scope of this article. However, the following points are worth mentioning.

Establishment of Compensation Caps for Trustees

The trustee compensation provisions introduced in the December Amendments were amended to place caps on a serving trustee's compensation.

Improved Sale Procedures During External Administration

The July Amendments establish minimally required disclosure requirements applicable to the external trustee's requests for approval from the creditors' meeting (committee) related to any proposed sale procedures that will govern the sale the debtor's business and now allow for the use of a specialist, such as a financial consulting or investment banking firm, to conduct such sales.

Payment of Sale Expenses

The July Amendments clarify that the costs of conducting a sale of property are remitted from the proceeds generated from such sale, although the exact priority of payment of proceeds remains unclear.

Key Proposed Amendments Included in the Bill

Name Change

The title of the current bankruptcy law would be changed from the "Federal Law on Insolvency (Bankruptcy)" to the "Federal Law on Financial Rehabilitation and Insolvency (Bankruptcy)" to underscore the shift in policy to support financial rehabilitation of distressed businesses.

Provisions for Consolidation of Bankruptcy

Proceedings of Related Entities

Currently, the law does not provide for consolidation of cases of related entities for administrative purposes. As a consequence, it is nearly impossible to restructure groups of entities because each entity is the subject of standalone proceedings, each of which may be pending before a different court in a different geographic location.

The Bill provides for the consolidation of cases of a "group of entities" - two or more entities that are under the control of one "controlling member of the group" (hereinafter, the controlling member). The controlling member is defined as the person who exercises effective control of a debtor, in the group of entities, including having the right to directly or indirectly exercise control of 50 percent or more of the voting shares of a joint stock company or participatory interest of a limited liability company; mandate actions of a debtor in the group, whether based on contract, organizational documents or otherwise; determine decisions and actions of the debtor in the group, including the terms of commercial activities; appoint the executive organ or more than 50 percent of the collegial executive organ of a debtor in the group or elect more than 50 percent of the board of directors (supervisory board) or any other collegial governing body of a debtor in the group.

Only the debtor has the right to seek approval for consolidated proceedings under the Bill as drafted and only one trustee may be proposed and appointed for such group.

Out-of-Court Arrangements and Prepackaged Bankruptcies

The Bill expressly acknowledges and approves out-of-court arrangements and the enforceability of forbearance arrangements. The Bill further provides that debtors and creditors may agree to an out-of-court arrangement that includes a preliminary agreement on a plan of financial rehabilitation and obliges the debtor to initiate rehabilitation proceedings to seek approval of such plan on a streamlined or expedited basis effectively opening the way for prepackaged bankruptcies.

Initiation of Financial Rehabilitation Proceedings

Under the Bill, a debtor would be able to file a petition voluntarily proposing financial rehabilitation as an alternative to a bankruptcy petition without providing a guarantee of payments under its plan, but only evidence of feasibility. The Bill also contemplates the ability of the debtor to borrow money to fund its rehabilitation. The Bill also adds as a new ground for filing a petition - the existence of creditor claims for payment or statutory payment obligations that have not been paid when due.

In addition to the other information required to be disclosed in a bankruptcy petition, a petition for financial rehabilitation must include:

- Information about unencumbered assets;
- In addition to a proposed interim trustee, the name of the proposed candidate, or self-regulating organization, to act as rehabilitation trustee; and
- A report of the debtor's financial condition.

Adoption of Cross-Border Insolvency Procedures

The Bill includes the addition of an entirely new chapter that would regulate cross-border insolvencies. The cross-border procedures are modeled after the European Union Regulation on Insolvency. Accordingly, the *situs* of the primary case should be determined by determination of the debtor's *center of main interests*.

The Bill provides that the Russian bankruptcy court would have exclusive jurisdiction over bankruptcy cases of debtors whose center of main interests are located in the Russian Federation and its jurisdiction would extend to all of the debtor's property, wherever located. A debtor would be able to seek to consolidate cases of "controlled persons" and "controlling persons" pursuant to the Bill's consolidation procedures.

Secondary proceedings may be initiated in Russia if the debtor has an "establishment" in Russia, or creditors may seek to initiate secondary proceedings if the creditor is located in Russia and its claims are related to activities of the debtor's establishment in Russia. Secondary proceedings would also be permitted if the debtor only had property located in Russia, under several circumstances, including to support a primary case pending in another jurisdiction.

The Bill currently provides that a Russian bankruptcy court could refuse to honor an order issued in a non-Russian bankruptcy court for several reasons, including (i) the failure to timely provide notice of the initiation of the non-Russian proceedings by reliable means which could materially prejudice the rights of creditors; (ii) in instances of material breaches of rights of creditors and others participating in the non-Russian proceeding; (iii) the matter is reserved to the exclusive jurisdiction of the Russian Federation; and (iv) the recognition of the order would violate the public policy of the Russian Federation.

The introduction of the recognition of cross border proceedings could further assist Russian businesses in distress to reorganize their affairs, because most all Russia's private companies of any scale, particularly those with foreign investors, have off-shore holding structures. However, while Russian courts are required to recognize foreign arbitral awards under the UN Convention on the Recognition and Enforcement of Foreign Arbitral Awards, recognition and enforcement of foreign judicial decisions is rare, mostly because of a lack of bilateral and/or multilateral treaties on mutual recognition and enforcement of court judgments to which Russia is a party. Accordingly, even if the Bill is adopted cross border practice will likely be uneven and inefficient for some time.

Conclusion

Substantial steps have been taken in the last year to better balance the interests of debtors and creditors and to

provide tools to combat abuse of the insolvency system. There is a marked tendency to make the process more transparent, increase disclosure and introduce concepts to improve the process. Because of the volume and number of recent amendments in such a short space of time, it remains unclear how the amendments will be implemented in practice. However, the trajectory of amendments appears very positive.

The adoption of the Bill (with some modifications) could revolutionize Russia's bankruptcy process and assist the banking sector in addressing the glut of bad debts on their books more efficiently and with better results. However, it would well serve the government to open the legislative process up and solicit comments and debate on the Bill from interested parties prior to rushing to adopt it in order to try to achieve the best legislative solution in the next draft. For example, the process would be much improved and less prone to abuse if the notice requirements were broadened and bolstered and a more effective disclosure mechanism was introduced. Perhaps, this could best be achieved through the thoughtful implementation of a user friendly internet based Unified Federal Register of Bankruptcy Information, which would align with President Medvedev's goals to create more transparent and electronic based governmental services.

1. In preparing this article, the authors have sought to use US and English terms that most closely approximate the concepts presented in the Bankruptcy Law. However, in some instances the Russian concepts may differ in material ways from the common law terms of art. The intent is to provide touchstones for those familiar with common law practices and improve readability.

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