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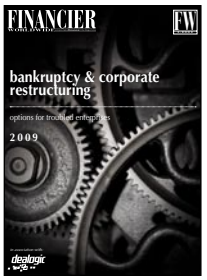

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2009 Bankruptcy & Corporate Restructuring
options for troubled enterprises

Russia's rapidly evolving commercial bankruptcy law

BY SERGEY A. TRESHCHEV AND PATRICK J. BROOKS

Russia's Federal Law No. 127-F3, 'On Insolvency (Bankruptcy)', dated 26 October 2002 (the 'Bankruptcy Law') was amended substantially over the last nine months by three separate bills and several clarifying orders of the Supreme Arbitration Court of the Russian Federation, the highest bankruptcy court in Russia, that are effectively binding upon inferior arbitration courts, or bankruptcy courts. Moreover, starting from December 2008 the laws 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 of further amendments to the Bankruptcy Law that would, if adopted, fundamentally alter Russia's bankruptcy system and debtor-creditor relations.

Since 1992, Russia has experienced three fundamental reforms of its commercial bankruptcy laws in 1992, 1998 and 2002. 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 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.

Initiating the process

A Russia-based company or sole proprietor cannot become the subject of a bankruptcy proceeding unless it can demonstrate that it meets the following bankruptcy indicators. Either, 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, such as 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.

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.

A debtor's management is required to file a bankruptcy petition as soon as possible if: (i) 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; (ii) the authorised body of the debtor has taken a decision to file a bankruptcy petition; (iii) enforcement actions against the debtor's property will complicate or preclude the debtor's continued operation; or (iv) the debtor is insolvent on either a cash flow or a balance sheet basis.

In practice, the obligation to file typically has been interpreted to be triggered only after the manifestation of the bankruptcy indicators. Nonetheless, general managers are well advised to keep their board of directors (if any) or shareholders timely informed of collection proceedings, and board members and shareholders should heed those warnings, to minimise risk of personal liability. Most creditors can initiate involuntary proceedings provided they

can prove the bankruptcy indicators.

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 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.

Bankruptcy proceedings. The Bankruptcy Law provides for the following types of insolvency proceedings: supervision, financial rehabilitation, external administration, composition arrangement and liquidation. If the 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, the 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.

Supervision. The purpose of supervision is to identify the debtor's creditors, determine the amounts of their claims and prepare a register of creditor's claims; suspend enforcement under writs of execution; analyse the debtor's financial state; 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. Notice of the creditors' meeting is made by publication if the number of registered creditors is greater than 500, otherwise personal notice by direct mail is required but only to "persons entitled to participate in the creditors meeting". Consequently, in most cases a small fraction of creditors holding legitimate unsecured claims receive any notice of creditors' meetings –- meetings at which the fate of the debtor and the likely recovery of creditors are determined.

Financial rehabilitation. The financial rehabilitation procedure was introduced in 2002 with the current Bankruptcy Law and was intended to encourage restructuring, but this has not occurred. 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 according to 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, although this 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's powers are terminated.

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 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.

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.

Registered claims are paid in the following order of priority. First priority is for claims for damages for personal injury and moral harm. Second priority is for claims for wages, salary, other employee benefits and royalties payable to authors of copywritten materials. Third priority is for 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: (i) 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); (ii) 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 (iii) the balance is applied toward current payments, if unencumbered assets are insufficient to satisfy those 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 (recognised 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, only creditors whose claims are registered in

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the debtor's claims register or are secured have a right to notice of, and to vote at, creditors' meetings. 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.

Key proposed amendments in the bill

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

Consolidation of bankruptcy proceedings. The Bankruptcy 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'.

Out-of-court arrangements. 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 basis opening the way for prepackaged bankruptcies.

Financial rehabilitation. The Bill would amend and restate the entire chapter governing financial rehabilitation to minimise obstacles to initiating the process and provide mechanisms to more efficiently maintain ongoing business operations. A debtor would be able to voluntarily file a petition proposing financial rehabilitation at the outset of the proceedings and would not need to produce a third party guarantee of satisfaction of claims under its plan of financial rehabilitation. The debtor would only need to demonstrate feasibility of its proposed plan. The Bill also includes a cramdown provision, but the threshold appears exceedingly low, particularly given the weak notice provisions and difficulty of creditors getting claims registered in the first instance to secure their right to vote.

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 modelled after the European Union Regulation on Insolvency. Accordingly, the situs of the primary case should be determined by determination of the debtor's centre of main interests.

The introduction of the recognition of cross-border proceedings could further assist Russian businesses in distress to reorganise their affairs because most all Russia's private companies of any scale, particularly those with foreign investors, have offshore holding structures. However, while Russian courts are required to recognise 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.

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. Nonetheless, the trajectory of amendments appears very positive. However, careful study of the Bankruptcy Law and Bill is warranted and efforts should be taken to better balance the interests of parties-in-interest by broadening notice requirements and further improving timely and meaningful disclosure, among other things. The adoption of the Bill (with some modifications) could revolutionise Russia's bankruptcy process by providing a workable mechanism to preserve the operation of viable businesses experiencing financial distress while more equitably addressing creditor claims. This in turn should assist the banking sector in dealing with the glut of bad debts on their books in a more efficient manner while improving recovery rates.

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