18. Insolvency

18.1 Overview

Russia has had a series of insolvency regulations and laws in place since 1992, which have been subject to regular changes and amendments. Russian insolvency law is rather extensive and provides several options including reorganization and rehabilitation of an insolvent company and debt rescheduling for natural persons as an alternative to liquidation/bankruptcy.

In practice, insolvency is not yet widely viewed as a reliable and transparent process for resolving debtor-creditor issues. To date, creditors often view it as a process used by debtors to transfer assets and avoid creditors; hence the concept of “sham insolvency” is addressed in the legislation as well as the concepts of suspicious and preferential transactions of a debtor, which may be challenged during insolvency proceedings. One of the instruments introduced to influence attitudes towards bankruptcy is the liability for controlling persons (i.e. management, shareholders, participants and other persons affiliated somehow with a debtor) responsible for the bankruptcy of a company.

While the Russian insolvency law previously applied only to legal entities and individuals who were registered as sole entrepreneurs, it is now applicable to both legal and natural persons, including those who are not engaged in any business activities. Separate rules are applied with respect to bankruptcy of core companies, farms, financial organizations (e.g. banks, insurance companies, etc.), strategic enterprises, natural monopoly entities and developers.

18.2 Legislation

Insolvency and restructuring in Russia is governed by Part I of the Civil Code of the Russian Federation and by Federal Law No. 127-FZ dated 26 October 2002 “On Insolvency (Bankruptcy)” (as amended) (the “Insolvency Law”). In addition, there are extensive rules and
regulations adopted by the government, the Ministry of Economic Development and various state bodies, in addition to court decisions of the Supreme Court and other courts, designed to standardize insolvency in practice.

In 2014 the rules related to signs of bankruptcy were amended. A debtor or creditor is empowered to file a petition with a court for bankruptcy if the debtor’s overall indebtedness exceeds RUB 300,000 for legal entities and RUB 500,000 for individuals. Bankruptcy proceeding of strategic enterprises and natural monopoly entities can be initiated only if the amount of indebtedness exceeds RUB 1,000,000.

From 29 January 2015 the tax authorities and banks are entitled to initiate bankruptcy proceedings against debtors if their debts are at least three months overdue.

There are also several draft laws pending in the State Duma (Russian Parliament) and the Russian Ministry of Economic Development aimed at improving the legislation and resolving various issues related to bankruptcy proceedings. In particular, it is planned that EGRUL will contain information on the stages of bankruptcy proceedings.

18.3 Procedure

Insolvency procedure may be initiated against a debtor in case it fails to satisfy creditors’ claims or to effect obligatory payments (tax, duty payment, etc.) within three months from the date the above claims and/or obligations become due. The Russian insolvency procedure can be initiated either by creditors, authorized state bodies, current and former employees or by the debtor itself. Creditors as well as current and former employees can file a petition to begin insolvency proceedings only after obtaining a court judgment that a debtor owes them in excess of RUB 300,000\textsuperscript{89} — in relation to legal entities, or in excess of RUB 500,000 — in relation to individuals. The requirement

\textsuperscript{89} After 29.01.2015
for a court judgment was designed to protect debtors from frivolous filings. Its downside is that it causes delays for creditors seeking to quickly initiate the procedure. This rule has an exception for credit institutions, which may initiate bankruptcy proceedings without a court judgment based on signs of insolvency of the debtor under the condition that they file a notification with a public state registry 15 days prior to initiating such proceedings. Under current court practice, the term “credit institution” covers not only banks with a Russian license, but banks with licenses under their law of incorporation as well. Furthermore, tax and customs authorities are also authorized to initiate bankruptcy proceedings without a court judgment 30 days after the relevant authority rendered a decision to collect the amounts due from the debtor.

The law requires debtor companies and individuals to file a petition for insolvency within a month of determining that satisfying one creditor would make it impossible to satisfy their other debts in full or if the debtor is more than 3 months late in paying salaries to their current employees and/or severance pay to former employees.

Once the grounds of the petition for insolvency have been verified, the debtor company enters the first phase of the procedure, which is called supervision. Each insolvency process involves a supervision period. Other phases, which will vary depending on the circumstances of the insolvency, include financial rehabilitation, external management, liquidation and amicable settlement.

As for natural persons, the Bankruptcy Law provides two types of procedures - debt rescheduling and seizure of property.

The information which is subject to publication under the Insolvency Law should be included in the Uniform Federal Register of Information on Bankruptcy and should be published in “Kommersant” newspaper.

It is no longer permissible for tax authorities to strike off from EGRUL those non-operating (inactive) entities which are going
through bankruptcy proceedings. This principle was established by the Act of the Russian Constitutional Court, aims primarily to protect creditor’s interests and ensure their right to receive satisfaction.

18.3.1 Supervision

The supervision stage is mainly aimed at having a court-appointed temporary (bankruptcy) administrator secure and value the debtor company’s assets and compile a list of creditors. Once these tasks are completed, the first creditors’ meeting is convened to decide on the next steps.

During the supervision stage, the debtor’s business is run to a large extent in the same way as before, since the temporary administrator has only limited powers over the debtor’s activities. The company’s management remains in place, unless the administrator receives court approval to dismiss the management. If the management is dismissed, the new management is appointed by the court from among candidates proposed by a representative of the company’s shareholders.

At the same time there are certain limitations imposed by law which need to be taken into account. First, during the supervision stage the temporary administrator’s approval is required (i) for any transactions with company’s assets with a value of 5% or more of the book value of the debtor’s assets as of the date of commencement of the supervision, (ii) for granting/receiving loans, assignment of rights, transferring debts, granting guarantees/suretyships, putting the debtor’s assets into trust. Second, the debtor (its management bodies) is prohibited from buying shares from its shareholders, issuing bonds or paying dividends, from taking decisions on reorganization, liquidation, establishment of branches or representative offices or participation in joint ventures, associations and holding companies.

According to recent amendments, after the supervision stage has commenced, no penalties or any other financial sanctions may be imposed on a debtor for failure to perform its obligations. Instead, the amount claimed by creditors accrues interest in accordance with the refinancing rate set by the Central Bank of Russia.
At the end of the supervision stage the temporary administrator submits a report to the court. On the basis of this report and the decision of the creditors’ meeting the court takes a decision on further procedures to be applied to the debtor.

The supervision stage should last for not more than seven months, although sometimes this period is extended.

18.3.2 Financial Rehabilitation

This procedure is rarely used in practice. It could be introduced if a debtor company’s creditors and the court believe that there are reasonable chances of the debtor avoiding bankruptcy liquidation. During this stage the debtor’s management remains in place and the business is carried out to a large extent as during the supervision stage, with certain minor exceptions.

At the financial rehabilitation stage a debtor presents a plan for repayment of the outstanding payments (debts) which can envisage, among other things, the writing-off of an important part of such debts. If the debtor succeeds in repaying its debts then the bankruptcy proceedings are terminated.

In our experience this stage can be extremely effective, especially if you find an investor prepared to invest into and develop the business.

18.3.3 External Management

External Management is aimed at restoring the debtor company to financial health. The debtor’s management is dismissed and a court-appointed administrator manages the debtor according to an external management plan, which is prepared by the administrator and approved at the creditors’ meeting. External management must be completed within 18 months, but in some instances this term can be extended.
18.3.4 Bankruptcy Liquidation

Note that in contrast to other jurisdictions where insolvency proceedings are often used as a tool to defend a company from its creditors and to help it recover from a difficult financial situation, in Russia most insolvency proceedings end up with liquidation of the company. Thus, bankruptcy liquidation is very often ordered by courts after the supervision stage.

At this stage all the debtor’s assets are sold to pay creditors’ claims in the order prescribed by law. Once the liquidation is completed, the debtor is wound up and ceases to exist. The bankruptcy liquidation could take from six months to six years to complete, where the actual term largely depends on the size of the company and its business, number and complexity of creditors’ claims as well as the number of claims brought by the bankruptcy administrator.

18.3.5 Debt Rescheduling

Debt rescheduling can be applied to natural persons to repay their debts in up to three years. The procedure may be initiated either by the debtor himself/herself if he/she contemplates insolvency and is unable to pay his/her debts and/or has insufficient property to pay. A creditor is entitled to file for bankruptcy of a natural person if satisfaction of claims of one creditor makes it impossible for the debtor to discharge in full monetary obligations which amount to at least RUB 500,000, to other creditors.

A court’s decision that the application for bankruptcy is justified has consequences similar to bankruptcies of companies, namely, the debtor may not perform its obligations towards creditors and may not conduct obligatory payments, including payments required by court decisions in force. The court decision also accelerates the maturity of all obligations for the purposes of bankruptcy proceedings.

The starting point is the draft debt rescheduling plan, which is to be prepared either by the debtor, or the creditor. In case no draft is presented within 2 month after the court’s decision to initiate
bankruptcy proceedings, the financial manager is to propose seizure of property.

The plan is subject to approval by the first creditor’s meeting by a simple majority. If voted in favour of, the plan is to be approved by the court. The court can enforce the rescheduling plan even if it is not approved by the creditor’s meeting provided that the court finds that the rescheduling will satisfy substantially more claims (at least 50% of registered claims) than immediate seizure of property.

The rescheduling is terminated by virtue of a court decision if all claims have been satisfied. Should not all claims be satisfied, the creditors may file a motion with the court to cancel the debt rescheduling plan not later than 14 days before the end of the period provided for repayment.

18.3.6 Seizure of Property

A competent court initiates the seizure of property of a natural person in the following cases:

- the debtor and the creditors have not proposed a draft debt rescheduling plan;
- the creditors’ meeting has not approved the draft debt rescheduling plan and a court has delivered a ruling on refusal to approve the debt restructuring schedule;
- the debt rescheduling plan has been cancelled.

The procedure to seize property procedure is to be conducted within 6 months, but this term may be extended by a court. Only the financial manager is entitled to exercise any rights over the debtor’s property and his/her mission is to appraise the property of the estate and to sell it.

A debtor is discharged from his/her obligations once the seizure is completed, unless:
• the debtor has been found criminally or administratively liable for illegal actions in the course of bankruptcy proceedings;
• the debtor knowingly provided incomplete or false information;
• the debtor acted in breach of the law when a creditor’s claim arose or during its performance;
• the debtor has been declared bankrupt within 5 years after the previous bankruptcy.

A natural person may not file for voluntary insolvency within 5 years after bankruptcy. He/she is also barred from managing legal persons for 3 years and is obligated for the next 5 years to notify a creditor under a credit or loan agreement of the fact that he/she has been declared bankrupt.

18.3.7 Amicable Settlement

The creditors and the debtor company or natural person are entitled to sign a settlement agreement at any stage of insolvency proceedings. Such an agreement will be subject to the court’s approval. Once a settlement agreement is concluded and approved by the court, the bankruptcy proceedings are terminated.

18.3.8 Bankruptcy manager

The Bankruptcy Law provides that a creditor should propose a candidate to be nominated as bankruptcy manager. The nominee should be a bankruptcy manager of a professional Russian self-regulating organization establishing and monitoring requirements and standards for bankruptcy managers. If the court concludes that the proposed candidate meets the legal requirements, the court approves this candidate as bankruptcy manager. According to recent amendments, a debtor may no longer propose a nominee for the bankruptcy manager position, even if the debtor initiates bankruptcy proceedings. Instead, a self-regulating organization is to be established in accordance with the guidelines which are to be adopted by the
Ministry of Economic Development. The authority of a bankruptcy manager has recently been expanded to include the right to request and obtain information on managers, controlling persons and data of a classified nature.

Note that the bankruptcy manager plays a key role in the bankruptcy procedures and it is very important who this person is. It is noteworthy that the bankruptcy manager is empowered to request that a debtor’s shareholder(s) be made vicariously liable or claim for the invalidation of transactions entered into by an insolvent company prior to or after the commencement of the bankruptcy proceedings.

18.4 Challenging transactions

Transactions of the debtor may be challenged under the Insolvency Law on the following insolvency specific grounds: suspicious and preferential transactions. The changes adopted in 2014 have extended the scope of persons entitled to challenge transactions beyond only bankruptcy managers. Now a bankruptcy creditor with more than 10% of the total bankruptcy claims in the register of claims has also been given the right to challenge transactions.

Two types of transactions are defined as suspicious, namely undervalue transactions and transactions that are deemed to infringe the rights of the debtor’s creditors. An undervalue transaction can be overturned by the court in insolvency proceedings if it is proven that:

- the counterparty to such transaction provided incommensurate consideration to the debtor; and

- the transaction is concluded within 1 year prior to, or after the initiation of, insolvency proceedings against the debtor.

A transaction which is deemed to infringe creditors’ rights may be challenged if the following conditions are simultaneously met:
• the conclusion of the transaction was intended to prejudice creditors’ rights and has resulted in such infringement;

• the counterparty to the transaction was aware or should have been aware of the aim of such transaction;

• the transaction was concluded within 3 years prior to, or after the initiation of, insolvency proceedings against the debtor.

A transaction gives preference to an existing creditor and may be challenged if such transaction concluded within 6 months (in some cases within 1 month) prior to or after the initiation of insolvency proceedings against debtor and if such transaction:

• provides for security for an existing creditor; or

• entails any change of priorities in which the existing creditors’ claims are satisfied; or

• may entail satisfaction of claims that have not yet matured; or

• results in preferential satisfaction of claims of one creditor over other creditors’ claims.

If a transaction is invalidated under the above grounds, the court will apply restitution and all assets transferred under such transaction will be returned to the debtor and form part of its insolvency estate. The claims of the counterparty under the invalidated transaction, which is deemed to infringe creditors’ rights and certain types of preferential transactions, may only be satisfied after satisfaction of all claims of creditors of all priorities. Claims of recipients of invalidated undervalue transactions may be satisfied in the third priority together with other unsecured claims.

In accordance with the recent amendments, information regarding claims to invalidate a transaction and corresponding court decisions is to be made publicly available through the Uniform Federal Register of Information on Bankruptcy.
18.5 Priority of Claims

Russian law envisages the following ranks of claims (creditors):

**Priority Rank:** Current expenses, which are monetary obligations that arise after the application for bankruptcy has been filed with the court, such as court expenses and bankruptcy manager expenses have priority over the claims of all other creditors; Russian law sets out the following order for settling current expenses: (1) court expenses and bankruptcy manager remuneration and expenses associated with engaging other persons, whose participation is mandatory under the Insolvency law (2) claims regarding salaries and severance pay, (3) expenses associated with engagement of persons whose participation in the bankruptcy proceedings is not mandatory, (4) utility and maintenance charges, (5) other current claims.

**First Rank:** Claims connected with bodily injuries, other injuries to health;

**Second Rank:** Claims of employees regarding their salaries and severance payments, royalties to the authors of items of intellectual property. Among such, claims of employees regarding their salaries and severance payments in the amount of RUB 30,000 per month per person are to be settled first, followed by the remaining claims of employees regarding their salaries and severance payments. Should any property remain after that, royalties to the authors of intellectual property items become subject to payment;

**Third Rank:** Claims of all other creditors, including claims of secured creditors, claims of state bodies (e.g. federal, regional government, tax, pension funds, etc.). The potential claims of regional government in connection
with closing mines also fall within this category.

The property available for distribution, including proceeds from the sale of assets, will subsequently be allocated among creditors of each rank on a pro rata basis.

A secured creditor having claims secured by the pledge of the debtor’s assets may enforce its security by means of foreclosure. Such secured claims are satisfied prior to other creditors’ claims of the same rank. In the event of foreclosure over pledged assets a creditor will receive 70% of the proceeds from the assets’ sale, and the remaining 30% will be used to cover claims of the creditors of the first and second ranks, as well as the court and bankruptcy manager expenses. If the pledge was to secure the debtor’s obligations under a credit agreement, 80% of the proceeds from sale of the asset shall go to the creditor and the remaining 20% shall be used to cover claims of the creditors of the first and second ranks, as well as the court and bankruptcy manager expenses.

For natural persons, 80% of the proceeds is used to discharge the pledger’s secured obligations, with the remaining 10% and 10% directed towards satisfying the claims of creditors of first and second priority and to cover court and other costs, respectively.

18.6 Treatment of Secured Creditors

Creditors whose claims are secured by pledge of the debtor’s assets may claim to levy execution over the pledged property and satisfy their claims at an early stage during financial rehabilitation or external management. If the secured creditor exercises this option, the pledged assets are sold at a public auction and the proceeds are used entirely to satisfy its claims. Should the proceeds from such an auction be insufficient to satisfy the creditor’s claims, the outstanding amount is to be satisfied on par with the claims of creditors of the third rank once the liquidation commences. Written consent of a secured creditor must be obtained if the pledged assets are on sale together with other assets. Importantly, the court is allowed to prohibit levy of execution
over the pledged assets if this will entail inability to reinstate the debtor’s solvency.

In 2015, the capacity of secured creditors to vote at creditors meetings was expanded. Previously, secured creditors were allowed to vote during the supervision stage and during the financial rehabilitation stage or external managements stage, provided such creditors do not levy execution over the pledged property. Now, secured creditors are also entitled to vote on matters of election of a bankruptcy manager, or filing for dismissal of the bankruptcy manager, as well as a right to vote on any matters during debt rescheduling or seizure of property of natural persons.

If the secured creditor chooses not to exercise, or waives the right to levy execution on the pledged assets prior to the debtor being declared bankrupt, such assets will be sold at a public auction in the course of liquidation. In this case, 70% of the proceeds (or 80%, if the underlying obligation secured by the pledge is a bank loan) will be used to discharge the pledger’s respective secured obligations (regardless of any claims filed by creditors of other ranks), 20% will be directed towards satisfying the claims of creditors of the first and second ranks, while 10% will be used to cover court fees and other costs (in the case of a bank loan, 15% and 5% respectively).

18.7 Liability of Controlling Persons

Vicarious Liability

Under the Bankruptcy Law a controlling person may be found liable for the bankruptcy of a company and be ordered to compensate creditors’ losses after all the assets of the insolvent company are distributed. This is possible if the controlling person issued instructions which led the company to bankruptcy.

A controlling person is broadly defined as a person (an individual or a legal entity) who can either control the debtor’s activity and give mandatory instructions to the debtor (including a member of a
 liquidation commission and an owner of more than 50% of the debtor’s shares, or who could do so within the two years prior to the initiation of the bankruptcy proceedings).

Under law the fault of the controlling persons in causing damage to the creditors is presumed, but this presumption may be rebutted by the controlling person: it would not be held liable if it acted in good faith and in the debtor’s interests, and thus did not contribute to the bankruptcy.

In addition, the amount of the controlling person’s liability may be reduced by the court if the creditors’ losses incurred as a result of faulty actions/omission to act of the controlling person are significantly lower than the overall amount of creditors’ claims that remain unsatisfied.

According to recent amendments, information on claims against controlling persons for vicarious liability are to be made public through the Uniform Federal Register of Information on Bankruptcy, as well as information on subsequent court decisions on such matters.

In practice there has been one high-profile case where the creditors have successfully sought orders for disclosure of assets and a freezing order regarding the controlling person’s assets globally in English courts in support of the bankruptcy proceedings in Russia. It should, however, be noted that English courts need to have jurisdiction over the case to be able to support bankruptcy proceedings in Russia.

*Criminal Liability*

A director may also face criminal liability, and in practice this could be used by the authorities as an instrument for putting pressure on a license holder in order to avoid redundancies, achieve fulfilment of certain obligations of the company under subsoil licenses, etc. In particular, under the Russian Criminal Code a director and/or other controlling persons, including shareholders, may be held criminally liable for:
(i) fraudulent actions aimed at concealing the assets of the debtor; or

(ii) intentional bankruptcy (when the director intentionally takes business actions that ultimately result in the bankruptcy of the debtor); or

(iii) sham bankruptcy (when the director intentionally makes the public believe that a company is insolvent).

The liability for these crimes may vary from a criminal fine to imprisonment. Russian law does not envisage criminal liability for companies (e.g. if a shareholder is a legal entity), but in this case their directors could be prosecuted.