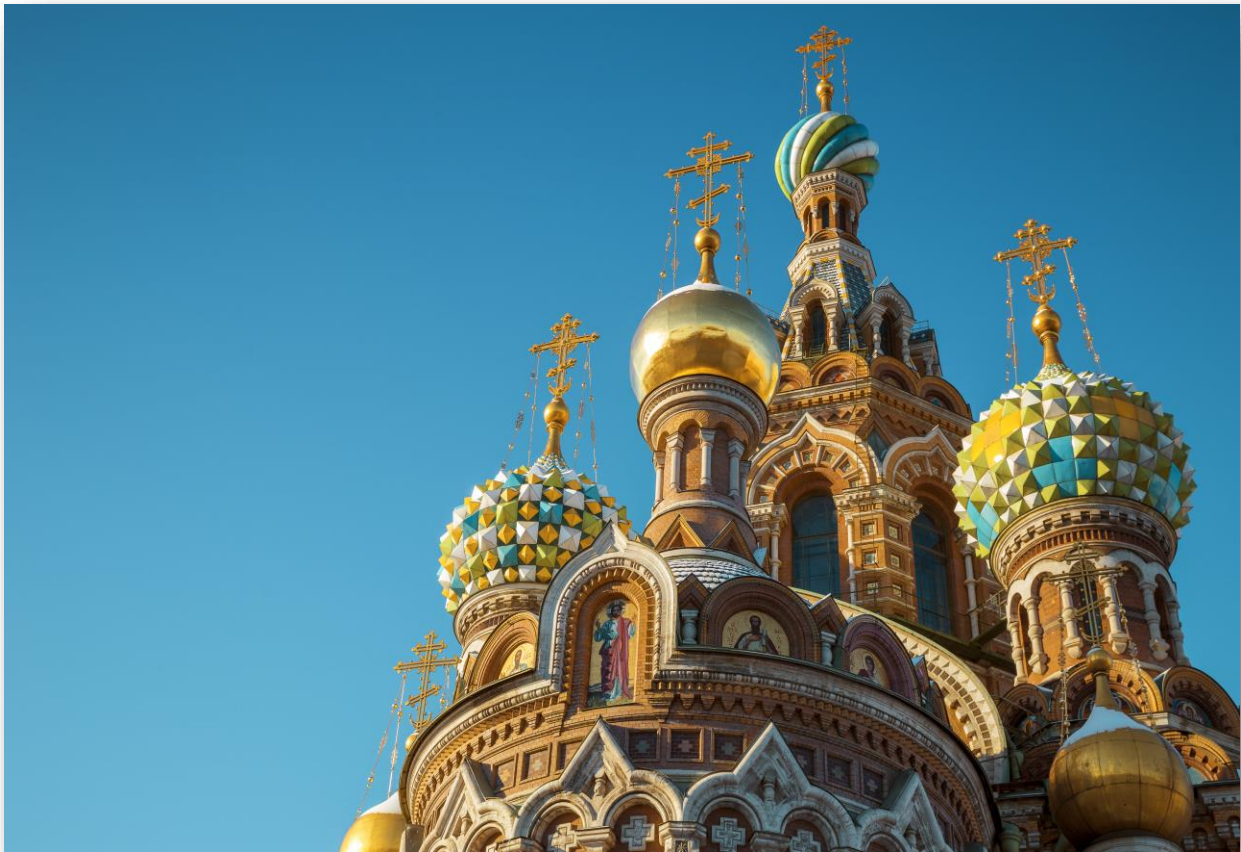




Spring | 19



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Bankruptcy, Insolvency & Rehabilitation Proceedings in Russia

ILN RESTRUCTURING & INSOLVENCY GROUP



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KEY FACTS OF BANKRUPTCY, INSOLVENCY & REHABILITATION PROCEEDINGS UNDER RUSSIAN LAW

The main piece of legislation that regulates the activities of parties in insolvency proceedings in the Russian Federation is the Federal Law dated October 26, 2002 N 127-ФЗ titled *On Insolvency (Bankruptcy)* (referred to here as the **Insolvency Law**).

A right to petition a court to declare a debtor insolvent is held by the debtor himself, the creditor, the authorized bodies, as well as by employees, or former employees of the debtor, to whom the debtor is in arrears of severance payments and/or wages.

Insolvency cases are within the exclusive competence of commercial courts. An entity is insolvent only once the court has ruled as such.

The following can be ruled as being insolvent or bankrupt:

- 1) legal entities (with the exception of state-owned enterprises, institutions, political parties and religious organisations); and
- 2) individuals, including individual entrepreneurs.

Signs of insolvency of a legal entity include, a) an inability to satisfy the creditors' claims and/or to fulfil the obligations to make payments within three months from the date they should have been made and b) the debt is not be less than three hundred thousand roubles.

The Insolvency Law refers to signs of bankruptcy of an individual, a) the inability of the debtor to discharge his obligations to the creditor(s) and b) the value of the debt is more than five hundred thousand roubles.

The Insolvency Law provides for involvement in cases of an administrator. The administrator is designed to respect the interests of creditors and help preserve the property of the debtor.

The powers of the administrator vary depending on the procedure applied: starting with an analysis of the debtor's activities and drawing up a report on the possibility of restoring its solvency (monitoring procedure), ending with full management of the debtor's activities (full insolvency proceedings). The administrator must be an individual with a higher education, managerial experience, who has passed a special exam and is a member of one of the self-regulating organisations of administrator.

Trends in the development of the law and judicial practice in insolvency cases in the Russian Federation are pro-creditor in nature. This is manifested in the establishment of numerous mechanisms to protect the rights of creditors, which provide them with the opportunity to obtain debts using the debtor's property. In turn, effective mechanisms that would protect the debtor are practically absent from the Insolvency Law.

Now to consider the procedures that are applied in insolvency cases.

1. Monitoring

The purpose of the monitoring procedure is to ensure the protection of a debtor's property, analyse its financial state, draw up a register of creditors' claims and hold a meeting of creditors. This procedure is followed after a court's decision as to the validity of an insolvency petition.

The general duration for monitoring is not established by law; however, the Insolvency Law states that this procedure must be completed taking into account the period for considering an insolvency case, which is seven months.

With the introduction of the monitoring procedure, the debtor's activities are limited.



The commercial court appoints an administrator who is entitled to monitor the debtor's business activities and influence it by legal means, for example, make demands to recognise transactions invalid, request removal of the debtor's management, coordinate transactions that may result in a reduction in the debtor's estate.

Information on the introduction of monitoring and on the introduction of any other procedure in an insolvency case is subject to publication in the *Kommersant* newspaper¹ and is included in the Unified Federal Register of Insolvency Information².

The debtor's creditors also hold the first meeting of creditors, which determines the further fate of the debtor, namely, it must be decided what procedure is to be next introduced, either of a rehabilitative nature (financial rehabilitation or external management) or dissolution (the opening of insolvency proceedings).

1.1. Implications of monitoring

1) the creditors' claims and obligatory payments (with the exception of current payments i.e. those that the debtor had before the creditors, after the date of the petition for insolvency), can be presented to the debtor only in accordance with the procedure set out in the Insolvency Law. Accordingly, creditors are entitled to submit their claims to the debtor within thirty calendar days from the date of publication of the notice of introduction of monitoring. If the creditor makes claims later, such claims will be subject to review by the court at the procedure that follows monitoring.

This occurs at the stage of monitoring and continues to apply throughout the insolvency proceedings.

1) At the request of the creditor, the proceedings on cases related to recovery of funds from the debtor are suspended, and the creditor in this case is entitled to submit his claims to the debtor in accordance with the procedure established by the Insolvency Law.

2) The performance of any dealings with property actions are suspended.

The basis for the suspension of the decision of the commercial court on the introduction of monitoring. This decision is sent to the bailiffs. The bailiff, having received the decision suspends the enforcement proceedings, and also makes decisions on the removal of arrests and other restrictions on the property of the debtor.

From the date of the introduction of the monitoring, the collection by the bailiff on the property, including out of court, is not allowed.

4) A claim from a shareholder or partner to allocate its share in the property of a debtor due to the withdrawal of the latter from the list of shareholders or partners is not allowed. Transactions that violate this prohibition are void.

5) A debtor's monetary obligations cannot be offset by a counterclaim if this violates the creditors' claims.

6) It is not allowed to pay dividends, as well as the distribution of profits between the shareholders and partners of the debtor.

7) Penalties and other financial sanctions for non-performance or improper performance of

¹ <https://bankruptcy.kommersant.ru>

² <https://bankrot.fedresurs.ru/?attempt=1>



monetary obligations and obligatory payments, except for current payments, cannot be charged.

A decision to make a company subject to monitoring is sent by the commercial court to banks with whom the debtor has a bank account, as well as to the court of general jurisdiction, the main bailiff at the location of the debtor and its branches and representative offices.

As above, monitoring is a procedure in which the financial condition of a debtor is determined, the possibilities for the debtor to pay off his debts and influences the follow-up procedure, which can be either rehabilitative or dissolution of the company.

Judicial statistics show that the number of cases for which rehabilitation procedures are introduced is extremely small. In the 4th quarter of 2018, rehabilitation procedures were introduced only in 1.5% of cases. This underscores that in Russia, insolvency almost invariably leads to liquidation.

Nevertheless, below we outline all other possible procedures that can follow a petition for insolvency.

2. Financial recovery

Financial recovery is a rehabilitation procedure aimed at overcoming financial difficulties of the debtor with the provision of certain guarantees to creditors. The introduction of this procedure allows the debtor to pay debts in accordance with an approved financial recovery plan.

Financial recovery is generally commenced by a commercial court on the basis of a decision of the meeting of creditors.

The total financial recovery period cannot exceed two years.

As a general rule, the managing bodies and the debtor's administrator are not barred from

doing business, but restrictions are imposed on transactions aimed at directly or indirectly reducing the assets of the debtor, its estate, and also providing them as security to others.

The financial recovery is completed either by deciding whether to discontinue the proceedings, or by introducing external management procedures, or declaring the debtor insolvent.

The implications of introducing a financial recovery procedure for the debtor are similar to those associated with introducing a monitoring procedure for the debtor.

2.1. Implications of financial recovery:

- 1) In respect of the requirements for mandatory payments, instead of accruing interest, interest is calculated based on the basic interest rate set by the Russian Central Bank on the day the procedure is introduced;
- 2) on obligations arising prior to the day of the introduction of the procedure of financial recovery, the accrual of financial sanctions (such as fines and penalties) are paused - they are not charged for the entire period during which the financial recovery procedure is in effect;
- 3) previously adopted measures to secure the claims of creditors are cancelled; arrests on the property of the debtor and other restrictions of the debtor regarding the transfer of the property may be imposed only during insolvency proceedings.

From the date of the introduction of the financial recovery procedure, the previously adopted measures to secure the claims of creditors are cancelled. When lifting an arrest on assets, the bailiff takes the necessary actions in the same manner that would have been used if the court had granted the claim for release of the property from the arrest.



In the financial recovery procedure, arrests on the debtor's property, including those provided for by the Law on Enforcement Proceedings, and other restrictions of the debtor regarding the transfer of property, can be imposed only by the decision of the court considering the insolvency case.

3. External management

This procedure is introduced in order to restore the debtor's solvency with the transfer of authority to manage the debtor to an administrator. External management is also a measure of rehabilitation.

External management is introduced for a period not exceeding 18 months and can be extended, but not more than 6 months.

The management of the debtor passes to the administrator, who has the right to transfer of the debtor's property in accordance with an external management plan, enter into a settlement agreement with creditors on behalf of the debtor, to refuse performance of contracts, to file with the commercial court on behalf of the debtor applications to invalidate transaction, and claims for recovery of damages.

With the introduction of external management, the consequences of the Insolvency Law in monitoring and financial recovery continue to operate.

In the procedure of external management, a moratorium is introduced on settling of creditors' claims. The moratorium extends to monetary obligations and obligatory payments, the deadlines for which were due before the introduction of external management.

With the introduction of the moratorium, the following occur:

1) certain powers are suspended.

In contrast to similar provisions provided for in monitoring and financial recovery, in this case only executive documents on decisions that entered into force before the introduction of external management and only for a number of reasons are subject to performance: on collecting payment arrears for intellectual property, the recovery of property from another's illegal possession, the reparation of harm caused to life or health and collecting debts on current payments.

2) penalties and other financial sanctions for non-performance or improper fulfilment of monetary obligations and obligatory payments, with the exception of current payments, are not charged.

By agreement of the creditors and the external manager, the interest on the debtor's monetary obligations may be reduced. This rule contributes to the restoration of the debtor's solvency.

4. Declaring a debtor insolvent

The sale of assets occurs when the debtor is ruled to be insolvent. In order to satisfy creditors' claims the debtor's assets can be sold.

The sale of a debtor's property is carried out at auction.

Debtor property that is subject to a charge and property held in escrow is separately considered and subject to mandatory valuation.

The sale of assets is introduced for a period of up to 6 months and may, in exceptional cases, be repeatedly extended.

Following a decision on declaring a debtor insolvency, the powers of the head of the debtor and other governing bodies are terminated, with all documents and necessary information passed to the administrator.



The administrator has the right to challenge the debtor's transactions, declare a waiver of contracts, file claims on behalf of the debtor, and dismiss employees in the manner prescribed by legislation.

4.1 Consequences of declaring a debtor insolvent

1) All claims of creditors, with limited exceptions, can be made only during insolvency proceedings.

In insolvency proceedings, claims of creditors may be filed before the closure of the register of creditors' claims. The register is closed two months after the date a debtor is ruled insolvent.

2) The deadline for the performance of obligations arising before the commencement of insolvency proceedings and the payment of obligatory payments to the debtor is considered to have passed.

3) Charter documents cease to apply.

4) The accrual of interest, penalties and other sanctions for non-fulfillment or improper fulfillment of obligations, except in cases specified in the Insolvency Law (referred to above), ceases.

5) The imposition of new arrests on the debtor's property and other restrictions on the transfer of the property is not allowed.

All previously imposed arrests on the debtor's property are removed on the basis of a court decision declaring the debtor insolvent and the commencement of insolvency proceedings.

At the same time, it is possible to impose arrests and other restrictions in connection with claims for disputes relating to the protection of possession or ownership of property, as well as in connection with demands to cease actions that violate exclusive rights to intellectual property.

4.2. The order of creditors' claims

Requirements for current payments are generally satisfied first with the claims satisfied in the order of calendar priority.

The requirements of creditors included in the register are satisfied in the following order:

1) Payments due to those that the debtor is responsible for causing harm and compensation for moral harm;

2) Payments due to individuals working for the debtor or working under an employment contract, and for payments due to the owners of intellectual property;

3) Payments due to other creditors. The claims of lenders for damages in the form of lost profits, recovery of penalties and other financial sanctions, including for non-performance or improper performance of an obligation, are recorded separately on the register of creditors and are subject to settlement after the principal amount is repaid debt and any interest due. The chances of such creditors receiving payment in full tends to be zero.

The claims of each subsequent group are only satisfied after the full satisfaction of the claims of the preceding group; if the property of the debtor is not enough to meet the requirements of one group, then the obligations are satisfied in proportion to the amounts of their claims to the debtor.

The Insolvency Law provides for the specifics of recording and settling the claims of third-stage creditors for debts secured by a charge on the debtor's property, namely, from the proceeds of the sale of the assets - 70% is used to repay the creditor's secured claims but no more than the principal amount of the debt and the interest due. The cash remaining from the amount received from the sale of the asset(s) is credited



to a special bank account – these funds must be used as follows:

- 20% of the amount received from the sale assets is to be used to repay the claims of the first and second group of creditors in that there is insufficient property to satisfy their claims in full; and
- the remaining funds are to be used for repayment of court costs and the administrator's expenses.

After settlements with creditors and all of the debtor's property has been disposed of, the administrator prepares a report which is provided to the commercial court. Following which the court concludes the proceedings by recording the dissolution of the debtor. It is from the date of making an entry on the Unified State Register of Legal Entities that insolvency proceedings are considered completed.

It is worth noting that the average duration of insolvency proceedings in Russia is 681 days with only around 5.2% of registered creditors' claims being satisfied.