Is restructuring possible in Russia?

Sergey A. Treshchev looks at the Russian insolvency legislation and asks if it is possible for a Russian debtor to reorganise

SERGEY A. TRESHCHEV
Partner, International Dispute Resolution, Squire Patton Boggs Moscow, (Russian Federation)

The main insolvency law in Russia is the Federal Law No. 127-FZ of October 26, 2002 "On Insolvency" (the "Law") which for the last 14 years has suffered about 50 sets of amendments.

The Law deals with pre-insolvency re-organisation and formal insolvency procedures including re-organisation. Starting from the 1998 crisis, the commercial courts have developed a great expertise in dealing with insolvency.

Who decides whether and when to enter insolvency proceedings?

Under Article 7 of the Law the debtor, a creditor, and authorised bodies (for example, tax authorities) have the right to file an application for declaring a debtor insolvent, as well as the debtor's current or former employees having claims for paying severance benefits or wages.

A creditor, the debtor's current or former employees, and the authorised body may apply to court in respect of money liabilities from the date on which a court decision with respect to debt repayment or a court judgment for enforced execution of arbitral awards on collection of amounts of money from the debtor becomes final.

A bank creditor may apply to court from the date on which the debtor starts to show the signs of insolvency. In accordance with Article 3 of the Law, a debtor shall be deemed to show signs of insolvency when incapable of paying its debts, or paying severance benefits or wages of the employees and/or make mandatory payments if the person does not discharge the obligations and duties within three months after their due date.

At least 15 calendar days before the bank's application to court, it must publish a notice of intention to file an application for deeming a debtor insolvent by means of including the debtor in the Unified Federal Register of Information on the Activities of Legal Entities.

The debtor is entitled to file a debtor's application with a court if an insolvency is anticipated and when circumstances exist that provide clear evidence of the debtor's incapacity to pay debts, claims for paying severance benefits and/or to pay wages and/or making mandatory payments when due.

The senior manager of the debtor is obliged to file a petition with a court to start insolvency proceedings if, in particular:

1) satisfaction of claims of one or more creditors makes it impossible for the debtor to pay debts or make mandatory payments and/or other payments in full to other creditors;
2) a levy of execution against the debtor's property is going to significantly aggravate or make impossible the pursuit of the debtor's economic activity; or
3) the debtor shows the signs of inability to pay and/or signs of insufficiency of property.

The debtor's application shall be filed with the court within the shortest time period possible but at the latest within one month after the date of emergence of relevant circumstances.

If in the course of its voluntary out-of-court liquidation a debtor starts to show signs of insolvency, then the liquidation commission of such a debtor is obliged to file the application with a court within ten days from the time when any of the signs are detected.

THE PRINCIPLE OF "THE EARLY BIRD GETS THE WORM" STILL APPLIES

Who controls the process?

The insolvency process is controlled by a trustee appointed by the court by recommendation of the debtor or creditors. The principle of "the early bird gets the worm" still applies.

A couple of key issues warrant highlighting at this point:

1) among the elements of a debtor's insolvency petition is the identification of a candidate to serve as interim trustee in supervision, the initial stage of Russian insolvency procedure. In practice, the interim trustee appointed by the court is usually re-appointed for other stages of the proceedings (e.g. external trustee);
2) the interim trustee is the gatekeeper of the debtor's claims register;
3) only creditor claims that are evidenced by a court judgment (recognised as binding in the Russian Federation), or that have been approved by the court within the insolvency procedure, can be registered in the debtor's claims register;
4) the supervision stage of the case cannot under the Law exceed a period of six months;
5) at the creditors' meeting only

> CREDITORS CURRENTLY HAVE A STRONG INCENTIVE TO AGGRESSIVELY PURSUE LEGAL ACTION AGAINST DISTRESSED BUSINESSES

THE LAW DOES NOT ENCOURAGE VOLUNTARY RESTRUCTURING OF DEBT IN A WAY DESIGNED TO PRESERVE THE CONTINUED OPERATION OF BUSINESS AND JOBS

creditors whose claims are registered in the debtor's claims register have a right to vote; and

6) the perception, right or wrong, is that the party who appoints the interim trustee exercises *de facto* control over a debtor's insolvency proceedings, at least over the supervision stage, because of his or her influence upon which claims are 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, to secure their vote at creditors' meetings and the right to propose their own candidate to serve as an interim trustee.

Is the debtor able to reorganise?

Theoretically, the answer is yes, however considering the above, it is clear that the Law currently does not encourage voluntary restructuring of debt in a way designed to preserve the continued operation of business and jobs. The interests of debtors and creditors are not appropriately balanced at present to achieve the best results.

Out-of-court Reorganisation

Under the Law, if signs of insolvency appear, the senior manager shall send information on such signs to the owner/shareholders having the right to convene an extraordinary general meeting, within 10 days after the date when that manager learned about the occurrence thereof.

As a result the owners/shareholders shall take timely measures for preventing the debtor's insolvency and restoring its solvency. In particular, they may provide financial assistance to the debtor in an amount sufficient to repay debts, claims for paying severance benefits and/or wages to employees, and make mandatory payments.

Reorganisation as stage of insolvency

After the supervision stage is finished the creditors may opt for and the court may order to either (a) financial rehabilitation or (b) external administration.

Financial rehabilitation

The financial rehabilitation procedure was introduced in 2002 to encourage restructuring but this has never occurred. The financial rehabilitation may last up to 24 months which does not seem sufficient term for a proper financial recovery of a debtor. Although the financial rehabilitation 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.

RICHARD TURTON AWARD

Sponsored by:

Richard Turton had a unique role in the formation and management of INSOL Europe, INSOL International, the English Insolvency Practitioners Association and R3, the Association of Business Recovery Professionals in the UK. In recognition of his achievements these four organisations jointly created an award in memory of Richard. The Richard Turton Award provides an educational opportunity for a qualifying participant to attend the annual INSOL Europe Conference.

In recognition of those aspects in which Richard had a special interest, the award is open to applicants who fulfil all of the following:

- Work in and are a national of a developing or emerging nation;
- Work in or be actively studying insolvency law & practice;
- Be under 35 years of age at the date of the application;
- Have sufficient command of spoken English to benefit from the conference technical programme;
- Agree to the conditions below.

Applicants for the award are invited to write to the address below enclosing their C.V. and stating why they should be chosen in less than 200 words by the 1st July 2016. In addition the panel requests that the applicants include the title of their suggested paper as specified below. The applications will be adjudicated by a panel representing the four associations. The decision will be made by the 1st August 2016 to allow the successful applicant to co-ordinate their attendance with INSOL Europe.

The successful applicant will

- Be invited to attend the INSOL Europe Conference, which is being held in Lisbon, Portugal from 22-25 September 2016, all expenses paid.
- Write a paper of 3,000 words on a subject of insolvency and turnaround to be agreed with the panel. This paper will be published in summary in one or more of the Member Associations' journals and in full on their websites.
- Be recognised at the conference and receive a framed certificate of the Richard Turton Award.

Interested? Let us know why you should be given the opportunity to attend the IE Conference as the recipient of the Richard Turton Award plus an overview of your paper in no more than 200 words by the 1st July 2016 to:

Richard Turton Award
c/o INSOL International
6-7 Queen Street
London
EC4N 1SP
E-mail: claireb@insol.ision.co.uk

Too old? Do a young colleague a favour and pass details of this opportunity on.

Applicants will receive notice by the 1st August 2016 of the panel's decision.

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 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 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 perform material transactions, to borrow or lend money, etc.

Secured lenders

The Law is more favourable to the secured lenders than unsecured creditors in Russia. Secured creditors' 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:

1) 70 percent (80 percent if obligation arises under a bank loan) is applied to satisfy 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);
2) 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
3) the balance is applied towards 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 claims; otherwise it is made available to all other third priority claims. The secured lenders may commence insolvency proceedings and are entitled to vote at creditors' meetings conducted during supervision without limitation and during financial rehabilitation and external administration provided such creditors forego the right to foreclose on its collateral during such proceedings.

If the secured creditor stands on its rights to realise 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 court to permit it to foreclose on its collateral during financial rehabilitation and external administration procedures. The 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.

Priority claims

Wage claims are paid in the second order of priority in Russia. First priority claims are claims for damages for personal injury and moral harm. Second priority claims are claims for wages, salary, other employee benefits and royalties payable to authors of copy written materials. To make such payments the trustees use proceeds from the sale of secured creditors' collaterals and other assets of the debtors.

Also, payments of wages and salaries to the debtor's employees are made in the form of "current payments" which are monetary or obligatory payment obligations that arise after the acceptance of the debtor's insolvency petition.

Conclusion

So theoretically, a Russian debtor is able to reorganise. However considering the above, it is clear that the Law currently does not encourage voluntary restructuring of debt in a way designed to preserve the continued operation of business and jobs. The interests of debtors and creditors are not appropriately balanced at present to achieve the best results. Creditors currently have a strong incentive to aggressively pursue legal action against distressed businesses, to secure their vote at creditors' meetings and the right to propose their own candidate to serve as an interim trustee. ■

THE INTERESTS OF DEBTORS AND CREDITORS ARE NOT APPROPRIATELY BALANCED AT PRESENT TO ACHIEVE THE BEST RESULTS