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Global Restructuring & Insolvency Guide

Russia

Overview

Russia has had a series of bankruptcy regulations and laws in place since 1992, which have been subject to regular changes and amendments. Notably, in recent years, a number of important amendments were made to Russia's bankruptcy laws that altered the circumstances in which a company is obliged to make a bankruptcy filing and introduced two types of insolvency proceedings for natural persons. Some of these amendments are yet to be tested in the courts to ascertain their exact scope.

Bankruptcy law provides for several options including reorganisation and rehabilitation of an insolvent company and debt rescheduling for natural persons as an alternative to liquidation and seizure of property.

Legislation

The insolvency regime for corporations and individuals in Russia consists primarily of the Civil Code and the Federal Law "On Insolvency (Bankruptcy)" N 127-FZ (the "**Bankruptcy Law**"). In addition, there are extensive rules and regulations adopted by the government, the Ministry of Economic Development and various state bodies, as well as decisions of the Supreme Court, designed to standardise insolvency in practice.

Russia's insolvency regime generally encourages debtor-friendly reorganisations, although, according to practitioners, the majority of insolvencies in Russia result in liquidations. The 2002 reforms enhanced financial rehabilitation, a type of bankruptcy proceeding akin to a US-like Chapter 11 debtor-in-possession reorganisation proceeding. In addition, corporations can reorganise through either court-approved amicable settlements or external management, where a third-party manager takes control of reorganisation proceedings and the debtor's operations. Bankruptcy proceedings are subject to the jurisdiction of state commercial courts in case of company and individual entrepreneur insolvencies and courts of general jurisdiction for natural persons not engaged in business. Out-of-court restructurings in Russia are relatively uncommon.

On 28 April 2009 Federal Law No. 73-FZ "On Amendment of Certain Legislative Acts of the Russian Federation" was adopted, which introduces amendments into the Russian bankruptcy legislation. In response to the growing number of bankruptcy cases and suspected instances of asset-stripping prior to and during the bankruptcy process, the legislators broadened the circumstances under which creditors in a bankruptcy can challenge transactions by the debtor or with respect to the debtor's assets. Those amendments were further refined by Federal Law No. 8-FZ "On Amendment of Certain Legislative Acts of the Russian Federation due to the adoption of the Federal Law "On clearing and clearing activities", dated 7 February 2011; Federal Law No. 144-FZ "On Amendment of Certain Legislative Acts of the Russian Federation", dated 28 July 2012; and Federal Law No. 134-FZ "On Amending Certain Legislative Acts of the Russian Federation regarding the Countering of Illegal Financial Transactions", dated 28 June 2013. The amendments to the Bankruptcy Law introduced a concept of "suspicious transactions", which include sales or transfers by a bankrupt entity of assets for a below-market value which have taken place within one year prior to bankruptcy having been initiated, and also transfers where the parties are assumed to have known that the intent of the transaction was to prejudice the debtor's creditors. The amendments also expanded the previous definition of "preferential transactions" relating to the debtor's existing creditors, which in the first instance will have to be considered by creditors seeking additional security from debtors with respect to a pre-existing debt. The amendments aim to protect creditors' rights by increasing the liability of the management and other controlling persons of debtors (including credit organisations) in bankruptcy proceedings and imposing new liability and penalties for credit organisation executives and members of management boards who fail to take action in the event of the insolvency of the credit organisation.

Finally, Federal Law No. 432-FZ, dated 22 December 2014, and Federal Law No. 476-FZ, dated 29 December 2014, have merged the Bankruptcy Law with the Federal Law No. 40-FZ "On the Insolvency (Bankruptcy) of Credit Institutions", dated 25 February 1999, and provide for two insolvency procedures for natural persons, namely, debt rescheduling and seizure of property, that came into force in July 2015.

In accordance with the latest practice of the Russian Constitutional Court, it is no longer permissible for tax authorities to strike off from EGRUL (Russia's Unified State Register of Legal Entities) those non-operating (inactive) entities which are going through bankruptcy proceedings. This decision is perceived as being aimed at protecting creditors' interests and ensuring their right to receive satisfaction.

Who May Initiate Bankruptcy Proceedings?

A Russian bankruptcy procedure can be initiated by both creditors and debtors. Creditors and employees (both current and former) can file a bankruptcy petition in relation to a debtor after obtaining a court judgment that establishes its claims against such debtor in excess of RUB 300,000 and provided that the debt has been unpaid for more than three months. In relation to debtors that are individuals, the bar is set at RUB 500,000. Bankruptcy proceedings for strategic enterprises and natural monopoly entities can be initiated only if the amount of indebtedness exceeds RUB 1,000,000.

Hence, before bankruptcy proceedings may be initiated, the creditors are forced to make an additional effort of first having their claims established through formal court proceedings by a court judgment that has entered into force (i.e. a statutory period for disputing this judgment at a court of a higher jurisdiction (e.g. court of appeal) has expired). In addition to state courts, claims may be established by arbitration proceedings provided the relevant agreement refers dispute resolution to arbitration.

From 29 January 2015, the tax and customs authorities, as well as credit institutions, are entitled to initiate bankruptcy proceedings against debtors if their debts are at least three months overdue. In relation to these, no court decision acknowledging the debt is required in order to initiate the bankruptcy proceedings. Under current court practice, the term "credit institution" covers not only banks with a Russian licence, but banks with licences under their law of incorporation as well.

The debtor has the right to file a bankruptcy petition if it reasonably believes, based on clear evidence, that it is not capable of performing monetary obligations and/or executing its duty to make mandatory payments when due. The Bankruptcy Law also prescribes the cases in which the debtor is obliged to file a bankruptcy petition. These include:

- Satisfaction of claims of one creditor or several creditors makes it impossible for the debtor to discharge monetary obligations in full to other creditors;
- The debtor's governing bodies have adopted a decision to file a bankruptcy petition with a court;
- A levy of execution against the debtor's property will significantly aggravate or discontinue the pursuit of the debtor's economic activity; and
- The debtor has signs of insolvency and/or signs of insufficiency of property.

For example, if a company is balance-sheet insolvent because its liabilities are more than its assets then there is an obligation to file. Similarly, if the company is cash flow insolvent it must file. In theory even one payment default may trigger the obligation to make a filing and put management at risk if there is a failure to file. However, it does not seem that the relevant obligations are put into practice by the courts. The persons that are obliged to file a bankruptcy petition if they fail to file a petition on time bear subsidiary liability for the losses incurred by the bankrupt entity and creditors.

Bankruptcy Procedures

The Bankruptcy Law envisages four bankruptcy procedures for legal persons:

- Supervision (*nabludenie*);

- Financial rehabilitation (*finansovoe ozdorovlenie*);
- External management (*vneshnee upravlenie*); and
- Liquidation (*konkursnoe proizvodstvo*).

As for natural persons, the Bankruptcy Law provides for two types of procedures:

- Debt rescheduling (*restrukturizaciya dolgov*); and
- Seizure of property (*realizaciya imushestva*).

The law also stipulates that in any procedure the debtor and bankruptcy creditors can conclude an amicable settlement (*mirovoe soglashenie*).

Arbitrage Administrator

Each stage of the bankruptcy procedure involves an arbitration insolvency specialist ("**arbitrage administrator**") approved by the court to carry out the relevant bankruptcy procedure and exercise authorities established by the Bankruptcy Law. Depending on the particular bankruptcy procedure the Bankruptcy Law refers to the arbitrage administrator as: "temporary receiver" during the supervision stage; "administrative receiver" during the financial rehabilitation stage; "external manager" during the external management stage; "liquidator" during the liquidation stage; and "financial manager" in case of insolvency of natural persons. At each stage of bankruptcy the arbitrage administrator has a different scope of authorities. Bankruptcy of banks has only one stage – liquidation; thus the arbitrage administrator is called liquidator and has the relevant scope of authorities.

According to recent amendments, a debtor may no longer propose a nominee for the arbitrage administrator position, even if the debtor initiates bankruptcy proceedings. Instead, the creditors' committee is to appoint an arbitrage administrator or self-regulating organisation established in accordance with the guidelines which are to be adopted by the Ministry of Economic Development for the competent court to appoint one if its members. 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.

Supervision

Supervision (*nabludenie*) is the initial and *sine qua non* phase of bankruptcy proceedings for legal persons. The idea behind this stage is to identify all of the debtor's creditors, analyse its financial standing, and make arrangements for a first meeting of creditors to decide on the subsequent course of action. Although the debtor's management retains all of its powers, the temporary receiver (as appointed by the court upon a motion from the person having requested the debtor's bankruptcy) exercises control over their actions. The statutory period prescribed for supervision is seven months, but it often drags out for more than one year under all manner of procedural excuses.

After the commencement of supervision the creditors of the debtor whose monetary claims are due have the right within 30 days to raise their claims against the debtor. These claims, if accompanied with pertinent documents, are accepted and included in the register of creditors' claims (*reestr trebovaniy creditorov*) ("**the register**") by a decision of a competent court. The creditors that failed to file their claims within the specified term are entitled to file them during other bankruptcy stages.

The consequences of the introduction of supervision are as follows:

- The levy of execution on property is suspended (save for claims of the first and second order of priority (this is described below) on the basis of court enforcement orders dated before the supervision);
- Withdrawal from the debtor's capital is prohibited;
- Set-off is prohibited if it changes the order of bankruptcy creditors' priority;

- The allocation of profit is prohibited;
- The power of the management to conclude certain transactions is limited and such transactions must be approved by the temporary receiver;
- The reorganisation of the debtor or the establishment of a new entity, branch or representative office is prohibited;
- All obligations incurred prior to acceptance of the bankruptcy petition by the court are deemed mature but only for the purposes of bankruptcy procedure;
- Enforcement of all writs of execution is suspended; and
- All the proceedings related to collection of debts from a debtor are suspended upon the petition of a creditor.

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 ("**CBR")**.

The management of the debtor must prepare a report on the debtor's property and provide it to the temporary receiver. At the end of supervision the court may render the following decisions:

- Approval of amicable settlement and termination of the bankruptcy proceedings;
- Introduction of financial rehabilitation;
- Introduction of external management; or
- Introduction of liquidation.

Financial Rehabilitation

What is frequently referred to as a "reorganisation" bankruptcy proceeding in line with Chapter 11 of the US Bankruptcy Code is known in Russian as financial rehabilitation (*finansovoe ozdorovlenie*) and external management.

During supervision, the debtor company (based on a decision of its shareholders), or third persons in agreement with the debtor, may request the creditors present at the first creditors' meeting to sanction the introduction of financial rehabilitation. If the creditors vote in favour, the court will resolve to commence the financial rehabilitation. However, the creditors may vote against the introduction of financial rehabilitation and instead opt to proceed to external management or liquidation.

If the first creditors' meeting votes against financial rehabilitation, the court may still decide to introduce financial rehabilitation if the debtor (or a third party) provides a security for all of the registered claims in the form of a bank guarantee for the claims in the debt repayment schedule. If the first creditors' meeting fails to make a decision on how the bankruptcy process should proceed within the period of time prescribed by law, the debtor may directly petition the court for the introduction of financial rehabilitation if it (or a third party) provides security (in any form) for all of the registered claims.

Apart from the debtor, a request to introduce financial rehabilitation may be lodged by a third party providing the security discussed above.

The court introduces financial rehabilitation for the period (not exceeding two years) stated in the petition upon introduction of financial rehabilitation. If the claims of all creditors are discharged in full prior to the end of the period established by court, the debtor may petition the court for an early termination of financial rehabilitation and the bankruptcy proceedings in connection with the reinstatement of the debtor's solvency.

Under article 77 of the Bankruptcy Law, together with filing a petition to initiate financial rehabilitation, the person filing the petition must present:

- A financial rehabilitation plan;
- A debt repayment schedule;
- A list of the debtor's shareholders which have voted for presenting a petition for the initiation of financial rehabilitation to the creditors' meeting;
- Information on the security offered by the debtor's shareholders or a third party for the discharge of all registered claims in accordance with the debt repayment schedule.

The provision of security mentioned above is generally optional, except in the circumstances described in the preceding paragraphs.

After commencement of the financial rehabilitation the court appoints the arbitrage administrator from the candidates proposed by the creditors' meeting.

The consequences of introduction of financial rehabilitation (article 81 of the Bankruptcy Law) are as follows:

- Injunction measures are terminated;
- In addition to set-off, other forms of the termination of obligations of the debtor are prohibited if this results in a change of priority;
- Contractual penalties stop accruing (save for current payments); only the CBR refinancing rate is applied on creditors' claims unless a lower amount has been agreed with the bankruptcy creditor;
- Conclusion of certain transactions requires the prior approval of the creditors' meeting or arbitrage administrator;
- The collection of property under writs of execution is suspended;
- The withdrawal from the debtor's capital is prohibited;
- Distribution of dividends is banned; and
- Settlements with creditors are made through the debt repayment plan.

The debtor's activities are subject to certain limitations and some of its powers are transferred to the administrative receiver. Prior approval is required from the receiver for transactions which result in:

- An increase in accounts payable of more than 5% of the total amount of creditors' claims;
- Sale of the debtor's assets, except for sale of goods or services in the ordinary course of business;
- A claim or debt assignment; or
- Taking of loans.

The creditors' meeting exercises a certain level of control over the debtor's actions. The following transactions must be approved by the creditors' meeting:

- Sale or purchase of assets with a value exceeding 5% of the value of all assets as per the last balance sheet;

- Receipt and granting of loans (credits), suretyship and guarantees, trust management of debtor's assets;

- Interested-party transactions; and

- Any transactions, if the total value of monetary claims which arose at the financial rehabilitation stage exceeds 20% of the total value of all claims included in the register.

Financial Rehabilitation Plan

As discussed above, the aim of financial rehabilitation is to restore the debtor company's solvency and repay its indebtedness in accordance with a debt repayment schedule. In order to achieve this, the debtor (or any other person petitioning for financial rehabilitation) must develop a rehabilitation plan which needs to be consistent with the debt repayment schedule. The financial rehabilitation plan is approved by the majority of the creditors present at the creditors' meeting. At the creditors' meeting, the bankruptcy creditor has a number of votes according to the share of the amount of its claim in the total amount of claims included in the register as of the date of creditors' meeting. Secured creditors are not entitled to vote during financial rehabilitation and external management unless they waive their right to levy execution on secured property during these stages of the process.

The Bankruptcy Law requires that the financial rehabilitation plan and the debt repayment schedule provide for a complete discharge of all of the creditors' claims included in the register. Under the financial rehabilitation plan the debtor starts to discharge the claims of the bankruptcy creditors within one month from the commencement of the financial rehabilitation and fully discharges the claims of the first and second priority creditors within six months after commencement of financial rehabilitation. The debt repayment schedule needs to provide for a *pro rata* repayment of creditors' claims according to the priority of creditors.

A financial rehabilitation plan may be amended if:

- The debtor fails to satisfy the bankruptcy creditors according to the debt repayment schedule; or

- The amount of claims presented by the creditors during financial rehabilitation and included in the register exceeds by more than 20% the total amount of the creditors' claims subject to repayment under the debt repayment schedule.

If either of the above occurs, the administrative receiver, debtor's shareholders or a third party that provided security is entitled (in the second instance, the receiver is obliged) to petition for the amendment of the financial rehabilitation plan with the creditors' meeting. The creditors' meeting may accept or reject amendments and also require security, if there are reasonable grounds for considering that further satisfaction of the creditors' claims will be problematic. If the creditors' meeting rejects amendments to the financial rehabilitation plan the creditors' meeting may file a petition with the court for the cancellation of financial rehabilitation and introduction of external management or liquidation.

Under article 83 of the Bankruptcy Law the administrative receiver, among other duties, is obliged to:

- Monitor the implementation of the financial rehabilitation plan and debt repayment schedule;

- Consider reports on the implementation of the debt repayment schedule and the financial rehabilitation plan presented by the debtor and to report to the creditors' meeting on the progress made;

- Monitor the debtor's timely performance of the creditors' claims under current payments;

- Supervise the timely discharge of bankruptcy creditors' claims; and

- Where the debtor fails to meet its obligations under the debt repayment schedule, levy execution on the security provided under the terms of the financial rehabilitation plan.

Prior to the expiry of financial rehabilitation, the debtor is required to provide a report (and its financials) to the administrative receiver, based on which the receiver prepares its own report on the results of the financial rehabilitation. Based on the results of the financial rehabilitation (first and foremost depending on whether the debtor managed to successfully discharge all registered claims) the court may resolve to either terminate the bankruptcy proceedings, or proceed with external management, or declare the debtor bankrupt and commence liquidation.

External Management

The objective of external management (*vneshnee upravlenie*) is similar to that of financial rehabilitation, since it is aimed at the restoration of the debtor's solvency. The main differences in the two procedures are in the much greater involvement of the external manager in the management of the debtor, the availability of extensive reorganisational measures and the preparation of the external management plan solely by the external manager.

This procedure is commenced by the creditors' meeting and approved by the court. Similar to financial rehabilitation, external management is an optional procedure. The duration of external management may not exceed 18 months and may be extended for an additional six-month period. The court appoints an external manager. Under article 94 of the Bankruptcy Law, the consequences faced by the debtor from the introduction of external management are:

- The debtor's management loses all authority and all decisions are made by the external manager (save for decisions that require creditors' meeting approval);
- A moratorium on the satisfaction of bankruptcy creditors' claims is imposed, save for current claims and claims of first and second priority;
- The external manager is entitled to refuse to fulfil executory contracts in cases where the fulfilment of such contracts prevents the restoration of the debtor's solvency and/or causes the debtor to incur losses;
- Default interest accrues at the refinancing rate of the CBR (and the contractual rate is ignored); and
- Part of the debtor's assets are sold pursuant to the external management plan.

The external manager is entitled to manage the debtor's business. The external manager is accountable to the creditors' meeting and the court.

The following transactions require approval by the creditors' meeting:

- Major and interested-party transactions;
- Loans, suretyships or guarantees, claim and debt assignments, sale or purchase of shares of other entities, establishment of trusts; and
- Any transactions if the total value of claims which arose during external management exceeds by 20% the total value of all claims included in the register.

External Management Plan

The external management plan is prepared by the external manager and needs to be presented to the creditors' meeting no later than one month after the external manager is appointed. The external management plan is adopted in the same way as the financial rehabilitation plan. The creditors and other persons whose interests are adversely affected as a result of the plan may challenge it in the court. The plan can be amended.

The external management plan envisages measures for the restoration of the debtor's solvency, the terms and procedure for implementing such measures, and expenses towards the implementation thereof. It also envisages a term for the restoration of the debtor's solvency. If a creditors' committee

was formed, the external management plan may also establish what powers have been delegated to the committee by the creditors' meeting.

Article 109 of the Bankruptcy Law enumerates possible actions that may be undertaken to restore the debtor's solvency and which can be included by the external manager in the external management plan, including:

- Establishing strategic objectives of the debtor;
- Closing down unprofitable production facilities;
- Collecting accounts receivable;
- Selling part of the debtor's property;
- Assigning of claims;
- The debtor's obligations being discharged by the debtor's shareholders or a third person(s);
- The charter capital of the debtor being increased through contributions of shareholders and third persons;
- Selling an enterprise of the debtor; and
- Replacing the debtor's assets, etc.

The main difference between an external management plan and a financial rehabilitation plan is that the latter requires that all of the bankruptcy creditors' claims are discharged during financial rehabilitation, whilst in external management the first priority is the restoration of the debtors' solvency and only then discharge of claims of the bankruptcy creditors. Using the external management results, the external manager prepares and submits a report to the court which establishes whether the debtor's solvency was restored or not. After consideration, the court may resolve to proceed with the satisfaction of creditors' claims or declare the debtor bankrupt and commence liquidation.

Liquidation

Liquidation (*konkursnoe proizvodstvo*) is initiated after the debtor is declared bankrupt by the court. The objective of liquidation is the satisfaction of the creditors' claims to the fullest extent possible, through sale of the debtor's assets or otherwise. The procedure may be initiated by the creditors' meeting with court approval or by the court itself. The maximum term for liquidation is six months, with the possibility of extension for an additional six-month period. The procedure is conducted by the liquidator appointed by the court. The consequences of the introduction of liquidation are:

- All creditors' claims are considered to be due and payable;
- Settlement of claims is performed in accordance with the priority of creditors;
- Contractual default interest stops accruing (save for current payments) and instead the CBR's refinancing rate is applied;
- The confidentiality and commercial secrecy regime in respect of the debtor's financial state is terminated;
- Termination of powers of governing bodies and the debtor's shareholders (save for general meeting and decisions on performance by a third party of the debtor's obligations);
- Transactions entered into in the six-month period before the filing for bankruptcy and/or upon such filing may be invalidated by the court at the suit of the liquidator or a creditor if such transactions give preference to some of the existing creditors of a debtor in insolvency;

- The liquidator must notify of forthcoming lay-offs within one month of the court decision on liquidation;
- All bank accounts of the debtor, save for one to be used for settlement, are to be closed by the liquidator;
- Performance of the debtor's obligations upon court writs is suspended;
- All the garnishments laid on the debtor's property are cancelled; and
- Sale of the assets and assignment of receivables are conducted for the purposes of settlement.

Liquidation ends with the court passing one of the following resolutions:

- Termination of liquidation procedures followed by official liquidation of the debtor;
- Termination of the bankruptcy case due to full satisfaction of all creditors' claims (no liquidation);
- Approval of an amicable settlement and closing the bankruptcy case; or
- Reverting to external management (provided financial rehabilitation and/or external management have not been introduced previously).

Debt Rescheduling

Debt rescheduling (*restrukturizaciya dolgov*) can be applied to natural persons to repay their debts over a period of up to three years. The procedure may be initiated by a debtor who contemplates insolvency and is unable to pay 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 monetary obligations in full, 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 his or her 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 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 two months after the court's decision on initiation of bankruptcy, the financial manager is to propose seizure of property.

The plan is subject to approval by the first creditors' meeting by a simple majority. If the meeting votes in favour, the plan is to be approved by the court. The court can enforce the rescheduling plan even if it is not approved by the creditors' 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.

Seizure of Property

A competent court is to initiate seizure of property (*realizaciya imushestva*) 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 the plan has not been given effect by the court; and

- the debt rescheduling plan has been cancelled.

The seizure of property procedure is to be conducted within six months, but the term may be extended by the court. Only the financial manager is entitled to exercise any rights over the debtor's property, and his mission is to appraise the property in the bankruptcy estate and sell it.

A debtor is discharged from his obligations after the seizure has been completed, unless one of the following conditions has been satisfied:

- the debtor has been found criminally or administratively liable for illegal actions in the course of the 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; or
- the debtor has been declared bankrupt within five years after the previous bankruptcy.

A natural person may not file for voluntary insolvency within five years after bankruptcy. He is also barred from managing legal persons within three years after bankruptcy and is obliged, during the five years after bankruptcy, to notify a creditor under a credit or loan agreement of the fact that he has been declared bankrupt.

Amicable Settlement

An amicable settlement (*mirovoe soglashenie*) may be concluded at any stage of the bankruptcy of a legal or natural person. The creditors' meeting is entitled to conclude the settlement agreement, approving it by a majority of votes of the bankruptcy creditors present at the meeting. The settlement agreement comes into force immediately upon its approval by the court. An amicable settlement agreement is binding for the debtor, bankruptcy creditors and authorised state bodies, as well as for third parties participating in the settlement agreement, i.e. parties not involved in the bankruptcy procedure itself (for example, these can be the debtor's investors discharging the debtor's obligations to creditors or persons/legal entities providing security).

In case of a breach of the settlement agreement, the size of creditors' claims is determined on the basis of the settlement agreement, even if the debtor's breach of the settlement agreement leads to commencement of the bankruptcy case anew (resumption of a bankruptcy case terminated as a result of settlement is not allowed).

According to the statistics published by the Supreme Arbitrazh Court of the Russian Federation, the courts tried 108,451 bankruptcy cases in the period from 2010 through the first half of 2013. Only in 332 cases was financial rehabilitation introduced and of those only 17 were terminated due to full satisfaction of the creditors' claims. The absolute majority of cases were resolved through liquidation, and 1,465 cases were terminated through amicable settlements.

Priority of Claims

Satisfaction of the creditors' claims according to priority is possible only during the liquidation or seizure of property stages of bankruptcy and in some cases during external management. In order to participate in allocation of debtor's property the claims of the bankruptcy creditors shall be included in the register indicating the amount of the claim, type of creditor (secured or unsecured) and grounds of the claim. Qualifying claims are included in the register by the arbitrage administrator. After commencement of the liquidation the bankruptcy creditors are eligible to receive satisfaction of their claims according to the priority set out in the Bankruptcy Law. The Bankruptcy Law provides for the following order of priorities for satisfaction of creditors' claims:

Payments Outside the Ranking List

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. As such, current payments are to be satisfied before all others.

In the event that the winding-up (cessation) of the activities of a debtor causes or may cause an industrial or ecological disaster, or human casualties, expenses for avoiding such consequences are settled at the same level of priority as the current payments, that is when these expenses become due and prior to any other payments.

Article 134 of the Bankruptcy Law ranks current payments in the following order:

- Court expenses, bankruptcy-manager remuneration and expenses associated with engaging other persons whose participation is mandatory under the Bankruptcy Law;
- Claims regarding salaries and severance pay;
- Expenses associated with the engagement of persons whose participation in the bankruptcy proceedings is not mandatory;
- Utility and maintenance charges; and
- Other current payments.

Payments within the Ranking List

In respect of claims of the bankruptcy creditors, the Bankruptcy Law establishes the following order of priority:

- First priority (Article 135): personal tort claims, including compensation for pain and suffering;
- Second Priority (Article 136): claims for severance pay, outstanding wages and authors' royalties. 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 Priority (Article 137): claims of all other creditors, including, specifically:
    - Claims arising out of violation of environmental legislation;
    - Claims of mandatory payments;
    - Secured creditors' claims (i.e. to the extent the creditors were unable to receive a full satisfaction under any security arrangements established to secure their claims against the debtor);
    - Unsecured creditors; and
    - Creditors whose claims arose from challenged suspicious or preferential transactions.

The Bankruptcy Law does not prescribe ranking of claims within one priority. Claims from creditors in any category may only be met once those from creditors in the higher category have been fully granted. Should it be impossible to satisfy claims in full, the claims of the same priority are met on a *pro rata* basis.

Shareholders of the debtor are not considered creditors of the debtor. If all claims of the bankruptcy creditors are discharged, shareholders are entitled to share proportionally in the debtor's remaining property.

The claims of third-priority creditors for compensation of losses in the form of lost advantage, collection of fines and penalties and other financial sanctions – in particular, those imposed for a default on or improper performance of the duty to make mandatory payments – are recorded separately in the register and paid after the payment of principal debt and accrued interest.

Treatment of Secured Bankruptcy Creditors

During financial rehabilitation or external management of the debtor, foreclosure for pledge is possible on those goods that are not needed by the debtor for becoming solvent again.

In case execution has not taken place when the debtor has been declared bankrupt, such assets are 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 loan) is used to discharge the pledgor's respective secured obligations (regardless of any claims filed by creditors of other priority categories), 20% is directed towards satisfying the claims of creditors of first and second priority, while 10% is used to cover court and other costs (in the case of a loan, 15% and 5%, respectively).

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

Written consent of a secured creditor must be obtained if the pledged assets are on sale together with other assets.

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 management stage, provided that they 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.

Avoidable Transactions

The Bankruptcy Law also prescribes special regulation of the transactions entered into prior to the commencement of the bankruptcy case or during bankruptcy proceedings. Most of these rules were introduced on 28 April 2009 by Federal Law No. 73-FZ "On Amendment of Certain Legislative Acts of the Russian Federation". They have been further refined several times, most recently by Federal Law No. 476-FZ "On Amendment of Certain Legislative Acts of the Russian Federation", dated 29 December 2014. It should be noted that as these applications are relatively recent the court practice is still undeveloped and some of the provisions need to be clarified.

The amendments, which broaden the circumstances under which bankruptcy creditors can challenge transactions by the debtor or with respect to the debtor's assets, were adopted in response to the growing number of bankruptcy cases and suspected instances of asset stripping prior to and during the bankruptcy process. Previously under the Bankruptcy Law, transactions were generally reversible by the court in favour of creditors if they had occurred within six months prior to bankruptcy, in the case of the transactions providing preference to one creditor over other creditors, and within a one-year limitation period in case of transactions with an interested party.

Challenging Transactions during Bankruptcy

The 2009 amendments to the Bankruptcy Law introduced a new chapter which sets the rules for challenging transactions in bankruptcy procedures. Such transactions may be challenged as suspicious, deemed to infringe creditors' rights, or preferential.

The changes adopted in 2014 have extended the scope of persons entitled to challenge transactions beyond only arbitrage administrators. Now, a bankruptcy creditor with more than 10% of the total bankruptcy claims in the register of claims is also entitled to apply for avoidance of transactions.

Suspicious Transactions (Article 61.2 of the Bankruptcy Law)

The amendments to the Bankruptcy Law introduce a new concept of "suspicious transactions", which may be challenged during bankruptcy proceedings. Two types of transactions are defined as suspicious, namely undervalue transactions and transactions which are deemed to infringe the rights of the debtor's creditors.

An undervalue transaction can be overturned by the court in bankruptcy proceedings if it is proven that:

- The counterparty to such transaction provides incommensurate consideration to the debtor; and
- The transaction is concluded within one year prior to, or after the initiation of, bankruptcy proceedings against the debtor.

Consideration will be deemed incommensurate where a materially lower price is paid to the debtor or when other conditions of the transaction are materially worse for the debtor, when compared with analogous transactions concluded in similar circumstances. The Bankruptcy Law gives as an example the sale of property at a price substantially lower than the market price.

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; and
- The transaction was concluded within three years prior to, or after the initiation of, bankruptcy proceedings against the debtor.

The concept of the infringement of creditors' rights is defined by the Bankruptcy Law as any reduction in the debtor's assets or any increase in the value of the claims against the debtor or any other consequences of the debtor's transactions or actions which result in the inability by creditors to obtain satisfaction of their claims.

According to the Bankruptcy Law, it is assumed that a transaction was concluded with the purpose of infringing creditors' rights if at the time of its conclusion the debtor was insolvent and:

- The transaction was gratuitous;
- The transaction was entered into with an interested party;
- The transaction aimed at the repayment by the debtor of capital to a participant;
- The amount of the debtor's assets alienated under such transaction equals more than 20% of the balance sheet value of its assets (or more than 10% for banks);
- The debtor changed its address without notifying its creditors before or immediately after the conclusion of such transaction, or concealed its property or destroyed or falsified title documents or accounting statements of the debtor; or
- After the conclusion of such transaction, the debtor continued to own and use the property alienated under such transaction or to give orders to the owner regarding the disposal of such property.

Preferential Transactions (Article 61.3 of the Bankruptcy Law)

The Bankruptcy Law clarifies what particular transactions may give preference to one creditor over other creditors for the purpose of challenging them during bankruptcy proceedings. A transaction gives preference to an existing creditor if such transaction:

- Provides for security to an existing creditor;
- Entails any change of priorities in which the existing creditors' claims are satisfied;

- May entail satisfaction of claims that have not yet matured; or
- Results in preferential satisfaction of claims of one creditor over other creditors' claims.

The transaction can be invalidated if it was concluded after the court accepted the bankruptcy petition or within one month prior to acceptance of the bankruptcy petition by the court. The transaction can be also invalidated if it was concluded within six months prior to acceptance of the bankruptcy petition by the court, provided that it meets the criteria specified above and it is established that the counterparty was aware of the insolvency signs or insufficiency of property. For instance, currently there is a dispute in which an insolvency receiver is requesting the return of money that was transferred from the account of a bank which had been in a financial crisis, and courts have unanimously confirmed that the money in question needs to be returned.

Actions that may be Challenged

The rules on challenging transactions of the debtor apply not only to civil law transactions (e.g. contracts) concluded by the debtor, but also to any actions relating to obligations arising from civil, labour, family, tax, customs, or court procedural legislation. According to the Decree of the Plenum of the Supreme Arbitrazh Court of the Russian Federation No. 63 "On certain questions related to application of Chapter III.1 of Federal law 'On insolvency (bankruptcy)'", dated 23 December 2010, the actions that can be challenged in bankruptcy include specifically:

- Fulfilment of obligations under civil law contracts, including cash or non-cash payments and transfer of property;
- Bank transactions;
- Payment of wages;
- Marital agreements and agreements on the division of marital property;
- Tax payments;
- Execution of court decisions, including amicable settlements; and
- Transfer to the claimant in the final process of cash proceeds from the sale of property of the debtor.

Thus, the Bankruptcy Law permits almost any action of the debtor that meets the criteria of a suspicious or preferential transaction to be challenged.

The Bankruptcy Law sets specific rules for challenging certain transactions. Transactions concluded in the course of organised trade on the basis of at least one bid addressed to an indefinite circle of trading participants, as well as actions aimed at the fulfilment of the obligations and duties resulting from such transactions, may not be challenged as suspicious or preferential transactions. Transfers of property and assumptions of obligations which are made in the normal course of business may not be challenged as constituting an incommensurate consideration or preferential transaction, if the price of the property transferred under such a transaction (or several related transactions), or the amount of assumed obligations, does not exceed 1% of the value of the debtor's assets. The debtor's transactions aimed at fulfilling obligations in respect of which the debtor received immediate commensurate consideration may be challenged only on the basis of possible infringement of creditors' rights.

Consequences of Invalidation (Article 61.6 of the Bankruptcy Law)

Suspicious and preferential transactions may be challenged during external management or liquidation by the external manager or liquidator at their own initiative or at the request of the creditors' committee or the creditors' meeting. If a transaction is invalidated under these grounds, the court will apply reciprocal restitution and all assets transferred under such transaction will be returned to the debtor and form part of its bankruptcy estate. The claims of the counterparty under an invalidated transaction which is deemed to infringe the 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 of the creditors. Generally, suspicious and preferential transactions can be challenged within one year of the date on which the plaintiff learned or should have learned about the grounds for declaring the transaction invalid.

Liability of Controlling Persons

Article 10 of the Bankruptcy Law (as amended on 28 June 2013) covers the question of directors' liability, introducing a general rule that chief executive officers are personally liable to the debtor for any loss incurred as a result of violations of the Bankruptcy Law. Furthermore, the article specifies several obligations that give rise to liability if they are violated.

The Bankruptcy Law requires the chief executive officer of a non-bank debtor to petition the court to initiate bankruptcy proceedings if the amount of the debtor's debts exceeds the value of its assets or if the debtor fails to make payments because it has insufficient funds. The chief executive officer must file a bankruptcy petition within one month of the occurrence of either of these events. If the chief executive officer fails to do so, he bears secondary (subsidiary) liability for the debtor's debts which arise after the date on which the chief executive officer should have filed the petition. Conversely, if the chief executive officer files for insolvency while the debtor is capable of satisfying all creditors' claims in full, he becomes liable for any possible loss incurred by creditors as a result of such unnecessary filing.

In addition to this, the Bankruptcy Law establishes the liability of a controlling person. The concept of a controlling person is broadly defined as a person (an individual or legal entity) who can control the debtor's activity and give mandatory instructions to it or who could have done so within a period of two years prior to the initiation of bankruptcy proceedings in relation to the debtor. If a controlling person infringed the rights of the debtor's creditors by its actions or instructions to the debtor, such controlling person may bear subsidiary liability for monetary obligations of the debtor if the debtor's assets are insufficient to satisfy all the creditors' claims. Until proven otherwise, it is assumed that the debtor is bankrupt due to the actions and/or absence of action of the controlling person if one the following circumstances exists:

- The property rights of creditors have been violated as a result of the conclusion or approval of transaction(s) of the debtor by or for the benefit of the controlling person; or

- The debtor's accounting statements have been lost or falsified prior to the initiation of bankruptcy proceedings. This provision is applicable to the managers who have obligation to organise the bookkeeping and storage of accounting or other reporting documents of the debtor.

The amount of such liability may be reduced if the controlling person proves that the creditors' losses are significantly less than their claims against the debtor. Infringement of creditors' rights is considered to have occurred in circumstances where: the value of the debtor's assets has decreased; the claims against the debtor have increased; or the creditors have failed to receive full or partial satisfaction of their claims as a result of the debtor's actions.

Corresponding provisions can be also found in Federal Law No. 40-FZ "On the Insolvency (Bankruptcy) of Credit Institutions", dated 25 February 1999 (as amended). The law provides that, if in relation to a bank there is evidence of insolvency, the management and shareholders of the bank must act to liquidate it. The measures to restore a bank's solvency (bankruptcy prevention measures) are not available at this stage. Insolvency of a bank is evident if: (i) it is unable to satisfy the claims of its creditors within 14 days after their due date; (ii) the value of its assets is insufficient to perform its obligations to its creditors; or (iii) its capital adequacy ratio falls below 2% (usually 10% if the bank is solvent).

Within 10 days after the occurrence of any of the above events or circumstances, the chief executive officer and the management board of the bank must notify its board of directors and the CBR. The directors must convene a shareholders' meeting or apply to the CBR with a request to revoke the banking licence of the bank. If the shareholders fail to adopt the decision to liquidate the bank, the

directors of the bank are obliged, within three days of the shareholders' meeting, to apply to the CBR to revoke the bank's banking licence.

If the chief executive officer, members of the management board, directors or shareholders of a bank fail to liquidate the bank in the circumstances described above, Russian law imposes upon them joint and several secondary (subsidiary) liability for the debts of the bank that arise after the insolvency of the bank becomes evident.

If the shareholders' meeting that was convened to decide on the bank's liquidation does not approve the liquidation, an individual shareholder can be absolved from the liability if it: (i) owns (together with its affiliates) less than 10% of the voting shares of the bank; (ii) voted for the liquidation of the bank; or (iii) was not properly notified of the shareholders' meeting.

If the accounting or other reporting documents of a non-bank debtor are missing or fail to contain, or contain falsified, information on the debtor's assets and liabilities, the Bankruptcy Law imposes on the chief executive officer secondary (subsidiary) liability for the non-bank debtor's debts. In contrast, in relation to a bank debtor, the managers having the obligation to secure the safekeeping of the bank's documents bear secondary (subsidiary) liability for the bank's debts if the accounting and other reporting documents of that bank debtor are missing.

If the accounting or other reporting documents of a bank debtor are missing or fail to contain, or contain falsified, information on the bank debtor's assets and liabilities, the Law on Insolvency (Bankruptcy) of Credit Institutions imposes secondary (subsidiary) liability on the managers having the obligation to secure the safekeeping of the bank's documents. Chief executive officers can also bear criminal and administrative liability for fraudulent activities. Article 195 of the Russian Criminal Code stipulates that chief executive officers committing fraud during insolvency proceedings or during the period when insolvency was foreseen can be sentenced to up to three years in prison. Section 2 of the same article provides that preferential satisfaction of creditors' claims can be punished by imprisonment for up to one year. Section 2 can also be applied to a creditor who accepts such preferential satisfaction. Article 196 of the Criminal Code provides liability for premeditated insolvency. The objective aspect of this crime includes any actions of the chief executive officer or a shareholder of a legal entity that consciously led to the insolvency of such entity. Any such actions that result in major damage can be punished by imprisonment for up to six years, possibly with an additional penalty of up to RUB 200,000 or of the amount of the violator's salary or any other income for a period of 18 months. Finally, article 197 (fraudulent insolvency) of the Criminal Code states that a patently false statement of the chief executive officer or a shareholder that concerns the insolvency of a legal entity and causes major damage is punishable by imprisonment for up to six years, possibly with a fine of up to RUB 80,000 or of the amount of the violator's salary or any other income for a period of six months. Damage is considered to be "major" when its monetary value amounts to RUB 1,500,000 or more.

The Code of Administrative Offices of the Russian Federation also imposes fines and other penalties for the actions of chief executive officers and shareholder mentioned above (articles 14.12 and 14.13) in case such actions resulted in lesser damages.

In addition, debtors experiencing financial difficulties are restricted by rules applicable to the challenging of transactions concluded prior to bankruptcy during the relevant suspect periods.

Therefore, Russian legislation provides a stringent set of rules and restrictions which must be followed by chief executive officers and shareholders in case their companies are experiencing difficulties. However, not all of those measures are often applied in practice. There have been only a few cases in the courts' practice (most initiated in respect of banks' management) in which the management was found guilty for conducting the fraudulent actions mentioned above. This is due to several factors. Firstly, it is difficult for courts to establish the date when insolvency became foreseeable, and in order to hold a person liable it needs to be proven that such person was aware or should have been aware of such circumstances. Only in exceptional cases have Russian courts given out prison sentences for managers. At the same time, applying pecuniary penalties of the insignificant amounts mentioned above cannot serve as a real deterrent for the managers. Nonetheless, the new rules on subsidiary liability described above may act as a more effective deterrent.

Sections of the Bankruptcy Law providing that company executives can be obligated to compensate losses caused to creditors are also very rarely applied. Given the scale of the average debtor's monetary obligations, it is unrealistic to expect that a manager can repay them from his own pocket.

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

Cross-border Aspects

The Bankruptcy Law does not regulate cross-border bankruptcy in general. However, the Bankruptcy Law establishes rules on the recognition and enforcement of foreign court decisions on bankruptcy by Russian courts.

The Bankruptcy Law provides that foreign court decisions on matters of bankruptcy are recognised in the Russian Federation in accordance with the international treaties of the Russian Federation. In the absence of an international agreement, foreign court decisions on matters of bankruptcy are recognised on the basis of reciprocity if federal law does not provide otherwise.

International Treaties

Russian is a party to a number of international treaties on the recognition and enforcement of court judgments, although none of these directly deal with matters of bankruptcy. These include the CIS Convention "On Legal Aid in Civil and Family Law Disputes and Criminal Prosecution", adopted in Minsk on 22 January 1993 (the "**Minsk Treaty**"), and the CIS Agreement "On Order of Settlement of Disputes related to Economic Activity", adopted in Kiev on 20 March 1992 (the "**Kiev Agreement**").

Under the Minsk Treaty and the Kiev Agreement each signatory state undertook to recognise and enforce court judgments rendered in other signatory states. However, Russian courts tend to apply these treaties only to final decisions rendered by foreign courts. Rulings of foreign courts adopting an injunction are not recognised and enforced in the Russian Federation. A decision is considered final if the dispute has been adjudicated on the merits as a result of a court procedure. Therefore, it is unlikely that interim decisions introducing moratoria would be recognised in Russia. It is more likely that a final decision completing the bankruptcy process would be recognised in Russia.

While considering the case, the Russian court will also take into account the procedural rules of Russian domestic law. Russian law provides for criteria for recognition and enforcement in addition to those of the Minsk Treaty and the Kiev Agreement. For example, the treaties do not provide for the refusal of recognition and enforcement on the ground of incompatibility of the decision with Russian public policy. It is not entirely clear whether these additional rules apply. The practice of the Supreme Arbitrazh Court of the Russian Federation confirms that the public policy test applies whether or not the relevant treaties provide for it. However, there is some conflicting case law in the lower courts.

Reciprocity

Russian legislation on bankruptcy provides that foreign court judgments on bankruptcy may also be recognised and enforced based on reciprocity. However, it is quite uncommon for Russian courts to apply the concept of reciprocity.

Examples of recognition proceedings

Matters regarding recognition of foreign bankruptcy proceedings very rarely come before the Russian courts. Some cases are briefly described below.

Supreme Arbitrazh Court of the Russian Federation – Recognition of Ukrainian Bankruptcy

The courts considered an application to recognise in Russia a Ukrainian court ruling introducing a moratorium on the satisfaction of creditors' claims. The claimant relied on both the Kiev Agreement and the Minsk Treaty.

The Supreme Arbitrazh Court of the Russian Federation examined whether the Ukrainian ruling is a final court decision declaring the debtor insolvent. The court decided that the Ukrainian ruling was not

of a final nature and refused to grant it recognition. The court noted that foreign court acts adopting injunctions are not recognised and enforced in Russia; only final court decisions resolving the dispute on the merits can be recognised and enforced.

Federal Arbitrazh Court for Moscow Circuit – Recognition of US Bankruptcy Injunction Order

The court considered an application to recognise an injunction order issued by a US court in the course of a bankruptcy. The Federal Arbitrazh Court for the Moscow Circuit decided that the injunction order was not a final court decision on the merits of the case and therefore was not subject to recognition and enforcement.

Federal Arbitrazh Court for Moscow Circuit – Recognition of US Bankruptcy Court Decision

The court considered a claim to oblige the respondent to register a transfer of shares on the basis of a decision of the US Bankruptcy Court of the District of Delaware declaring the debtor insolvent and distributing its assets. The court noted that the relevant US decision could be recognised in Russia, but denied the claim because the formalities for share transfer were not complied with.

Supreme Arbitrazh Court of the Russian Federation – Recognition of Danish Bankruptcy

The Supreme Arbitrazh Court of the Russian Federation confirmed the ruling of the Arbitrazh Court for the Saint Petersburg and Leningrad region granting an application to recognise and enforce a decision of a Copenhagen commercial court declaring a Danish company insolvent and appointing a receiver.

UK Court Ruling in Support of Russian Bankruptcy

In a recent, high-profile case, the London-based Chancery Court supported bankruptcy proceedings in Russia by siding with creditors who sought orders for disclosure of the assets of a controlling person of a bankrupt Russian credit institution and a freezing order regarding the assets.

Expected New Legislation

The Russian government is planning to introduce certain amendments to the Russian bankruptcy legislation which would, *inter alia*, incorporate cross-border bankruptcy provisions along the lines of the UNCITRAL Model Law on Cross-Border Insolvency. It is not entirely clear when these amendments will be adopted since the review of the draft bill has been suspended for further refinement and revision.

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