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INTERNATIONAL

2ND QUARTER 2021

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The Quarterly Journal of INSOL International

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# SUBORDINATION OF CLAIMS FILED BY AFFILIATES/OWNERS AGAINST A DEBTOR AS AN INSTRUMENT TO PREVENT CONTROLLED INSOLVENCIES IN RUSSIA



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“the Russian courts may subordinate the claims of both affiliated and controlling persons of an insolvent company.”

## (1) Introduction

As in other jurisdictions, Russia’s insolvency legislation is based on the *pari passu* principle. However, this principle is subject to certain exceptions, specifically with respect to shareholders and other non-arm’s length creditors, such as the controlling persons of an insolvent company (“Affiliated Creditors”).

In practice, Affiliated Creditors use other instruments (e.g., loans, intergroup supplies etc.) to have their claims listed in the creditors’ register of an insolvent company.

First, this enables such creditors to control insolvency proceedings through participation in the creditors’ meetings, to block the approval of important decisions, and to appoint a favorable insolvency manager etc. Second, having their claims listed enables Affiliated Creditors to return their *de facto* investments through insolvency proceedings. This is despite the fact that the financial distress of the company often stems from improper management by these Affiliated Creditors.

To prevent such adverse practices, which harm the interests of independent creditors, the Russian courts drew up rules on the subordination of Affiliated Creditors’ claims.

This article is an overview of subordination mechanisms and their development in the recent practice of the Supreme Court of the Russian Federation (the **SC**) and State Arbitrazh (commercial) Courts.

## (2) Subordination rules

Federal Law No. 127-FZ dated 26 October 2002 “On Insolvency (bankruptcy)” (the “Bankruptcy Law”) does not directly provide for the subordination of Affiliated Creditors’ claims. Only claims arising out of corporate participation are disallowed from

inclusion in the creditors’ register of an insolvent company.<sup>1</sup>

Court practice has expanded this rule to the claims of Affiliated Creditors under ordinary civil contracts. In 2010, the Supreme Arbitrazh [State Commercial] Court disallowed a claim of a debtor’s shareholder under a surety agreement. The court held that shareholders bear the risk of mismanagement of the debtor so that they cannot have their claims satisfied alongside independent creditors.<sup>2</sup> However, court practice on this issue remained controversial and sometimes more lax approaches were employed.<sup>3</sup>

On 29 January 2020, the SC issued an Overview of the Court Practice related to Affiliated and Controlling Creditors’ Claims in Insolvency Proceedings (the **Overview**). The Overview is aimed at providing a uniform approach to the criteria and conditions for subordination of Affiliated Creditors’ claims.

## (3) Whose Claims Are Subject to Subordination?

According to the Overview, the Russian courts may subordinate the claims of both affiliated and controlling persons of an insolvent company.

The formal criteria for affiliation are ownership of more than a 20% participation interest (20% of shares) or belonging to the same group of companies.<sup>4</sup> However, courts have moved beyond the formal criteria and introduced the so-called “factual” affiliation. “Factual” affiliation can stem from the fact that a creditor and a debtor have the same counterparties<sup>5</sup> or the same ultimate beneficial owner.<sup>6</sup> The list of affiliation criteria is not exhaustive.

The Bankruptcy Law defines a controlling person as an individual or legal entity entitled to give mandatory instructions to the debtor or otherwise direct its actions.<sup>7</sup>

<sup>1</sup> The Bankruptcy Law, Paragraph 8 of Article 2.

<sup>2</sup> See case #A45-808/2009, Supreme Arbitrazh [State Commercial] Court of the Russian Federation.

<sup>3</sup> See case #A33-16866/2013, Supreme Arbitrazh [State Commercial] Court of the Russian Federation, case # A33-16866/2013, the Supreme Court of the Russian Federation.

<sup>4</sup> Law of RSFSR No. 948-1 dated 22 March 1991 “On Competition and Restriction of Monopolies on Commodities Markets”, Article 4.

<sup>5</sup> See case #A53-885/2014, Supreme Court of the Russian Federation.

<sup>6</sup> See case #A63-4164/2014, Supreme Court of the Russian Federation.

<sup>7</sup> The Bankruptcy Law, Article 61.10.

#### (4) Criteria for Subordination

##### a. Capital contribution

Affiliated Creditors cannot reclaim capital contributions by means of corporate investments once the company has fallen into insolvency. Hence, instead of corporate contributions, Affiliated Creditors use ordinary transactions (e.g., loans) to have an opportunity to return their investments in insolvency proceedings.

To prevent such practices, the courts tended to classify loans as capital contributions and refuse to list them in the creditors' register.<sup>8</sup>

The Overview has affirmed this approach but also introduced more balanced subordination criteria: a loan can be considered as a capital contribution only if the Affiliated Creditor provides it to make up for manifestly insufficient working capital. However, the claim will not be subordinated if the Affiliated Creditor proves that the loan was a part of a strategy to manage the debtor's economic performance and was not aimed at retrieving investments in case of insolvency.<sup>9</sup>

##### b. Compensatory finance

Pre-Overview court practice usually subordinated the claims of major shareholders. Courts stated that shareholders bear the risk of a company's insolvency.<sup>10</sup>

In the Overview the SC introduced a more specific rule on subordination of compensatory finance - that is investments provided by an Affiliated Creditor, not only company shareholders, as financial support in times of financial distress.<sup>11</sup>

Such finance may take various forms (e.g., a loan, supplies etc.). By providing the compensatory finance, the Affiliated Creditor assumes the risk of losing its investments in case of insolvency. Therefore, a compensatory finance claim is subject to subordination.

The Overview also specified exemptions from the subordination of compensatory finance (e.g., claims of financial institutions secured by pledge of shares; loan investments made under the instructions of a major creditor).<sup>12</sup>

##### c. Coverage agreement

A "coverage" agreement is an agreement (expressed or implied) under which an Affiliated Creditor performs the debtor's obligations to an independent creditor. After such performance, the Affiliated Creditor obtains the right of claim of the independent creditor against the debtor. Once the debtor becomes insolvent, the Affiliated Creditor submits this claim for inclusion into the creditors' register.

Pre-Overview court practice did not define a coverage agreement as separate ground for subordination, instead disallowing such

claims either as bad faith<sup>13</sup> or as corporate claims.<sup>14</sup>

The Overview introduced coverage agreements as separate grounds for subordination and gave guidance for the courts on applying these grounds: when the coverage agreement is used to relocate assets within the group of companies<sup>15</sup> a claim against the insolvent company based on such coverage agreement is subject to subordination.

#### (5) Burden of Proof

Affiliated Creditors often use fictitious claims aimed at increasing their control over the debtor's insolvency proceedings to prevent repayment to independent creditors.<sup>16</sup>

In response, pre-Overview court practice applied a higher standard of proof to the bankruptcy submissions of Affiliated Creditors. Courts disallowed such claims if the Affiliated Creditor was unable to counter reasonable doubts as to the real character of the claim.<sup>17</sup>

The Overview confirmed this approach: the burden of proof of the claim's validity is shifted to the Affiliated Creditor once the court has reasonable doubts about the claim.

#### (6) Receiver Appointment Rules

Under the Bankruptcy Law, the debtor cannot propose its candidate for the position of interim manager in cases of voluntary filing.<sup>18</sup> This rule ensures the impartiality of the interim manager.

Courts expanded this restriction to Affiliated Creditors<sup>19</sup>: the court would not consider a candidate nominated by such persons, but rather appointed a candidate at random, or utilized the candidates proposed by independent creditors.<sup>20</sup>

The Overview confirmed this rule, but extended it not only to the interim manager position, but also to other insolvency officials (e.g., receiver, financial administrator).<sup>21</sup>

#### (7) Conclusion

The Overview appears to have had a double-edged effect in practice.

On the one hand, the Overview has provided useful guidelines for the lower courts when dealing with claims by Affiliated Creditors and preventing controlled insolvencies.

On the other hand, there is a risk that lower courts will subordinate all Affiliated Creditors' claims, even those lacking bad faith intent. Hence, foreign companies accustomed to financing Russian subsidiaries through loan instruments now need to adjust their investment strategies to take account of the risk of subordination and be able to cover the losses in the event of the insolvency of such subsidiaries.

8 See case #A60-11749/2017, Supreme Court of the Russian Federation, case #A32-20128/2016 Supreme Court of the Russian Federation.

9 See Overview, Section 9.

10 See case #A68-10446/2015, Supreme Court of the Russian Federation, case #A06-9157/2018, Arbitrazh [State Commercial] Court of Povolzhskiy District.

11 See Overview, Section 3.1.

12 See Overview, Section 7, 10, 11.

13 See case #A25-2825/2017, Supreme Court of the Russian Federation.

14 See case #A43-3036/2016, Supreme Court of the Russian Federation.

15 See Overview, Section 5.

16 See case #A32-19056/2014, Supreme Court of the Russian Federation.

17 See case #A38-1381/2016, Supreme Court of the Russian Federation.

18 The Bankruptcy Law, Article 37.

19 See Overview of the Court Practice on the Participation of the Competent Authorities in Insolvency Proceedings and Applicable Bankruptcy Procedures, dated 20 December 2016, Section 27.1

20 See Case #A41-23442/2019, the Supreme Court of the Russian Federation.

21 See Overview, Section 12.



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