

2 July 2014

Kazakhstan's New Rehabilitation and Bankruptcy Law

The new law extends the grounds for shareholders' liability and invalidation of transactions.

On 26 March 2014, the new Rehabilitation and Bankruptcy Law (the New Law) took effect in Kazakhstan. The New Law supersedes the Bankruptcy Law adopted in 1997 (the Old Law).

The Old Law was criticized for its focus on bankruptcy, piecemeal regulation, and failure to meet international best practices. In this context, the name change from the Bankruptcy Law to the Rehabilitation and Bankruptcy Law emphasizes the legislators' intent to promote rehabilitation as an effective tool for the financial recovery of insolvent companies.

The New Law raises the following key issues:

- Expanded liability of the debtor's management, e.g., a director may bear subsidiary liability for the insolvent company's debts if a manager fails to initiate bankruptcy proceedings in a timely manner
- Expanded grounds for invalidation of the debtor's transactions concluded before insolvency proceedings, e.g., the validity of ultra vires transactions may be challenged by a bankruptcy trustee
- Potential unenforceability of clauses that provide for contract termination in the event of the debtor's bankruptcy

Insolvency Proceedings

In general, proceedings applicable to insolvent debtors (i.e., expedited rehabilitation, rehabilitation, and bankruptcy) remain largely the same in the New Law, apart from the so-called "external monitoring procedure," which has been repealed because it was deemed practically ineffective.

The New Law introduces a number of procedural and other improvements that purport to enhance the efficiency of insolvency proceedings (e.g., new parties and instruments, deadlines, disclosure duties, etc.). For instance, the New Law provides for a temporary administrator and a temporary trustee, who are appointed by the court to handle preparations for rehabilitation and bankruptcy proceedings, respectively. The New Law also includes provisions related to the bankruptcy of an absentee debtor. In particular, creditors may petition the courts to declare that a debtor is bankrupt and dissolve the debtor without going through the bankruptcy proceeding if the debtor and its assets cannot be found.

Involuntary Petitions for Bankruptcy

The New Law permits the following categories of creditors to force an insolvent debtor into bankruptcy proceedings:

- The Tax Committee of the Ministry of Finance of the Republic of Kazakhstan for claims that exceed approximately USD1,500 and are overdue for four months
- Other creditors for claims that exceed approximately USD3,000 (for individual entrepreneurs) or USD10,000 (for legal entities) and are overdue for three months

In addition, the New Law enables creditors with claims related to personal injury, alimony, payroll, and compensation to force an insolvent debtor into bankruptcy proceedings for claims that exceed approximately USD1,000 and that have been overdue for three months. Further, the New Law broadens circumstances when the debtor is obliged to initiate insolvency proceedings. Specifically, this obligation triggers when the following occur:

- In the course of voluntary liquidation, the debtor's funds are insufficient to cover all creditors' claims
- Discharge of one or several creditors' claims prevents the debtor from satisfying in full the remaining claims
- The debtor knew or should have known about its insolvency (the debtor must file a bankruptcy case within a six-month period)

Expansion of Management and Founders' Liability

The New Law extends the liability of the debtor's management by introducing subsidiary liability of the company's officers for the bankrupt's debts if they fail to initiate bankruptcy proceedings in a timely fashion, disclose accounting records and other information to a bankruptcy or rehabilitation trustee, and provide access to such data (as discussed below). Notably, managers may bear joint liability in respect of any amount that cannot be collected from the debtor.

Such provisions may have significant practical implications. For instance, under the New Law, a director may be held liable for an insolvent company's debts if he or she fails to file for bankruptcy within six months from the date when the company's tax obligation exceeded approximately USD1,500 and was four months overdue.

Further, the New Law extends to cases where management and founders (who were held criminally liable under bankruptcy proceedings) are not allowed to register new companies until such liability is lifted. Under the New Law, information about bankrupt companies is posted on the website of the Ministry of Finance of the Republic of Kazakhstan.

Invalidations and Trustees' Avoidance Powers

The New Law introduces additional grounds for challenging and invalidating transactions concluded within three years prior to the initiation of bankruptcy or rehabilitation proceedings. Specifically, a bankruptcy or rehabilitation trustee should seek to invalidate transactions in the following cases:

- If a transaction led to a financial loss
- If a transaction did not match the debtor's usual activity or was not permitted by law or the debtor's charter (This provision is especially important in practice because it underscores the necessity to check if the activity is within the counterparty's charter and within the authority of the respective person or body.)
- The debtor's property was transferred free of charge, at below market prices or without economic substance, to the detriment of creditors (including for temporary use)
- Deeds of gift concluded beyond usual business activity

Further, a bankruptcy or rehabilitation trustee may also challenge certain types of reorganization on the debtor's part that involve asset transfer.

The creditors' committee sets the period for initiating an action to invalidate a transaction discovered by the bankruptcy or rehabilitation trustee. When it is impossible to claw back assets following an invalid transaction, the transferee or person who made a decision to transfer assets as well as the temporary administrator or trustee who approved the transfer should compensate damages up to the value of the transferred assets.

The New Law preserves the rehabilitation trustee's right to refuse to perform the debtor's obligations, in whole or in part, if the trustee believes that performance will be to the detriment of other creditors or if the agreement contains burdensome provisions for the debtor in comparison with analogous agreements. The New Law also

empowers the rehabilitation trustee to refuse to perform the debtor's obligations, in whole or in part, in interested parties' transactions (with affiliated parties).

Further, under the New Law, the bankruptcy trustee is obliged (per the creditors' committee decision) to amend, terminate, or challenge (depending on circumstances) the validity of contracts concluded before bankruptcy proceeding.

Termination on Bankruptcy Clause

The New Law challenges the enforceability of "termination on bankruptcy" clauses (which are common in commercial and financing agreements), under which the bankruptcy or insolvency of one contracting party triggers the contract's termination by the other party. Under the New Law, any agreement on contract termination because of bankruptcy proceedings against the debtor (concluded before filing a bankruptcy case) is void. (Notably, no statute of limitations for the invalidation of a termination on bankruptcy clause has been imposed.) The rehabilitation or bankruptcy trustee may challenge the clause.

Debtor's Duty of Disclosure

The New Law introduces detailed procedures related to a debtor's disclosure duties in the course of insolvency proceedings. Specifically, a debtor is obliged to disclose information on its business activity, financial standing, assets (pledged and leased assets, money on bank accounts, etc.), and foundation documents. This information is disclosed to the bankruptcy or rehabilitation trustees, temporary administrator or trustee, court, and/or creditors.

Further, the debtor must provide a report on the implementation of a rehabilitation plan and its commercial activity during rehabilitation to its creditor(s) or creditors' committee.

Including the Meeting of Creditors in Bankruptcy Proceedings

To promote more active creditor participation in bankruptcy proceedings, the New Law introduces the meeting of creditors in bankruptcy proceedings (in addition to the previously provided creditors' committee). The creditors' meeting includes all creditors in the creditors' register and has broader powers than the creditors' committee, including the authority to select the bankruptcy trustee and control over the sale of a debtor's property. In the event that the creditors are not satisfied with the trustee, they may terminate his or her contract and appoint a new trustee. Notably, decisions of the creditors' meeting are taken under the principle whereby a claim for one Kazakhstan tenge equals one vote.

To avoid lobbying of debtor's interests by influencing the decisions taken by the creditors' meeting, the New Law excludes any debtor's affiliated parties from participation in the meetings. Furthermore, courts will refuse to find the debtor bankrupt in cases where there are no other creditors but the claimant.

Priority of Claims Amended

The New Law amends the order of priority for creditor claims by combining the first and second priorities into the first priority. All other claims have moved up one priority notch. The amended priority order is as follows:

- First-priority claims must be paid in the following order: personal injury damages, unpaid alimony, employee payroll and compensation, social contributions to the National Social Insurance Fund and mandatory pension contributions, and compensation due under copyright agreements.
- Second-priority claims must be paid to secured creditor claims.
- Third-priority claims must be paid to tax claims.
- Fourth-priority claims must be paid to unsecured creditor claims and claims of secured creditors for the difference between the amount received from a pledged property and the amount actually owed.
- Fifth-priority claims must be paid to contract damage claims as well as fines and penalties on such claims.

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Note that administrative expenses and taxes incurred during the period of bankruptcy proceedings are outside of the order of priority for creditor claims and must be paid ahead of all creditor claims.

Changes to Other Laws

In connection with the New Law, amendments have also been made to 35 other laws and regulations. For instance, amendments to the Code of Administrative Violations include sanctions for improper performance of duties by the trustee and failure by the trustee to securely monitor property of the estate. The debtor's management or founders may be fined for concealing or destroying assets, transferring assets, concealing information about assets, or falsifying accounting documents.

Contacts

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