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Insolvency Proceedings In Russia: Recent Developments

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Russian legal environment

Foreign investors, being generally apprehensive of the perceived inflexible nature of Russian law and Russia's unpredictable court practice, prefer for transactions with a Russian counterparty to be governed by foreign law and to provide for international arbitration. Such a trend is completely understandable and international participants usually obtain the comfort they require by avoiding the murky waters of the Russian legal system. However, when it comes to the insolvency of a Russian entity, it is impossible to bypass Russian court proceedings.

In view of falling oil prices and the sanctions imposed by the Western states, Russian companies have recently been affected both by a reduction in their ability to attract overseas funding and a substantial increase in the costs of attracting funding generally. Together these factors have significantly increased the number of insolvency proceedings heard by Russian courts.

Due to a number of loopholes in the Russian Law on Insolvency (Bankruptcy) No. 127-FZ dated 26 October 2002 (the "Insolvency Law") and due to the fact that the balance of debtor versus creditor rights in all insolvency procedures is heavily in the debtor's favour, a Russian debtor has ample opportunity to act in bad faith and abuse the apparent rights of a creditor during the bankruptcy proceedings.

Transparent, consistent and efficient bankruptcy regulation is a key element of a fluid market economy and a necessary tool for dealing with distressed businesses. The recent amendments to the Russian Insolvency Law (the "Amendments") introduced at the end of 2014 and in January 2015 (although certain amendments will take effect only in the middle of 2015) appear to be a clear step towards achieving such goals and towards dealing with the major loopholes uncovered by practice.

Major loopholes in Russian insolvency law and recent changes

1. Contesting inflated claims

One of the major problems faced by bona fide creditors in recent years has been the creation of artificially-inflated claims which allow bad faith creditors to gain a majority of votes at the creditors' meeting of the debtor and unilaterally make any desired decision on the course of the insolvency proceedings, including the decision on further stages of insolvency proceedings and appointment of the insolvency manager.

The transactions aimed at the creation of such claims can be contested either on a general basis (e.g. on the grounds of abuse of rights) or on the basis of the specific grounds provided in the Insolvency Law (transactions giving preference, transactions infringing creditors' rights and transactions at undervalue).

Proving abuse of rights is very difficult as Russian courts are inconsistent in their interpretation of this concept. Prior to the implementation of the Amendments, insolvency managers had exclusive rights to contest the transactions on the basis of the specific grounds provided in the Insolvency Law. Although insolvency managers are supposed to be independent, in practice they often act under the instructions of the party which nominated them to such position. If they are nominated by a creditor whose claims are inflated they are of course reluctant to contest the transactions on the basis of which the claims of such creditors are made.

According to its recent clarifications, the Russian Supreme Commercial Court has allowed a creditor to contest such transactions on the specific grounds provided in the Insolvency Law if the creditor proves to the court that the inaction of the insolvency manager in this respect is illegal. However, this procedure is very time-consuming and not always successful.

According to the Amendments, any creditor whose claims exceed 10% of the total amount of creditors' claims is now entitled to contest the transactions mentioned above. Moreover, any claims based on the transaction

being contested shall not be counted when calculating the 10% threshold.

2. A debtor is no longer entitled to nominate the insolvency manager

Another major drawback to the Insolvency Law was the ability of the debtor filing the insolvency petition to nominate, at its own initiative, the insolvency manager or to choose a self-regulated organisation of insolvency managers from which an insolvency manager is to be appointed by the court.

It should be noted that the insolvency manager is a key figure in the Russian insolvency proceedings and is in charge of the day-to-day operation of the debtor. The rights of the creditors to control the insolvency manager's activity are substantially limited. The creditors are not even entitled to replace the insolvency manager without the court's approval.

In practice the insolvency managers nominated by the debtors often acted under their control and refused to cooperate with the bona fide creditors in preventing the stripping of assets from the debtor's estate and in contesting the transactions entered into with the aim of creating inflated claims

According to the Amendments, a debtor filing an insolvency petition is no longer entitled to nominate the insolvency manager or choose a self-regulated organisation of insolvency managers from which an insolvency manager is to be appointed by the court. Instead, if the insolvency proceedings are initiated by a debtor, the self-regulated organisation will be determined by random choice in accordance with a procedure to be further established by law.

3. Initiation of insolvency proceedings by banks has been substantially simplified

According to the general rule, an insolvency petition can be filed by a creditor as soon as the claim of such creditor is confirmed by a court or arbitration judgment in separate proceedings. In practice shell companies controlled by the debtor are in a much better position to obtain such a judgment if the debtor does not object to the satisfaction of such a claim. On the contrary, the proceeding initiated by bona fide creditors may last for quite many months if the debtor is using the various tools to delay such proceeding.

In the meantime, the creditor initiating the insolvency proceedings is allowed to nominate the insolvency manager which, as mentioned above, is often crucial for the further course of the insolvency proceedings.
As soon as the claim of shell creditor is confirmed by a judgment such creditor is in a position to initiate the insolvency proceedings and nominate the insolvency manager, who would then act under its control.

The Amendments allow a bank whose claims against the debtor have been due for more than three months to initiate insolvency proceedings subject to 15-days' prior publication of information about such intention in the Unified Federal State Register of Facts of Activity of Legal Entities. It remains unclear however, whether this applies to a non-Russian bank.

This amendment is also a very important and positive development since it has substantially simplified the procedure for banks to initiate insolvency proceedings in comparison to other creditors. Although it may be argued that certain debtors will use unfair banks acting in concert with them for the same purpose, the amendment is still generally a positive step since banks are subject to tight control by the Russian authorities and establishing a shell bank is far more difficult than establishing a shell company.

4. Other amendments

The other significant recent amendments include, inter alia, the introduction of provisions which permit the insolvency of individuals (effective from July 2015) and the extension of the liability of a debtor's shareholders and management. The latter amendment is also a positive sign as the previous provisions relating to the liability of a debtor's management, shareholders or persons entitled to give the debtor binding instructions or having indirect control over the debtor by other means whose actions had caused the insolvency were vague

and limited in scope and as such these persons were rarely held liable for their actions. The Insolvency Law has been revised substantially in recent years both in terms of clarifying the grounds for and the conditions of such persons' liability, although the practice of the application of this amendment has not yet been sufficiently developed.

Summary

Russian insolvency laws are constantly being developed in reaction to the loopholes and inconsistencies uncovered by practice. The recent amendments appear to be a substantial step forward in terms of balancing the respective rights of debtors and creditors in bankruptcy procedures and attempting to limit a debtor's opportunities to abuse the rights of creditors during the bankruptcy proceedings. However, the effect of these amendments is still to be tested by Russian courts.