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Enhanced Protection of Creditors' Rights: Recent Changes in Russian Insolvency Law

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I. Introduction

The increasing number of company liquidations in Russia caused by the global economic downturn has highlighted inadequacies in the protection afforded to creditors under Russian insolvency law (specifically, Federal Law No. 127-FZ 'On Insolvency (Bankruptcy)' ('The RF Law on Insolvency')). The lack of proper safeguards against asset-stripping has been an issue of particular concern.

Federal Law No. 73-FZ 'On Amendment of Certain Legislative Acts of the Russian Federation' (which was adopted on 28 April 2009 and came into force on 5 June 2009)¹ ('the Amendments') adds new provisions to the RF Law on Insolvency that are designed to address this issue.

In summary the Amendments:

- (a) allow a new species of *suspicious transactions* to be set aside (**Article 61.2**);
- (b) widen the circumstances in which *preferential transactions* ('preferences') may be set aside (**Article 61.3**); and
- (c) expand the situations in which the management of an insolvent company ('the Company') may be liable for its losses and extend the scope of such liability to a new category of *controlling persons* (**Article 10**).

2. Suspicious transactions (Article 61.2)

The Amendments introduce a new category of *suspicious transactions* (*подозрительных сделок – podozritelnykh sdelok*) which may be set aside in the course of bankruptcy proceedings. Two types of suspicious transactions are identified:

- (a) transactions at an undervalue; and
- (b) transactions that prejudice the rights of proprietary creditors.

Transactions at an undervalue (Article 61.2(1))

A transaction at an undervalue is defined as one under which the obligations of the other party to the transaction ('the counterparty') are not commensurate to those of the Company in relation to price or other terms that are detrimental to the interests of the Company and substantially different to those normally found in similar transactions.

Any such transaction may be declared invalid by the Russian Arbitrazh Court if it was entered into by the Company not more than *one year* prior to (or any time *after*) the commencement of bankruptcy proceedings.²

Transactions that prejudice the proprietary rights of creditors (Article 61.2(2))

A transaction that prejudices the proprietary rights of creditors is defined as one contains the following features:

- (a) it was entered into with *the intention* of prejudicing the proprietary rights of creditors by depriving the Company of the means by which (some or all of) their claims could have been discharged;
- (b) that was the *actual consequence* of the transaction; *and*
- (c) the counterparty *knew (or should have known)* of this intention.

Such a transaction may be invalidated by the Russian Arbitrazh Court if it was entered into by the Company

Notes

- 1 In relation to *bankruptcy proceedings commenced after that date* it applies to *all* transactions and in relation to pre-existing bankruptcy proceedings it applies only to *transactions entered into after that date*.
- 2 That is, the date on which court accepts the bankruptcy 'petition'.

not more than *three years* prior to (or any time *after*) the commencement of bankruptcy proceedings.

Intention in the context referred to in Article 61.2(2) will be *presumed* if:

- (a) the Company was insolvent at the date of the transaction; *and*
- (b) one of the following applies:
 - (i) it received no consideration under the transaction; *or*
 - (ii) the counterparty was *an interested person*; *or*
 - (iii) the purpose of the transaction was to repay to a participant/shareholder the share capital that he/she had invested in the Company; *or*
 - (iv) it involved the transfer of Company assets worth more than 20% of the book value of its assets (10% in the case of banks) in the last reporting period prior to the date of the transaction; *or*³
 - (v) the Company changed its address without informing its creditors before or immediately after entering into the transaction, or concealed its property, or destroyed or interfered with title or accounting documents; *or*
 - (vi) after entering into the transaction the Company continued to use, or remained in possession of, the property transferred under it or instructed the owner as to its disposal.

Prejudice in the context referred to Article 61.2(2) is deemed to arise if there is any reduction in the Company's assets or any increase in the claims against it or if the Company is in any other way rendered unable to meet its creditors' claims in full as result of the relevant transaction.

Knowledge in the same context will be *presumed* if the counterparty is *an interested person* or if he/she was aware at the date of the transaction of facts that indicated that the Company was insolvent.

An *interested person* (*Заинтересованные лица – zainteresovanie litsa*) is a concept that is recognised in the original RF Law on Insolvency (**Article 19**) and includes:

- (a) a parent or subsidiary company of the Company;
- (b) the manager (*руководитель – rukovoditel*) and directors of the Company, its chief accountant, and all persons who held these positions in the *one year* prior to the commencement of bankruptcy proceedings; and
- (c) their relatives.

The Amendments expand the categories of *interested persons* to include *companies within the same group* as the Company⁴ and *affiliates* of the Company⁵ (**Article 19(1)**).

3. Preferences (Article 61.3)

Article 103(3) of the original RF Law on Insolvency made it possible for a preference involving *an interested person* (as defined above) to be set aside if it was entered into not earlier than *six months* prior to the date of the commencement of bankruptcy proceedings. However, a preference was not defined other than as a transaction that conferred an advantage to specific creditors over others in terms of meeting their claims.

Article 103 has been repealed by the Amendments and replaced by **Article 61.3** which provides as examples of preferences a transaction that involves (or may involve):

- (a) providing security to an existing creditor; or
- (b) changing the priorities in which the claims of creditors are met; or
- (c) providing for the satisfaction of claims that have yet to fall due; or
- (d) satisfying the claims of specific creditors in preference to others. (**Article 61.3(1)**)

The Russian Arbitrazh court may now declare a preference invalid if it is made:

- (a) within *one month* prior to the commencement of bankruptcy proceedings or any time after that date; (**Article 61.3(2)**); *or*
- (b) within *six months* prior to the commencement of bankruptcy proceedings where:

Notes

- 3 The literal wording of Article 61.2(2) suggests that the conditions referred to in sub-paragraphs (iv)-(vi) may form one cumulative basis for proving intention rather than separate alternative bases for doing so. However, there seems to be little logic in adopting the former approach given that there is no obvious reason for interlinking them, each appears to a legitimate basis (on its own) for arousing suspicion and therefore inferring intention and the cases in which all three would be present are likely to be rare. Whether the Russian Arbitrazh Court accepts this reasoning/approach remains to be seen.
- 4 As defined under the RF Law 'On the Protection of Competition' (No 135-FZ dated 26 July 2006).
- 5 As defined under the Law of the Russian Soviet Federal Socialistic Republic No 948-1 dated 22 March 1991 'On the Competition and the Limitation of Monopolistic Activities in the Goods Market'.

- (i) the transaction is of a kind referred to in sub-paragraphs (a) and (b) of the preceding paragraph (i.e. securing a creditor's pre-existing claims or changing the priority of creditors' claims); *or*
- (ii) the creditor knew at the date of the transaction of the Company's insolvency or of facts from which it was possible to conclude that it was insolvent. Again knowledge is presumed where the counterparty is an *interested person*. (Article 61.3(3))

4. The procedure for setting aside a suspicious or preferential transaction and the consequences of doing so

An application to set aside a suspicious or preferential transaction may be made by an external manager (ie. administrator) or liquidator (either of their own motion or at the request of the creditors' committee or the creditors' meeting) to the Russian Arbitrazh court dealing with the bankruptcy proceedings (Article 61.8(1)) in accordance with the usual procedure set out in the Russian Arbitration Procedure Code and on notice to the Company's creditors and the counterparty (Article 61.8(3)).

If the transaction is set aside the court will order restitution of the assets to the Company (for appropriate distribution) or (if that is not possible) payment of a sum equivalent to their value at the date of the invalidated transaction.

The claims of counterparties to invalidated transactions at an undervalue and preferences that may only be invalidated if they are entered into within *one month* prior to the commencement of bankruptcy proceedings (or anytime thereafter) will be met *along with* those of unsecured creditors (in so far as the claims of the latter have not already been met) as long as the relevant asset or money equivalent has been returned/paid to the Company (Article 61.6(2)).

By contrast the claims of counterparties to transactions invalidated on the grounds that they prejudiced the rights of creditors or were preferences that may be invalidated up to *six months* prior to the commencement of bankruptcy proceedings may only be met *after* the claims of *all* other creditors have been met, (as long as the relevant asset or money equivalent has been returned/paid to the Company (Article 61.6(3)). By effectively being relegated to the back of the queue of creditors, the counterparty in this second category of cases is likely to end up in a significantly worse position than would have been the position if he/she had not entered into the relevant transaction at all. Accordingly, the sanction in these cases (*all of which involve an element of bad faith*) is penal in nature. This is a novel development.

5. The liability of managers and controlling persons for losses incurred by the company

Under the previous version of Article 10 of the RF Law on Insolvency a Company's shareholders/'participants', its 'manager', and others who were entitled to issue mandatory instructions to the Company or who are otherwise able to control its activities may be liable for the Company's debts (in so far as its assets are insufficient to discharge them) if its bankruptcy was caused by them (Article 10(4)).

The Amendments broaden the categories of people who may be liable to pay the Company's debts by including a newly defined category of *controlling persons* (*контролирующее должника лицо – kontroliruiushee dolzhnika litsa*). A *controlling person* is defined under Article 2 as one who at the commencement of bankruptcy proceedings or at any point in the *two years* prior to that date had the right to issue binding instructions to the Company or was able to control its activities in other ways (for example by issuing instructions to or influencing its 'manager' or board of directors) and includes persons entitled to enter into transactions on behalf of the Company under a power of attorney, and persons who control 50% or more of the Company's shares in the case of a joint-stock company or more than half of the share capital of a private limited company.

A controlling person will be liable for the Company's debts, unless he/she proves that he/she acted reasonably and in good faith in the Company's interests. In principle, the extent of the liability will be the shortfall between the creditors' claims and the Company's assets. However, the court is entitled to reduce a controlling person's liability if the losses caused by his/her default are substantially less than this shortfall (Article 10(4)).

Following the Amendments a Company's 'manager' may now be made liable for its debts if its accounting documents are missing, incomplete or incorrect (Article 10(5)). This is a significant development. The new sanction is intended to address the problems caused by company officers who conceal, destroy or manipulate a Company's accounting records to stifle a proper investigation into its trading history and the detection of asset-stripping. Prior to these changes the only recourse in such cases was to instigate criminal proceedings, which failed to address the interests of creditors.

A claim against a controlling person may be submitted by the liquidator (acting either on his/her own initiative or in accordance with the decision of a creditors' meeting or a creditors' committee) but *only in the bankruptcy proceedings* (Article 10(5)). It had previously been possible to issue similar claims in separate civil proceedings. This is no longer the case. Confining such claims to the bankruptcy proceedings prevents the risk of parallel claims and the inevitable confusion and delay caused by competing jurisdictions, which is helpful.

6. Conclusion

The Amendments have been welcomed by most lawyers and judges in Russia because they have (in principle at least) improved the position of creditors by extending the scope for setting aside dubious transactions and making it easier to hold to account those involved in asset-stripping. However, the effectiveness of these changes will, as ever, depend on the rigour with which they are implemented by the Russian Arbitrazh Courts. There are currently several high profile insolvency cases before the courts in which the issues referred to above are likely to arise. Therefore it should not be long before the *practical* impact of these new sanctions and their effectiveness at countering asset-stripping becomes clear (or at least clearer).

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

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