

"Changes to the Russian Law on Bankruptcy"

Dmitry Pavlov and Kristina Teplova,
Lidings Associates

As a continuation of long-awaited reforms of bankruptcy legislation started on January 2009, the State Duma on April 2009 adopted the new Federal Law No. 73-FZ "On the Amendments to the Certain Statutes of the Russian Federation" (the "Amendments", "the Statute"). The new Amendments emerged as a response to vastly growing number of bankruptcy and insolvency cases as well as asset stripping from bankrupt companies. The Amendments introduced new legal concepts unknown to the Russian law before: "suspicious transactions", "controlling persons" and extended the concept of "preferential transactions". For several months courts have been actively applying the amended law on bankruptcy and certain practice was formed on range of issues.

The Amendments introduced new definitions in the Russian law: "suspicious transactions", "preferential transactions" and "controlling persons"

The Statute introduced two concepts of transactions that can be challenged in the Russian Arbitrazh Court during the bankruptcy proceeding: "suspicious" and "preferential" transactions.

I. "Suspicious" transactions

Under the Amendments, "suspicious transactions" are: (i) transactions with intentionally lowered price (undervalue transactions) and (ii) transaction that were concluded in order to harm lawful rights of creditors (harmful transactions).

Undervalue transaction

Transactions at an undervalue can be challenged in case two criteria are met together simultaneously:

- a) counterparty of the debtor provided unequal consideration¹; and
- b) the transaction was concluded one year prior to initiation of the bankruptcy procedure.

Harmful transaction

The harmful transactions can be challenged in court in case it contains the following three characteristics simultaneously:

- a) transaction was aimed to harm creditors' rights and resulted into such harm or damage for the creditors. Under "harm" for the creditors, lawmakers inferred significant decrease in the value of the debtor's assets or increase of the value of claims to the debtor and any other consequences which resulted into infeasibility to satisfy creditors' claims.
- b) one party of such transaction knew or must have known about harmful intent of such transaction; and
- c) the transaction was concluded three years prior to the bankruptcy procedure started (from the moment when the notification on bankruptcy was filed within the Arbitrazh Court) against the debtor.

Under the Statute, transaction is recognized as harmful for the creditors by the Arbitrazh Court in case the debtor was insolvent and in case:

- a) it did not receive consideration;

¹ Under the Article 61 of the Amendments, consideration can be recognized as unequal when the debtor paid higher price than he would have paid in similar circumstances for the similar goods or services. The Amendments provide an example of such transaction when market price of property is higher than the price at which the property was sold.

- b) transaction was concluded with an interested party;
- c) transaction was aimed to repayment of participatory interest to participant by the debtor;
- d) total value of assets transferred under transaction constitutes 20% of the asset value; and
- e) the debtor changed its address without notifying creditors before or after transaction, hid or destroyed constitutive or financial documents.

II. "Preferential" transactions

According to the new rules, the court may decide that one transaction is void in case such transaction resulted or may result in preferences to one creditor over another if at least one of the following conditions met:

- a) transaction provides security to one particular creditor;
- b) the transaction provided or may provide change of order of claim settlement; or
- c) resulted or may result into discriminatory satisfaction of one creditor's claim over another creditor's claims.

The new rules stipulate what sort of transaction can not be challenged as "suspicious" or "preferential": stock exchange transactions, transactions concluded in the ordinary course of business and transactions where the debtor received equal consideration

III. Transactions that can be challenged

The Amendments allowed to challenge not only civil law agreements but labor, tax, customs and other actions and agreements as well.

The new rules clearly stipulated what sort of transaction can not be challenged as "suspicious" or "preferential". Among them are transactions concluded on stock exchanges, transactions concluded in the ordinary course of business and transaction where the debtor received equal consideration.

Results of recognition a transaction as void

If a transaction was found void, all assets that were transferred under such transaction must be returned to the bankrupt company for further distribution among the creditors (restitution). In case it is not feasible to return the property, the buyer must repay the sum that was paid for the property.

The claims of the counterparty under preferential and harmful transactions can only be satisfied after satisfaction of all claims of creditors of all priorities. The claims of the counterparty under undervalue transaction are satisfied in the third priority.

IV. Controlling persons

The Amendments introduced a new legal concept of "controlling persons". Controlling person is a person (legal entity or an individual) that can control activity of the debtor and give instructions or define debtor's activities in any way as a manager or an authorized person (including a member of liquidation commission and owner of more than 50% of the debtor's shares). Controlling person should have performed the abovementioned actions two years before the bankruptcy procedure was initiated.

The debtor's controlling persons jointly and severally bear subsidiary liability for the debtor's debts in case of insufficiency of the debtor's assets unless they prove that they acted reasonably and in good faith for the benefits of the debtor. The amount of liability shall be defined as a difference between the amount of creditor's claims and those that actually were satisfied with the debtor's assets. However, liability of controlling persons is described very vaguely and will need further clarification in courts.

The amount of liability may be decreased by the court if the creditor's losses are significantly lower than their claims against the debtor. Additionally, the chief executive officer of the debtor is subsidiary liable for the debtor's debts if the debtor's accounting documents are missing, incomplete or were falsified. The claim of controlling persons' liability shall be filed during within bankruptcy proceedings.

Controlling person is a person (legal entity or an individual) that can control activity of the debtor and give mandatory instructions to it

V. Amendments to the credit organizations' bankruptcy procedure

The Amendments provided new rules for bankruptcy procedures of credit organizations as well. The Statute stipulated that the transaction of credit organization can be challenged on the same grounds and the same procedure as non-credit organizations. However, the hardening period is calculated from the date of appointment the temporary administration by the Central Bank, but not from the date of filing the bankruptcy application within the Arbitrazh Court.

According to the new rules, the debtor's management bodies must apply to the Central Bank for revocation of the debtor's banking license in case any bankruptcy condition are met or the debtor's capital adequacy becomes less than two percent.

The statutory provisions stipulated additional obligations of management bodies to initiate bankruptcy provisions. In case the managements failed to initiate the proceeding, members of the board of directors, shareholders and (or) beneficiaries will be jointly and severally subsidiary responsible for the debtor's obligations.

Individuals that are or were subjects to subsidiary liability for the debtor's obligations are not allowed to purchase more than 5% of the credit organization's shares within ten years and hold top managing positions in credit organizations within three years after the debtor was declared bankrupt by the court.

The new rules enlarged the scope of persons that may be held liable for the debtor's debts and amended the list of grounds for making them liable for the credit organization's debts. Currently, the Amendments provide for the subsidiary liability of the credit organization's

managers, members of the board of directors and shareholders arising when the credit organization's bankruptcy is attributable to their actions or lack of action.

The Amendments came into effect on June 5, 2009 and will be applicable to bankruptcy cases initiated after that date. Although the Amendments will apply to bankruptcy procedures that started before June 5, 2009 in relation to challenging transactions that were concluded after this date, it is still unclear on how the courts will apply provisions of the Amendments about limitation periods of transaction concluded prior to June 5, 2009. Likewise, the effectiveness of the new Statute will largely depend on further implication of the rules by the courts and understanding the rules by the Arbitrazh judges.

Incompleteness of the law adopted in January lead to necessity to clarify certain provisions of that statute on April 2009. In July of the same year, the Higher Arbitrazh Court issued several documents on clarification of the January amendments. However, not all questions were covered by those clarifications including provisions on challenging transactions. As of today, certain court practice in relation to the Statute was not formed but clarifications on the Amendments will be issued by the Higher Arbitrazh Court soon.

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The comment has been prepared by Dmitry Pavlov and Kristina Teplova Lidings Law Firm Associates. If any questions occur you can contact them: DPavlov@lidings.com, KTeplova@lidings.com tel.: +7 495 913-67-66; +7 495 228-18-66