Delayed-action bankruptcy in Russia

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This article looks at several practical consequences for both debtors and creditors, of the bankruptcy moratorium introduced in Russia in April 2020, as an emergency measure to protect business from the Covid-19 pandemic. The authors offer some practical solutions to minimise the risks and ensure effective debt recovery.

Introduction

Russia is among the few jurisdictions globally that since early 2020 have had to face not only total business lockdown due to the Covid-19 pandemic restrictions, but also the impact of a dramatic fall in oil prices, causing a significant devaluation of national currency and exchange rate increases. In April 2020, the Russian GDP decreased by almost one-third compared to the same period the previous year.[1]

This forced the authorities to urgently pass anti-crisis legislation, covering a variety of spheres, starting with social guarantees for its citizens, and extending to writing off taxes and introducing new provisions on the lease of premises for business.

During this period, Russia's bankruptcy law was supplemented in an expedited legislative process with the provisions governing a so-called 'bankruptcy moratorium' (article 9.1) aimed at protecting companies from the sectors significantly affected by the pandemic. Interestingly, this new article has already been amended twice, due to significant legislative flaws and criticism from the business community. For the moment, the number of companies falling under the moratorium exceeds 1.5 million, with the possibility of further extension depending on how the situation develops.[2]

While it is not feasible to discuss here all the peculiarities of the moratorium regime, the following merits discussion:

- companies falling under the moratorium cannot be declared bankrupt at the application of their creditors;
- the debtor's management or shareholders' duty to apply for bankruptcy is suspended unless the moratorium expires;
- enforcement proceedings against debtors falling under the moratorium are suspended; and
- accrual of financial sanctions (penalties) for non-performance by the debtors under the moratorium of their obligations is also suspended.

It is already clear that after expiry of the moratorium (presumably in early October 2020) a lot of companies, especially those dealing in the service sector, will ultimately face bankruptcy. For these reasons, the practical implications of such a moratorium are of primary interest both for debtors and creditors.

This article address such practical aspects and elaborates on some specific issues that could be important for creditors to effectively enforce their rights, and for debtors to minimise their liability risks.

Duty to apply for bankruptcy – between Scylla and Charybdis

The clear provision of the new legislation is that management and shareholders of debtors falling under the moratorium are not obliged to apply for bankruptcy for the duration. The underlying logic is to give those businesses, disrupted by the pandemic, the possibility to resume normal operations and to recover from the fall in revenues. At the same time, the law does not in any way limit the debtor's own discretion to apply for bankruptcy.

It is not clear how these provisions will work for situations when an entity showed signs of insufficient assets before introduction of the moratorium, and already faced technical insolvency. There is no guidance in law or court practice on whether the benefits of the moratorium should be applicable to such entities by a formal reading of law, or if it is possible to argue that suspension of the duty does not cover such situations, taking into account that the purpose of

the moratorium is to protect solvent entities facing temporary difficulties. The answer to this question will cause serious implications in real bankruptcy cases.

In practice, management of an entity subject to a moratorium shall not merely rely on the formal interpretation of the law regarding an obligation to apply for bankruptcy, but should carefully double check if the signs of insolvency are actually linked to the pandemic. Such an analysis is a crucial step due to the so-called concept of 'subsidiary (secondary) liability', widely applicable in bankruptcy proceedings in Russia. In a nutshell, debtors' controlling persons (formally or informally) may be held legally liable for the debts of the respective legal entity, if inter alia they failed to apply for bankruptcy when required to do so. This is a cornerstone issue. If a case about failure to apply for bankruptcy is successful, such controlling persons risk facing personal liability for the company's debts, equal to the amount of the creditors' claims that emerged when the debtor continued its business while technically insolvent.

It is concerning that this question will be resolved by the courts on case-by-case basis, unless some uniform approach is elaborated, or the Supreme Court of Russia proactively provides explicit guidelines, which is unlikely to happen soon. In this period of such legal uncertainty it is advisable to minimise the risk of personal liability by paying extra attention to compliance with the duty to apply for bankruptcy, and to be ready to reasonably substantiate any such decision.

It is prudent in practice to prove the existence of, or lack of, grounds to apply for bankruptcy and protect management, to obtain expert opinions from reputable consulting companies or private practitioners dealing with analysis of the financial state of an entity and its further operation and solvency. Additionally, in case a decision is taken not to apply for bankruptcy, despite the existence of its certain signs, it is advisable to elaborate and adopt a detailed and economically justified 'business rescue plan'. In the case of an ultimately negative outcome, these documents could be presented to a judge as evidence confirming the good-faith behaviour of management, and legitimate grounds to believe that the business could be saved, subject to certain conditions being met.

What can be done to proactively secure interests of debtors and creditors?

The first thing to remember when considering the instruments for recovery of debts from entities put under moratorium, is that, in practice, the most effective way of debt recovery in Russia is still filing for debtor's bankruptcy. The risk of losing a business is usually a strong incentive to pay the outstanding amounts and prevent unnecessary and lengthy litigation, that could trigger even larger expenses and create the risks of personal liability for management and shareholders. Therefore, once the restrictions are lifted, one should be ready to apply for its debtor's bankruptcy.

To apply for a debtor's bankruptcy, a creditor must meet some very basic formal criteria, which are: (1) existence of a three-month overdue debt; (2) exceeding RUB 300,000.00; (3) confirmed by the respective judgment of the Russian court or foreign judgment recognised in Russia. Additionally, the status of an applicant provides a creditor with some advantages (of a more practical than legal nature) compared to other creditors, who join an already pending bankruptcy process. However such status also imposes additional duties, such as a duty to provide financing for the bankruptcy procedure.

While the Russian moratorium legislation imposes restrictions on initiation of bankruptcy procedures by creditors, there are no provisions preventing creditors from applying to courts with debt recovery claims. This makes the moratorium period a good opportunity to secure a claim against the Russian debtor and get the respective judgment, which after expiry of the moratorium could be used for ordinary debt recovery process, or for applying for debtor's bankruptcy.

In support of such a claim, and in order to prevent alienation of the assets, which often happens in anticipation of bankruptcy, a creditor could also apply for interim relief preventing any disposal of the debtor's assets. If obtained (in Russia, the chance of success varies depending on the region and courts), such interim measures could be the most effective instrument to ensure good chances of actual enforcement of the judgment. It is questionable whether this approach will remain unchanged due to significant risk of freezing by the creditors of all their debtors' assets, and actual blocking of any business activity, thus facilitating a bankruptcy. For this reason, it is likely that the courts will need to find some balance between the interests of debtors and creditors, however, for the time being no such approach exists.

The aforementioned remedies are obviously favourable for the creditors, and the bankruptcy law also provides (or attempts to provide) some instruments available for the debtors to prevent their immediate bankruptcy after release of the moratorium and respective restrictions.

The first option is to obtain a written consent from a creditor to the terms and conditions of debt settlement procedures proposed by the debtor. If consent is obtained, the respective creditor will be deemed to

be in support of the proposed settlement, should the debtor be ultimately declared bankrupt. Unfortunately, this novel approach raises many practical questions due to very poor legislative regulation and no precedents in previous practice of Russian courts, starting from the low or imprecise level of settlement details to the way in which a consent must be expressed.

Currently, the only feasible solution for debtors appears to be preparing some document offering settlement terms and conditions in as much detail as possible, and sending this to all known creditors with a request to explicitly confirm their acceptance. Since such settlement must be approved by the court, it is also crucial to ensure its compliance with the basic settlement principles set out by bankruptcy law, including the requirement of settlement proportionality and non-preference to any creditors.

A further mechanism which aims to support debtors who have complied with the duty to apply for bankruptcy, is raising before the court a motion seeking an order establishing the procedure of debt repayment in installments. This is another novel legislative step, urgently introduced to serve as an emergency restructuring procedure. It is worth noting, however, that bankruptcy procedures in Russia end up with debtor's liquidation in over 95 per cent of cases, and the rehabilitation procedures envisaged by the existing provisions of bankruptcy law are not working. To address this issue before the pandemic, the government started drafting a brand new chapter of bankruptcy law aimed at enhancing the solvency restoration procedures, which included dozens of articles with very detailed regulation of its various aspects. However, as a result of the legislative rush caused by the necessity to rapidly address the need for new support measures, the authorities had to put on hold further development of this new chapter, and instead adopted very brief guidelines on the aforementioned procedure for debt repayment in installments.

Unfortunately, considerable unclear wording of the law means the new procedure raises more issues than it answers. The general idea is that a company that falls bankrupt after release of the moratorium may apply for a court order by which its debt will be 'restructured' on the terms and conditions envisaged by law, with certain possible adjustments. Such terms include a minimum of one year deferred payment in equal installments with the possibility of further prolongation, imposition of certain restrictions on business operations, providing creditors with the rights to access information, etc.

Considering very ambiguous legal regulation, an apparent solution would be seeking some contractual mechanisms to ensure a degree of predictability and security for both parties. As this is not the focus of this article, only a few examples of these possible options are mentioned. They could include entering into securing transactions with third parties not affected by risks of bankruptcy and moratorium, transfer of debts to such parties, introducing a right of unilateral withdrawal from an agreement in case of moratorium, and the right to keep title over a property before its full payment.

At the same time, one must be very careful when agreeing on specific mechanisms, due to the risks of them being challenged in case of subsequent bankruptcy of the company. For example, set-off transactions involving companies under moratorium are explicitly prohibited by law, or any other preferential transactions could be relatively easily challenged by the bankruptcy receiver of creditors.

How to combat illegal actions aimed at evading debt repayment

It is clear, however, that in some cases proactive measures to secure a claim may be impossible or too late – for example, bad faith debtors very often undertake various measures aimed at disposal of their assets to affiliated third parties, pledging such assets to such parties to ensure their higher priority in bankruptcy, making preferential payment to favoured creditors, and many others.

Russian bankruptcy law provides several traditional instruments available to creditors to protect their rights, which are clawback action and subsidiary liability of the management. Their implementation will be significantly affected by the moratorium, changing the traditional course of bankruptcy cases.

With a view to protect the interest of creditors, the legislator has significantly extended the so-called 'periods of suspicion', being the period of time preceding acceptance of the bankruptcy petition, taken into account when deciding on possibly invalidating a specific transaction. Transactions entered between the parties within these suspicion periods may be challenged, subject to compliance with other elements of the standard of proof. The grounds for challenging traditionally include making preferential transactions (one or six months), transactions at undervalue (one year) and transactions to the detriment of creditors' proprietary interests (three years).

The periods of suspicion for companies falling under the moratorium now include: (1) the standard period for a kind of transaction; plus (2) the period of moratorium duration; and plus (3) the period between release of the moratorium and acceptance of bankruptcy petition, but no longer than three months.

In a simple example, the period for invalidation of a basic preferential transaction, which in standard situations is only one month, now extends to a maximum of nine months in cases where a company falls under the moratorium.

These extensions only apply to companies declared bankrupt three months after the introduction of the moratorium. Therefore, in order to use the opportunity of suspension periods extension for transactions challenging a creditor shall apply to the court with a bankruptcy petition at the earliest possible date. Since a pre-condition for filing such a petition is existence of a valid judgment confirming the debt, undertaking the proactive steps for its obtaining becomes a real necessity (and sometimes the only possibility) to ensure protection of violated rights.

The extension of suspicion periods does not guarantee the successful outcome of clawback action, which requires proving numerous circumstances, depending on the type of transaction and alleged ground of invalidity. In the majority of cases the most cumbersome aspect to prove is knowledge of the debtor's counterparty about existence of its bankruptcy signs. A practical solution to ensure a better chance of a successful outcome may include making public announcements about the actual financial state of the debtor (eg, in the newspapers) and sending direct notifications to its counterparts (if known) making them aware of the same. This may not only help fulfil the burden of proof but will also make bad-faith debtors aware that creditors are closely watching their actions.

Extension of the periods also applies for determining the scope of the debtor's controlling persons for the purpose of their subsidiary liability, working in the same way as for suspicion periods. The concept of subsidiary liability and its development in Russian law deserves a separate analysis. It is enough to say here, that in light of the clear trend of an increase of such cases, management and shareholders of Russian entities must be very careful when making any business decisions that could influence potential debtor's solvency – especially those related to disposal of the assets and assuming new obligations.

Moreover, it is important to bear in mind, that the outcome of clawback action may significantly influence development of litigation on subsidiary liability of its controlling persons. For this reason, during the period of moratorium, and for some time afterwards, it is advisable for debtors to abstain from any major transactions, or alternatively to be fully ready to prove their economic rationale and have the respective evidence in hand, should the matter eventually end up in court.

Conclusion

A clear conclusion emerging from the considerations discussed here is that recent amendments to Russia's bankruptcy law on the moratorium introduced earlier this year, raises a variety of practical questions which will be dealt by the courts in the following years or even decades. It is also obvious that the courts will continue following and developing the general goals of Russian bankruptcy law, which are mostly aimed at preventing illegal, or close to illegal schemes and practices, giving creditors flexibility in the way they enforce their rights.

Notes

1 See www.rbc.ru/economics/19/05/2020/5ec1a2bb9a79471ed0de4175.

2 An easy service to check if a company falls under moratorium is available at the official website of the Federal Tax Service of the Russian Federation at https://service.nalog.ru/covid, accessed 21 July 2020.

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