Challenging Transactions Made by Debtors in Anticipation of Insolvency: The Plenary Session of the Russian Supreme Commercial Court Made the Clarifications

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This article reviews recent changes to the regime of challenging transactions made by debtors in anticipation of insolvency that were introduced in the Resolution adopted at the Plenary Session of the Supreme Commercial Court of the Russian Federation.

This article reviews the most important recent changes to the regime of challenging transactions made by debtors in anticipation of insolvency. These changes were introduced in the Resolution adopted at the Plenary Session of the Supreme Commercial Court of the Russian Federation (the "Supreme Commercial Court") No. 63 "Certain Matters Relating to the Application of Chapter III.1 of the Federal Law "On Insolvency (Bankruptcy)"[1] dated December 23, 2010 (the "Resolution").[2]

Initially, the provisions of the Insolvency Law[3] and the first version of the Resolution were aimed at preventing debtors from syphoning off assets in certain situations, e.g. when debtors anticipate their insolvency and prepare for it in advance by transferring assets to third parties, or when creditors that are aware of the debtor's upcoming insolvency attempt to discharge obliga-

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tions owed to them and circumvent other creditors' claims. However, debtor's transactions[4] relating to discharging obligations owed to persons acting in good faith are being increasingly challenged on the grounds that they meet the criteria of suspicious transactions,[5] transactions aimed at causing harm to creditors,[6] or those resulting in one of the creditors being preferred to other creditors.[7]

Bona fide recipients of performance under such transactions include lending organisations (mainly banks) and public authorities, being recipients of mandatory payments. The external administrators and receivers often contest legality of such payments seeking to include in the insolvency estate those assets that were transferred in previous transactions, but that are to be returned to the insolvency estate if such transaction is declared invalid. The new provisions of the Resolution are primarily aimed at protecting the interests of persons acting in good faith.

The most important changes reviewed in this article include:

- listing specific facts evidencing that the creditor knew about the debtor's insolvency or insufficiency of the debtor's assets;
- clarifying the characteristics of transactions made in the ordinary course of the debtor's business;
- allowing a registered creditor to challenge transactions made by the debtor in anticipation of the situation;
- imposing a duty on the insolvency administrator (prior to filing an application to challenge the transaction) to suggest to the creditor that it voluntarily return what it received as a result of the transaction and determining the consequences of the creditor following this suggestion or failing to do so;
- clarifying the grounds and the limits for challenging, as Unfair Preference Transactions, of transactions involving sale of pledged assets or their transfer to the creditor in settlement of a claim, and explaining the consequences of declaring such transactions invalid.

THE CREDITOR'S KNOWLEDGE ABOUT THE DEBTOR'S INSOLVENCY OR INSUFFICIENCY OF ITS ASSETS

Some Unfair Preference Transactions may only be challenged once it has been proven that the creditor knew about the debtor's insolvency or insufficiency of the debtor's assets.[8] Clarification as to which facts demonstrate the creditor's knowledge and which do not is useful for legal practitioners.

The following circumstances do not evidence by themselves that a creditor had the requisite knowledge: the creditor received payments as part of enforcement proceedings, or after a significant delay, or from a third party; or, in most cases, when a notice that a creditor initiated the debtor's insolvency proceedings has been published on the Supreme Commercial Court's Web site in the database of the cases.[9]

By contrast, the facts that demonstrate the creditor's knowledge include: the debtor making requests on several occasions to the creditor for an extension of time in which to pay its debts; the creditor (a lending organization) being aware that there has been a schedule of overdue payments to be made from the debtor's bank account for a considerable period of time, or the debtor filing an insolvency petition.[10]

If an insolvency petition is filed by the creditor whose transaction is being challenged, or another creditor, the creditor's intentions in filing such a petition need to be assessed. If it is established that the creditor viewed the commencement of the insolvency case as a means to accelerate the enforcement of a court judgment, the filing of the insolvency petition will not demonstrate that the creditor acted in bad faith.

The fact the creditor is a lending organisation or a tax authority does not necessarily serve as evidence that the creditor knew about the debtor's insolvency or insufficiency of the debtor's assets. The person challenging the transaction needs to provide specific evidence that the creditor acted in bad faith. Where a borrower provided documents relating to its financial position to a lending organisation pursuant to the law or a loan agreement it needs to be proven that such documents included specific information clearly demonstrating the debtor's insolvency or insufficiency of the debtor's assets.[11]

If a transfer of funds made by a lending organisation in anticipation of its insolvency from one of its client's accounts to this client's account in another lending organisation is challenged, it is important to ascertain whether the

client knew about the lending organisation's insolvency or insufficiency of the lending organisation's assets.[12]

It needs to be established that the creditor knew about the debtor's insolvency or insufficiency of its assets at the time the transaction was entered into.

In general, the changes made at the Plenary Session of the Supreme Commercial Court are aimed at limiting the opportunities to challenge transactions. This is done by setting out clearer criteria which help to determine when the creditor's knowledge is proven and when it is not.

TRANSACTIONS IN THE ORDINARY COURSE OF BUSINESS

It is important to understand what constitutes a transaction being carried out in the ordinary course of business. This is because if a transaction is categorised as such the creditor is protected from the risk of the transaction being declared invalid as a Suspicious Transaction or an Unfair Preference Transaction. Such clarification will be especially important when transactions are challenged as Unfair Preference Transactions when it is not necessary to establish that the creditor acted in bad faith.[13]

The Plenary Session of the Supreme Commercial Court provided further details on what constitutes transactions carried out in the ordinary course of a debtor's business. These include: scheduled loan repayments, monthly rent, payment of salaries, taxes, utilities, telecommunications services, etc.[14]

However, delayed payments, transfers in settlement of a claim and prepayment of a loan without reasonable economic justification do not qualify as transactions in the ordinary course of business.

At the Plenary Session of the Supreme Commercial Court, a presumption was introduced that the one percent value threshold established for transactions in the ordinary course of business is calculated based on the value attributed to assets in the balance sheet. However, the court may take into account the market value of the assets if this figure significantly exceeds the balance sheet value.

Criteria was also established at the Plenary Session to determine what constitutes a lending organisation acting in the ordinary course of business in cases when transactions made in an insolvency situation are challenged. The following facts may evidence that a transaction is not in the ordinary course of its business:[15] the Central Bank of the Russian Federation forbidding the lending

organisation to continue operating; there being a schedule of clients' payment documents, payments under which were not made due to the absence of funds in the correspondent account; circumventing the order of payments; the client (the recipient of the disputed payment) and the lending organisations' employees being affiliated; there being no reasonable economic justification for the client to transfer its money from a deposit before maturity (resulting in the loss of interest) and; the client discharging its obligations under a suretyship agreement entered into shortly before the payment was made in order to secure a third party's pre-existing obligation to the lending organisation.[16]

A REGISTERED CREDITOR'S RIGHT TO CHALLENGE TRANSACTIONS

An important provision adopted at the Plenary Session of the Supreme Commercial Court is aimed at making the procedure of challenging the debtor's transactions in an insolvency situation more efficient. It allows a registered creditor to challenge such transactions[17], even though such provision does not exist in the Insolvency Law.

The court may allow a registered creditor to challenge transactions if the court grants a complaint regarding the insolvency administrator's failure to act. This occurs when an administrator fails to exercise due care and diligence and refrains from challenging a transaction in a situation where the registered creditor duly proved that such transaction was invalid.

The registered creditor is allowed to file an application to challenge the transaction and a complaint against the insolvency administrator simultaneously. This results in application proceedings being suspended pending the consideration of the relevant complaint. The purpose of this provision is to comply with the statute of limitations (there is a one-year statute of limitations to challenge transactions).

VOLUNTARY RETURN OF ASSETS PRIOR TO THE ACQUISITION OF SUCH ASSETS BEING CHALLENGED

Clarifications and additions relate to the consequences of a voluntary return of assets by creditors in a situation when they enter into a transaction

with the debtor, but return to the insolvency estate what they received in the relevant transaction once they discovered that insolvency proceedings had been initiated with respect to the debtor and anticipated that such transaction may be challenged. The advantage for creditors in this situation is that they are not penalised by having their claim ranked lower in the order of priority, and they may file their claims in the insolvency proceedings within the general time frame.[18]

A new rule also was introduced, with the purpose of promoting out-of-court settlements. Under this rule, prior to filing an application to challenge a transaction, the insolvency administrator is required to suggest to the creditor that it voluntarily return assets or their cash equivalent to the insolvency estate. If the creditor does not follow this suggestion within a reasonable time and the transaction is subsequently declared invalid, the creditor will suffer general consequences: the ranking of its claim may be lowered when it is included in the register of creditor's claims.

There is no regulation as to whether a registered creditor that was granted a right to challenge the debtor's transactions by the court bears the duty mentioned above in the same way as the insolvency administrator. The question remains open as to whether the registered creditor has such a duty and what the procedure and timeframe is to discharge such duty, considering that the Resolution allows the creditor to file an application to challenge a transaction before the court grants it a right to challenge the transaction. In general, the procedure and timeframe for the voluntary return of assets by a creditor at the initiative of a registered creditor that was granted a right to challenge the debtor's transactions has not been dealt with.

CHALLENGING TRANSACTIONS TO DISCHARGE OBLIGATIONS SECURED BY A PLEDGE

Under Russian law, a pledge is the main form of security, and has the purpose of discharging obligations owed to some creditors in preference to those owed to others. A number of changes to the Resolution address the need for additional clarification as to the procedure and the consequences of challenging pledges considering that it is necessary to preserve the pledge in those cases when it does not prejudice registered creditors' rights.

It was clarified at the Plenary Session of the Supreme Commercial Court on what grounds realisation of pledged assets or their transfer in settlement of a claim may be challenged as an Unfair Preference Transaction which requires proof that the creditor acted in bad faith.[19] To declare such transactions invalid, it is necessary to prove that when the transaction was made, the pledgor not only knew about the debtor's insolvency or insufficiency of the debtor's assets, but also knew that such transactions resulted in the pledgor receiving greater performance that it would have received if distributions in the insolvency proceedings were made according to the general priority of creditors' claims.

Therefore, it needs to be proven that the secured creditor knew or should have known that the discharge of the obligation owed to it led to at least one of the following two outcomes: (1) impossibility for obligations owed to first- and second-ranking creditors to be discharged and/or impossibility to cover the expenses regarding the insolvency proceedings as set out in Article 138 of the Insolvency Law, (2) performance of the obligation to pay the fine and other financial penalties owed to the secured creditor as a result of which the debtor no longer has sufficient assets to discharge its obligations to pay principal amount and accrued interest to other creditors.

At the Plenary Session of the Supreme Commercial Court, the consequences of a transaction being declared invalid when pledged assets are transferred in settlement of a claim was explained. As a general rule, pledged assets are to be returned to the insolvency estate. In addition, the portion of an obligation owed to the creditor that was discharged in preference to other creditors may potentially be included in the register of creditors' claims. This is provided that its priority may be lowered depending on whether it is proven that the creditor acted in bad faith. To the extent that the obligation was terminated without a preference, the secured creditor's claim is deemed to have been filed for registration in due time, provided that it is filed within two months from the day when the judicial act declaring the transaction invalid comes into force.

However, it is not always possible or justifiable to return pledged assets, in order to restore registered creditors' rights that were breached. New rules have been introduced to address this. The goal of these new rules is to make it possible to preserve transactions relating to a realisation of pledged assets or their transfer in settlement of a claim.

For example, if it is impossible to return pledged assets to the insolvency estate (especially when they were transferred to a third party), the pledgor does not need to return the entire proceeds from the realisation of the pledged assets. The pledgor only needs to return the portion required to discharge the obligations having priority over the pledgor's claims.

Similarly, if pledged assets were transferred to the secured creditor in settlement of a claim, the pledgor does not have to return those assets to the insolvency estate. Instead the pledgor may transfer funds in the amount required to discharge higher-ranking obligations whilst an application to challenge the transaction is being considered. In this case, the court will refuse to declare the transaction invalid.

There are other new provisions intended to preserve transactions involving pledged assets. Specifically, if a secured creditor was given in settlement of a claim certain pledged assets, it is possible to return to the insolvency estate one or some of those assets, i.e. those assets whose proceeds of sale are sufficient for a discharge of the obligations having priority over the secured creditor's claims.

It is explained in a similar manner that, if a secured creditor challenges a payment received following the realisation of pledged assets, the court will declare invalid only a portion of such payment. That portion will amount to the sum required to discharge the obligations where such discharge constitutes a preference, rather than the entire payment.

It should be emphasised that the primary purpose of challenging Unfair Preference Transactions is to protect the interests and restore the rights of other registered creditors. This explains why the Resolution clarified the rules on challenging transactions involving pledged assets being realised or transferred in settlement of a claim, and established that they may only be challenged to the extent that it is required to restore other creditors' rights.

OTHER PROVISIONS

In addition to the new provisions adopted at the Plenary Session of the Supreme Commercial Court discussed above, there are other important clarifications and additions relating to the following matters:

- correlation between Transactions aimed at causing harm to creditors and Unfair Preference Transactions based on the period within which they may be challenged;
- limiting the opportunity to challenge payments under a revolving facility agreement by the established lending limit in the Agreement;
- determining the procedure for charging mandatory interest for the use of another's money on the amount repayable to the debtor;
- correlation between restitution and retention of the asset if the transaction relating to the transfer of the asset is declared invalid; and
- other matters of proving, qualification and challenging transactions in an insolvency situation and the consequences of their invalidity.

NOTES

[1] Federal Law No. 127-FZ dated October 26, 2002 "On Insolvency (Bankruptcy)" (the "Insolvency Law").

[2] The changes were introduced by Resolution No. 59 dated July 30, 2013 "On Amending and Supplementing the Resolution No. 63 dated December 23, 2010 "On Certain Matters Relating to the Application of Chapter III.1 of the Federal Law "On Insolvency (Bankruptcy)" adopted at the Plenary Session of the Supreme Commercial Court and published on the Supreme Commercial Court's Web site on August 21, 2013 at http://arbitr.ru/as/pract/post_plenum/90954.html.

[3] Chapter III.1 of the Insolvency Law.

[4] For the purposes of insolvency laws, transactions aimed at discharging obligations include payments (para. 3 of Article 61.1 of the Insolvency Law, para. 1 of the Resolution). As a general rule, payments are treated as transactions for value (sub-para. 3 of para. 9.1 of the Resolution).

[5] Suspicious transactions are defined in para. 1 of Article 61.2 of the Insolvency Law ("Suspicious Transactions").

[6] Transactions aimed at causing harm to creditors' property interests are defined in para. 2 of Article 61.2 of the Insolvency Law ("Transactions aimed at causing harm to creditors").

[7] Transactions resulting in one of the creditors being preferred to the other creditors are defined in Article 61.3 of the Insolvency Law ("Unfair Preference

Transactions").

[8] Para. 3 of Article 6.3 of the Insolvency Law.

[9] Para. 12 of the Resolution.

[10] The draft Resolution also mentioned that the fact that the debtor's impending insolvency was widely reported in the media and that its ratings were lowered evidenced the creditor's knowledge. However, the final Resolution does not include these provisions, given that they are matters of judgment. International rating agencies' data is rarely used by Russian courts (court decisions in case No. A40-119763/10-73-565B relating to the insolvency of Mezhdunarodny Promyshlenny Bank CJSC are rare examples).

[11] Para. 12.2 of the Resolution.

[12] Para. 35.2 of the Resolution.

[13] Para. 2 of Article 61.3 of the Insolvency Law.

[14] Para. 14 of the Resolution.

[15] Many such criteria were set out in the resolution of the Supreme Commercial Court Presidium No. 7372/12 dated May 28, 2013 (*Doynikov v. Sotsgorbank*).

[16] Para. 35.3 of the Resolution.

[17] Para. 31 of the Resolution.

[18] Para. 29.2 of the Resolution.

[19] Para. 29.3 of the Resolution; in this case, the basis for the challenge is the criteria set out in subpara. 5 of para. 1 and para. 3 of Article 61.3 of the Insolvency Law.