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ClientAlert

Financial Restructuring and Insolvency

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Amendments to Insolvency Law

In December 2014, amendments were introduced to the Federal Law "On Insolvency (Bankruptcy)" No. 127-FZ, dated 26 October 2002 ("**Insolvency Law**"). This alert analyses some of the amendments that are of crucial importance to all categories of debtors.[1] These include in particular:

- changing the procedure for initiating insolvency proceedings by debtors and creditors being credit organizations, with the aim to restrict the options of debtors and give advantages to creditors;
- enhancing the protection of secured creditors and vesting them with additional rights in the course of receivership; and
- providing creditors, with some exceptions, with the option to challenge debtors' transactions independently.

Altogether, the developments introduce efficient tools to protect the interests of creditors being credit organizations, especially whose claims are secured by a pledge.

Conditions for declaring a debtor insolvent

The minimum amount of outstanding creditors' claims admissible as a ground to initiate a legal entity's insolvency proceedings has been risen. It is to be no less than RUR 300,000[2] instead of the former amount of RUR 100,000. For strategic enterprises and organizations, and natural monopolies, the threshold is to be RUR 1,000,000[3] instead of the former amount of RUR 500,000.

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1 The amendments were introduced by the Federal Law No. 482-FZ, dated 29 December 2014, "On the Introduction of Amendments to the Federal Law "On Insolvency (Bankruptcy)" and to the Administrative Offences Code of the Russian Federation" ("Law No. 482-FZ"), which came into effect on 29 January 2015, and apply to certain insolvency procedures introduced after the above date and to insolvency cases initiated thereafter (with some exceptions). Several general amendments analyzed in this alert were introduced by the Federal Law No. 432-FZ, dated 22 December 2014, "On the Introduction of Amendments to Certain Legislative Acts of the Russian Federation and on the Recognition of Certain Legal Acts (Provisions of Legal Acts) of the Russian Federation as Lapsed" ("Law No. 432-FZ"), which came into effect on 23 December 2014 (with some exceptions).

2 Article 6 (2) of the Insolvency Law. See footnote 13 for the specifics of these amendments coming into effect.

3 Article 190 (4), Article 197 (3) of the Insolvency Law.

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A creditor filing an insolvency petition against a debtor

The conditions that credit organizations must meet to initiate insolvency proceedings against their debtors have been simplified.

A creditor being a credit organization[4] becomes entitled to file an insolvency petition against a debtor from the date on which the debtor starts displaying indications of insolvency.[5] If that is the case, unlike other creditors to civil law obligations, credit organizations are not required to confirm the validity of their claims by a binding and enforceable court decision.

In order to exercise this right a credit organization must publish a notice of its intention to file an insolvency petition against the debtor in the Unified State Register of Information about the Facts of Legal Entities' Activity[6] ("**Legal Entity Information Register**"). Such publication must be made at least fifteen calendar days prior to the date of filing the relevant petition with the court.[7]

The notice publication rules will apply as of 1 July 2015 or an earlier date if the appropriate technical capability is available. Pending these rules coming into effect, a credit organization will only need to notify the debtor and other creditors of its intention at least thirty days before filing an insolvency petition.[8]

Debtor's insolvency petition

A number of provisions intended to preclude the debtor's right to select an insolvency administrator or a self-regulated organization of insolvency administrators ("**SRO**") have been introduced.

In the past, a debtor could arrange for the appointment of a loyal insolvency administrator, the practical result of which was that the debtor, acting through that insolvency administrator, largely controlled the procedure of insolvency and the sale of assets.

It was the case, for example, that, immediately after the adoption of a decision on its liquidation, the debtor could file an insolvency petition and, as part of the simplified procedure of insolvency of the debtor in liquidation, the court would appoint the receiver proposed by the debtor.[9] If there were no serious offenses of law on the part of that receiver, other creditors' ability to replace the receiver was significantly limited. In the case of an ordinary insolvency procedure, the creditors had an opportunity to replace the insolvency administrator in the course of the next insolvency procedure only if their votes exceeded the number of the creditors' votes loyal to or controlled by the debtor.

To eliminate such a situation, the legislator has introduced a number of provisions.

Firstly, the legislator has introduced provisions creating a debtor's duty to report the intention to file an insolvency petition. A debtor is now required, at least fifteen calendar days before the date of filing the insolvency petition, to publish a notice of such intention in the Legal Entity Information Register.[10]

The notice publication rules will apply as of 1 July 2015 or an earlier date if the appropriate technical capability is available. Pending these rules coming into effect, a debtor will only need to notify all creditors of its intention at least thirty days before filing an insolvency petition.[11]

This provision makes it possible for creditors, whose claims are confirmed by court decision, as well as for credit organizations, who notified on their intention in advance, to go, after notification from the debtor, to court ahead of the debtor.

Secondly, the option for a debtor to nominate an insolvency administrator has been ruled out. Such nominee is to be proposed by a SRO, which is identified through a random selection in accordance with the procedure established by the Ministry of Economic Development of Russia.[12] Currently, such procedure has not yet been developed,[13] and the SRO is to be

4 In our view, for the purpose of the bankruptcy legislation the notion of "creditors being credit organizations" should also include "foreign credit organizations" (by virtue of Article 1 (5) of the Insolvency Law). The opposite interpretation would result in unjustified discrimination of non-Russian creditors.

5 Article 7 (2, Para. 2) of the Insolvency Law.

6 http://www.fedresurs.ru/

7 Article 7 (2.1) of the Insolvency Law.

8 Article 4 (3) and (4) of Law No. 482-FZ.

9 Articles 224- 225 of the Insolvency Law.

10 Article 37 (4, Para. 2) of the Insolvency Law.

11 Article 4 (3) and (4) of Law No. 482-FZ.

12 Article 37 (5) of the Insolvency Law.

13 It should be noted that, pursuant to Article 4 (5) of Law No. 482-FZ, the coming into effect of the provision on raising the amount of outstanding claims admissible as a ground to initiate insolvency proceedings (Article 33 (2) of the Insolvency Law) is dependent on the date of approval of the procedure by the Ministry of Economic Development of Russia. The provision on the amount of creditor claims will only apply after the expiration of sixty days from the date of approval of the SRO selection procedure. However, this regulation is in conflict with the effective date of Article 6 (2) of the Insolvency Law, which also establishes a new minimum amount of outstanding claims (29 January 2015). Additionally, it is still unclear what has prompted the need to link the effective date of the provision on the amount of creditor claims with the date of approval of the procedure for selecting a SRO.

selected by a court.[14] In practice, the courts have full discretion in making this selection and need not give any reasoning for their decision.

However, in practice, a debtor's ability to secure the selection of a nominated insolvency administrator is not precluded. Such ability exists, for example, where an insolvency petition against the debtor is filed and the selection of an insolvency administrator is made by a creditor affiliated with the debtor. For this purpose, such creditor may obtain a debt recovery decision against the debtor in courts of general jurisdiction (for example, by joining an individual as co-defendant), because information about civil cases is hard to monitor and is not always publicly available.

Changed position of secured creditors

Additional voting rights

In the past, one of the issues that secured creditors faced was that they were not entitled to vote on matters of appointment and removal of an insolvency administrator in the course of receivership. The result was that unsecured creditors, whose claims in value terms were insignificant against secured creditors' claims, could, by obtaining removal or discharge of the receiver, secure the appointment of a receiver loyal to them and thus enhance their control over the sale of assets. They could also attempt to delay the procedure for selling the object of pledge by attempting to change to the external administration procedure.

The amendments have addressed these issues. Secured creditors will now be able to vote on matters of:

- selecting an insolvency administrator or SRO, one of the members of which will be appointed as such administrator;
- filing a petition for removal of the insolvency administrator to a court;
- filing a petition for termination of the receivership and changeover to external administration[15] to a court; as well as
- the matters of the first creditors' meeting where it has not been held within the established timeframe.[16]

Rights in a sale of pledged property

The amendments provide for acceleration of the pledged property sale procedure by specifying that the terms of sale shall be defined by the creditor in insolvency proceedings independently, without participation of the receiver, as it was previously required.

A secured creditor shall specify not only the initial sale price for the object of pledge, the procedure and the terms of the auction, but also the procedure and terms of arranging for safekeeping of the object of pledge. Such information is required to be entered in the Unified Federal Register of Insolvency Information ("**Insolvency Register**") at least fifteen days prior to the date of commencement of the auction. The receiver and the parties involved in the insolvency proceedings are entitled to challenge such terms within ten days of entering information in the register.[17]

A secured creditor is entitled to acquire the pledged property in the course of an auction of property through public offer. The creditor may do so at any stage of an auction when the price is reduced in the absence of any auction bids for the price announced for such stage.[18]

Socially significant objects, cultural heritage objects, and utility infrastructure objects – public offer

According to the provisions previously in force, if such objects have not been sold at an auction in the form of competitive bidding, they would pass to municipal ownership. Now a creditors' meeting or creditors' committee may decide on the manner of the further sale of property through public offer.[19] Bidders or persons who have made an offer must assume an obligation to provide for the proper maintenance and use of the objects in accordance with their intended purpose, and other obligations established by relevant legislation. Unsold objects shall be transferred to municipal ownership.

The regulation provides secured creditors with more opportunities to sell property, especially in a situation where the initial purchase price happens to be considerably higher than the market price, and avoids gratuitous transfers of property to municipal ownership.[20]

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14 Article 4 (6) of Law No. 482-FZ.

15 Article 12 (1) of the Insolvency Law.

16 Article 73 (3) of the Insolvency Law.

17 Article 138 (4) of the Insolvency Law.

18 Article 138 (4.2) of the Insolvency Law.

19 Article 132 (4.1) of the Insolvency Law.

20 In the past, courts would refuse compensation for property that was transferred to municipal ownership. In doing so they did not apply the Resolution of the Constitutional Court of the Russian Federation No. 8-P, dated 16 May 2000, which allows such compensation, explaining that this Resolution was adopted in respect of the inoperative procedure for transferring property, which was provided for by the lapsed Federal Law No. 6-FZ "On Insolvency (Bankruptcy)", dated of 8 January 1998 (Resolution of the Federal Commercial Court (the "FCC") for the Volgo-Vyatsky Circuit No. A39-1161/2006, dated 7 September 2009, Resolution of the FCC for the North-Western Circuit No. A56-29143/2007, dated 30 June 2008). With the adoption of the amendments to the Insolvency Law, the possibility for the gratuitous transfer of socially significant objects, cultural heritage objects, and utility infrastructure objects to municipal ownership became limited.

Joint sale of pledged and unpledged property

In the past, the Supreme Commercial Court of the Russian Federation ("**SCC**")[21] and the Supreme Court of the Russian Federation ("**SC**")[22] noted the necessity to take into account secured creditors' rights and legitimate interests where pledged or unpledged property is being sold at an auction as a single lot. However, it was undecided whether a secured creditor had the unconditional right to block the sale of pledge property as a single lot.

The amendments enshrine the need for the secured creditor's consent to the procedure and terms of selling the property as a single lot.[23] This amendment is designed to protect secured creditors from situations where a joint sale of pledged and unpledged property would not result in selling the pledged property with maximum efficiency.

Secured creditors' rights upon substitution of assets

In its practice, the SCC[24] has adopted the view that, following a substitution of debtors' assets, the pledge of property contributed to the share capital of the established company would not cease and, in the absence of the secured creditor's consent, only the pledgee would be replaced. Such mechanism was inefficient, because shares in the established company whose property was in pledge were unappealing and frequently remained unwanted.

The amendments establish a new procedure. It proposes, instead, the creation of a pledge over the shares of the established legal entity. The value of the shares to be pledged must be proportionate to the market value of the pledged property contributed to the share capital.[25]

According to the new procedure, a buyer will be able to acquire shares in the company whose property is unencumbered and attract financing secured by the pledge of such property.

For the purposes of enhancing the guarantee for creditors' rights, an external administrator or receiver shall be the sole executive body of the established company. They can appoint other person to this position upon the decision of the creditors' meeting. The creation of a collegial management body and approval of the company's articles of association are within the competence of the creditors' meeting or the creditors' committee. The established company is not entitled to dispose of property contributed to its share capital until all of its shares are realized in the course of the insolvency procedures.

Rights to challenge transactions

In the past, the Insolvency Law provided[26] that the right to challenge transactions made by the debtor in anticipation of the insolvency was vested in the insolvency administrator.[27]

Under the amendments, the legislator has drastically changed the former provision and vested the creditor with the right to challenge transactions if the amount of its registered claim exceeds 10% of the total amount of the registered indebtedness before the creditors, excluding the amount of claims of the creditor whose transaction is challenged, and of its affiliated persons. This provision applies to the insolvency procedures introduced before the effective date of the amendments.[28]

Procedure for challenging creditors' claims

To make the procedure of challenging creditors' claims more transparent and to encourage filing of claims at the stage of supervision, the amendments have changed the procedure for raising objections against creditors' claims in the course of external administration, financial rehabilitation and receivership.[29]

Creditors shall submit their claims not only to the court but to the insolvency administrator as well.[30] The latter must, within five days of the date of receiving an application, publish information in the Insolvency Register about such

21 Resolution of the SCC Presidium No. 14016/10, dated 30 July 2013 (OJSC Sberbank of Russia case).

22 SC Ruling No. 306-ES14-60, dated 22 October 2014 (OJSC Bank Uralsib case).

23 Article 138 (4, Para. 3) of the Insolvency Law.

24 Resolution of the SCC Presidium No. 18749/13, dated 25 March 2014 (OJSC AKB Rosbank v OJSC Resurs-Invest, OJSC Invest-Resurs).

25 Articles 115, 141 of the Insolvency Law.

26 Article 61.9 (2) of the Insolvency Law.

27 In its practice, the SCC interpreted the provision as allowing the registered creditor to challenge transactions if the court grants its 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 (Clause 31 of Resolution of the Plenary Session of the SCC No. 63, dated 23 December 2010, "On certain Matters Relating to the Application of Chapter III.1 of the Federal Law "On Insolvency (Bankruptcy)" as amended by Resolution of the Plenary Session of the SCC No. 59, dated 30 July 2013; see our Alert for November of 2013).

28 The amendments were introduced by Article 7 (7) of Law No. 432-FZ and came into effect on 23 December 2014.

29 The amendments relate to external administration (Article 100 of the Insolvency Law), financial rehabilitation (Article 81 (5) of the Insolvency Law), and receivership (Article 142 (1) of the Insolvency Law). It should be noted that the procedure for raising objections against including claims in the register of creditors' claims at the stage of supervision is not changed. Information about receipt of creditor's claims is not to be published and objections may be filed with court within fifteen calendar days of the date when the time limit for filing creditors' claims expires (Article 71 (2) of the Insolvency Law).

30 Article 100 (1) of the Insolvency Law.

application and make it possible for the parties involved in the insolvency proceedings to acquaint themselves with its contents.[31] Objections against such claims may be filed with court within thirty days of the date of entering the information in the Insolvency Register.[32]

The amendments also provide for certain adverse consequences for the creditor if it makes its claims in the insolvency procedures after the stage of supervision. If the grounds for this delay are found to be unreasonable, the court may impose on the creditor a liability to reimburse it for the costs of notifying creditors about the making of that claim.[33]

The above provisions apply to the creditors' claims filed after 1 July 2014.[34]

Request for information by insolvency administrator

An insolvency administrator is vested with additional rights to request (i) information about persons included in the debtor's management bodies, controlling persons, property belonging to them, counterparties and obligations of the debtor; and (ii) information constituting an official, commercial or bank secret.[35]

Other amendments

A number of the amendments establish the rules already adopted in the SCC practice,[36] on the accrual of moratorium interest in insolvency and the application of sanctions against solvent debtors who have filed an insolvency petition with the view to obtaining unlawful benefits from insolvency procedures.[37]

Conclusion

The adopted amendments are intended mostly to protect the interests of creditors being credit organizations and provide them with several efficient tools to recover debt in the event of insolvency. The amendments are relevant to both pending and new insolvency proceedings, which grow in number amid the financial crisis. In view of the importance of these amendments, close attention should be given to planning and adjusting the strategy and tactics to be employed in the handling of insolvency cases subject to the new rules.

31 Article 100 (2) of the Insolvency Law.

32 Article 100 (3) of the Insolvency Law.

33 Article 100 (7) of the Insolvency Law.

34 Article 21 (7) of the Federal Law No. 379-FZ, dated 21 December 2013, "On the Introduction of Amendments to Certain Legislative Acts of the Russian Federation".

35 These rules also apply in insolvency proceedings initiated before 29 January 2015 (Article 4 (10) of Law No. 482-FZ.)

36 Resolution of the SCC No. 88, dated 6 December 2013, "On the Accrual and Payment of Interest under Creditors' Claims upon Insolvency" (see our Alert for April of 2014).

37 Article 63 (6) of the Insolvency Law.