European Insolvency Law: Current Issues and Prospects for Reform

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Chapter 2

Russian Insolvency Law: The Mechanism for the Creditors' Protection or the Opportunity to Raid the Company?

Olga Lvova

Introduction

Effective insolvency law should provide protection of both creditors' and debtors' rights because of its necessity for normal economic development of the country. First of all, due to insolvency provisions creditors should be protected from unfair actions of the debtor who may try to withdraw assets from the indebted company and, therefore, with the result that creditors get nothing back. In case of deliberate bankruptcy the existing legal principle "one ruble equals one voice" may give creditors (who are friendly to the debtor due to an artificially enlarged volume of obligations) the opportunity to abuse it during voting at the creditors' committee. Therefore the committee may take the decision, beneficial for this friendly creditor while the others interests may be harmed. Secondly, insolvency law usually contains mechanisms providing the defense of one creditors' interests against unfair actions of another creditors during this so-called "competition of creditors" for the debtor's assets. The last type of insolvency law functions here concerns the debtors' protection from unfair actions of creditors and from third parties wishing to acquire its assets.

In Russia, practice demonstrates two opposite ways of insolvency law enforcement, which, on the one hand, can serve as a real mechanism for creditors' interests protection but, on the other hand, provide a legal opportunity to seize the company.

Under current Russian law "On Insolvency (bankruptcy)"[1] there are three main mechanisms of creditors' rights protection:

1 Federal law No.127-FZ at 26.10.2002 «On insolvency (bankruptcy)» (last amendment at 17.07.2009 by the law №145-FZ).

1. Transaction avoidance.

2. Subsidiary liability of the debtor's management, board members and shareholders for failure to take measures for asset preservation, creditors satisfaction and filing for bankruptcy when its features have appeared. Upon being found liable the described persons can be required to settle the shortfall if the assets are not enough to satisfy creditors during the insolvency procedure.

3. Early filing for the debtor's bankruptcy to have an opportunity to choose the Insolvency Administrator. In Russia the result of a bankruptcy procedure to a large extent depends upon *who* was the initiator of the court procedure due to the potential to suggest a candidate for insolvency administration.[2] Therefore, early filing in respect of the indebted company bankruptcy is the way for creditors to have a loyal administrator who has a wider range of legal authority than creditors. For instance, nowadays only an insolvency administrator can void transactions.[3] He is also entitled apply to the court for additional measures in respect of assets safety protection.

Transaction avoidance

The first type of transactions that can be avoided are the so-called "*suspicious*" ones.

The first type within this category relates to transactions with unfair counter-performance made during the one year before filing for bankruptcy. It means that the debtor's assets in such deals were sold at a price which was obviously more or less than market level.

The second type of suspicious transaction relates to those intended to causing harm to creditor's interests. They also should have been be closed within 3 years before bankruptcy. To void such a transaction the insolvency administrator as the only entitled person should prove that:

1. causing harm to creditor's interest (which really took place) was the purpose of the debtor. One of the indicators here is that during the transaction assets were acquired or sold for free.

2. the other party to the deal knew or should have known about the aim of the debtor to cause harm. Proofs can be the following:

2 *Ibid*. – Articles 37, 39.

3 It should be noticed that before this legal amendment creditors had similar right of transaction voidance too, but they very often abused it and that is why the right was cancelled.

- this "other party" was an interested, affiliated company or even its director who controlled the debtor;
- it is assumed that the partner knew that the company was insolvent if there was information in the mass media about filing for its bankruptcy – therefore, the obligations under this voidable transaction could not have been fulfilled. Interesting that if the fact of "having an interest" has been proven, the logical conclusion about its awareness of the real debtor's financial position should not been proven (there is a presumption of guilt). It seems right because such persons in reality usually have access to financial and accounting documents of the controlled company. The positive thing for creditors here is the opportunity to recover a debt from this main controlling company in a case where assets belonging to the debtor are lacking.

3. Some kind of mixture of above mentioned two forms: if the transaction was formally fair and made at the market price but the other party knew that the assets participating in the contract were absent – such deal also may be nullified.

The second type to be voided relates to *transactions giving preference* to one creditor over others. It means that through this deal such a creditor tried to get an unfair additional security in respect of an existing obligation in advance to debtor's bankruptcy. As a rule these are transactions between an indebted company and banks, demanding more security in respect of pledged immovable property. However, taking into account current legal provisions, such banks should remember the possibility of the transaction becoming invalid in case of bankruptcy when everything obtained by the bank as the result of the deal will come back to the bankrupt's estate to be distributed among all creditors. Some kind of penalty for creditor participation in an invalid transaction is the latest turn to get something back in bankruptcy procedures. The equity of such a penalty is the controversial question. There is an opinion[4] that it is unfair: may be a creditor really wanted to help the insolvent company and agreed to acquire its assets at the higher price or gave it some money taking into consideration that insolvency in the modern economic world is quite often but a temporary thing. Such specialists say: "Why should such a kind creditor be the last in the turn?" Under the opposite view, pragmatists don't believe in such wastefulness of creditors and think that this measure should make creditors think to get more in case of indebted business

4 A. Goloviznin, S. Zabolotsky, "About the problem of voidance of the debtor's suspicious transactions", (2011) July No.7 Laws of Russia: experience, analysis, practice.

partner bankruptcy. In conclusion it should be emphasized that the above mentioned amendments of Russian legal framework provided mechanisms for creditors' interests to be protected to a greater extent in comparison with the former edition of Law.[5]

Reasons for bad performance of liquidation proceedings

However according to different estimates,[6] in Russia *creditors typically receive only 5-7% of their claims* at the end of bankruptcy procedures. There are some main reasons:

1. Assets of distressed companies are sold at low prices. Taking into consideration that the company has significant debts the potential customer wants to pay the lowest price for its assets. In the same time the seller (which is the owner of the indebted company) says that his financial contribution in it is high and offers the sale price at a pre-crisis level. Some problems with setting a price can arise here but in reality distressed assets are bought by sustainable companies majorly financed from equity – without debt financing. The specific feature here is the short term process of making a deal because the accounts payable of the company-seller may grow at a fast tempo and this company will try to sell assets before default in payments occurs. In such cases the legal due diligence conducted by customer concerns only acquiring assets and assessment of potential losses in case of the transaction avoidance in future. The legal due diligence can be also provided by the seller's initiative to find out risks and whether to increase or refuse to allow a decrease in the price.

Anyway, in making such a transaction, the buyer should remember that: it can be voided in case of a seller's bankruptcy or it can arouse the interest of the tax authorities which can impose a tax (or fine) upon the deal made at a price lower or higher than market for 20%. The amount of tax and fine is counted from the market level of similar transactions.

Nevertheless, in Russia the former liquidity crisis made some companies sell assets almost for free. Ninety percent of the shares of the investment bank "KIT finance" were acquired by the consortium of Russian railways and investment group mainly dealing with diamond extraction at the price of 100 rubles (2.5 Euro). One of the managing partners of this bank "KIT finance" said in the interview: "In fact it was

5 Federal law No.6-FZ at 8.01.1998 "On insolvency (bankruptcy)".

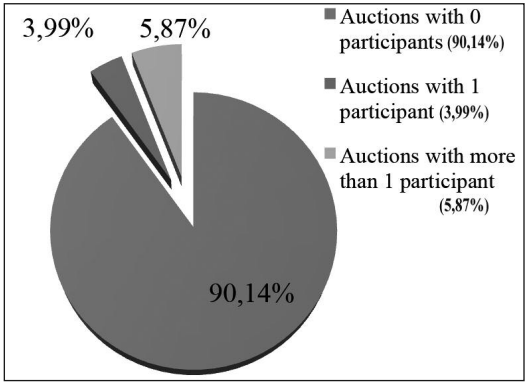
6 See: Y. Sakhapov, "On effectiveness of liquidation proceedings", (2011) No.5(54) Insolvency Administrator magazine. Available at: <http://tatarstan.arbitr.ru/files/pdf/Об%20эффективности%20проведения%20конкурсного%20производства_0_0.pdf> (last viewed 28 June 2012).

nationalization of the bank. The state did not presented money to "fat bankers" and I personally turned from the simple Russian millionaire to simple Russian waged manager and lost about $1.5 mln".[7] In another example, the main Russian bank and state corporation "Vnesheconombank" bought 98% of "Svyaz' bank" for 5000 rub (125 Euro).

2. The other reason for the small output of bankruptcy procedures for creditors is the *repeated pledges for the one asset*. The technology here is to rub or change one figure in the inventory number of some production tool with the result that the numbers in various documents will differ and in other bank it will be absolutely other machinery to be pledged one more time. As a result in case of bankruptcy there will be many opposite creditors secured in fact by the same estate. The bad thing for creditors here is that claims of the next collateral holder will be satisfied from the proceeds of a pledged property sale only *after satisfaction of any former* collateral holder's claims.

3. The third reason is *unfair auctions* during liquidation procedures. Often the asset should be sold to the particular customer at a definite price which is lower than the market price. For this insolvency administrator, being loyal to the customer, conducts some consecutive auctions during which – besides many other real customers – there are always two fictitious buyers competing in price setting. As a result, during the final stage the "proper" customer buys the asset at the lowest and a priori determined price.

On the diagram you can see that in reality even more often the first stages of sale are realized without participants at all – 90% of auctions are with zero participants.



7 "The biggest shareholder of «Rostelecom» was nationalized", CNews, 9 October 2008. Available at: < http://www.cnews.ru/top/2008/10/09/krupnejshij_aktsioner_rostelekoma_natsionalizirovan_za_100_rub__322221 > (last viewed 10 June 2012).

There was more than one participant only in 6% of cases. As a rule, the real purchase is made during public offering of the asset in accordance with the above mentioned mechanism. Here some other barriers for fair auctions work: people can't see the asset they are going to buy because of the limited opportunities of electronic trading platform, often they can not find in reality the address of the auction, etc.

The other reasons for the poor performance of liquidation procedures can be the following:

- An absence of united criteria for the conversion of claims expressed in foreign currency into the national one. Nowadays all claims in bankruptcy procedures should be expressed in rubles but there are no any specifications as to what course (actually what period of time?) should be used.
- The debtor itself can substantially slow down the proceeding by producing various opposing demands before the court.
- Before filing for the debtor's bankruptcy the creditor should apply for an enforcement proceeding that is often just a waste of time during which debtor can withdraw assets.

Asset stripping as a specific problem

Asset withdrawal is a very actual problem in Russia.

One of the widespread schemes here is when the debtor withdraws an asset by *contributing it to the equity capital of other legal entities*. Hence property rights are transferred and after a future merger or acquisition of this legal entity the assets will hardly be included in bankruptcy estate due to the concept of the final "innocent buyer". To prevent it and other actions of the debtor's management, a creditor can just try to monitor the financial activity of its debtor or be the first who files for its bankruptcy. Before the court a creditor can try to void transactions through a loyal insolvency administrator. In other situation *banks can withdraw funds through sponsoring their management's ambitious projects*, which soon can become unprofitable. In the case of the insolvency of such a business project the bank can be turned from creditor into debtor. Practice shows that in reality only 3% of all criminal actions in respect of asset stripping come to trial whereas conviction in such cases is an exception from the norm.[8]

8 A. Samsonova, "Ways of asset withdrawal prevention before bankruptcy proceeding", (2010) No.2, Judicial work in credit organization.

Asset stripping is almost an essential part of criminal bankruptcies along with fraud, wastage, abuse of rights, made deliberately by the debtor. *Deliberate and fictitious bankruptcies* are used for getting out of debt during an insolvency procedure where creditors get nothing. The mechanisms here are the following:

- a transfer of all of a company's assets by its director to his own charitable fund by a contract of charitable contribution. Such a transfer makes the company insolvent because it can not fulfill its obligations under existing contracts.
- misapplication by wasting money on activities which are not linked with the main economic activity of the company;
- giving commercial credits to other legal entities at an interest rate lower than the percentage at which the first company (future debtor) has borrowed money;
- excessive expenses to soon make a company insolvent;
- making deals which are obviously unprofitable and unreal: for instance, when the sum under a contract is even higher than the book value of a company's assets, making impossible further commercial activity of the company;
- a latent form of embezzlement: early payment of a debt to affiliated creditors, being the guarantee under a doubtful transaction, etc.

Why creditors file for bankruptcy of assetless debtors?

In a case when all assets have been taken out of the company some creditors will still file for its bankruptcy. The probability of creditors getting something back is absent but creditors can have another motivation.

1. If during a bankruptcy procedure obligations were acknowledged as bad and hopeless, then the tax authorities can write it off after debtor's liquidation. However this opportunity will be profitable only if the sum of debt is large because a creditor will spend his own money on the bankruptcy procedure of an assetless debtor. But these expenses can diminish profit taxes and this variant suits large-scale creditors. After a bankruptcy procedure a creditor can also apply to the court for compensation of court costs in bankruptcy proceeding.
2. The other reason is that a creditor is affiliated with the debtor and pursues some other goals – not to get money back. This scheme may be a part of some long-term strategy.

3. At last a creditor can just not think about this feature of the debtor. For example, the natural monopoly company "Gazprom" recently filed for the bankruptcy of about 1500 debtors during one week.[9]

Protection of the debtor's rights from creditors

Despite the described facts that unfair debtors abuse their rights, in contemporary Russia the threat of the company being seized by its creditors through applying for the commencement of a bankruptcy mechanism still exists. A creditor acquires a significant part of the debt and becomes the main creditor. Then under the threat of bankruptcy where he would have the major vote at the committee, or during bankruptcy proceedings he grabs the firm's most expensive asset (real estate, land, etc.). Afterwards he usually sells it at market price having profited up to 500%.[10] The current Criminal code does not contain a special offence called "corporate raiding" which would anyway be hard to prove.

Conclusions

Current Russian Insolvency Law is more oriented to creditors' rights protection than before. It contains a modern basis for transaction avoidance and other ways to influence the process, that increase the chances to clear debt. At the same time, a bankruptcy mechanism still can serve both as a mean of a hostile takeover of a debtor's assets and a waste of time by creditors trying to get money back.

The existence of quite widespread schemes by unfair creditors or debtors to avoid the law and abuse rights shows the necessity of the further modernization of the Insolvency, Corporate and Criminal legal framework.

9 A. Yukhnin, "Development of Russian insolvency institute", (2012) 29-31 May, Materials of the 10th annual international conference "Public Administration in the 21st century: agenda for Russian authorities", Section "Enhancing Financial and Economic Management as a Long-Term Growth Factor".

10 Alla Bobyleva (ed), Management In The Unsustainable Economy: Strategy and Instruments (2011, Moscow University Press, Moscow).

Chapter 7

Analytical Review of Informal Workouts and Non-Insolvency Procedures in Russia: Examples of Failure and Success

Alla Bobyleva

A specific feature of the Russian institution of bankruptcy is the large number of informal workouts and non-insolvency procedures, even though the vision of their prevalence may vary due to the discrepancy in understanding of these terms. The most common out-of-court agreements between the management of the troubled company and its creditors are understood as the informal workouts. But from our point of view informal workouts also can include the agreements for state support to a particular company. Sometimes "grey schemes" for the implementation of actions aimed at the use of the institution of bankruptcy for repartition of the property, raider captures, nonfulfillment of financial obligations can also be considered as Informal Workouts.

Informal workouts are significant in Russia. This is due to a number of factors: high influence of the state and municipal enterprises, businesses with the state share, "strategic" enterprises; a large number of giant companies and holdings, as well as the economic situation in the country as a whole, where the proportion of loss-making companies reaches one third.

The importance of informal workouts in Russia and their intensive usage in insolvency situations causes the necessity of the criteria for identification of the informal workouts success. Commonly used criteria are not transparent and cause debates among scholars and practitioners.[1] We suggest the following criteria for the identification of the success of informal workouts:

- prevention of bankruptcy of "strategic" companies;
- elimination of expensive procedures of bankruptcy;
- supporting the value of business of troubled companies;
- reduction of the business recovery time;
- more complete satisfaction of requirements of all stakeholders.

1 Alla Bobyleva (ed), Management In The Unsustainable Economy: strategy and Instruments (2011, Moscow University Press, Moscow).

Statistical data allows us to make a conclusion that there is a high success of informal workouts in Russia. The number of companies in the risk group (with losses) exceeds 30%, the payables that are not paid in time are 50% of the total accounts payable[2] but the number of bankruptcy cases, initiated in court, is less than 1% of the existing companies.[3] It means that many issues associated with insolvency are solved through informal workouts. However, there is a question: does the existing practice of informal workouts in Russia increase the viability of the business or give only a temporary respite?

In accordance with the 2008-2009 Russian Crisis Programs[4] a significant part of the Federal budget was directed to the selective support of the giant companies. For example, in 2008-2009 support was provided to JSC *AvtoVaz* in the amount of approximately US $1billion in the form of interest-free loans. But *AvtoVaz* spent 97% of these funds for execution of current obligations. The company did not get under the procedures of bankruptcy, but the experience of the late twenty years shows that it is likely that very soon *AvtoVaz* will ask the government for some support again. Thus the question as to whether this workout can be considered successful is controversial. Other examples of informal workouts with the help of the Government are:

- the additional funding of the JSC Russian Railways equal to US $2 billion and increasing its stock to the amount of US 100 mln;
- Magnitogorsk Steel Company has been released from the payment of some taxes for a large new project, government guarantees were given and company increased its debt in spite of aggravation of economic indicators;
- Aviation (Aeroflot, Siberia, Transaero) was supported in the form of direct contracts with fuel suppliers and bank loans at rates lower than market, the moratorium on tariffs for using foreign aircrafts.

As a result, these companies overcame the crisis and continue to exist, although the situation with their debts is still very serious. In 2011 the financial leverage in the

2 Russia in figures 2011. (2011, Rosstat, Moscow).

3 Official statistics of the Supreme Commercial Court of the Russian Federation, available at <http://arbitr.ru/press-centr/news/totals/> (last viewed 11 June 2012).

4 The program of Crisis Measures of Russian Government for 2009, available at <http://www.rg.ru/2009/03/20/programma-antikrisis-dok.html> (last viewed 10 June 2012).

most stable aviation company Aeroflot is 2.5,[5] in Siberia – 11,[6] Transaero – 19[7] (whereas normal meaning is 2). One can see that the Government support does not allow these companies to undergo bankruptcy but as a rule they stay unsustainable.

In less monopolistic industries – construction and agriculture, workouts with the participation of the state are often even less successful. This can be explained by an inefficient mechanism of transferring budgetary funds, based on the idea of injecting money into the banks and issuing credits on preferential conditions to the companies: in practice, most of the funds were used inadequately: they were invested by the banks into financial instruments and did not reach the real sector.

The specific measures in workouts are used for so called strategic enterprises. Government policy towards strategic enterprises mainly consists of the following:[8]

- writing-off of bad debts;
- allocation of subsidies, preferential financial and commodity loans, tax credits (tax holidays), guarantees, debt restructuring;
- preventing the cut-off of companies from energy sources;
- direct allocation of funds in the regional budgets for "budget loans";
- special arrangements for opening and maintaining the bankruptcy proceedings for such companies.

The above measures show that such workouts of strategic enterprises may help as protection against collapse, prevent cessation of activities, reduce the risk of massive layoffs. But such workouts do not create the conditions for the strategic restructuring, or independent development of strategic companies. A lack of transparent criteria for listing in the group “strategic companies” enhances the possibility of lobbying, corruption in budget allocation and increases the financial and economic instability of the economy as a whole.

The crisis of 2008 gave new impetus for the development of workouts with the help of State Corporations. For example the State Corporation “Rostehnologies”

5 “Aeroflot” Annual Report, available at <http://yellowdog.ru/works/w/annual_report_aeroflot> (last viewed 5 July 2012)

6 “Siberia” Annual Report, available at <http://s.rts.ru/content/annualreports/669/1/mrsk-sibiri-godovoy-otchet> (last viewed 5 July 2012).

7 “Transaero” web site, available at <http://transaero.ru> (last viewed 5 July 2012).

8 Alla Bobyleva (ed), Management In The Unsustainable Economy: strategy and Instruments (2011, Moscow University Press, Moscow).

consolidates 443 companies. The main aim of State Corporation is ensuring financing. So, financing of "AvtoVaz" is organized by providing interest-free loans by "Rostehnologies", which gets resources as subsidies from Federal Budget. It is difficult to imagine that such a scheme of workout can give good result in the long term. It generates relationships of constant dependence, makes "AvtoVaz" confident that the state will always come to the rescue and does not stimulate an initiative of company management to implement some innovative break.

It is logical to assume that the number of informal workouts with the help of agreements on mergers, divisions should increase in a crisis. However, in Russia these processes have a decreasing trend. According to KPMG, this market dropped more than five times during the second part of 2008.[9] Nevertheless, the integration of the Russian aircraft manufacturing company *JSC RSK MIG* into the United Aviation Company *JSC OAC* is an example of a successful informal workout of this kind. The company's losses were reduced from 800 million in 2009 to 80 million in 2011, the capital structure of the company has become more balanced, and the company has a stable portfolio of orders now.

The number of small businesses in Russia is approximately one-third of all existing companies. Our empirical study confirms that the largest number of bankruptcies in the last years in Russia have concerned small and medium-sized businesses. Informal Workouts among these firms were not effective enough. More successful were firms who have been integrated into the activities of large enterprises.

Ten to twenty years ago "grey schemes" for workouts were very popular in Russia. The instruments of such "grey schemes" were: agreements for non-payment of accounts receivable, purchase of "cheap" assets, arising as a result of the aggravation of financial situation; bankruptcy "by agreement" of the parties, etc. About 12.5% of assets were involved in such forms of informal workouts while corporate raids enabled a profit of up to 500%.[10] During the last ten years such activities have significantly decreased but still remain.

Our study shows that the main instruments for Informal Workouts in contemporary Russia are assignments for a delay of payments, changes in the capital structure, as well as direct state support to the selected companies.

9 KPMG Research, available at <http://kpmg.ru/russian/supl/publications/surveys/MA_Survey_2009_ru.pdf> (last viewed 15 June 2012).

10 Alla Bovyleva (ed), Management In The Unsustainable Economy: strategy and Instruments (2011, Moscow University Press, Moscow).

Delay of payment brings desirable results in cases where there are relatively simple and short-term problems. The use of this tool can restore solvency but does not ensure the sustainability of the business. Changes in the capital structure (substitution of the debt to the rights of property, mergers, divestments, etc.) give wide opportunities for recovery, but have limitations: high risks while entering a troubled business; orientation of stakeholders towards quick results and unwillingness to wait for the increase of the business value, resulting from the joint efforts; the unwillingness of owners to go for such options and phasing their business out; their delay in taking crucial decisions, which decreases their efficiency or makes them inapplicable. The direct support of the Government and creation privileges for some companies usually do not reach the goal to ensure a sustainable business growth, because it reduces the incentives to increase competitiveness, improve product quality, creates conditions for inefficient activities and corruption, causes dispersion of means and impossibility to allocate sufficient resources for reorganization and innovative development.

Thus, the results of informal workouts can be both positive and negative. On the one hand, informal agreements may give a fresh start to a business and a unique chance for a recovery. On the other hand, informal workouts may artificially extend the life of an unviable business, increase the losses for all stakeholders or contribute to the development of criminal corruption schemes.