Insolvency and Groups of Companies

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Chapter 12

Insolvency of Corporate Groups in Russia

Olga Lvova

Introduction

During the last few years in Russia, the processes of business integration were quite typical. The great synergic effect coming from the "group of companies" form allows them, on the one hand, to develop to a better tempo and, on the other hand, to overcome financial difficulties associated with the global crisis. Typical major enterprises increasingly developed a highly complex structure with various parts of the business allocated to numerous subsidiaries according to function (sales, manufacturing, finance or the like) or geography. The relations can be direct or indirect ownership or control or they are both owned or controlled by a third party or there are other related interests.

Nowadays in Russia, corporate groups, also known as "holdings", are quite widespread forms of large-scale business. It should be emphasized that the term "holding" in the country does not imply only a parent company which manages and controls the activity of its subsidiaries, but it means the corporate group as a whole.

Nevertheless, the legal framework which should set certain rules for the activity of such holdings practically does not exist. The term "holding" is also absent as well as the term "holding or corporate group insolvency", instead of which Russian bankruptcy law uses the general one "legal entity insolvency". There are only a few legal provisions, which to a certain extent cover holding-type relationships between the parent company and its subsidiaries, namely certain parts of joint-stock law, tax and accounting law and antimonopoly law. Such a situation obviously obstructs the effectiveness of the existing insolvency system, which only allows for bankruptcy declarations against separate legal entities, whereas they might not even own any assets (so-called "assetless debtors"), but only bad debts that will never be covered.

To protect important assets from any legal enforcement, the company within the group may put these assets on the balance sheet of a limited company, which has been established specially for this purpose. Then the company which needs these

assets for its operations takes it on lease for a long time. Taking into account that, legally, it does not belong to the main firm, the latter has nothing to sell during potential bankruptcy proceedings, which are conducted separately for each business unit of the corporate group.

Legal Problems of Corporate Group Insolvency

Recently in Russia, there have been many cases of the bankruptcy of companies which had accumulated huge debts of other single corporate group elements that had been owned by the same group of people. In other words, the following scheme has become quite widespread: major obligations of a single holding are thrown down to the one enterprise of the group, which enters the bankruptcy procedure to be liquidated as a result. In such "operations", some Russian corporate groups acting in the telecommunications, real estate and retail sectors have been noted. Such liquidations usually attract little attention or correspond to a part of M&A processes.

This situation explains the existence of many additional problems connected with the implementation of insolvency proceedings in respect of corporate groups in Russia:

(i) Taking into account that all assets have been already stripped out from such firms, the creditors of the holdings will never get their money back.
(ii) To prove the fact that this debtor depends on the parent company, whose balance sheet contains only assets without significant debts, is very difficult, because of the low transparency of property relations among the numerous subsidiaries and the main company within the holding.
(iii) Moreover, if it is even possible to find a real owner, the creditors will hardly get anything back because of the absence of appropriate legal provisions.
(iv) If the company has subsidiaries abroad, which is quite common for many corporate groups, it will be impossible to participate in possible bankruptcy procedures against its subsidiary and vice versa. In Russia, there are no provisions on cross-border insolvency.

Bankruptcy as a Means of Unfair Repatriation of Property

The assets of the well-known Russian oil company, Yukos, during the process of its liquidation through the bankruptcy procedure, were sold to a firm which none had ever heard about. It was established a month before specially to become a buyer of these expensive and important assets and then to transfer them to the famous Rosneft company, which is partly state owned. This is often called one of the brightest examples of "hostile merger made by the state". Despite the constant modernization of insolvency law, it still cannot fully prevent unfair takeovers by means of bankruptcy. The price of the takeover significantly decreases by using such possibilities in insolvency regulation as:

(i) The low threshold for liabilities;
(ii) The specific procedure for the appointment and control of the insolvency administrator; and
(iii) The possibility to use the financial rehabilitation procedure to make third parties (often for instance, interested parties/aggressors) new owners. Articles 113 and 125 of the applicable Federal Insolvency Law "On Insolvency (Bankruptcy)" stipulate that any person has the right to pay off all the company's debts on equal terms with the shareholder and thus to become the new owner of the company.

An aggressor company may buy accounts payable of the company, which then becomes a debtor of the aggressor in bankruptcy proceedings usually started after this transaction. Besides, it can only threaten the company to apply for its bankruptcy to the court to make it sell shares at a low price.

Insolvency proceedings can be initiated by the debtor's management, which may act on behalf of potential aggressors. It is very difficult to expose deliberate bankruptcy in a proper way. The insolvency administrator, who is often controlled by creditors, should verify if the company became insolvent deliberately and can be guided by the special provisions titled "On Temporary Rules of Identification of Deliberate and Fictitious Bankruptcy by the Insolvency Administrator" of 2004. These rules contain suggestions to evaluate only the operating activity of the debtor and do not concern financial or investment ones. The main trend of evaluation, which can indicate deliberate bankruptcy, is "the great decline of all balance sheet coefficients". Indeed, this decline could happen even in the case of normal bankruptcy as the result of the increase in competition, changes in oil prices etc. Besides deliberate and fictitious bankruptcy, bankruptcy can also be accompanied by a slight decrease in coefficients when it results from a total campaign of strategic action caused by interested parties to make the company insolvent. So the effective methodology for the detection of unfair actions is also absent.

Low Transparency of Corporate Groups

The form of related enterprises is created mainly for pursuing certain economic goals. The motivation and objective of forming related enterprises are various, for example, to monopolize markets, reduce costs or avoid taxes etc. The owner of one popular perfumery and cosmetics business organized in a single group, which went bankrupt, is now being pursued through the criminal law for tax violations. He obviously used some schemes for tax evasion, which may be realized only within the "holding" form.

In Russian practice, the bankruptcy procedure can be used for a merger or an acquisition of medium-sized companies, which is not possible by the usual way of purchase because of antimonopoly legal provisions. For example, nowadays, there are some large insurance companies on the market, many of which have significant assets and turnover in comparison with other separate actors. It

happened due to the use of bankruptcy procedures for the acquisition of small businesses.

One of the major advantages of the holding is the opportunity to provide free financial flows between the companies within a single corporate group, i.e. to transfer money or other assets from one element to the other for the realization of different economic purposes. However, the level of transparency within the holding decreases so dramatically that even its managers cannot define the real level of such affiliated financing. According to expert estimates in 2007, nearly 60-70% of company directors could evaluate the real volume only approximately. It confirms that such a way of financing is one of the first in modern investment practice in Russia. Besides, numerous affiliated subsidiaries make it impossible to understand the organizational structure of any huge Russian joint-stock holding.

In Russia, there is a special group of enterprises which are excluded from the Federal Insolvency Law and can never be declared bankrupt, the so-called "strategic enterprises". For example, the following companies have special conditions: The Russian Corporation of Nanotechnologies (RUSNANO), The Russian Technologies State Corporation, The State Atomic Energy Corporation ROSATOM and, less importantly from the state safety point of view, ones such as Automobile Concern "Autovaz". This situation often results in non-market methods for the protection of some enterprises and their artificial support by the government. Many companies are willing to get onto the list of strategic enterprises to benefit from this. Moreover, a large number of such enterprises produce non-competitive goods and, without this government support, would have become insolvent years ago.

The Draft Law "On Financial Rehabilitation and Insolvency (Bankruptcy)"

The objective necessity, nevertheless, for the introduction of provisions in respect of corporate groups caused the development of the draft law regulating corporate group bankruptcies. The draft of the Federal Law "On financial rehabilitation and insolvency (bankruptcy)", proposed by the Ministry of Economy in 2009, should amend (and change the title of) the applicable Federal Insolvency Law, passed in 2002 and amended in 2009. This draft law, which introduces legal provisions for holdings, was not accepted by the Government at the first and, although to date has been amended a number of times, it still has not been passed. The main provisions of the draft law are the following:

(i) First of all, this draft introduces the definition of the term "enterprise group" as: "some debtors – legal entities – one or several of which are under control of the controlling entity – a member of the enterprise group – and related by the single management, production or technological processes."

(ii) In case of insolvency proceedings against some companies from the single corporate group, the court will consolidate actions, which will be considered by one court. But there will be problems of enforcement of this provision by the courts: the complex process of cooperation between regional courts has hardly been implemented.

(iii) All bankruptcy procedures, including financial rehabilitation, can be enforced in respect of the whole group, whose insolvency proceedings can be also managed by a single administrator. This measure should increase transparency and prevent asset stripping to a certain extent.

(iv) Theoretically, it is assumed that these amendments will allow debtors to restructure complex debts of a holding, while creditors will increase their opportunity to recover debts from the whole group. There will be an opportunity for creditors to request the bankruptcy of all members of the group if its activity was conducted in an unfair way (e.g. asset stripping or internal transactions at prices below market ones etc. took place).

(v) Besides, creditors will get an opportunity to ask for satisfaction of their claims by the parent company. If the court accepts such petitions, the main company of the group will become liable for the debts of its subsidiaries.

(vi) The draft law also introduces provisions on cross-border insolvency but the possibility of national protectionism and implementation of the policy of asset protection can make insolvency proceedings more complex in foreign courts. In Russia, the process of cross-border insolvency can be even more difficult because foreign courts do not admit the decisions of Russian courts.

However, despite the theoretical possibility for such restructuring, from our point of view, in practice it is hardly real: it is hard to imagine that the parent company, which has enough money to cover the debts of its subsidiary, will wait for official bankruptcy proceedings in the court. It is more likely that these provisions in the law draft are aimed towards unfair owners.

What to Do?

The following measures could improve the situation:

(i) Detection of affiliated companies through identification of long-term business relations between the group company and its suppliers and/or clients with which it works for many years.

(ii) A statutory prohibition on re-selling "liquidated" assets which were recently bought. In the case involving the Yukos company, its assets was resold by the unknown intermediary firm to Rosneft within a week.

(iii) Some tax benefits for those groups of companies which draw up consolidated accounting statements for the whole group.

Detection of deliberate and fictitious bankruptcy can be conducted through analytical procedures which allow the finding of reasons for the absence of money (and therefore the solvency itself) as:

(i) Purchases of illiquid assets, like getting illiquid promissory notes as payment from buyers; investing money in low-quality securities and/or in authorized capital of friendly firms or specially established short-lived companies.

(ii) Price manipulations, like buying raw materials for a price which is higher than market prices; selling of goods at lower prices through intermediary firms, which accumulate all the profit; debt financing by friendly companies at higher interest rates.

(iii) Accumulation of money in accounts receivable: transfer of unreasonable payments to a supplier under a preliminary agreement; placing of customer advance payments on accounts belonging to third parties.

(iv) The Rules of Identification of Deliberate and Fictitious Bankruptcy should be amended by particular tasks for the detection of: understatement (overstatement) of obligations, tangible and intangible assets, accounts receivable; improper evaluation of securities, the business or its component parts; veiled excess expenditures by company management; rental payments which are higher than market ones; manipulation of proceeds.

Conclusion

It should be emphasized that, if the draft law is passed, the courts must detect all relations within a holding and its final owners. The main problem here will be to prove that this or that entity in reality controls the whole group. Standard criteria such as controlling interests or possession are hardly used in practice.

In general, in spite of recent suggestions oriented towards the modernization of Russian legislation, several problems still require a solution. There are no effective mechanisms for detecting these corresponding relationships within holdings having a lot of affiliated companies within. Our practice of law enforcement needs significant amendments providing an increase of transparency and making possible the detection of real owners of holdings.