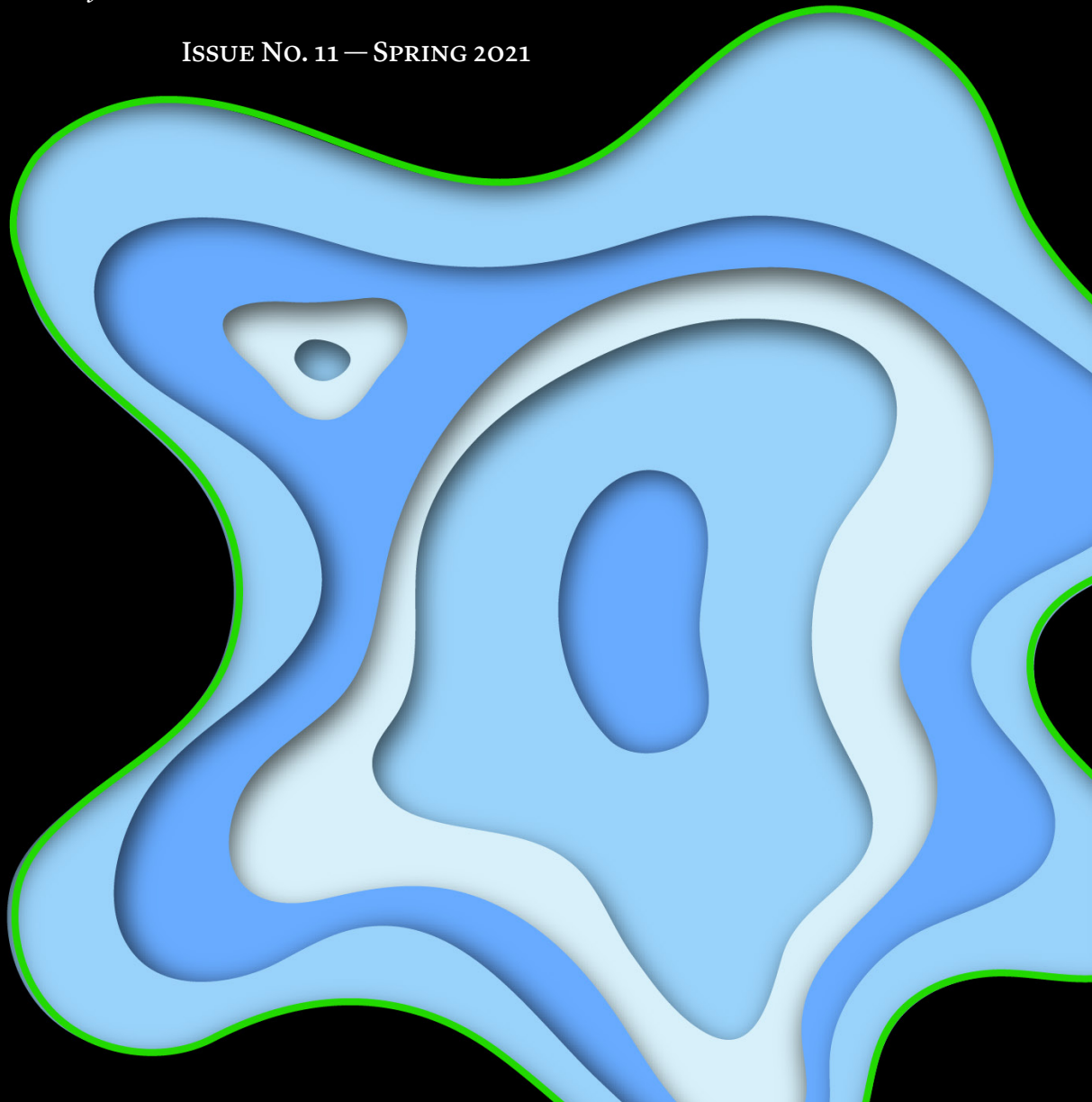


CLEARY GOTTLIB

Anticipated Reform of Russian Insolvency System

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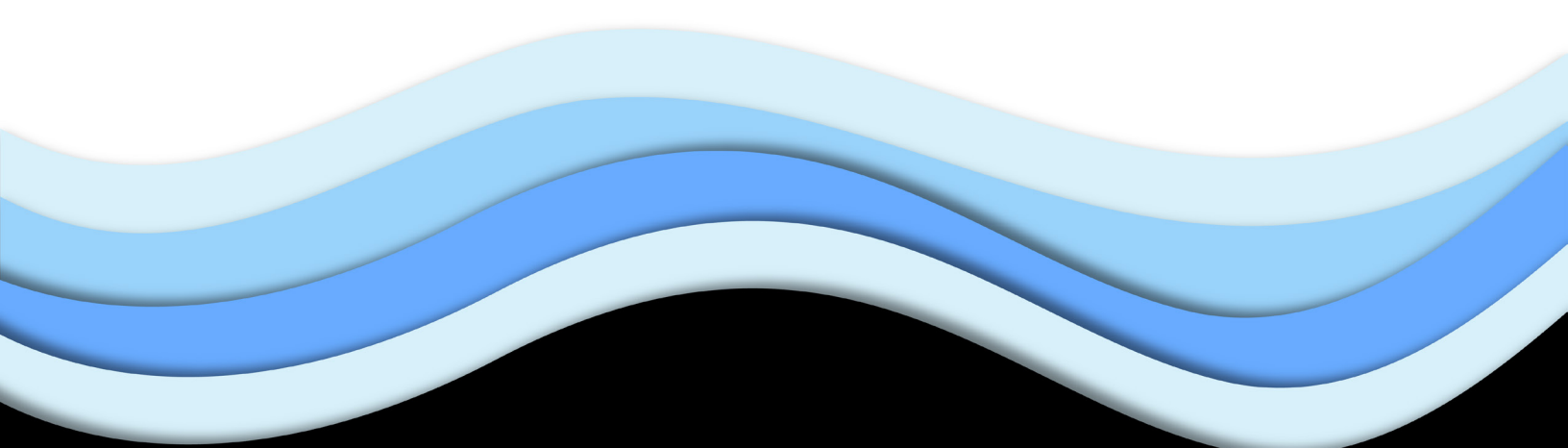
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Anticipated Reform of Russian Insolvency System

Following the President’s message to Russian Parliament (in February, 2019) announcing the policy change towards simplification of over-regulated state supervision system by 2021, Russian Ministry for Economic Development came up with the draft bill suggesting a number of fundamental changes (the “**Amendments**”) to Federal Law No. 127-FZ “On Insolvency (Bankruptcy)” dated October 26, 2002, as amended (the “**Bankruptcy Law**”). The bill was published on March 12, 2020 for public discussion and further development, a bit less than a year ahead of the deadline for the announced goal. This article briefly describes the proposed amendments as well as the public reaction to the Amendments, current status of the bill and prognosis for its implementation.

Changes to Bankruptcy Proceedings

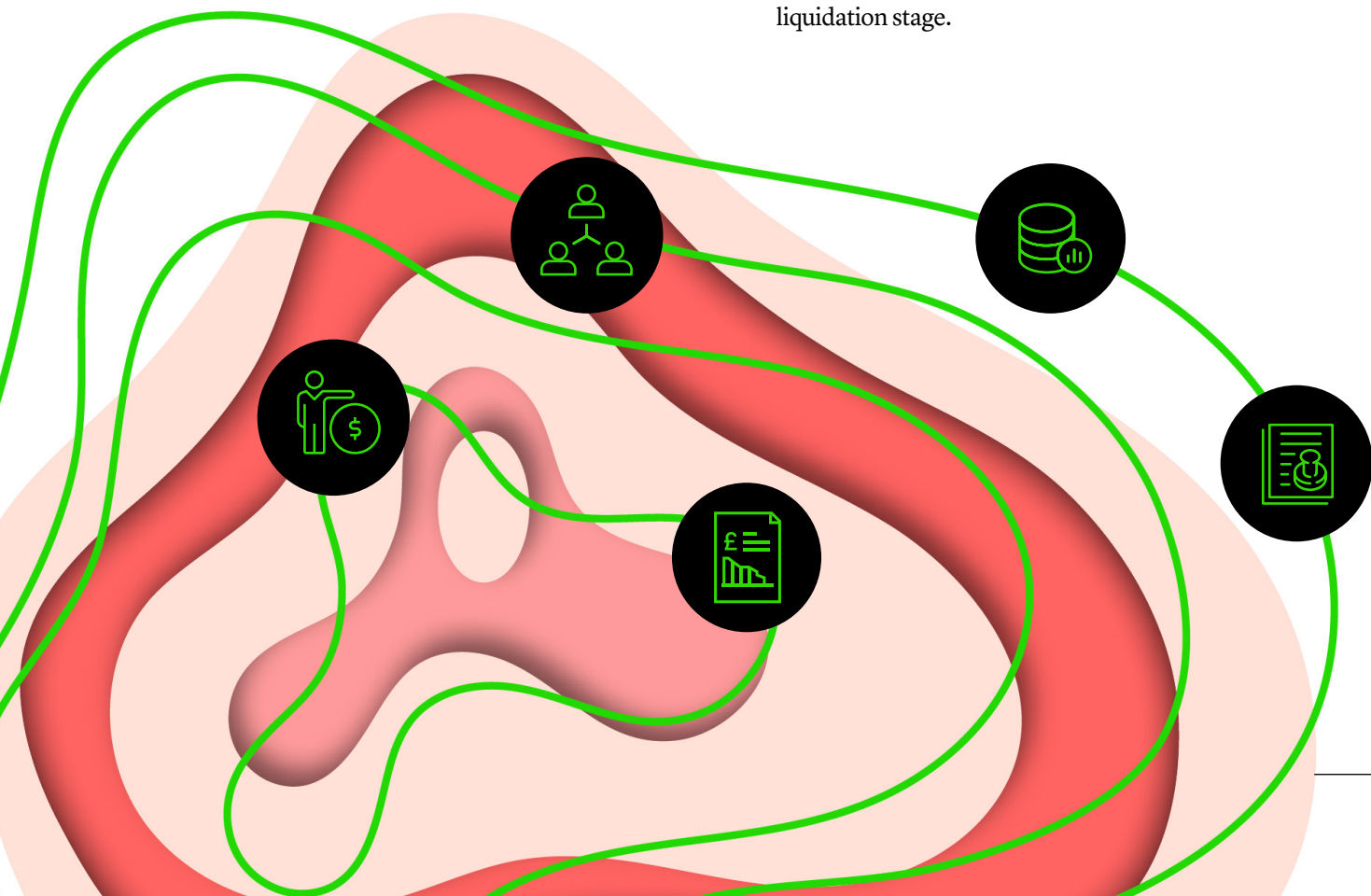
Existing Bankruptcy Regime

The current version of the Bankruptcy Law provides for 5 stages of bankruptcy proceedings applicable to legal entities:

- Supervision;
- Financial rehabilitation;
- External management;
- Bankruptcy liquidation;
- Amicable settlement agreement.

Generally, supervision is the first stage for all bankruptcy proceedings. It is a provisional stage that initially may be set up for up to 7 months (however, under the existing regulation it is possible to prolong this stage for as long as several years). Supervision objectives are preserving debtor's assets, analyzing its financial state, collecting information on creditors' claims (forming a register of claims) and holding the first meeting of creditors.

Upon completion of supervision, the court decides whether financial rehabilitation, external management or bankruptcy liquidation shall follow (the amicable settlement agreement stage may be invoked at any moment if all parties reach a consensus in this regard). The first two options, i.e. financial rehabilitation and external management, are aimed at restoring debtor's solvency while the third option, i.e. bankruptcy liquidation, speaks for itself: a debtor is found insolvent upon finalization of this stage and its assets are liquidated to pay out its outstanding debts. Financial rehabilitation may last up to two years. It involves preparation of financial rehabilitation plan as well as debt repayment schedule and essentially leads to restructuring of the outstanding debt in accordance with the plan and the schedule. An administrative manager is appointed to supervise implementation of the rehabilitation plan and the repayment schedule. If the debt is successfully repaid by the debtor, the bankruptcy proceedings for such debtor are deemed completed. If not, the next stage for the debtor would be either entering into the external management phase or going straight to the liquidation stage.



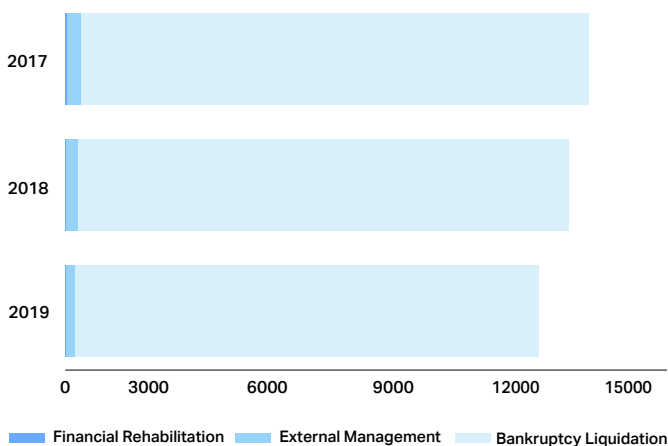
Financial rehabilitation is not generally used because the law requires that the plan is drafted in a way to make the debtor pay out its debt in full in up to two years. Further, in certain circumstances security may be required to be provided by third parties to secure the debt.

Similar to financial rehabilitation, the external management stage aims at restoration of debtor's solvency. However, the external manager that supervises this stage of proceedings has more authority than the administrative manager at the financial rehabilitation stage. The external manager replaces the debtor's initial CEO. He/she is entitled to manage debtor's property, claim on debtor's behalf, challenge the validity of the debtor's transactions (and claim any relevant damages in court), challenge creditors' claims and implement an external management plan. The external manager reports to the creditors meetings on implementation of the plan. The external management stage may be initially introduced for up to 18 months with the possibility to further extend this stage for six more months. If the actions taken in the course of this stage do not lead to the restoration of debtor's

solvency, such debtor has no other way but to enter into the liquidation stage.

Bankruptcy liquidation is the lengthiest stage and the most commonly used one among financially troubled companies in Russia. It is designed to satisfy creditors' claims by means of sale of debtor's assets via auction. Under the general rule, this stage may be instituted for up to six months with possible further six-month extension(s). Since the number of such extensions is not limited under the Bankruptcy Law, the proceedings at this stage may last for years and even decades. On average this stage lasts for 787 days which is a little over than two years (while the average length of external management is 201 day¹).

The bankruptcy liquidation is supervised by a bankruptcy administrator/trustee who replaces the debtor's original management. His/her main duty is to search, evaluate, pool and arrange the debtor's assets for sale. The statistics below² show how rarely financially troubled businesses in Russia restore their solvency as a result of the bankruptcy proceedings:



The majority of the cases lead to liquidation which in itself represents a lengthy fight between the creditors for the remainder of debtors' assets. On average, upon completion of this stage, the creditors do not recover more than 4.7% of their claims³.

Bankruptcy Regime Under the Amendments

With that background, when announcing the Amendments, Russian Ministry of Economic Development claimed that the aim of the Amendments is to increase the number of companies restoring their solvency from under 2% to 10%. The proposed key changes are briefly described below.

The Amendments suggest simplifying the described bankruptcy stages by limiting them to:

- Debt restructuring stage; and
- Bankruptcy liquidation stage.

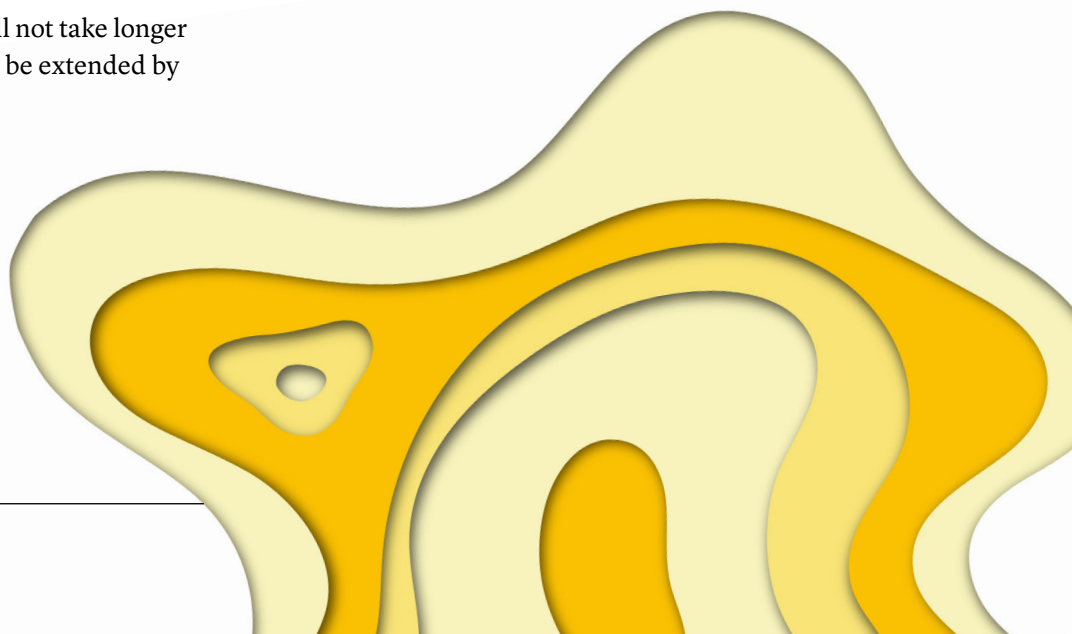
Supervision (which now serves as an introductory stage to the rest of bankruptcy stages and which is generally considered as an extra phase unnecessarily extending the whole procedure) will cease to exist. The debt restructuring will replace the existing external management stage and financial rehabilitation stages. The restructuring proceedings are contemplated to involve the following:

- Within four months as of commencement of the restructuring stage a restructuring plan shall be prepared;
- Implementation of the plan shall not take longer than four years (this period may be extended by four more years).

The Amendments try to avoid the possibility of unlimited extensions unlike the current wording of the Bankruptcy Law which allows for the liquidation stage to last for decades.

The Amendments set out a more flexible approach for choosing debtor's management during the restructuring, while the current version of the Bankruptcy Law prescribes for specific management option for each bankruptcy stage. Four options contemplated by the Amendments are:

- 1. Preserving the right to appoint debtor's management with the debtors' shareholders;**
- 2. Replacing existing management of the debtor with a bankruptcy administrator;**
- 3. Authorizing the creditors meeting/ committee with the right to appoint debtor's management; and**
- 4. Appointing dual management, i.e. one CEO is to be appointed by the debtor's shareholders while another one is to be appointed by the creditors (the competence of these CEOs is supposed to be divided in accordance with the restructuring plan).**



Either of these options may be reflected in the restructuring plan as long as the plan is properly adopted as described below.

Under the Amendments, the obligation to come up with the restructuring plan lies with the debtor. However, creditors, bankruptcy administrator, debtor's shareholders and even its employees or other interested third parties (including governmental bodies) have the right to propose an alternative plan. Then the plan is to be presented at the meeting of creditors for their approval. Such approval is considered received if a simple majority of the creditors present at the meetings voted for the plan. It should be noted that the secured creditors are not permitted to vote unless the plan impacts their security or otherwise changes the status of their debt. Also the other creditors present at the meeting, but not affected by the plan, are not entitled to vote either.

Once the restructuring plan is approved at the creditors meeting, it is then to be adopted in court. The court may reject the plan on the grounds set out

in the Amendments, some of which imply quite broad discretion, e.g. the plan may not be adopted if the court finds: (i) that the plan violates the interests of the first- and second-ranking creditors; or (ii) that debtor acted in bad faith.

Under the Amendments, the debt restructuring stage will be available for a debtor: (i) upon request for restructuring – if the debtor proves it is able to restore solvency; and (ii) upon request for liquidation – if the debtor is unable to prove either its ability or inability to restore solvency. Which means that the court will by default have to choose restructuring (in cases when the requests were initially for liquidation) if the debtor failed to provide evidence of its ability or inability to restore solvency. This still may change as a result of the drafting sessions to follow in relation to the draft bill⁴ proposing the Amendments. The Amendments also suggest a non-exhaustive list of the measures any of which may be included into the restructuring plan. The list includes the following measures:

1. Reorganization of a debtor;
2. Increase of share capital of debtor;
3. Sale of a debtor's business or part of a debtor's assets
4. Replacement of a debtor's assets
5. Novation of a debtor's obligations
6. Discharge of a debtor's obligations by accord and satisfaction
7. Conversion of debt into shares or other securities of the debtor
8. Change in the terms, procedure and scope of a debtor's obligations
9. Termination of a pledge, amendment of the terms of a pledge agreement;
10. Debt release and other measures.

Reaction of the Professional Community

One of the key figures involved in Russian bankruptcy proceedings is a bankruptcy administrator/trustee also known as arbitration manager (in Russian: arbitrazhniy upravlyayushchiy). Arbitration manager is the professional that now takes on the role of temporary/ administrative/ external/ liquidation manager in bankruptcy proceedings (as mentioned above, depending on the stage of the proceedings, such manager replaces the debtor's regular management to a certain extent). Their activity is managed and controlled by self-

regulating organizations ("SRO"): in order to practice, each arbitration manager is obligated to join a SRO of its choice.



Proposed changes will in fact add up to restrictions relating to the appointment of SROs to bankruptcy cases and complicate the life of arbitration managers

Despite the announced overall rationale behind the Amendments to simplify the bankruptcy system, the proposed changes will in fact add up to restrictions relating to the appointment of SROs to bankruptcy cases and complicate the life of arbitration managers. For instance, the Amendments, introduce categorization and ratings for SROs and worsen compensation system for seem to undervalue the role of SROs and arbitration managers in the present bankruptcy system which lead to a negative reaction to the changes in the arbitration managers' community. The professional society's outcry found its way in the letter submitted by Russian National Society of SROs of Arbitration Managers to the Russian Government on July 28, 2020. The letter contains a thorough analysis of the provisions which impact arbitration managers badly and explains the ways in which the Amendments are likely to harm the existing "ecosystem" of SROs.

Current Status of the Amendments and Further Prognosis

Initially, when announcing the draft bill setting out the Amendments in March, 2020, Russian Ministry of Economic Development estimated the bill to enter the Parliament hearings before the end of spring session so that it could be enacted by 2021. However, the bill has not yet been submitted to the Parliament and remains at the stage of development within Russian Government. It is hard to tell whether it was the COVID-19 pandemic that slowed down the process, the negative reaction of the professional community, or all factors in combination. The aims behind the Amendments are certainly

beneficial for the business community as a whole. However, the suggested measures seem to lack a systematic approach or take account of insolvency professionals' interests. It is obvious that the Amendments need further development to strike a balance between its initial aims and the interests of the parties involved.

But if the legislator will do a good job at it, Russian bankruptcy system will get a chance at changing for the better.





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Lyadnova's practice focuses on a broad range of cross-border debt transactions at various levels of capital structure. Her experience includes bank lending, debt restructuring, and debt capital markets. She is dual-qualified, Russia and England. She is particularly noted for her work for emerging markets clients. Polina joined the firm in 2007 and became a partner in 2013. Prior to joining Cleary, she worked at another international law firm and as a legal counsel at a large Russian metals and mining company.



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1. Statistical report of Unified State Register of Bankruptcy Information as of June 30, 2020
2. Statistical report of Unified State Register of Bankruptcy Information as of June 30, 2019
3. Statistical report of Unified State Register of Bankruptcy Information as of June 30, 2020
4. Draft Bill "On introduction of changes to Federal Law "On Insolvency (Bankruptcy)" dated March 12, 2020, No02/04/03-20/00100272



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