

Rehabilitation in Kazakhstan: A Renewed Path for Businesses in Trouble

By JOEL BENJAMIN, ADLET YERKINBAYEV,
KAIRAT BAIZAKOV and MAKSIM GREKOV



IN 2014, KAZAKHSTAN ADOPTED A NEW BANKRUPTCY LAW¹, which included a rehabilitation procedure (i.e. a procedure which allows a company to restructure its debts with court protection). The Government has long been trying to provide insolvency proceedings as an alternative to straightforward bankruptcy. Rehabilitation has existed since 1997; however, until 2012, it was vaguely described as a procedure to be conducted, mainly, by a rehabilitation manager under the supervision of an authorized state body with limited involvement from creditors and courts. In 2012, the amendments to the then-current bankruptcy law introduced rehabilitation in its substantially current form—with court hearings on whether to start rehabilitation, a separate court approval of a rehabilitation plan, greater creditor control over all stages of the procedure, the right to keep pre-rehabilitation management and other novelties. The 2014 bankruptcy law, among other things, introduced a number of rules applicable to all insolvency procedures—including rehabilitation—and included enhanced responsibility of management and shareholders for wrongdoing, limitation of rights of affiliated creditors, a separate priority line for penalties and indemnities, etc.

In 2014-2015, a significant oil price downturn resulted in a devaluation of the Tenge, Kazakhstan's currency, against the US Dollar (more than 2.5 times) and a decrease in the growth rate of Kazakhstan's economy, which is expected to be at 1.2% in 2015, relative to 4.3% in 2014.² In August 2015, the National Bank of Kazakhstan stopped supporting the Tenge and started targeting inflation. Small and mid-size companies in the oil and gas sector and companies in other sectors having substantial hard currency indebtedness were mostly hit. We have seen such companies use rehabilitation proceedings in an attempt to cure their financial affairs and avoid bankruptcy. Although up-to-date data is not available yet, there were 22 court decisions on rehabilitation in 2014 and ten court decisions on rehabilitation within only the first two months of 2015.³

What is Rehabilitation?

In Kazakhstan, bankruptcy results in the liquidation of a company; the rehabilitation procedure, however, is intended to enable debtors to pay their debts and avoid liquidation on the basis of a rehabilitation plan approved by the creditors



and ratified by court. Both bankruptcy and rehabilitation are initiated through a judicial procedure.

Only commercial entities and entities that do not benefit from state support measures may be brought under rehabilitation. There are also specific provisions for rehabilitation of natural monopolies and entities having a dominant position in the market as well as certain other companies, however, such provisions are not the subject of this article.

Rehabilitation Benefits

First, rehabilitation protects the debtor from claims of creditors for the period of rehabilitation. This enables the debtor to approach all creditors at once and negotiate a comprehensive restructuring.

Second, the rehabilitation plan may provide for the extension and/or straight discounting of monetary obligations of the debtor. The plan may also provide for debt or equity investments from third parties (including the creditors) and other

measures. Rehabilitation may last for up to five years, with a possible extension for up to six months.

Third, normally, upon approval of the rehabilitation plan, the court appoints a rehabilitation manager who undertakes day-to-day management of the debtor. However, if the debtor so requests and the creditors approve, the court may allow the company's officers to perform the management functions of the rehabilitation manager.

Rehabilitation Test

From the text of the law and court practice,⁴ in order for a debtor to commence rehabilitation it must prove two facts to the court:

- its insolvency and/or inability to fulfill financial obligations coming due within the next 12 months; *and*
- its ability to restore its solvency.

A debtor is considered *insolvent* if any of the following conditions is met:

- certain payment obligations⁵ are not fulfilled within three months after their due date, provided their amount is not less than 100 times the monthly calculation index (MCI) (one MCI is equal to KZT 2,121 or, as of 21 January, 2015, around US\$5.50); or
- tax obligations of the debtor are not fulfilled within four months after their due date, provided their amount is not less than 150 MCI; or
- obligations to other creditors are not fulfilled within three months after their due date, provided their amount is not less than 1,000 MCI.

Generally, the court looks at the assets and liabilities of the debtor, including immediately available cash, fixed assets, assets that are pledged and/or under arrest, outstanding court and arbitral decisions, contingent liabilities (whether financial or otherwise) when considering whether the debtor is truly insolvent and indeed meets the criteria listed above or whether it is not able to pay its debts within the next 12 months.

Establishing the “ability to restore its solvency” could be more complex, as neither the law nor existing practice give sufficient guidance on what exactly this means and how such ability can be proven.

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Rehabilitation Timeline and Protection

There are four key dates in rehabilitation:

Initiation of rehabilitation proceedings

The date when the court has accepted an application for rehabilitation (whether from the debtor or from a debtor's creditor). From that date:

Debtor may not undertake operations outside ordinary business activity without the approval of a temporary manager/administrator.

Execution of outstanding court or arbitral decisions is postponed and no execution may be levied on the debtor's assets.

All claims of creditors may be filed only as part of rehabilitation procedure.

Shares in the debtor may not be alienated.

Court Decision to start rehabilitation

If the court considers the conditions required for the rehabilitation test to have been met, it issues a decision commencing the rehabilitation.

Once such decision is issued, penalties and interest on any outstanding debt stop to accrue.

The court appoints a temporary administrator (a qualified individual registered with state authorities as eligible to act as such) to form a register of creditors.

The register must be compiled within 2 months

Claims by the creditors must be brought to the attention of the temporary administrator within 1 month from the date of public announcement of rehabilitation.

Approval of a rehabilitation plan

Within 3 months of the court decision commencing the rehabilitation, a rehabilitation plan must be developed and approved by the creditors' meeting.

At the meeting all creditors included in the list of creditors except for creditors that are affiliated with the debtor (including direct and indirect holders of 10% or more of the debtor's shares) may vote on a "one tenge – one vote" basis.

Upon the court's approval of the rehabilitation plan, the rehabilitation starts and the plan becomes binding on the debtor and its creditors. By the same decision the court approves the duration of the rehabilitation and appoints a rehabilitation manager (a qualified individual registered with state authorities as eligible to act as such) to run the debtor.

If the debtor so requests and the creditors approve, the court may allow the company's officers and shareholders to continue performing day-to-day management of the debtor during the rehabilitation.

Termination of rehabilitation

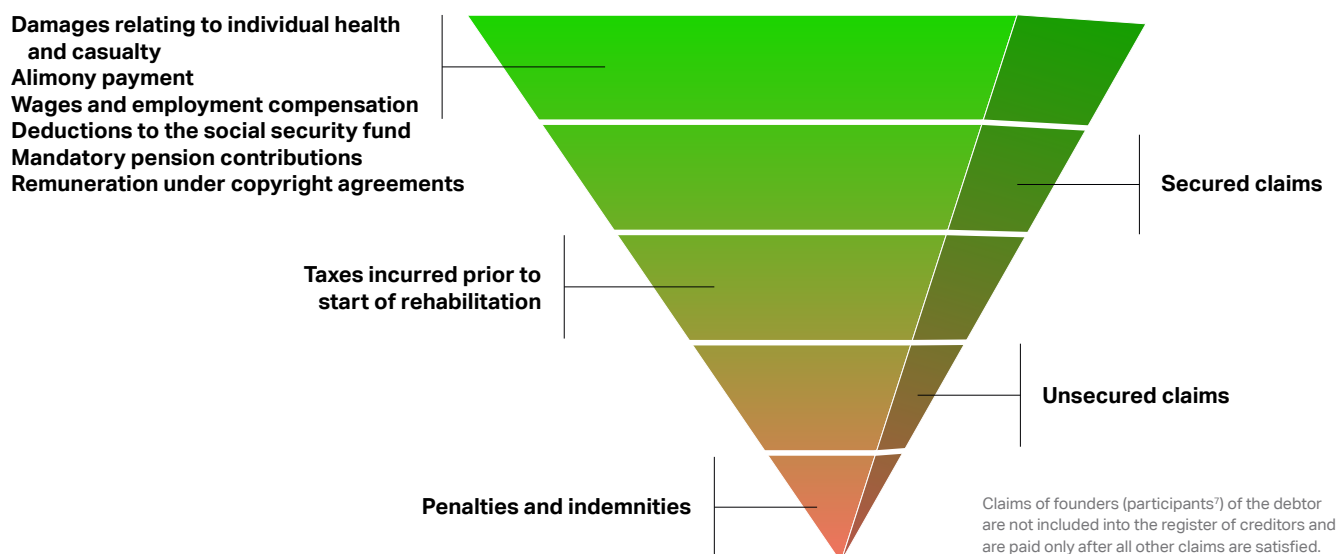
On the basis of a decision of the creditors' meeting, the rehabilitation manager applies to the court to terminate the rehabilitation by reason of either achieving the purpose (to restore solvency) or an inability to achieve the purpose.

Shareholders and/or creditors may also apply for termination in case of wrong-doing by the debtor (non-fulfilment of payment terms of the plan for more than 3 months or other damage to the interests of shareholders or creditors).

In case the rehabilitation manager applies for termination of rehabilitation because it has achieved its purpose, the court terminates the rehabilitation and the debtor is restored as a solvent entity with no limitations.

In all other cases, upon termination of the rehabilitation, the court simultaneously initiates bankruptcy proceedings.

Waterfall Structure in Rehabilitation



Treatment of Creditors

Below are several considerations relevant to the treatment of creditors during a rehabilitation process.

Claims Subject to Restructuring

The claims included into the register of creditors⁶ and, thereafter, included into the rehabilitation plan are paid not in accordance with their contractual terms, but rather in accordance with the terms of the plan.

The law provides for five levels of priority of payments during rehabilitation. Claims of a given level are paid after full satisfaction of the claims of the preceding level.

Ahead of and outside of the rehabilitation payments—administrative and court expenses and taxes incurred in tax periods after the start of rehabilitation;

Claims outside restructuring

Once the rehabilitation plan is approved, the debtor should first make, among other things, certain payments, such as alimony payments and damage to the health of an individual, salaries and salary related taxes and claims that “became due” (note our comment in the Section Claims Outside Restructuring below) after the approval.

Making a claim

Only monetary liabilities that (i) are known at the moment of bringing a claim and (ii) are actually claimed may be included into the register of creditors. For example, if there is a service

contract, which was partially fulfilled, only indebtedness for the services already delivered may be included into the register. By way of additional example, a creditor having a claim has a choice whether to submit such claim to the temporary administrator or not. In the latter case the claim will not be included into the register and will unlikely be paid during the rehabilitation as there is a moratorium on enforcement of claims. However, if a claim is not included in the register and, thus, the rehabilitation, then, subject to the statute of limitations and any other specific terms of the claim, such claim can be brought after the completion of rehabilitation.

Acceleration

There is substantial ambiguity on the treatment of liabilities with different maturities, for example, repayment of loans in installments or repayment of trade indebtedness that are not matured during rehabilitation. As for bank loans, most of them provide for automatic acceleration in the event of insolvency or substantial deterioration of a financial state of a debtor. It may sound logical that debts not having similar automatic acceleration provisions should be treated differently. Market practice, however, ignores contractual schedules of payments and allows a creditor to demand the debtor to include the whole outstanding amount into the register of creditors (provided that the amounts are known at the moment of registering the claim) even if such schedule is longer than the term of rehabilitation.

Operational and Legal Challenges

Rehabilitation is not a straightforward process, and a debtor may face significant pitfalls on the way to an effective

rehabilitation. The main problems appear to be inconsistent court practice and a lack of developed legislation. Below are examples of some issues we have seen in rehabilitation practice.

- **Establishing insolvency:** From a plain reading of the law, establishing the debtor's insolvency/inability to pay its debts on the basis of the criteria listed above should not be difficult. However, Section 14 of the Supreme Court's Normative Resolution No. 5, dated 2 October, 2015 (the "SC Resolution") says that a debtor may not have as the purpose for rehabilitation to delay the performance of its obligations. Neither the law nor practice contain specific criteria for establishing such a purpose, which leaves the matter to the discretion of the court. Thus, there is a risk that a court may refuse to commence rehabilitation if it believes that a debtor's purpose is to simply delay payment of its obligations.
- **Establishing ability to restore solvency:** As mentioned above, there is insufficient guidance on what the "ability to restore solvency" means and how such ability can be proven. The SC Resolution requires the debtor to prove that there is a number of interrelated specific measures aimed to restore financial health and based on mutual consent between the debtor and the creditors. To that effect, a court may require the debtor to submit during hearings on whether to start rehabilitation evidence of financial support of shareholders (if any), contracts with customers, list of specific measures to decrease expenses, prospected financial flows, discount levels, etc. However, it is likely that the debtor may only get clarity on most of such issues during the course of development and approval of the rehabilitation plan, i.e. after the decision to start rehabilitation.
- **Consent of the creditors:** Similarly, it is not clear at what stage the debtor should secure the consent of its creditors to the rehabilitation. The law provides that the creditors approve the rehabilitation plan, which is prepared and approved only after the rehabilitation starts. The SC Resolution, however, effectively requires the debtor to secure creditors' support for rehabilitation at an earlier stage, during the court hearings. It may be difficult for the debtor to convince creditors to support rehabilitation at the stage of court proceedings (in practice, even before the start of the proceedings) when the debtor may only be able to present creditors a satisfactory level of plan details only later in the process.
- **Claims outside restructuring:** As mentioned above, claims of creditors that "became due" after the approval of the plan should be satisfied in full in accordance with their contractual terms. According to one interpretation, "become due" means the claims under the contracts entered into after the approval

of the plan. According to another interpretation, though, it may include claims based on the contracts entered into before the approval of the plan that became payable after the approval of the plan. We believe the former interpretation is correct because it is more consistent with treatment of financial claims (see above). However, the courts may take a different view.

- **Limitless "Haircut":** The law sets no limit on the amount of the "haircut" that may be applied to claims included into the rehabilitation plan and, when applying haircuts, does not distinguish between various classes of creditors (secured/tax claims/unsecured/affiliated). Some creditors may prefer to pursue claims against the debtor in court on an individual basis in anticipation that the return will be higher compared to what they will receive in the event of a rehabilitation involving a significant discount for creditors.
- **Monetary liabilities only:** As a conceptual matter, the law does not provide for a possibility to restructure non-monetary liabilities, for example, to postpone an obligation to deliver goods or services produced by the debtor. This also substantially limits the applicability of the law.

Conclusion

The new rehabilitation legislation represents a significant development in the legislation. We see an increasing number of companies pursuing this route to restore financial health. However, we also see the need for further legislative changes to simplify and better describe each state of the rehabilitation process, including rights of creditors, the debtor and its shareholders. ■

1. Law on Rehabilitation and Bankruptcy dated 7 March 2014 No. 176-V (as amended, the "Law on Rehabilitation and Bankruptcy").
2. <http://www.ebrd.com/where-we-are/kazakhstan/overview.html>
3. http://kgd.gov.kz/sites/default/files/Reabilbankrotstvo/info/2_ob_o_prim_reab_pr_6.xlsx.
4. Article 5.3 of the Law on Rehabilitation and Bankruptcy.
5. This includes obligations to pay damages to the life and health of an individual, alimony payments, wages, employment compensation, deductions to the social security fund, mandatory pension contributions, or remuneration under copyright agreements.
6. Only monetary liabilities are subject to inclusion into the register of creditors and are subject to restructuring. For example, an obligation to deliver goods or services by a certain date may not be included into the register as opposed to a claim for reimbursement of damages for non-delivered goods/services.
7. The law uses the term 'participants' which, strictly speaking, relate only to equity holders in a limited liability partnership and do not relate to equity holders in a joint stock company. For information, limited liability partnerships and joint stock companies are two most popular forms of commercial entities in Kazakhstan. We are of the view that the intention of law was to cover both participants and shareholders; however, we cannot exclude other interpretations.



▼ **Joel Benjamin** is a Managing Partner at Kinstellar, focusing on Central Asia. Joel has a broad experience in corporate and commercial transaction with a particular focus on banking and finance, where he has developed top rankings within Kazakhstan and Central Asia. He has played a leading role in numerous transactions including bilateral and syndicated loans, trade finance, project finance, equity/debt capital markets and banking matters. Recent representations include: Ad Hoc Committee of the Recovery Unit Holders of JSC BTA Bank, Steering Committee of JSC Alliance Bank, JSC Temirbank and an American Agricultural Machinery Producer (with respect to claims in a Kazakhstan rehabilitation proceeding). Mr. Benjamin received a B.A. in Economics from Cornell University, an M.B.A. in Finance from the Wharton School, and a J.D. from the University of Pennsylvania Law School.



▼ **Adlet Yerkinbayev** is a Partner at Kinstellar, focusing on Central Asia. Adlet's practice focuses on M&A, capital markets and banking and finance. Over the years, Adlet has been involved in a large number of high-profile M&A, capital markets and finance transactions in Kazakhstan, in particular in the banking and telecommunications sectors. His recent representations include: Steering Committee of JSC Alliance Bank, Ad Hoc Committee of the Recovery Unit Holders of JSC BTA Bank, JSC Temirbank, and a Kazakhstan-based Oil Producer (in rehabilitation proceedings in Kazakhstan). Mr. Yerkinbayev received a Specialist in International Law (J.D. Equivalent), with distinction, from Al-Farabi Kazakh National University and an L.L.M. from Harvard Law School.



▼ **Kairat Baizakov** is Of Counsel at Kinstellar, focusing on Central Asia. Kairat spearheaded a number of major transactions in the region, and his expertise includes extensive work in the areas of capital markets, finance and M&A law. He has advised on many of the country's pioneering transactions including the first large-scale privatisation in Kazakhstan, the first sovereign Eurobond issue, the first international offering of Kazakhstan equity through ADRs and GDRs and the first securitisation transaction. Furthermore, Kairat played an instrumental role in drafting key legislation in Kazakhstan (including notable restructuring law and legislation allowing consolidation of second tier banks). His recent representations include: BTA Bank, JSC Alliance Bank, and the Sovereign Wealth Fund Samruk-Kazyna JSC in the restructuring of the mentioned banks. Mr. Baizakov received a Bachelor's Degree in Law from Kazakh State University.



▼ **Maksim Grekov** is Of Counsel at Kinstellar, focusing on Central Asia. Maksim has over 20 years of experience advising major international and local companies in Kazakhstan and other Central Asian countries spanning a wide range of practice areas, including general banking and finance, debt & equity capital markets, derivatives and other financial products and M&A and general corporate. His recent representations include: Steering Committee of Creditors of BTA Bank, Creditors of Alliance Bank, Astana Finance, a Kazakhstan-based Oil Producer (in rehabilitation proceedings in Kazakhstan), a BVI Court-Appointed Receiver and an American Agricultural Machinery Producer (with respect to claims in a Kazakhstan rehabilitation proceeding). Mr. Grekov received a Diploma in Physics from Novosibirsk State University and a Diploma with honours in Commercial Law from Adilet Higher Law School.