Substantive Harmonisation and Convergence of Laws in Europe

PROFESSOR REBECCA PARRY
Nottingham Law School

Editor

INSOL Europe
Nottingham • Paris

Published by
INSOL Europe
PO Box 7149
Clifton
Nottingham NG11 6WD
England

INSOL Europe website:
http://www.insol-europe.org

ISBN 978-0-9570761-2-9

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Russian Insolvency Law Modernization: Changes That Make Russia Closer to Europe

Olga Lvova
Dr. Prof. Alla Bobyleva

Introduction

The process of bankruptcy institute development in Russia began from the adoption of the first insolvency law in 1992. It was the attempt to define the general order of the main bankruptcy procedures realization. But the law has been adopted in the period of early beginning of a market economy in Russia and the law enforcement showed its ineffectiveness. Furthermore bankruptcy mechanism regulated by this insolvency law of 1992 was used to initiate hostile takeovers and raiding of Russian enterprises.

The next period of making insolvency procedure in Russia was more fair, transparent and applicable and closely associated with the adoption of the Federal Law "On insolvency (bankruptcy)" in 1998. This law significantly changed the concept of the public regulation of insolvency proceedings, expanded the range of debtors which could be declared bankrupt, introduced some new legal definitions (such as "bill of debt", "obligatory payments", "creditors in bankruptcy proceedings", "head of the debtor", "representative of the debtor's workers", etc.), brought the new initial bankruptcy procedure – "supervision" which is the first stage after the commencement of legal bankruptcy proceedings when the debtor is supervised by the insolvency administrator who analyzes its financial situation and tries to save its assets and when all debts enforcement proceedings are suspended (under the so-called "moratoria").

The current insolvency law in Russia has been functioning from 2002. It was a rather advanced legal document for Russia – the Law introduced a new bankruptcy procedure of financial rehabilitation, the new order of regulation of the insolvency administrators' activity based on the self-regulated professional organizations and had some other new features. But nevertheless during almost ten years it has been strictly criticized by the lawyers, insolvency practitioners, accountants of both the

debtors and the creditors, foreign insolvency specialists and partners of debtors. This is why the Law had been amended about twenty times at the time of this paper.

All recent amendments undoubtedly bring Russia closer to Europe and other developed countries in this context but have some specifics which should be analyzed.

The present of reorganization procedures

Financial rehabilitation was introduced in 2002 and now is the second bankruptcy procedure oriented towards the debtor's solvency restoration along with the traditional procedure of external administration. Financial rehabilitation is, per se, the way to get any financial aid from interested parties while the debtor has an opportunity to manage business by himself just under control of insolvency administrator. In case of external administration the court appointed administrator manages the debtors' company and tries to rehabilitate it by such special reorganizing activities as changing the line of business, selling its unprofitable parts, collecting accounts receivable, etc. In other words, external administration represents a synonym to the reorganization procedure in its classical world sense. In our country these two procedures practically do not work.

Article 79 of the effective Law provides that during financial rehabilitation the discharge of a debtor's obligations can be secured by a pledge, bank or public guarantee or by bail. Earlier there was only one permitted type of security which was required to have a value a minimum of 20% in excess of the obligations that it secured (former Article 75, paragraph 2). Despite the fact that the above-mentioned added wording is a step forward in comparison with the earlier one condition for securing, the current Law edition still assigns any securing existence to provide the procedure and, thus, to a large extent terminates the opportunity for financial rehabilitation.

The statistical data confirms the imperfection of the Russian insolvency institution by demonstrating that there have been very few attempts to restore companies' solvency. Table 1 shows the tendency of decreasing in the amount of rehabilitation and reorganization procedures. The amount of financial rehabilitation procedures grows but nevertheless makes a scanty part of all insolvency cases: in 2010 they formed only 0.54%. The main part of rehabilitation procedures belongs to the external administration. But the quantity of cases in which the external administration was initiated is reduced in comparison with 2000-2005. The liquidation procedures prevail in Russian practice: during the last five years their share is more than 95%.

Table 1. The amount of bankruptcy procedures in the last ten years[1]

	00	01	02	03	04	05	06	07	08	09	10
Financial rehabilitation				10	29	32	39	33	48	53	91
External administration	3051	2973	2696	2081	1369	1013	947	752	579	604	908
Liquidation	15143	38386	82341	17081	9390	13963	76447	19238	13916	15473	16009
Composition	747	785	403	170	150	84	106	126	126	127	255
Liquidation, %	80	91	96	88	86	93	98.5	95	95	95	93
Reorganization procedures, %	20	9	4	12	14	7	1	4.2	4	4	6.5
Including:											
Financial rehabilitation, %				0.05	0.27	0.21	0.05	0.16	0.33	0.33	0.54
External administration, %	16	7	3	11	13	7	1	3.7	4	3.7	5
Composition, %	4	2	0	1	1	1	0.1	0.6	0.9	0.8	1.4

The considerations below could e**xplain the high number of liquidation procedures in Russia**:

- The majority of liquidation procedures are initiated in respect of so-called "assetless companies" and when the debtor can't be found. The big number of applications in 2006 is also explained by the easy procedure of application for the bankruptcy of a missing debtor, which was made more complicated in 2007.
- The Insolvency Law is usually enforced when it is already impossible to restore solvency. In many respects it is connected with the fact that the institute of insolvency is still perceived only as liquidation activities in our community. Procedures of insolvency under the Law are not considered as a possible way of reorganization to get through the crisis. This is why companies try to delay the moment of going under the Insolvency Law, unfortunately they do it when there is no possibility to relaunch the company.
- The low outcome of reorganization procedures. Statistical data show that in the whole period of survey (2000-2010) the financial rehabilitation procedures were successful on average only in 7.7% of cases, external management was even more rarely successful.

1 According to the data of the High Arbitration Court of Russian Federation. – <http://www.arbitr.ru/> (20.07.2011)

These figures show not only serious problems in our insolvency institution in place but also the problems in our economic and social development as a whole, the misunderstanding of the role of the insolvency in the economic and financial system, in searching for ways to overcome the crisis.

To make the insolvency institute satisfy the main purpose of insolvency proceedings in the market economy – the restoration of debtor's business – Russian legislators introduced some new provisions. The most recent changes in the Russian Insolvency Law have happened during the period of 2008-2010. These changes were crucial for Russian bankruptcy practice to make it more modern and oriented on the market principles of insolvency regulating.

New rules for the Insolvency Administrators

The professional qualification of insolvency administrators is crucial for the successful implementation of reorganizational procedures because financial analysis, working out the strategy and the complex system of measures for business restructuring require special skills and experience. Unfortunately today the requirements under Russian Law for potential insolvency administrators are poor – to work in this capacity a person should:

- be the citizen of Russia;
- have high professional education;
- work in an executive position for 1 year and pass the internship as the insolvency administrator's assistant in the bankruptcy proceedings for 6 months or just work as an above-mentioned intern for 2 years;
- pass the exam within the program of insolvency administrators preparation;
- have no previous convictions;
- not be disqualified for administrative offences.

In our opinion this does not guarantee the high professionalism of such insolvency practitioners: one can see that the particular profile of a high education is not specified, having engaged in practical activity as an intern for a short period is not enough to get the special skills of managing the indebted business. The majority of modern insolvency administrators in Russia are economic executives who worked in the enterprises of the USSR in administrative command systems and who do not have necessary skills. The restrictions which do not allow foreigners to be insolvency administrators in Russia impede the integration of Russia into the world economic and legal system.

So, to increase the professional level of insolvency administrators in December 2008 the **self-regulated organizations of insolvency administrators** (so-called 'SRO') were introduced.[2] They represent the associations of insolvency managers and now are responsible to issue internal rules and standards of professional activity of their members, examine their qualification, etc. Professional associations are generally recognized in the world as an effective form of professional activity regulation which exists in the majority of countries and helps to restrict activities to only high-qualified insolvency managers. Thereby the lack of federally assigned legal provisions regulating the minimal requirements for potential insolvency practitioners is compensated for by the opportunity to make them stricter in each particular case, to examine knowledge and skills of the insolvency manager who is obliged to be a member of any SRO. In Russia today there are about 38 such SROs, each of which includes a minimum of 300 members who pay member fees equal to a of minimum 50,000 rubles per year (about 1250 Euro).

Despite their announced responsibility to control the activity of insolvency administration by self-regulated organization, in practice SROs are oriented on the necessary-time tasks: imposing sanctions on their own members who violate any rule or the Law a SRO only suggests that such insolvency administrator increases the size of the member fee, almost nobody is excluded from SROs though many complaints were received by arbitration courts.

New law provisions **allow a creditor** who is filing for the bankruptcy of his debtor or the creditors' committee **to choose a particular person to manage this particular proceeding** from the range of insolvency practitioners **and even to present additional requirements** for him (Article 20.2 of the current Insolvency Law), e.g.:

- to have high economic or legal education or to be educated in the particular sphere in which the debtor's business works;
- to work in an executive position in the particular economic sector;
- to conduct only some definite procedures from the whole range during the bankruptcy proceedings.

On the one hand, using this opportunity, creditors can provide a more qualified specialist who knows the specifics and can act more reasonably, making creditors more protected. On the other hand the opportunity to choose an insolvency administrator does not guarantee the freedom of making fair decisions as creditors, perhaps, will try to impede the debtor's rehabilitation in order to get their money back in a short period of time. In practice the appointed insolvency administrator

2 See Federal Law № 296-FZ "On alteration of the Federal Law "On insolvency (bankruptcy)" from 30.12.2008.

in the majority of cases is still controlled, whether by creditors or by the debtor who filed for bankruptcy to escape from his debts when all valuable assets have been already removed.

To stimulate insolvency administrators to provide reorganization and other procedures more effectively the system of **remuneration became more modern**: now their salary depends on the type of the bankruptcy procedure and includes **not only a fixed minimum but also the sum of percentages** from the book value of the debtor's assets.

- For the supervision procedure the fixed minimal remuneration is 30,000 rubles (750 Euro);
- For the financial rehabilitation procedure – only 15,000 rubles (375 Euro);
- For the external administration the amount is the largest – 45,000 rubles (1125 Euro);
- For the liquidation procedure the fixed remuneration is 30,000 rubles (750 Euro).

Obviously the legislators set the maximum sum for an external administrator to demonstrate the proper priority of reorganization as a bankruptcy institute while the administrator in the financial rehabilitation procedure is still discriminated against with the smallest fixed salary which is even less than average salary in Russia which in 2010 was about 21,550 rubles (540 Euro). The sum of percentages for the administrator in the financial rehabilitation procedure is also as small as for the administrator during the first bankruptcy procedure – supervision.

Connection with "the book value of assets as of the last balance sheet date before the procedure commencement date" (Article 20.6, paragraph 14) also does not make the procedures' implementation more effective. In this case the remuneration is not paid for the quality of the insolvency administrator's work but depends on the debtor's size: an administrator who has had no opportunity to work yet will get the remuneration even if his further activity will not give any results. Besides, taking into consideration how this book value can be derived before bankruptcy – whether it can be artificially overrated or underrated (when all assets was hidden) – we can say that the book value size can not reflect the real volume of the insolvency administrator's work and the remuneration based on this factor will not motivate the administrator to work better but will only stimulate administrators to choose the most indebted businesses.

According to the Article 20.7 of the current Law an insolvency administrator can get additional remuneration at the expense of creditors who decide to give him

such additional money or of the amount due to them as repayment of their demands. Thereby an insolvency administrator is interested in satisfying this particular group of creditors and this may negatively influence the other groups of creditors and the debtor.

Thereby although these amendments are in keeping with the world practice they still do not increase the effectiveness of rehabilitation procedures.

Creditors' position during the insolvency proceedings

The recent financial economic crisis also sharpened the problems in respect of creditors' protection which is also necessary in most cases for getting their agreement for the debtor's rehabilitation procedure and to make legislation more balanced according to the European practice as a whole. So, another Federal Law[3] was passed very quickly at the end of 2008 and has changed some provisions about the rights of usual and secured creditors.

Secured creditors got the opportunity to charge the pledged property in the process of financial rehabilitation and/or external administration if the debtor would not be able to prove that it would make his solvency restoration impossible. In practice this means that, on the one hand, secured creditors become more protected and the order of pledged property sale is now specified in a better way, but, on the other hand, if one of the creditors takes this most important and expensive pledged asset away during the procedure there could be left nothing to sell for satisfaction of other creditors. In this case the rehabilitation of the debtor's business will also hardly be possible.

The Law guarantees that from **20 to 30 percent of the pledged property the selling price is reserved for the satisfaction of claims of the most vulnerable unsecured creditors** – the first- and second-priority creditors, i.e. people to be paid for the life and health damage and workers of the company-debtor. So one can see that if in European countries these socially vulnerable creditors are often protected by the State, in Russia it is only the first step to make workers get compensation after the bankruptcy of their employer.

The court costs should be estimated

One more innovation concerns the expenses of the bankruptcy proceedings in the court. According to the new provisions (Article 57.1) insolvency proceedings stop

3 See Federal Law "On Alteration Of Some Russian Federation Legislative Acts In Connection With Perfection Of The Order Of Charge On The Pledged Property" from 30.12.2008 № 306-FZ

if a debtor's money is not enough to cover the court costs. This measure looks progressive and is close to regulation in Europe but it has some specification in Russia connected with the bankruptcy costs. In practice all court costs in the usual bankruptcy procedure are about 300-400 thousand rubles[4] (7.5-10 thousand Euro) plus monthly expenses on the lawyers. But the assets value of 90-95% of debtors is less than 1 million rubles (25,000 Euro). So when the court costs are relatively high rehabilitation procedures are hardly possible.

Transparency of insolvency proceedings

In the modern world the questions of transparency are of particular importance: transparency makes insolvency administrators more responsible and cautious, and the process of monitoring by the interested parties is made easier – you can refer to the court in time (if you see that your partner is insolvent), analyze the current positions of business in different economic sectors, etc.

The next Law modernization in 2010-2011 was connected with increasing the transparency of bankruptcy proceedings:

- Offline auction as a method of assets selling was practically denied. Now the majority of auctions during the bankruptcy procedure are conducted online and that establishes the selling price in a fair way and minimizes corruption.
- Before 2010 all information about insolvency proceedings in Russia was published only in the Saturday issue of the newspaper "Kommersant" at 20-25 sheets in small print. Now the Unified State Register of Bankruptcy Data has been established: on the special website you can see the information about the company-debtor, about insolvency administrators in the convenient table form.

The Law draft

Today the understanding of the use of bankruptcy procedures as a way of crisis management is common in the world: both in Russia and in European countries legislation continues to modernize trying to make rehabilitation procedures more applicable and a priority. In Russia the draft of a new Insolvency Law presented by Ministry Of Economic Development in July, 2009 even changed its name from the Law "On insolvency (bankruptcy)" to **the Law "On financial rehabilitation and insolvency (bankruptcy)"** that shows how serious the intentions of our legislators are. The following provisions are proposed:

4 A. Yukhnin – Director of the Centre of Bankruptcy Problems, Overview of the Main Changes in Russian Insolvency Law (May 2011, Materials of his open lection in The Lomonosov MSU, Moscow).

- The debtor gets an opportunity to apply to the court directly for restoration of the business without the first obligatory procedure of supervision. It is common in many developed countries and allows the debtor not to lose time but to start reorganization of temporary insolvent business having good chances to restore its operational, financial and investment activity. Unfortunately the set of financial and economical instruments used for the business rehabilitation in Europe is much wider than in Russia.
- The financial rehabilitation period is a maximum of five years. In our opinion this measure is the question at issue: a 5-year period is too long just to restore the solvency of the usual business and can be used mostly for the giant enterprises. It should be taken into consideration that during all these 5 years there will be a moratorium on the debts charging which can disrupt the financial performance of creditors, make the debt lose its value and break the balance between creditors and the debtor. If it comes into force large creditors like banks will definitely be displeased because of the inflation and risks of asset-striping by the debtor during this long period.

As to the other directions of the draft legal provisions it is also suggested that the following be introduced, provisions which are absolutely new for Russia but usual for most European countries:

1. **Corporate groups insolvency** the introduction of which is the most problematic direction of bankruptcy law modernization because holdings do not want to be liable for their subsidiaries' debts. Despite the fact that in 2009 some special definitions (like "control person of the debtor", "obligatory guidance") appeared in the Law, the adoption of this amendment will be a long way off as these large business structures have a strong lobby in the Government and legislative authorities.
2. **Cross-border insolvency** amendments which are practically prepared and approved but due to the majority of legal approving stages this law draft still is not passed. This is the world well-known mechanism of transnational bankruptcies: the insolvency proceedings of companies whose centres of main interests (COMI) are situated in Russia should be in the competence of the Russian commercial courts. This step is very important for the integration of Russia in the world economic and legal system, for expanding partnerships all over the world but the problem here is that the concept of COMI should be specified in the Law. The criteria which usually define the COMI concept can be contradictory, be challenged owing to political interests and national protectionism. This is why the transnational bankruptcy proceedings are hardly used not only in Russia but in many other countries.

Conclusions

In the last ten years Russian insolvency legislation has been amended many times but recent and forecasting amendments are crucial for our country, they mostly make bankruptcy proceedings more transparent and applicable for modern conditions where the viable business should be rather reorganized than liquidated. Though the majority of new provisions are like the European legislation in Russia they have some specifics. In general the volume of the current Insolvency Law criticism has significantly decreased but many problems still need to be solved.

The further modernization of Russian bankruptcy law will develop in the following directions that should help our country to perform better in the world economic space:

- Improving the professional level of insolvency administrators by using advanced training for them in accordance with special programs of this professional training for crisis managers which should be worked out and contain the amount of such study hours. The practice of systematic refresher training exists in association with the professional accountants or auditors, gives good results and should become a obligatory condition to continue professional activity as an insolvency administrator.
- Building an effective system of remuneration and control of insolvency administrators when their salary will depend on the results, i.e. solvency restoration instead of "the book value of assets".
- Making financial rehabilitation and external administration real chances to restore solvency without procrastinations which allow asset-stripping.
- Accelerated adoption of the corporate groups' insolvencies provisions.