

Restructuring, enforcement or bankruptcy in Russia: Options of a creditor

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The financial crisis has strongly impacted the ability of many Russian companies to repay their debts. Creditors having financially troubled borrowers may, depending on the circumstances of each transaction and the financial standing of the borrower, consider any of the following options to recover their debts:

- i) restructuring of the borrower's indebtedness;**
- ii) enforcing available security; or**
- iii) filing an application for the borrower's bankruptcy.**



Restructuring

Debt restructuring

Creditors having significant exposure to the borrower generally opt for the option of restructuring if the possibility exists that the borrower's financial standing as a result of the restructuring may be restored. There is no "one size fits all" model approach for a restructuring and many permutations exist on the market. However, the following options of a debt restructuring are most frequently used by creditors in the market:

- i) refinancing of the borrower's indebtedness by way of providing additional financing to the borrower ("Refinancing"); and
- ii) renegotiation of the terms of the existing loans without providing additional financing to the borrower ("Renegotiation").

Refinancing. Existing creditors and often new creditors will enter into a syndicated loan agreement to provide additional funding to the borrower in order to refinance the borrower's existing indebtedness to its creditors and to ease its liquidity problems.

The performance of the borrower's obligations under the new loan agreement may be secured by security to be provided by the borrower or a third party. If security is to be provided and part of the security package includes assets which have already been pledged to secure the borrower's existing facilities, the syndicate creditors either (i) take a second ranking security over assets already pledged and upon refinancing and release of such security – the second ranking security in favour of the syndicate creditors becomes a first ranking security; or (ii) wait until release of the existing security and then take a first ranking security.

Renegotiation. In certain cases, creditors will not be prepared to provide additional financing but may be prepared to renegotiate the terms of the existing loan documentation to provide other accommodations to the borrower. In this case, the creditors and the

borrower merely amend the existing loan documentation to reflect the renegotiated terms of the loan facilities (e.g. waiver or relaxation of financial covenants, extension of the loan maturity and/or rescheduling of payments under a new repayment schedule, increased margin, tighter covenants, additional security, etc.).

To make this type of restructuring effective it is important for the creditors who are bilateral creditors to harmonise the main provisions of the existing loan documentation. It is helpful if, for example, all creditors have the same acceleration rights following the occurrence of an event of default under any loan agreement. In addition, the creditors may also consider entering into an intercreditor agreement to provide for a mechanism of the creditors' joint actions in recovering the borrower's debts, enforcing the available security and sharing the proceeds received by the creditors as a result of any enforcement.

Practical steps

Where the borrower has multiple creditors who will take part in the restructuring, it is essential to coordinate the actions of all of the borrower's creditors. Based on our experience, the following steps should be undertaken by the creditors to implement the restructuring of the borrower's indebtedness:

- i) **Standstill agreement or analogous:** Signing of an agreement (e.g. in the form of a memorandum of understanding or an English law governed standstill agreement) whereby the creditors agree, *inter alia*, during a certain period not to (a) demand repayment, or accelerate payment, of amounts due; (b) demand payment of interest and/or default interest; (c) enforce their rights in any underlying security; or (d) file an application for the borrower's bankruptcy.
- ii) **Classes of creditors:** Identification of all classes of the borrower's existing creditors (e.g. suppliers, landlords, bondholders, etc.) and the borrower's

exposure to such creditors in order to assess the ability of the borrower to perform its obligations to such creditors during the restructuring.

A restructuring with one group of creditors where another group of creditors, for example, bondholders, can accelerate their indebtedness will likely not be acceptable to the first group of creditors or the borrower. All creditors should be identified and an attempt made to include all parties in an overall agreed restructuring. Often due to timing considerations of contacting multiple bondholders, bondholders will be dealt with separately from other creditors.

- iii) **Steering committee or analogous:** Formation of a “steering committee” or appointment of the creditors that would lead the restructuring.
- iv) **Financial audit:** Performance by an independent auditor of a financial audit of the borrower. An independent audit is recommended in order to provide creditors with sufficient independent financial information for the purposes of developing a restructuring plan.
- v) **Financial recovery plan:** Delivery of the borrower’s financial recovery plan. It is advisable that the financial recovery plan (if prepared by the borrower) is reviewed and confirmed by the independent auditor which has performed the financial audit of the borrower.
- vi) **Term sheet:** Signing of a term sheet detailing the terms and conditions of the agreed restructuring.
- vii) **Restructuring documentation:** Often the “steering committee” will lead the process of drafting and negotiating the restructuring documentation.

The participation of all creditors in the restructuring of the borrower’s indebtedness is recommended in order to achieve a successful restructuring. It will also minimise the risk of a third party who is not taking part in the restructuring filing an application for the borrower’s bankruptcy and/or challenging the validity of the transactions concluded by the borrower as part of the restructuring. If certain creditors refuse or are not invited to participate in the restructuring, it is important to ensure that such creditors’ claims are satisfied by the borrower in a timely manner.

INSOL principles

International creditors will often expect any restructuring to follow the principles of the International Association of Restructuring, Insolvency and Bankruptcy Professionals (INSOL). However, the application of the INSOL principles in restructurings involving Russian borrowers has been rather limited, mainly, due to a lack of practical restructuring experience on behalf of Russian borrowers and creditors. For example, Russian borrowers generally

prefer to agree separate arrangements on a bilateral basis rather than developing a unified approach *vis-à-vis* all creditors and signing a multilateral agreement with the creditors.

Further, Russian borrowers are often reluctant to provide sufficient financial and accounting information to their creditors (in particular, foreign creditors), which may significantly impact the creditors’ ability to analyse the borrower’s financial standing and to prepare an appropriate restructuring plan.

Risks related to restructuring under Bankruptcy Law

Restructuring arrangements concluded on the eve of a borrower’s bankruptcy may be challenged by an arbitrazh manager under Federal Law No. 127-FZ “On Insolvency (Bankruptcy)” dated October 26, 2002 (“Bankruptcy Law”). In particular, the arbitrazh manager is entitled to challenge the following transactions entered into by a borrower:

- i) **“Unfair transaction”**, i.e. a transaction in the year preceding the court’s acceptance of the bankruptcy application and at any time after its acceptance, where the value of the consideration received by a borrower is less than the value of the borrower’s own performance.
- ii) **“Suspicious transaction”**, i.e. a transaction in the three years preceding the court’s acceptance of the bankruptcy application and at any time after its acceptance which aims at causing detriment to creditors’ property rights, provided the counterparty was aware of this aim. The Bankruptcy Law presumes the counterparty was so aware if (a) it is an interested party; (b) it is aware or should have been aware of such detriment to creditors’ property rights; or (c) evidence exists of financial insolvency or insufficient assets of the borrower.² Further the Bankruptcy Law presumes the aim of a transaction is to cause detriment if, *inter alia*, the borrower fell under the criteria of financial insolvency or insufficient assets.
- iii) **Preferential transactions**, i.e.
 - a transaction concluded within one month preceding the court’s acceptance of the bankruptcy application and at any time after its acceptance which results in a preference conferred upon a particular creditor (e.g. provision of new or additional security, shortening of a loan maturity with respect to a selected creditor; etc.); or
 - a transaction concluded within six months preceding the court’s acceptance of the bankruptcy application, provided the creditor was aware or should have been aware that the borrower fell under the criteria of financial insolvency or insufficient assets.³

The arbitrazh court will not include the creditors' claims in the debtor's register of bankruptcy claims until the legal proceedings in respect of an alleged invalidity of a restructuring transaction (or a part thereof) have been completed. Such a creditor will, thus, be prevented from exercising its bankruptcy creditor rights under the Bankruptcy Law.

All of the assets, which have been returned to the borrower as a result of a successfully-challenged transaction, become part of the borrower's bankruptcy estate. Creditors' claims under a suspicious transaction or a preferential transaction mentioned above, which has been declared invalid under the Bankruptcy Law, are satisfied last after the third priority creditors' claims have been settled. As for creditors' claims under a successfully-challenged preferential transaction mentioned above, such claims are satisfied in accordance with the general procedure established by the Bankruptcy Law.

Therefore, each restructuring transaction should be carefully considered by the relevant creditors who should assess the impact of the restructuring on the property rights of the borrower's other creditors and whether the borrower will fall under the criteria of financial insolvency or insufficient assets in the foreseeable future.

Enforcement

A creditor who holds security may decide that it would prefer to seek to enforce that security rather than enter into a restructuring where the long-term outcome may be more unpredictable than receiving enforcement proceeds now.

Under Russian law, foreclosure on pledged property may be undertaken either through court proceedings or without recourse to courts.

Judicial enforcement

The judicial levy of execution on pledged property includes two stages:

- i) **Judicial procedure:** Consideration of a claim on judicial levy of execution by a competent arbitrazh court.
- ii) **Execution procedure:** Institution of the enforcement proceedings by a court marshal on the basis of the arbitrazh court's decision, which may include seizure over debtor's property (the type, scope and terms of limitations over the debtor's property are determined by a court marshal on a case-by-case basis) and organisation and conduction of a public sale. The pledgee's claims are satisfied out of the proceeds from the sale of the pledged property immediately after payment of enforcement related costs and expenses.

As a result of the impact of the global financial crisis on the Russian economy, Russian arbitrazh courts

have developed an approach where they will examine claims with respect to recovery of debts and foreclosure on pledged property with greater scrutiny. If a creditor is unable to confirm the occurrence and duration of a significant payment default, the arbitrazh court may reject the creditor's claims as an "abuse of rights" under Article 10 of the Civil Code of the Russian Federation.

Extrajudicial foreclosure

Foreclosure on pledged property may be generally undertaken without recourse to courts if specifically provided for in an agreement between the pledgor and the pledgee which can be either in the form of a separate agreement or be incorporated in the pledge agreement. Generally, it is recommended that pledge agreements when entered into contain out-of-court enforcement provisions.

The provisions of Russian law regulating out-of-court enforcement have been considerably expanded and improved to include, *inter alia*, the following:

- i) **Enforcement options:** The parties may generally elect any of the following enforcement options which shall be specifically listed in the enforcement agreement:
 - a public sale organised by the pledgee, a specialised organisation or another person;
 - transfer of the ownership title to the pledged assets to the pledgee; or
 - sale of the pledged assets to a third party without a public sale (either by the pledgee or through an agency agreement).
- ii) **Minimum period prior to commencement of foreclosure:** The pledgor shall be notified of commencement of the out-of-court enforcement proceedings, which generally may start only upon expiration of either 10 days from the date when the pledgor has received the enforcement notice or 45 days from the date when the enforcement notice has been sent to the pledgor; if this term has occurred earlier.
- iii) **Independent appraisal:** In most of the cases, the initial sale price of the pledged property shall be determined by an independent appraiser (e.g. foreclosure upon property with the value exceeding R500,000, non-traded securities or lease rights). However, Russian law is uncertain in respect of the requirements of an independent appraisal of pledged property (e.g. it is not clear how recent an appraisal report needs to be).
- iv) **Notary public's judgment certificate:** If the pledgor does not cooperate with the pledgee during the extrajudicial foreclosure, the pledgee is generally entitled to seek initiation of foreclosure on the basis of a notary public's judgment certificate, which may be granted only if the pledgor does not

raise any substantial objections.

However, given that any dispute in terms of performance of extrajudicial foreclosure would result in a court dispute anyway and that ambiguities in the Russian legislation exist, a creditor will still need to consider whether, in any particular situation, out-of-court enforcement will achieve the desired results.

Risks related to enforcement against pledged property

Prior to initiating enforcement against pledged property, a creditor should carefully consider the following risks associated with foreclosure proceedings:

- i) **Initiation of bankruptcy proceedings by a borrower:** If, *inter alia*, as a result of the foreclosure against pledged property, the borrower's commercial operations will be significantly affected or the borrower will not be able to perform its monetary obligations to other creditors, the borrower will be obliged to file a bankruptcy application with an arbitrazh court pursuant to the Bankruptcy Law. Further, a borrower may file a bankruptcy application if its bankruptcy is anticipated, provided there is clear evidence that the borrower will not be able to satisfy its debts in a timely manner.
- ii) **Mala fide actions by a borrower:** We have seen cases where, as a result of the borrower's *mala fide* actions, the market value of pledged property was significantly decreased on the eve of enforcement proceedings. Therefore, where there are grounds to believe that the financial condition of the borrower has been deteriorating, it is advisable for the creditors to constantly monitor the pledged property to prevent the borrower from taking any *mala fide* actions that would be aimed at decreasing the market value of such property.
- iii) **Significant delay in foreclosure:** We have also recently seen cases where secured creditors were prevented from foreclosing on pledged property as such property had been seized to secure the claims of another creditor of the borrower under an ongoing court proceeding. As a result, the enforcement proceedings were significantly delayed as the pledged property could not be foreclosed upon until the legal proceedings initiated by the other creditor had been completed.

Bankruptcy

General

If creditors have not managed to agree with the borrower on the restructuring of its indebtedness or have been otherwise unsuccessful in recovering their debts from the borrower, a creditor may consider initiating bankruptcy proceedings against the borrower. The initiation of bankruptcy proceedings may act as a

pressure point to bring the borrower to the negotiation table but it may also result in other creditors filing for bankruptcy creating a "snowball" effect which may be difficult to reverse. Accordingly, if the aim of filing a bankruptcy application is to persuade the borrower to negotiate then this tactic should be applied with caution.

According to the Russian newspaper "Vedomosti"⁴, this strategy has been recently successfully tested by OAO "Alfa-Bank" which managed to recover its outstanding debts from Basic Element on the same day on which bankruptcy applications were filed against certain affiliates of Basic Element.⁵

However, the strategy has not always proved to be effective since borrowers may adopt measures to counter such creditors' actions. For example, in recent court cases initiated by OAO "Alfa-Bank" for the recovery of debts owned to it by a borrower belonging to the group of companies "Prodo" the latter has skillfully used, *inter alia*, the following measures which resulted in OAO "Alfa-Bank" abandoning the court proceedings and agreeing to the restructuring of the borrower's indebtedness:⁶

- i) taking a significant amount of loans from the group members to ensure that the borrower's assets will remain within the group;
- ii) defaulting under certain payment obligations of the borrower to the group members and accelerating consideration of the respective claims by Russian courts;
- iii) applying for seizure of the borrower's main assets to secure the claims of the group members arising out of the borrower's payment obligations and, thus, preventing the other creditors, whose claims are secured by such assets, to foreclose upon them; and
- iv) significantly delaying the court proceedings initiated by OAO "Alfa-Bank" against the borrower (e.g. by way of election of arbitrazh assessors or involvement of a third party in a dispute or various other procedural means).

Arbitrazh manager

An arbitrazh manager has a special role during any bankruptcy proceedings. Recent changes to the law have resulted in the authority of the arbitrazh manager being significantly strengthened. Arbitrazh manager's authority includes, *inter alia*, the rights to convene the creditors' meeting, request information about the debtor from any persons, state or municipal institutions, challenge the validity of transactions concluded by the debtor on the eve of the bankruptcy proceedings, analyse the debtor's financial standing and the results of the debtor's operations, protect the debtor's assets, identify the signs of a deliberate or fictitious

bankruptcy, etc.

Satisfaction of secured creditor's claims within bankruptcy proceedings

Unlike other creditors, creditors whose claims are secured with a pledge over the debtor's property ("secured creditors"), have a special status in the bankruptcy proceedings.

The Bankruptcy Law prohibits out-of-court foreclosure on pledged property as of the date of institution of the supervisory procedure which is the first stage of bankruptcy. However, a secured creditor is entitled to foreclose on pledged property during financial recovery and external management, unless the debtor demonstrates to the court that foreclosure on the property will make the restoration of its financial standing impossible.

The claims of a secured creditor rank in third order of priority. However, the secured creditors' claims are satisfied out of the proceeds from the sale of the pledged property in a special manner:

- i) 80% of the proceeds from the sale of the pledged property are used to satisfy the secured creditor's claims arising out of a loan agreement; and
- ii) the remaining 20% of the proceeds from the sale of the pledged property are generally used to satisfy the claims of first⁷ and second⁸ ranking priority creditors and to pay legal costs, remuneration of the arbitrazh manager and other persons engaged by the arbitrazh manager to perform his/her functions.

If the proceeds from the sale of the pledged property are insufficient to pay the secured creditor in full, its claims would be ranked *pari passu* with regular third priority claims (which includes both secured and unsecured creditors).

Conclusion

A creditor finding that its borrower is in financial distress will wish to assess all the options available to it to determine which option will best optimise the chances of recovering its debt. Based on our experience and given certain practical difficulties associated with the enforcement and initiation of bankruptcy options as discussed in this article, a consensual restructuring option is the one most likely to optimise recovery for the creditors.

Notes:

- ¹ An effective court decision or arbitral award acknowledging the borrower's indebtedness is

required.

² "Insufficient Assets" - the debts of the debtor exceed the value of its assets.

"Financial Insolvency" - the debtor stops satisfying its monetary obligations due to its insufficiency of funds (the insufficiency of funds is presumed unless proven otherwise).

³ The participation of interested parties in the aforementioned transactions makes the applicable rules stricter (i.e. knowledge of signs of bankruptcy on the part of interested parties will be presumed).

⁴ See "Vedomosti", 55 (2573), dated March 30, 2010.

⁵ Pursuant to the Bankruptcy Law, an arbitrazh court will terminate the bankruptcy proceedings if, *inter alia*, all bankruptcy creditors participating therein have agreed not to demand satisfaction of the borrower's claims or have refused to pursue the application to declare the borrower a bankrupt.

⁶ See "Vedomosti", 55 (2573), dated March 30, 2010.

⁷ The first priority ranking claims include claims for settlements relating to the claims of the citizens to whom the debtor is liable for harm inflicted to life or health, such settlements being effected by means of capitalising relevant time-based payments, and also compensation for moral harm.

⁸ The second priority ranking claims include claims for settlements relating to disbursement of severance benefits and remuneration for the labour of the persons who are working or have been working under a labour contract and disbursement of royalties under copyright contracts.

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