

A NEW INSOLVENCY LAW FOR RUSSIA:

SUMMARY

Within the framework of the Centre for Co-operation with Non-Members, a group of insolvency experts from OECD countries and members of international organisations, together with Russian high-level policy makers and members of the judiciary, met in March 1995 to discuss the current insolvency legislation, the problems of its implementation, and to suggest ways to improve the insolvency framework, taking into consideration the mounting need for financial discipline in both state-owned and private (privatised) enterprises, as well as the large scale re-allocation of resources which is currently under way in the Russian economy. This process will, to a great extent, be carried through insolvency related procedures of re-organisation and liquidation.

THE LEGAL AND ECONOMIC BACKGROUND OF INSOLVENCY

THE ECONOMIC BACKGROUND

Russia is in the midst of a turbulent transition process, characterised by high inflation, low liquidity in the economy and at the same time an ambiguous subsidies policy towards enterprises. As a result enterprise arrears rose by the end of 1994 to more than Rb 100 trillion (corresponding roughly to 30 per cent of annual GDP). Arrears are proportionally larger in larger enterprises; although they are a cross-sectoral phenomenon, they seem to be more problematic in the energy, ferrous metals, and machine building sectors - most of them parts of the defence-industry complex.

More than 70 per cent of the arrears are inter-enterprise, i.e. they are in the form of "commodity credits" to downstream firms. The rest are mostly debts to the state budget, with only a small proportion owed to banks. Although data are scarce, it seems that, in general, state-owned enterprises are much bigger debtors than even partially privatised or private firms.

A first attempt to face the arrears problem was the introduction of the so-called "bills of exchange", i.e. IOUs by debtor enterprises that are tradable securities. A market was created in this paper but most of it trades at a considerable discount. One result is that banks - presumably better debt collectors than enterprises - have assumed part of the inter-enterprise debt. Nevertheless, and notwithstanding its possible negative macro-economic effects, this approach has yielded very modest results in lowering inter-enterprise arrears.

THE LEGAL CONTEXT

Since the introduction of the current bankruptcy law in 1992, only 231 cases have been brought before the courts. In half of them the court found that the insolvency criterion was not satisfied. Approximately 1/4 of the rest resulted in re-organisation (i.e. external administration) procedures and only two in rehabilitation (sanacia). The great majority were liquidation cases. It is obvious from the above figures that the current law has not functioned in a satisfactory way; apart from a set of disincentives incorporated in the law and discussed below in the section on "the substantive areas of the law", deficient implementation can be traced to a number of other reasons:

- The non-accrual of interest for overdue payments, a powerful disincentive to creditors to initiate proceedings, given the latter's length and the level of inflation. However, according to the recently adopted Civil Code such interest is now due and it can be contractually based on a hard currency rate.
- The very high fees for filing a petition with the Court.

- Big procedural lacunae, related to both the commencement of proceedings, their smooth evolution and the execution of judicial decisions.
- The lack of experienced bankruptcy practitioners.
- The lack of "neighboring" legislation in areas such as accounting, joint stock companies, as well as the lack of the infrastructure for implementing legislation on pledges.
- The need to adopt a Civil Procedure Code, which would address issues such as filing of claims, discovery procedures, execution of judicial decisions, auctioning of assets, etc.
- The inadequacy of insurance legislation (credit insurance being one of the most widely used substitutes for security for lenders).
- The lack of an appropriate and enforceable judicial framework related to fraudulent transactions and breach of fiduciary duties.
- The lack of a Land Code that would allow commercial transactions to be secured by real-estate and provide for a thorough system of registration of land transactions. Art 17 of the Civil Code that allows land transactions is at present inoperative and will remain so until the adoption of a Land Code.

Considerable confusion in the implementation of the current insolvency legislation has been added by the adoption of the Civil Code. The latter provides explicitly (Art 64 and 65) that a new order of claim satisfaction should be applied in the context of liquidation. The order is different - albeit not better - than the existing one, in terms of effective creditor satisfaction; the Civil Code introduces secured creditors as claimants even though the current bankruptcy framework excludes them from liquidation proceedings. These provisions should be reviewed in the context of the current insolvency law reform.

An important new development has been the adoption in March 1995 of a presidential decree on arrears. This decree, which will enter into force in May 1995, provides, among other things, that if a creditor does not, within certain time limits, initiate action against a debtor, the former's claim is transferred to the state budget. Such a measure is indeed very harsh and heavy-handed - bordering on expropriation - and might be extremely difficult to implement. On the other hand, it indicates the willingness of the government to combat the arrears problems and might be useful as a transitory discipline-enhancing measure until the introduction of a more effective insolvency framework.

THE GENERAL APPROACH TO A NEW INSOLVENCY LAW

Before entering into the discussion of specific substance areas within the insolvency legislative framework, policy makers and legislators should agree on certain, general guiding principals upon which the law should be built. These include:

- The scope of the law. The new general framework for insolvency should encompass all commercial enterprises, including physical persons engaged in commerce, although in the latter case specific rules might need to be elaborated. No exceptions should be made for state-owned companies, co-operatives (although specific rules might be needed in this case too), or other, non-corporatised entities. Insolvency proceedings for other, non-commercial entities such as municipalities, non-profit institutions etc. might require a different legislative framework.
- The subject-matter of the law. The contents of the law should be focused on issues of insolvency proper, i.e. on the creditor-driven procedure, initiated and overseen by the Court. The current Russian regulatory framework includes, apart from the Bankruptcy law of 1992, a number of other legislative and institutional arrangements regarding mainly the formation, mandate, and function of the Federal Agency on Insolvency (Bankruptcy) (FAIB). The Agency plays in itself a very useful role in the broadbrush restructuring and quick privatisation of state-owned companies "in difficulty"; this role should be maintained in the transition period as well as the "pre-bankruptcy" procedures related to it.

Moreover, the FAIB could be a central player in creating and developing the infrastructure for outside administrators and facilitating information flows between insolvent debtors and potential bidders. However, all these tasks should remain outside the scope *rationae materiae* of the insolvency law; they serve a different purpose which is, to a great extent, linked to the transition stage of the Russian economy. Incorporating them within the insolvency law would create considerable confusion since it would introduce different and competing notions of insolvency for different types of debtors and create a new and potentially dangerous role for "owners" in the context of bankruptcy proceedings. Apart for certain explicit mentions of FAIB powers within the law (see below), the bulk of legal provisions related to its constitution and tasks should either be codified in a separate law or remain in the form of presidential decrees as it currently is the case.

- The nature of proceedings. It is suggested that insolvency proceedings are of a unitary nature, i.e. that single procedure is implemented that could lead to going-concern re-organisation, piece-meal liquidation, or any other outcome in between. This approach has already been adopted by a number of countries in the context of recent insolvency reforms. It minimises costs and avoids considerable delays and duplication of efforts, when compared with the more traditional, multiple procedures framework.
- The drafting strategy. The law should anticipate the specificities of Russian economic and institutional development in the medium term. These include, on one hand, the existence of a comparatively large number of troubled firms that will have to go through insolvency proceedings; on the other hand, courts have very few resources to rapidly develop their institutional capacity and the same can be said for the rest of institutional players in the context of insolvency (i.e. infrastructure and training for external administration). Consequently, the drafters of the law should place special emphasis in its "user-friendliness", the facility and effectiveness with which it can be implemented. Three methods to enhance this aspect of the law are: the adoption of "bright lines", i.e. hard and fast rules when it comes to thresholds, amounts, voting rules etc. as well as clear-cut definitions of rights and obligations of different agents in the insolvency process; a system of presumptions in areas where court decisions have to be made and the consequent changes on the burden of proof; and finally, time limits for all actions in the insolvency procedure and clear default solutions in the case of non-action.
- Social issues. Although widespread insolvency in the economy is likely to result in increased social problems, such as mass firings and unpaid wages, the insolvency law is not the proper instrument to address them. Specifically-designed social policies, including a wider social security coverage through funds created for these purposes, are a much more efficient solution; they help directly the citizens worst hit by - and usually less responsible for - the enterprise's downfall while preserving the possibility for the debtor to restructure and thus generate new and, possibly, better employment.
- Jurisdiction. Under the current legal framework a lot of confusion is created by conflicting jurisdictional claims between Arbitrazh and General Civil Courts in the adjudication of issues related to insolvency proceedings. The new law should provide explicitly that all types of disputes related to the debtor estate following the initial decision on insolvency should be adjudicated by the territorially competent Arbitrazh Court.

THE SUBSTANTIVE AREAS OF THE LAW

THE STANDARD OF INSOLVENCY

The present Russian law uses a mixed test of balance sheet and payment default criteria. This has created a lot of ambiguities and has been a major disincentive in the implementation of the law by the Courts.

A clear cut payment default criterion should be used to indicate insolvency. There should be a presumption according to which if an enterprise does not pay (a) mature debt(s) amounting to a certain sum to one or more creditors and that payment is overdue for a certain period of time, this enterprise is assumed to be insolvent; the threshold of both the amount and time should be reasonably low (i.e. not the current three month waiting period). As regards the amount, an additional criterion/floor could be established, apart from absolute numerical one, that would relate the debt in question to the size of the debtor: when the amount is for example less than 10 per cent of the outstanding, payed-up equity, the presumption of insolvency would become inoperative. Provided that the above default/liquidity tests are met, the burden of proof of solvency should be assumed by the debtor and should be quite onerous (for example, that payment - including interest - will be effectuated beyond reasonable doubt within the next 30 days). In case of debtor filings the criterion could be somehow broader so that it can include the case where cessation of payments is reasonably expected in the immediate future; the debtor's burden of proof in this case would consequently be lighter.

Any creditor, acting alone or jointly with other creditors could initiate bankruptcy proceedings. Debtors could also file under the conditions outlined above. Compulsory filings could also be envisaged, but in this case the amount and (possibly) time thresholds of the trigger should be higher; if compulsory filings are adopted they should be backed by pecuniary sanctions for the manager/chief executive (in the case of a legal person) or the entrepreneur. Finally, the FAIB should be explicitly allowed to file for bankruptcy, in the case of enterprises that come under its scope.

All mature debt (i.e. both commercial and financial) should be included in the definition of insolvency.

Bad faith filings should in principle be dealt with outside the bankruptcy framework - i.e. as tort actions. Moreover, in cases of creditor-led filings, the debtor' counter-filing of a bad faith complaint against the creditor should not result, in principle, in a stay of the bankruptcy process. There could be a provision on fines for abuse of the bankruptcy law for a mala fide filing.

THE MANAGEMENT OF THE DEBTOR

As with the trigger discussion, the main issue here is to make proceedings simple effective and market-oriented. These objectives are best served with the introduction of a creditor-driven procedure. For this purpose, the law should provide for an early creditors meeting. Until then it should appoint a provisional external administrator/trustee.

The creditors could decide on the appointment of an external administrator or the maintenance of debtor-in-possession arrangements; in the latter case it might be advisable to provide for a qualified majority of claims. Debtor-in-possession arrangements should neither be encouraged nor excluded; in some cases it might be prohibitively expensive to hire external administrators. The Court should accept the creditor's choice unless there is strong evidence - raised by creditors or, where appropriate the FAIB - of a wilful attempt to abuse the process. However, and given the current situation of enterprise management, where debtor-in-possession arrangements are chosen it might be advisable to provide the nomination by the court

of an external supervisor. The creditors committee should also be allowed at any point to change existing debtor-in-possession arrangements.

Where the FAIB is a party to the proceedings, there might be a presumption on the appointment of external administration by the Agency, unless a qualified majority of creditors opposes it.

The law should provide for a very flexible regime regarding the administrator's remuneration. Performance-linked schemes should be specifically allowed.

The administrator (or debtor-in-possession) should have wide ranging powers, which should include the disposal of assets not essential to the business. This could include, with the permission of the Court, the exclusion from the automatic stay of certain collateralised assets.

THE EFFECTS OF BANKRUPTCY DECISION

A bankruptcy decision by the Court should have four important consequences, outlined below. At present, the 1992 Law provides only for some of them in certain procedures and in an incomplete manner.

The creation of an estate. The creation of an estate which encompasses all property rights of the debtor, including collateral and mortgaged property should be the first result of bankruptcy decision. All assets in the books/balance sheet of the debtor should be assumed to be part of this estate, but the administrator (including a provisional one) could also include assets that are not in the accounts of the company; the bankruptcy court should decide through a summary procedure, on the ownership status of these "hidden" assets, for the purposes of the bankruptcy proceedings (i.e. the administration of these assets).

In the case of Russia, a thorny issue related to the estate question might be the ownership of a vast array of "social assets", i.e. workers housing, stadiums, kindergartens, vacation facilities, etc. by the enterprises involved. It seems preferable not to include these assets in the estate for obvious social reasons; on the other hand, they should be separated quasi-automatically (i.e. as a direct consequence of the bankruptcy declaration) from the enterprise and transferred to the local authorities.

Stay of creditor action. A comprehensive, automatic moratorium on creditor action is a fundamental prerequisite for the creation of real collective proceedings that will avoid a "run" for the debtor's assets. All pre-insolvency creditors - including secured ones - should be included in this moratorium. Excluding secured creditors from the bankruptcy process as it is now the case under the 1992 Law cancels most of the benefits of collective proceedings. On the other hand, inclusion of secured creditor should be compensated by ensuring that interest and depreciation of collateral are treated as part of their original claim.

It probably makes sense to include set-off (i.e. the mutual cancellation of claims between debtors-creditors), in the automatic stay, since this would facilitate the work of the trustee and the creditors committee in assessing the real situation of the debtor. Nevertheless, the trustee could ask the court for approval (i.e. exemption from the moratorium) of set-off arrangements, if that is beneficial to the estate. A separate case for excluding set-offs with the government could be made; such an arrangements would probably be beneficial to the other creditors, given the priority ranking of tax claims.

Avoidance powers. There should be vast powers of avoidance vested in the administrator of the estate. These should encompass all transactions that objectively have harmed creditors as well as gratuitous acts. Given the need for speed in the proceedings, avoidance powers should be exercised for a large category of acts, such as satisfaction of immature claims and gratuitous acts, on the basis of a presumption - such acts could be enumerated in the law. Even more stringent rules - i.e. heavier burden of proof - should be applied to transactions with insiders; in this case the rules could assume that all acts except for wages fall within

the avoidance power of the trustee. Nevertheless, in cases where the avoidance of collateral is anticipated, the Court may need to be more involved in deciding on the substance.

Executory contracts. Executory contracts (i.e. contracts not fully executed by both parties, such as leases, labour contracts, etc.) should be subject to rejections for their future component, irrespective of the time they were concluded.

A different arrangement should be made for utility services (i.e. electricity, water, etc.). Such services should be assured even if the original contract is terminated. Utilities thus become administrative creditors and their claims for the insolvency period have priority ranking.

Social problems related to the use, through executory contracts, of social assets should be dealt with in the context of their separation from the estate, outlined above.

THE INSOLVENCY PROCEDURE

The 1992 law provides for 5 different alternative procedures that can be followed in the context of insolvency. The two that are meant to serve re-organisation of the debtor seem to be rather ineffective (the composition procedure is cumbersome and riddled with wrong incentives); rehabilitation (sanacia) is a procedure of restructuring which has little relevance to the fact of insolvency. External administration and compulsory liquidation, albeit quite incomplete as they now stand, could provide a basis for the elaboration of a new procedure. Finally, voluntary liquidation is a useful tool which, however, should be within the confines of company rather than bankruptcy legislation.

It was already mentioned that a unitary procedure seems to be the most effective way to organise insolvency proceedings. The creditors should be able to choose between different plans of selling the business as a whole, selling parts of it as going concerns or separate assets or re-organising the firm and its capital structure by reshuffling property rights among existing shareholders and creditors; obviously the final solution could in any particular case be a combination of the above. In order to get as many alternative as possible, the submission of bids should be open to anyone (i.e. including current shareholders, managements, employees, creditors, and third parties). Another important prerequisite for the facilitation of bids is the availability of information on the debtor company; on this, there should be specific provisions on the powers and obligations of the administrator of the estate.

Both cash and non-cash bids should be allowed in the process of re-organisation/liquidation. This accepted principle is even more important in Russia where liquidity is very low. Debt-equity conversions in particular should be encouraged (with an exception where the state or enterprises majority-owned by the state are the creditors).

There should be no threshold for claim satisfaction in the context of re-organisation as there now is in composition procedures. Creditors should be free to accept any amount of debt write-offs they see fit. As mentioned below, the state should in principle be treated as a general creditor. However, in case it is decided that it should have a priority status as claimant for the purpose of distribution of the proceeds, the state as creditor should be statutorily obliged to accept to write-off or reschedule debt on conditions that are as favourable as those of the immediately lower class of creditors.

In order to approve or reject plans, creditors should be grouped into classes of creditors; the opposite might result in a serious breach of the absolute priority rule. However, given the complexities and transaction/administrative costs involved, the class structure should be simple (maybe no more than two classes should exist); shareholders could be excluded from the decision making process, with the possible exception of the FAIB. The required majorities should be claim-based and the thresholds for approval low

(i.e. 51 per cent of the amount of claims in each class). There should also be a possibility for the court to impose the re-organisation plan adopted by one class onto another class of creditors, a procedure known as "cram-down". The implementation of the cram-down rule by the court should be guided by a number of considerations: the amount of claims dissenting to the proposed solution (in both the upper and the lower classes), the availability of other feasible alternatives, or whether the plan is manifestly unjust, i.e. it allows junior classes to satisfy their claims even though senior claimants are not 100 per cent satisfied, it allows a class to get more than 100 per cent of their claims, or it imposes a settlement for manifestly less than full liquidation value.

In order to facilitate the complicated evaluation and voting procedure within different classes, detailed rules should be laid down to this effect. Such rules should not necessarily be a part of the bankruptcy law; they could be an annex to the latter or the subject of a decree, following a specific enabling provision in the law.

ORDER OF CLAIMS

The present order of claims in the 1992 Law is unsatisfactory. Moreover, as mentioned above, the introduction of the civil law has further confused the situation.

Administrative/post-insolvency claims should in principle have priority over other, pre-insolvency claims. This is especially true for the administrator's fees (not, however, their performance-related bonuses) and expenses related to the procedure. Other post-insolvency creditors, including post-insolvency wage claimants, should not have absolute priority over secured creditors, since this could significantly distort market-based incentives. Nevertheless, it might be advisable to "split the pie" between post-insolvency and secured creditors, so that re-organisation attempts become more likely, with the provision of fresh working capital and the maintenance of an adequate labour force.

Claims by secured creditors should be on the top of the order. This is a fundamental prerequisite for the market-conformity of the proceedings and for the development of an effective system of corporate finance by the banking sector.

Although in many OECD countries tax arrears and other state budget claims have priority ranking, most experts and policy makers agree that such a ranking is not justified and may actually be an obstacle to successful re-allocation of resources within the insolvency framework. It is more rational to treat state authorities as general creditors.

Tort claims related to personal injury and loss of life are generally the object of insurance coverage and should therefore not figure at all among priority claims, at least in principle. However, given the fact that insurance coverage is not yet widespread enough in Russia, such claims could figure ahead of the general creditors, in cases where there was no insurance coverage.

Claims for unpaid wages should also be, in principle, covered by social security in the case of bankruptcy. However, given the current transition difficulties in Russia, such claims, limited to a brief (i.e. no more than 3-month) period before insolvency, could be ranked above general creditor claims.

Bondholders should be clearly included under the general creditors category.

Interest of unsecured claims for the post-insolvency period should be subordinated to general creditor claims. That should also be the case for shareholder credits to the debtor.

Shareholders should be the last category in the order of claims. There should be no distinction between different types of shareholders (i.e. employees, managers, the general public, etc.).