The Bankruptcy Law and its Enforcement in Russia

Alla Bobyleva\(^1\), Olga Lvova\(^2\)

Abstract

The article is devoted to the analysis of bankruptcy institute development in Russia. Insolvency system is one of the key factors of increasing the market economy efficiency. The objective of the research is to reveal specific features of Russian insolvency legislation and its enforcement, to identify the main problems and suggest directions for its improvement and integration with global trends. The article describes the main features of current Russian Insolvency Law and its disparity with European approaches, the specific features of informal workouts in Russian insolvency system, the current initiatives to improve the insolvency institution and further directions of modernization.

The conducted research allows to make the following conclusions.

1) Despite the constant updating of bankruptcy legislation in Russia, most of the amendments contain only partial changes and do not address conceptual issues of bankruptcy: improving the effectiveness of recovery procedures, increasing debt repayment.

2) The traditional understanding of informal workouts as out-of-court agreements between distressed companies’ management and their creditors can be completed by governmental actions for state support to a particular company. The results of these widespread informal workouts in Russia can be both positive and negative. On the one hand, the selective governmental support may give a fresh start to a business and a unique chance for a recovery. On the other hand, such informal workouts may artificially prolong life of actually unviable business, increase losses for all stakeholders or contribute to the development of criminal corruption schemes. The practice of Insolvency Law implementation shows the possibility of its “creative” application when institution of bankruptcy is used for repartition of the property, corporate raiding, failure to meet obligations. A large number of informal workouts is not always transparent and accountable and the rule of law is not the main principle in their implementation.

3) We see the following main priorities of Russian insolvency institute modernization: prevention of bankruptcy by so called “pre-packed bankruptcy” and “pre-packed sales”; strengthening rehabilitation opportunities within insolvency procedures by the development of tools for reorganization of operational, investing and financial activities of distressed companies; making the remuneration of insolvency administrators more result-oriented by introduction a transparent scale of stimulation and motivation of their interest in increasing the number of rehabilitation cases, the value of distressed business and (or) its assets for sale; development of market approach in the support of large-scale “strategic” companies; transformation of international collaboration concept from protectionism to the international cooperation, coordination of efforts, transparency, fairness, reduction of prices of international insolvency proceedings.

The main directions of insolvency institute modernization in Russia should be implemented through the adoption of a full-scale new Insolvency Law: the fundamental changes are impossible on the basis of the random amendments to the current Law.

It is also important to change public opinion: to move from a current understanding of bankruptcy as a purely liquidation procedure and business collapse to the perception of insolvency proceedings as the possibility to restore distressed company and give the fresh start.

---

\(^1\) Doctor of Economics, Professor, School of Public Administration, Lomonosov Moscow State University, Moscow, Russia.

\(^2\) PhD in Economics, Associate Professor, School of Public Administration, Lomonosov Moscow State University, Moscow, Russia.
**Keywords:**
Insolvency, bankruptcy, business recovery, distressed companies, informal workouts, bankruptcy prevention.

**Points for practitioners**

The debtor’s goal is prevention of bankruptcy at the first signs of financial failure. It can be autonomous out-of-court agreement between the distressed company’s management and its creditors. If such workout is impossible because of debtor’s poor financial situation or creditors’ intractability, the debtor should make attempt to make “pre-pack bankruptcy” or “pre-pack sale” with the help of insolvency administrator under control of the court.

*Insolvency administrator* should try to restore indebted company. He must identify the debtor’s financial situation and the key drivers of restoration, create a reorganization plan and convince key stakeholders and the court that the plan is feasible. If rehabilitation is impossible, insolvency administrator should strive to provide complete satisfaction of creditors’ claims by selling debtor’s assets or the whole business at maximum possible price.

*Legislative and executive authorities* should make efforts for: strengthening rehabilitation opportunities in bankruptcy procedures; prevention of bankruptcy, stimulating so called “pre-packed bankruptcy” and “pre-pack sales”; distinguishing cases of the acquisition or divestment of a distressed company from the total mass of mergers and acquisitions (M&A). The state can also play an active role in M&A with distressed companies by the development of privatization plans of large state-owned enterprises. Also it is necessary to adapt Russian law to the international rules of cross-border insolvencies: Russia is a part of global economic system and arising contradictions should be resolved with a glance to international Law and practice.

**1. Introduction**

Insolvency institute is one of the key factors of increasing the efficiency of market economy and it attracts much attention all over the world, including Russia. Insolvency Law in contemporary Russia started to develop in 1992 when the first specific Law was adopted. The current Federal Law №127-FZ at 26.10.2002 “On insolvency (bankruptcy)” came into force in 2002 and more than 90 amendments were adopted during the next years.

In spite of ongoing improvement, most of interested parties are still discontented with current insolvency legislation. These parties are:

- creditors to whom the debtor fails to repay debts;
- debtors who have few possibilities to undergo rehabilitation procedures and restore their business;
- legislators who constantly try to modernize the current Law;
- judges, who often do not have a clear guidelines to act in specific situations;
- authorized bodies (i.e. Federal Tax Service) who act as the creditor on obligatory payments and do not have possibility to administer collection of debts adequately;
- analysts, experts, scientists who monitor the changes in the bankruptcy institution in Russia and abroad.

A certain delay in the development of the bankruptcy institution from the needs of time confirms statistic data:

- the level of creditors’ claims satisfaction is reducing: in 2015 6.2 % of claims were refunded after bankruptcy proceedings, in 2018 – only 5.2 % (UFRBI 2018);
rehabilitation procedures were only 1.25-2 % of the total court bankruptcy procedures in 2015-2018 (UFRBI 2018);

duration of the most popular procedure in bankruptcy – liquidation – increased over the past two years by almost 33 % and now on average is 511-665 days depending on the type of debtor (UFRBI 2017).

Thus, many problems related to insolvency and bankruptcy remain unsolved in Russia. At the same time statistical data of USA, France, Germany, England and Wales show positive dynamics of the above indicators. In this regard, the recent novels of legislation and its enforcement in these foreign countries as well as the examination of recent attempts of Russian Insolvency Law modernization should be considered.

2. Theoretical framework

Although scientists around the world pay attention to the bankruptcy problems, various aspects are investigated differently. Many researchers focus on cross-border insolvency and international bankruptcy law, which is very important due to the strengthening of cross-border cooperation: such fundamental works are made by Wessels (2014) and Omar (2008). The important role for the practical application of the unified insolvency principles is played by the activities of “Working group V: Insolvency Law” of the United Nations Commission on International Trade Law (UNCITRAL)3.

Russian scientists and practitioners also address these issues, but research is mainly limited by analytical and descriptive approach: the insight of international experience and models of cross-border insolvency regulation, known in Europe, Latin America, Africa and Asia. As a rule, there are no specific proposals on how to integrate the Russian insolvency institute into the global processes: usually the authors devote studies to summarizing individual cases on the recognition of Russian insolvency-related judgements in foreign countries and conversely.

The most cited scientific works of Russian authors belong to Karelina (2018), Kareлина and Gubin 2018) and describe the system of insolvency legal regulation for companies and citizens. Telyukina (2016) is well-known with her works in the field of liquidation procedures. Scholars of financial management department of the Lomonosov Moscow State University, including authors of this paper, have been conducting studies concerning economic and financial aspects of bankruptcy since 2009 (Bobyleva 2009, 2010, Lvova 2010, 2014).

Nevertheless, despite the undoubted depth and wide coverage of the main components of the insolvency institute, the systemic vision of legislation development and its enforcement is not traceable in Russia. Therefore, the question if the rule of law is indeed the main principle of insolvency institute development in Russia, is still open and requires further research.

3. Methodology

Methodology of the research is based on a systemic approach and comprises objective setting, task development and selection of research methods: logical and comparative analysis, methods of scientific classification, expert analysis.

The objective of the research is to analyze specific features of Russian bankruptcy legislation and its enforcement, to identify shortages in insolvency institute and suggest directions for its improvement.

The authors’ proposition is that the failures of the market economy, gaps in Russian bankruptcy legislation, selective state support of companies and other forms of informal workouts still do not allow the rule of law to become the main principle of insolvency mechanism implementation.

3 Available at https://uncitrail.un.org/en/content/working-group-v-insolvency-law (last accessed 15 March 2019)
Specifically, the research is focused on the following questions:

- What are the existing discourses in Russian bankruptcy Law and its enforcement?
- Is it any difference between the development of Russian insolvency institute and global trends?
- What information about insolvency proceedings does statistical data give?
- What are the existing mechanisms for bankruptcy prevention?
- What are the advantages and weaknesses of pre-pack bankruptcy?
- What are the specific features of informal workouts in Russia?
- What are the criteria for identification of informal workouts’ success?
- What are the main priorities of current Law Draft “On debt restructuring”?
- How to improve insolvency legislation and its enforcement in Russia?

Complex investigation of the above-mentioned issues will add value to the concept of bankruptcy institute in Russia. Answers to these questions are relevant for improvement of interplay between debtors and creditors, lawyers and economists, economic policymakers and insolvency administrators who manage concrete crisis situations to make insolvency proceedings transparent and effective.

Given research was based on the specific indicators of bankruptcy proceedings performance: the share of rehabilitation and liquidation cases, the level of creditors’ claims satisfaction, the duration of insolvency proceedings, etc.

The data for the study was gathered from official sources as Federal State Statistics Service (“Rosstat”) (Statistical Yearbook of Russia 2011-2018, Russia in figures 2018), Unified Federal Register of Bankruptcy Information (UFRBI), published analytical papers and monographs, public crisis management programs (plans) adopted in Russia from 2009 to 2016.

4. The main features of current Russian Insolvency Law and its compliance with international approaches

Similarly to other countries, the Insolvency Law in Russia has been updated continuously. Three Laws alternated each other since 1992. Since adoption the current Law in 2002, the following important novels came into force in Russian bankruptcy legislation:

- introduction of consumer bankruptcy proceedings;
- clarification of special rules for insolvency of certain categories of debtors (agricultural companies, financial, insurance organizations, pension funds, securities market professionals, banking institutions, real estate developers, etc.);
- inclusion the concept of “bankruptcy prevention” in the legislation;
- definition of covenants for debtor’s transactions avoidance and subsidiary responsibility for its managers;
- introduction of electronic trading platforms and online auctions to encourage the sale of debtor’s assets at the market price and minimize corruption;
- introduction of the self-regulated organizations of insolvency administrators (so-called ‘SRO’) which are responsible to control the activities of their members, issue internal rules and standards of professional activities, examine qualification of insolvency administrators, etc.

The process of Russian insolvency legislation evolution has certain stages but some problems still remain unsolved.
The adoption of the first Insolvency Law in 1992 was an attempt to define the general order of the bankruptcy mechanism realization. But the early 90's were the period of the beginning of market economy in Russia and the Law implementation showed that bankruptcy mechanism has been often used to initiate hostile takeovers and raiding. So, the rule of law was just the framework, but not the main principle of bankruptcy proceedings application in that period.

The next period was oriented at making insolvency proceedings more fair, transparent and applicable in Russia and associated with the adoption of the next Federal Law “On insolvency (bankruptcy)” in 1998. This law significantly changed the concept of the public regulation of the proceedings, brought the new initial bankruptcy procedure – Supervision. The main goals of Supervision are to guarantee the safety of debtors’ property, to determine debtors’ financial position, to make a decision about the following bankruptcy procedure. However, insolvency administrators often are not ready to fulfill these tasks. For example, financial analysis does not always give an objective and unambiguous answer about financial situation and prospects of the distressed company (Bobyleva 2017, Lvova 2017). There are several reasons for such situation:

• owners and management of distressed company may try to hide the true financial position and falsify data;
• sometimes insolvency administrator is not qualified enough to take into account all nuances of distressed company’s position;
• sometimes insolvency administrator represents the interests of one of the parties (debtor or creditor) and is not objective in his/her conclusions.

Above mentioned examples show that the rule of law is not always executed in Supervision procedure in particular (Lvova 2018).

In 2002 new bankruptcy procedure of Financial Rehabilitation was introduced. However, in spite of intendment of the procedure, the analysis of the corresponding articles of the Law and its enforcement in the following years demonstrates very limited possibilities for actual rehabilitation. In particular, the Insolvency Law sets up (Art. 72 para. 2) that Financial Rehabilitation can be commenced only if there is a provided security which exceeds the debtor's obligations at least by 20 per cent. This covenant is very difficult to fulfill. The Law also determines very short terms of the debt repayment for some categories of creditors and other strict conditions of the procedure’s initiation (Bobyleva and Lvova 2014).

Statistical data confirms practical non-applicability of Financial Rehabilitation procedure: in 2015-2017 it was initiated only in 0.15-0.2 % of all bankruptcy cases (near 30 companies every year) (UFRBI 2017). The main category of companies involved in the procedure of Financial Rehabilitation is large businesses with state support, so-called “strategic enterprises”: only such debtors can fulfill the requirements of the law or get an individual scheme of debt repayment and rehabilitation. Sometimes huge budgetary funds are inefficiently spent for these purposes, rehabilitation plans are stretched for a decade. The reasons for choosing the companies for rehabilitation are often political and social instead of economic ones.

It should be mentioned that in USA there is also protection of “strategic” companies: for example, “US railways” must go for insolvency proceedings only under Chapter 11 “Reorganization” (Bernstein (ed.) 2018). But the difference is that the U.S. Bankruptcy Code sets clear rules for rehabilitation of such companies while in Russia there are no such transparent rules.

The other rehabilitation procedure in Russian insolvency legislation is the External Administration. It contains mechanisms for debtors’ business reorganization but is also rarely applicable in practice. Although in 2015-2017 the External Administration has been initiated in 7-11 times more often than the Financial Rehabilitation procedure, the debtors’ solvency is restored rather rarely. Such results are due to several reasons:
• owners’ low interest in External Administration: as a rule, they lose the company at any outcome;
• low qualification of insolvency administrators, their lack of managerial skills, insufficient knowledge of industry and concrete business. The requirements for insolvency administrators specified in the Law are very generalized, so many of present insolvency administrators pass relatively short special training program which assumes only superficial study of modern financial and economic mechanisms;
• low “white” salary of insolvency administrators that makes possible actions in the interests of third parties.

Our survey shows the tendency of decreasing in the number of rehabilitation and reorganization procedures. The amount of cases in which the External Administration was initiated in 2015-2017 reduces in comparison with 2000-2003 in 7 times (in comparison with 2008-2010 in 2 times); the amount of cases in which the Financial Rehabilitation was initiated in 2015-2017 is 60 % of the amount in 2008-2010.

The liquidation procedures prevail in Russian practice: during the last years their share was about 98%. Liquidation procedures often allow to close the company, but does not solve the problems of creditors: in 2015-2017 the creditors’ claims were not satisfied at all in 67-68 % of cases, creditors got only 20% of their claims in 18-21% of cases. The share of cases where creditors’ claims were satisfied up to 80% is only about 5.5% and has the decreasing trend (UFRBI 2017, 2018). These figures reveal not only serious problems in our insolvency institution but also the problems in Russian economic and social development as a whole, the misunderstanding of the role of the insolvency institution in economic and financial system.

The considerations below could explain a high number of liquidation procedures in Russia:
• the essential part of liquidation procedures is initiated with so-called “assetless companies” and when the debtor cannot be found;
• the Insolvency Law is usually enforced when it is already impossible to restore solvency. In 2015-2017 the share of cases where the results of inventory showed zero assets, was 40%. Property valuation in bankruptcy procedures showed even significantly worse results: zero value of property was fixed in 61% of cases (UFRBI 2017);
• the low outcome of reorganization procedures. In many respects it is connected with the fact that the Russian insolvency institute is still perceived only as liquidation activities. Insolvency procedures are not considered as a possible way of reorganization and crisis overcoming. This is why distressed companies try to delay the moment of applying to insolvency proceedings, understanding the absence of possibility to relaunch the company.

So, from the one hand, the rule of Law is not fully implemented because of poor enforcement of the legislation, but, from the other hand, due to the imperfection of the Law itself. For example, low salary of insolvency administrators, lack of incentives for debtors’ reorganization make them indifferent to debtor’s recovery.

Another example of imperfection of the Law concerns bankruptcy proceedings with foreign participants. In particular, in addition to the Law, international agreement of recognition of foreign insolvency-related judgements is required. Russia has such international agreements only with limited number of countries. In other cases ambiguous decisions can be made. Also there are some other points that make common international rules difficult to use. For example, the well-known mechanism of cross-border insolvency based on companies’ center of main interests (COMI) is not specified in the Russian Law although it is important for the integration of our country in the world economic and legal system. However, it should be mentioned that the criteria usually defining COMI concept can be considered contradictory and used in political interests and national protectionism. This is why the cross-border insolvency proceedings are passed hardly not only in Russia but in many other countries.
The other problem of modern Russian Insolvency Law is the selection of groups of companies which cannot be declared bankrupt or have special conditions for the declaring. The bankruptcy rules are not applied to some State Corporations: “Nanotechnology Corporation”, the “Rostech” state corporation, the Russian nuclear state corporation “Rosatom”. For strategic enterprises and natural monopolies there are preferential terms to commence insolvency proceedings. It often leads to nonmarket methods of the protection for some inefficient companies and owners, their artificial support by the State. Many companies aspire to enter the exhaustive list of strategic enterprises without sufficient reasons for it. Such lists promote the development of corruption, redistribution of financial resources for doubtful purposes and slow down the economic development of the country.

Russian Insolvency Law includes chapters on bankruptcy prevention (Art. 30, 31) but concrete measures and tools are not specified. So, the Law remains ambiguous and does not allow to use the opportunities for preventing the threat of bankruptcy in full measure. In most developed countries the experience of institutional support of bankruptcy prevention is much broader.

At the same time M&A with distressed companies are quite widespread in Russia. They often occur simultaneously with the first signals of distress (decline of indicators in financial statements, other negative signals to the market), but they don’t have any special legal support as particular type of transactions: they are not separated in a special category, not controlled by commercial court and are often nontransparent, provide the interests of a narrow group of stakeholders.

Nowadays there is the lack of regular information about the nature of M&A deals in Russia and target companies’ financial indicators. So, the conclusions about the specific features of deals with distressed companies can be made only on the basis of our empirical research, i.e.:

- Most of M&A deals in Russia are related to weakened companies (financially distressed, at the stage of cyclical recession, without state support, etc.). Therefore, it is especially necessary to develop legislative support for M&A with distressed companies in Russia.
- In recent years some foreign investors, primarily banks, left the Russian market after selling their subsidiaries. It was due to negative geopolitical processes, sanctions, etc. The price of such business on sale was often low. The clear rules and legal guarantees should be developed to attract them back to the Russian market. Special attention should be devoted to Asian investors, in particular, from China, where significant capital is concentrated.

The development of rehabilitation procedures and bankruptcy prevention mechanisms is successfully supported in many countries and reflects the market request for the tools that allow business to survive, to save the employment, to replace inefficient management, to find additional funding and fresh ideas. In general, the review of foreign experience shows that, on the one hand, pre-pack bankruptcies and, in particular, pre-pack sales allow to revive the business, to reduce losses for owners, creditors and society as a whole. On the other hand, these procedures have lower transparency, are controlled by a narrow groups of top management, and do not always guarantee that the interests of all creditors and minority shareholders will be taken into account. As a result, pre-packed sales in some cases cause criticism because of the high share of sales to related groups, in particular, to management (Nesvold et al. 2011). These pitfalls should be taken into account in the development of the Russian legislation.

So, despite the constant updating of insolvency legislation in Russia, most of the amendments contain only partial changes and do not address conceptual issues of bankruptcy: improving the effectiveness of rehabilitation procedures, increasing debt repayment. In contrast to the Russian experience, global trends in XXI century indicate an increase of attention to the prevention of bankruptcy. The main focus is the use of possibilities to organize “pre-
planned bankruptcy” that makes possible reducing the time and cost of court proceedings and, as a rule, recovery of business. Special attention is paid to the development of specific mechanisms of M&A with distressed companies under the court’s control.

5. The specific features of informal workouts in Russian insolvency system

The most common out-of-court agreements between the distressed company’s management and its creditors are considered as informal workouts. This type of workouts is wide-spread both in Russia and abroad.

Statistical data confirms that there is a success of such informal workouts in Russia. The number of companies in the risk group (with losses) is about 26-30 % (Russia in figures 2018). At the same time, by our estimations, the number of initiated bankruptcy cases is less than 1% of the existing enterprises. It means that many issues associated with insolvency are solved through informal workouts.

From our point of view, the term “informal workouts” can be understood more broadly and can also mean governmental actions to provide state support to a particular company. This is one of the most widespread forms of informal workouts in Russia because of the high share of the state-owned enterprises in Russian economy and the above mentioned large proportion of loss-making companies.

In many cases measures of public regulation in informal workouts cannot be regarded as the rule of Law because they do not satisfy its main principles: legal certainty, transparency, accountability, efficiency and effectiveness. This thesis can be confirmed by the analysis of public crisis management programs (plans) adopted in Russia from 2009 to 2016. In accordance with them, a significant part of the Federal budget was directed to the selective support of the giant companies.

For example, in 2008-2009 the large financial aid was provided to JSC “AvtoVaz”: the automotive producer got the sum of approximately US $1bln in the form of interest-free loans. The experience of the late 10 years shows that JSC “AvtoVaz” looks for government support again and again. Thus, the question whether this workout can be considered successful is controversial.

Other illustrations of informal workouts with the governmental help during crisis are:

- providing the additional funding of the JSC “Russian Railways” equal to US $2 bln and increasing its equity to the amount of US $100 mln;
- tax relief for the new investment project of JSC “Magnitogorsk Steel Company”, providing government guarantees due to which the company increased its obligations against the aggravation of financial indicators;
- support of the air carriage industry (JSC “Aeroflot”, JSC “Siberia”, JSC “Transaero”) in the form of direct contracts with fuel suppliers and bank loans at interest rates below the market, etc.

In addition to these measures other specific instruments in workouts are used for so called “strategic enterprises” (Bobyleva (ed.) 2011): writing-off of bad debts; allocation of subsidies, preferential financial and commodity loans, tax credits (tax holidays) and guarantees, debt restructuring;


5 Management In The Unsustainable Economy: strategy and Instruments / Ed. Alla Bobyleva (2011, Moscow University Press, Moscow).
• preventing the blackout of companies from energy sources;
• direct allocation of funds in the regional budgets for “budgetary loans”;
• special arrangements for opening and maintaining insolvency proceedings for such companies.

All these measures are aimed to save large-scale companies from bankruptcy but the regulatory governmental process cannot be considered as a safeguard of the rule of law and a way to prevent corruptive practices. The direct state support and creation privileges for some companies often do not reach the goal to ensure a sustainable business growth, because it reduces the incentives to improve competitiveness and product’s quality, creates conditions for inefficient activities and corruption, causes impossibility to allocate resources for reorganization and innovative development.

The above measures show that such workouts may help as protection against collapse, reduce the risk of massive layoffs and unemployment. But such workouts do not create the conditions for the strategic restructuring or successful development of large scale companies. A lack of transparent criteria for including into the list for support also enhances the possibility of lobbying, corruption in budget allocation and may increase the financial and economic instability of the country as a whole. As a result, many Russian companies overcame recent crises and continue to exist, although the situation with their debts remains very serious. As a rule they remain unsustainable and some of them became bankrupt in a few years (e.g. JSC “Transaero”).

The crisis-2008 gave new impetus for the development of workouts with the help of State Corporations. For example, the State Corporation “Rostec” consolidates 443 companies and its important goal is to provide financing. Above mentioned interest-free loans were provided to JSC “AvtoVaz” by “Rostec”, which got resources as subsidies from Federal Budget. From our point of view, such a scheme of workout makes “AvtoVaz” and other involved companies confident that the State will always come to the rescue and does not stimulate an initiative of company’s management to implement some innovative break.

In less monopolistic industries – construction and agriculture – workouts with the state participation are often even less successful. This can be explained by an inefficient mechanism of transferring budgetary funds, based on the idea of injecting money into the banks and issuing credits to the companies on preferential conditions: in practice, most of the funds were used inadequately, i.e. invested by the banks into financial instruments, exported abroad and did not reach the real sector. The largest number of bankruptcies in the last years in Russia affected small and medium-sized businesses. Informal workouts among these firms were not effective enough.

Our study shows that the most common instruments for informal workouts in contemporary Russia are the delay of payments, changes in the capital structure, as well as direct state support to the selected companies. Delay of payment brings desirable results in relatively simple cases with short-term problems. The use of this tool can restore solvency but does not ensure the sustainability of the business in future. Changes in the capital structure (debt-for-equity swaps, mergers, divestments, etc.) give wide opportunities for recovery, but have limitations:

• high risks of dealing with distressed business;
• stakeholders’ orientation towards quick results and unwillingness to wait for the increase of the business value, resulting from the joint efforts;
• unwillingness of owners to go for such options;
• delay in taking crucial decisions, which decreases their efficiency or makes them inapplicable.

Some attempts to prevent bankruptcy of the borrowing companies are made by Russian banks as key creditors. In particular, the Department for work with distressed assets of PJSC “Sberbank” has crisis managers as staff members. Their task is to identify the threat of insolvency of borrowing business and prevent it by applying the complex of legal, economic, managerial tools. Nevertheless, some new problems arise and remain unsolved. For
example, the bank may need complete credentials to implement crisis measures at the borrowing company (replacing the position of the director, joining the Board of directors with a special legal status, etc.) but even if such a possibility is adjusted by the contract, its implementation can be perceived as raider seizure and challenged in the court.

The importance of informal workouts in Russia and their intensive usage in insolvency situations causes the necessity to identify the criteria of the informal workouts’ success. Sometimes such criteria are not transparent and cause debates among scholars and practitioners (Kastrinou 2014, Blazy et al. 2014, Davydenko and Franks 2008). We suggest the following criteria for the identification of the informal workouts’ success:

- more complete satisfaction of requirements of all stakeholders;
- increase in the share of restored enterprises;
- elimination of expensive procedures of bankruptcy;
- supporting the value of distressed business;
- reduction of the business recovery time.

As a whole, the results of widespread informal workouts can be both positive and negative. On the one hand, they may give a fresh start to business and a unique chance for a recovery. On the other hand, informal agreements may artificially extend the life of an unviable business, increase the losses for all stakeholders or contribute to the development of criminal corruption schemes. The practice of Insolvency Law implementation shows the possibility of its “creative” implementation for using the bankruptcy institution for repartition of the property, raider captures, failure to perform financial commitments.

6. Modernization of Russian insolvency system and possibilities for its integration into global processes

Continued development of Russian insolvency legislation is based not only on the constant amendments to the current Law but also on several law drafts which have been presented to State Duma from 2009. Although no law draft has been adopted, we can trace the development of the insolvency concept during the last years.

The law amendments presented by Ministry of economic development in 2009 suggested to change the Insolvency Law’s title from the Law “On insolvency (bankruptcy)” to the Law “On financial rehabilitation and insolvency (bankruptcy)”. It illustrates serious motivation of Russian legislators to change the insolvency concept giving preference to rehabilitation. The idea of the similar draft bill updated in 2017 suggests the third rehabilitation procedure called “debt restructuring for legal entities”. The main idea is to give insolvent debtors an opportunity to apply directly for rehabilitation using new procedure without first procedure of Supervision which is obligatory for all debtors now. Such opportunity is common for many developed countries and allows not to lose time but to start reorganization of insolvent business having good chances to restore its operational, financial and investment activities.

These draft Laws were not yet adopted due to several reasons. On the one hand, they contain revolutionary changes that do not suit for various interested parties. In situation when 98 % of debtors are liquidated, the majority of insolvency administrators are not ready for conducting reorganization because of low qualification. At the same time debtors are not ready to provide valid financial statements to establish the real value of the distressed business while creditors do not believe in the possibility of debtors’ rehabilitation, etc. So, these groups lobbied for the failure

---

6 Law Draft № 239932-7 “On business debt restructuring during insolvency proceedings”.
of the last draft law in the State Duma pursuing of personal interests. On the other hand, the draft law objectively contained weak points. For example, it was assumed that the rehabilitation period could continue for five years. In our opinion, 5-year period is too long just to restore solvency of the usual business and can be used mostly for the large-scale enterprises. It should be taken into consideration that during these 5 years a moratorium on the debts’ repayment should be introduced which can disrupt the financial performance of creditors, devalue financial obligations, increase losses of the inflation and risks of withdrawal of assets by the debtor during this long period (Bobyleva and Lvova 2018).

Proposed by the second draft bill special incorporation of debt restructuring procedure seems nonapplicable: debt restructuring as a tool can be included in each of the existing rehabilitation procedures – Financial Rehabilitation, External Administration, Settlement Agreement, where this measure is used as a part of the system for business recovery. As a rule, bankruptcy is the result not only of financial activities but failures in operational and investment activities. The delay in the payment of debt without a systemic reorganization will give a short-term result and may not lead to recovery but only delay the complete destruction of the company. Even earlier amendments of 2015-2016 (which were also not adopted) supposed the procedure of reorganization in the bankruptcy much more broadly than debt restructuring. They were more consistent to Chapter 11 of the US Bankruptcy Code which is a benchmark of the reorganization legal framework for many countries. So, the suggestions on debt restructuring reflect selective support for companies through debt restructuring while other rehabilitation tools and opportunities are not considered.

In general, it can be argued that the initiatives to improve insolvency institution in Russia are half-hearted: although many of them affect the most important components of the system, their content is not completely developed, takes into account neither Russian nor foreign experience, amendments are not systemic and focus on partial changes of the bankruptcy institution. The current version of draft law “On debt restructuring” is now in the State Duma but actually it is not conceptually ready and ignores many proposals of scientists and practitioners (Bobyleva 2018).

From the perspective of the current stage of insolvency institution development, we see the following main priorities for its modernization.

- One of the most important tasks is strengthening of rehabilitation opportunities in bankruptcy procedures. It should be resolved not only through the proposed debt restructuring, but also through the rehabilitation of indebted business, including the reorganization of operational, investment and financial activities. Debt restructuring may be one of the components of the reorganization process, its particular case, but not the only measure.

- Particular attention should be paid to bankruptcy prevention, so called “pre-packed” bankruptcy. The advantages of agreements before insolvency include: more rapid and flexible solutions; relatively low costs (including court and administration costs); confidentiality of actions, low reputation losses. The “pre-packed bankruptcy” must not be independent of traditional court bankruptcy proceedings: it must be approved by the court, although the procedures may vary depending on the type of pre-trial planning.

- An important part of business recovery all over the world is the use of mergers and acquisitions (M&A) which often occur at the stage of bankruptcy prevention. The Russian legislation should clearly outline in which cases the acquisition or divestment of a distressed company can be carried out under the protection of the court, i.e. such deals should be distinguished from the total mass of M&A. The separation of M&A with distressed companies will increase possibilities to attract bank and venture financing for such deals. The state can also
play an active role in M&A with distressed companies, placing its shares in companies on the market, developing plans for the privatization of large state-owned enterprises.

- The current system of remuneration of insolvency administrators has not been modified for many years, despite the changes taking place in the country. It remains partially fixed, partially tied to an uninformative indicator – the book value of debtor's assets. Such approach makes profitable to administer large enterprises cases, regardless of the success in business recovery or level of debt repayment. The system of remuneration of insolvency administrators should be more result-oriented: the introduction of a transparent scale of stimulation and motivation in Russian practice could raise their real interest in increasing the distressed business value and (or) assets for sale and expand the whole number of restored enterprises.

- Russia is a part of global economic system and arising contradictions should be resolved with a glance to international law and practice. Consequently, the legal certainty, cross-border cooperation in cases of insolvency needs not only to be regulated more comprehensive but the concept of collaboration must be revised: a shift from protectionism to the international co-operation, coordination of efforts, transparency, fairness, reduction of prices at processes of international bankruptcy.

- It is reasonable to stop creating of special conditions for bankruptcy and support of state corporations and strategic companies. The market approach to developing of such business types will help to reduce corruption and diversion of financial resources on questionable purposes, increase competition and, on this basis, will accelerate the development of the country.

- It is important to change public opinion: to move from a current understanding of bankruptcy as purely a liquidation procedure and the collapse of the business, to the perception of bankruptcy as the possibility of a revival of business on a new basis. This may become one of the most difficult and long-term tasks, which will require joint efforts of the executive and legislative power, insolvency administrators, business and the mass media.

- The main directions of modernization of the insolvency institution should be implemented through the development of a full-scale new Law on insolvency (bankruptcy). The fundamental changes required by time are impossible on the basis of the amendments to the current Law.

The USA and EU countries continue to work on improving bankruptcy prevention mechanisms. In particular, in March 2019 the European Parliament and of the Council finally adopted amendments to a “Directive (EU) On restructuring and insolvency 2017/1132”, oriented on preventive restructuring frameworks, on discharge of debt and disqualifications, and on measures to increase the efficiency of procedures concerning restructuring, insolvency and discharge of debt. Unfortunately, Russia does not raise these issues in draft bills.

7. Conclusion

Russian insolvency legislation has made a significant step forward by introducing a number of legal provisions concerning consumer bankruptcy proceedings, clarification of bankruptcy terms for certain categories of debtors, definition of covenants for subsidiary responsibility and so on. It allows to resume that in general the Russian law has become closer to the EU legislation and corresponds to global trends. But it is important to note that the current Federal Law “On Insolvency (Bankruptcy)” has been developed mainly by introduction of amendments. Some of them are contradictory, clarify minor issues, are the result of lobbying interests and do not contribute to the systematic implementation of the Rule of Law.

From our point of view, the efforts of legislators and the executive authorities should focus on overcoming the following problems of Russian insolvency institute:
extremely low business recovery rate in bankruptcy procedures;
low level of debt repayment during liquidation in bankruptcy;
the lack of mechanisms to prevent bankruptcy;
undeveloped terms of M&A deals with distressed companies under the protection of the court;
inefficient system of remuneration and control of insolvency administrators, its independence on the results of recovery or level of debt repayment in liquidation;
low transparency of liquidation procedures;
insufficient adaptation to international rules of cross-border insolvency;
prevalence of non-market methods for state corporations and strategic enterprises support.

The perfection of the bankruptcy legislation and strengthening the rule of law in Russia should be supported by the development of market discipline, regulation and promotion of business ethics.

References


