Russia's Bankruptcy "Ecosystem": The prevailing interests of the majority creditor

Olga Savina and Julia Shilova discuss the problems arising from the weak legal status of the Russian official receiver

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The realities of modern Russian bankruptcy boil down to the fact that the majority creditor in the bankruptcy case has unlimited possibilities with respect to the debtor. Moreover, the existing legal tools do not allow minority creditors to influence the bankruptcy procedure of a debtor.

The problem of the predominance of the interests of majority creditors in bankruptcy is largely due to the passive role of the arbitration manager (i.e., the bankruptcy trustee). Instead of acting as an independent third party in a bankruptcy case and serving the interests of the bankruptcy estate, in the Russian reality the arbitration manager is a mere tool, acting as a *de facto* representative of the interests of the majority creditor. Thus, the "ecosystem" in Russian bankruptcy is built around a majority creditor or affiliated group, who uses the legal tools to serve their own property interests.

If we look at the Russian judicial practice, it is obvious that the determining factors in the "management" of the current bankruptcy cases are the following:

Whose candidate has been approved by the court?

The legitimate interest of any creditor is to satisfy the claims to the maximum extent possible. All the rights and guarantees granted by the Bankruptcy Law[1] are aimed at achieving this goal. One such tool to achieve this goal is the right of the first bankruptcy petitioner to propose an insolvency arbitration manager or a self-regulatory organisation from among whose members the manager will be approved. However, in such a case, the arbitration manager is selected only for the supervision procedure, which, according Article 62 to the Bankruptcy Law, lasts seven months.

When implementing this procedure, it is important to have a friendly creditor with a claim of a sufficient amount to establish control within the framework of the debtor's bankruptcy procedure. This is necessary because the debtor will not be able to choose a bankruptcy administrator, due to a direct prohibition in Paragraph 5, Article 37 of the Bankruptcy Law. However, a friendly creditor with the highest percentage of votes is not limited by this rule. The bankruptcy of the debtor to be liquidated makes it possible to choose a friendly bankruptcy trustee and to establish control over the bankruptcy procedure.

In order to combat managed and controlled trustees and to prevent abuses by them, the issue of appointing trustees by random selection is constantly discussed, but the proposal is often criticised for the following reasons.

- There is currently no legislative regulation of multi-entity management in the bankruptcy system, which could help balance the rights and legitimate interests of the persons involved. Without such legislation, grounds persist for possibly unsupported conclusions about the concentration of management functions in one person, the arbitration manager.
- The proposal would result in the accumulation into the hands of self-regulating organisations of the main powers that allow those organisations to determine who will be appointed as arbitration manager.
- The emerging trend to the complete removal of the debtor and creditors from participation in the approval of the arbitration manager can lead to an imbalance of rights and legitimate interests of the main participants in the bankruptcy.
- Strengthening the role of self-regulating organisations in solving the issues of the removal of arbitration managers (by excluding the manager from self-regulating organisations), while reducing the manager's influence on decisions by the arbitration court (e.g., in the issues of approval of, and control over, the activities of the manager), could ultimately lead to a distortion and destabilisation of the system.

Who has the right to pledged property included in the bankruptcy estate?

According to Article 138 of the Bankruptcy Law, a secured creditor has an advantage over other creditors who seek to satisfy their claims in the bankruptcy case, since seventy percent of the funds received from the sale of the collateral is used to repay the

creditor's claims on the secured obligation (eighty percent, if the claims of a bankruptcy creditor under the loan agreement are secured by the pledge of property). Consequently, the prospects of obtaining settlements from the debtor often depend on the availability of the collateral.

The principle of elasticity of pledge has recently been enshrined in the Russian court practice, as reflected in: Paragraph 1 of the Information Letter No. 90 of the Presidium of the Supreme Arbitration Court of the Russian Federation, *Review of the Practice of Consideration by Arbitration Courts of Disputes Related to the Mortgage Agreement* (28 January 2005); Paragraph 10 of the Resolution No. 10 of the Plenum of the Supreme Arbitration Court of the Russian Federation, *On Some Issues of Application of the Legislation on Pledge*; and Decree No. 902/11 of the Presidium of the Supreme Arbitration Court of the Russian Federation of 12 July 2011.

Pledge is defined as a "right to the value of the pledged object," which should be preserved during various transformations of the pledged object" (elasticity of the pledge). Thus, a formal change in the collateral does not entail termination of the pledge. The most typical examples of the elasticity of collateral are the processing of the pledged movable object or the division of a building into separate premises. More complex examples of the elasticity of collateral are cases in which the subject's collateral is replaced by money, such as the payment of insurance benefits. Thus, in the decision of the Supreme Court of the Russian Federation No. 304-ES18-1134 in the case A03-15338/2015 (9 July 2019), the court concluded that the bank is entitled to be a pledge creditor, as the subject of the pledge was transformed into a claim for damages, because the original subject of the pledge was lost. Therefore, the amount of the losses recovered in favour of the debtor is subject to the pledge regime.

Should the tax authority have priority in claims against assets pledged to other creditors?

With respect to bankruptcy, the current civil legislation proceeds from the principle of equality of persons (e.g., creditors and other authorised claimants), whose requirements fall into the same category of payments (Paragraph 1 of Article 1 of the Civil Code; Paragraph 4 of Article 134 of the Bankruptcy Law). It is assumed that this principle should be observed not only in the distribution of the bankruptcy estate, but also in the procedures for filing claims against the debtor and determining their relative status and priority.

At the same time, the Federal Tax Service of Russia does not agree with the current principle of equality of competing creditors in satisfying claims against the debtor. The Russian Union of Self-Regulatory Organisations of Arbitration Managers has prepared a draft federal law to amend the Bankruptcy Law (http://sozd.parliament.gov.ru/bill/239932-7). It was adopted in the first reading by the State Duma (the lower house of the Federal Assembly of Russia). The Federal Tax Service has proposed to supplement the draft law with a provision that the arbitration court shall recognise the claims of the tax authorities as being secured by the pledge. Thus, the tax authority would have an advantage not only over competing creditors, but also over secured creditors entered in the register.

The proposed moment of creation of a superior right to pledged property contradicts the current civil law in Russia, which provides for the principle of public reliability in the documentation of secured transactions. This principle means that the rights of a third party, such as the Federal Tax Service, to the debtor's collateral pledged as security for a loan from a credit institution, for example, can be recognised only if the parties in the bankruptcy knew or

reasonably should have known about the existence of a competing tax claim, i.e. from the entry of such a pledge interest in the register. To allow a claim against the collateral, about which the creditor to whom the property was pledged did not know and could have known at the time of the pledge, is contrary to common sense. Nonetheless, the proposed changes would allow the previously unregistered claims by tax authorities to take precedence.

If the amendments are adopted, the number of business loans issued by banks will be sharply reduced, a result that is contrary to the objectives of a market economy and business development. Moreover, the State has an objective interest in the normal functioning of business entities and stability of their activities, because businesses drive the generation and distribution of the financial resources needed to address public needs. ■

THE FEDERAL TAX SERVICE OF RUSSIA DOES NOT AGREE WITH THE CURRENT PRINCIPLE OF EQUALITY OF COMPETING CREDITORS IN SATISFYING CLAIMS

Footnotes:

1 Federal Law No. 127-FZ, *On Insolvency (Bankruptcy)* (26 October 2002), as amended (herein, "the Bankruptcy Law").