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A story of troubled retailers in Russia

According to statistics provided in the Competition Development Bulletin “Concentration on the Russian Markets: Trends in the Period of Recession” published in December 2015 by the Analytical Centre of the Government of the Russian Federation, the period from the 2nd quarter of 2013 to the 1st quarter of 2015 saw an upward trend in the number of insolvencies in the construction, real estate, retail and wholesale sectors of the Russian economy. In December 2014, 295 companies were in insolvency proceedings. By March 2015, the number of insolvencies had increased to 348 companies.

Based on information provided by the analytical company “Nielsen” (published by the Russian business newspaper “Kommersant”), in the 1st quarter of 2016 the index of consumers' trust was the lowest during the last 11 years:

- 61% of the respondents refused to purchase new clothes;
- 45% decided to postpone purchase of new consumer electronics; and
- 52% started consuming cheaper food products.

Consequently, the crisis affected a lot of previously famous brands. The Finnish clothes retailer “Seppala”, the Dutch clothes manufacturer and retailer “Mexx”, as well as the consumer electronics retailer “White Wind Digital” and the decorating materials supplier “Starik Khottabych”, both of Russian origin, closed in Russia due to losses.

In 2015 the Russian sport retailer “Sportmaster”, as well as “Adidas” and “Reebok”, announced they would open 50% less new shops than had been planned. According to experts the Spanish company “Inditex”, being a leader of the Russian clothes retail sector (such brands as Zara, Oysho, Massimo Dutti, Bershka, Pull and Bear, Zara Home, Stradivarius, Uterque and Lefties) was planning to reduce its portfolio in Russia and close the less successful and profitable projects. In 2014 Zara closed its main shop located in the centre of Moscow at Tverskaya Street. In May 16, 2016, Alfa Bank filed a claim with the Moscow City Commercial Court to start the insolvency of Russia's biggest and oldest shoes retailer, “Carlo Pazolini”.

Although there are certain exceptions and some fashion brands like “Furla” are successfully increasing their presence in Russia, the main trend remains negative and more companies are turning to insolvency.

Case Study

A foreign investor provided a loan under promissory notes to two Russian companies affiliated to a Russian fashion house. Payment was not made on time. The foreign investor’s demands for payment were rejected by the fashion house. More than that, the two Russian companies filed for a voluntary liquidation without having properly informed all their creditors as required by Russian law.

According to the fashion house, the brands were registered in a foreign jurisdiction and owned by a Russian fashion designer who was one of the two shareholders in the two Russian companies.

On behalf of the foreign investor, we took the following steps:

- 1) Filed petitions with the state commercial court and stopped the voluntarily liquidation of the two Russian companies;
- 2) Started litigation against the two Russian companies to recover the debt;
- 3) After the courts of first instance and appeal issued rulings in favour of the foreign investor and issued the writs of execution, the first stage of the Russian insolvency proceedings started and an arbitration manager was appointed by recommendation of the foreign investor. The foreign investor was the major creditor of the two Russian companies;
- 4) The arbitration manager found that the remaining assets of two Russian companies were insufficient to pay their creditors and the liquidation was started by the court;
- 5) During the liquidation, having examined the commercial contracts, tax and accounting statements of the two Russian companies, the liquidator found that significant amounts have been loaned by those companies to a third company registered in another region of Russia which was also affiliated with the fashion house, and which was liquidated earlier so no documents were available;
- 6) The liquidator's inquiries with the tax authorities confirmed that the third company had never had significant assets and therefore never had the ability to repay the loans;
- 7) The corporate decisions of two Russian companies to provide significant loans to the third company were approved by the two shareholders, one of those being the General Manager of both companies;
- 8) Under the Russian Federal Law on Insolvency, the liquidator filed claims against the General Manager accusing him of negligence and claiming joint and several liability for the two Russian companies’ debts;
- 9) The courts of the first instance and of regional appeal held the General Manager was liable and ordered him to compensate the foreign investor for the loaned amounts; and
- 10) Realising that the next step would have been seizure of the shareholders’ assets in Russia and abroad (and we were preparing to obtain an injunction freezing the

brands and to litigate in a foreign jurisdiction), the shareholders entered into negotiations to settle the dispute with the foreign investor.

The whole process lasted more than three years and incurred significant expense.

In the light of the current troubles in the Russian retail and fashion industry, we would make these general recommendations to lenders proposing to invest in the fashion business in Russia:

- 1) As all brands and other valuable intellectual property are usually registered abroad, they need to be put in pledge by the foreign entity/person in favour of the lender.
- 2) Independent guarantees should be concluded with the owners of the Russian companies.
- 3) Legal due diligence, finance and tax audit of the target companies/borrowers are a must.
- 4) All assets of the target companies (including) real estate assets should be pledged to the investor.
- 5) Rights under commercial contracts (supply, distribution, marketing, advertising, etc.) should be pledged to the investor.

Such precautions and use of legal instruments will significantly minimize the risk of losses in the case of negative economic climate affecting the Russian borrower.

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