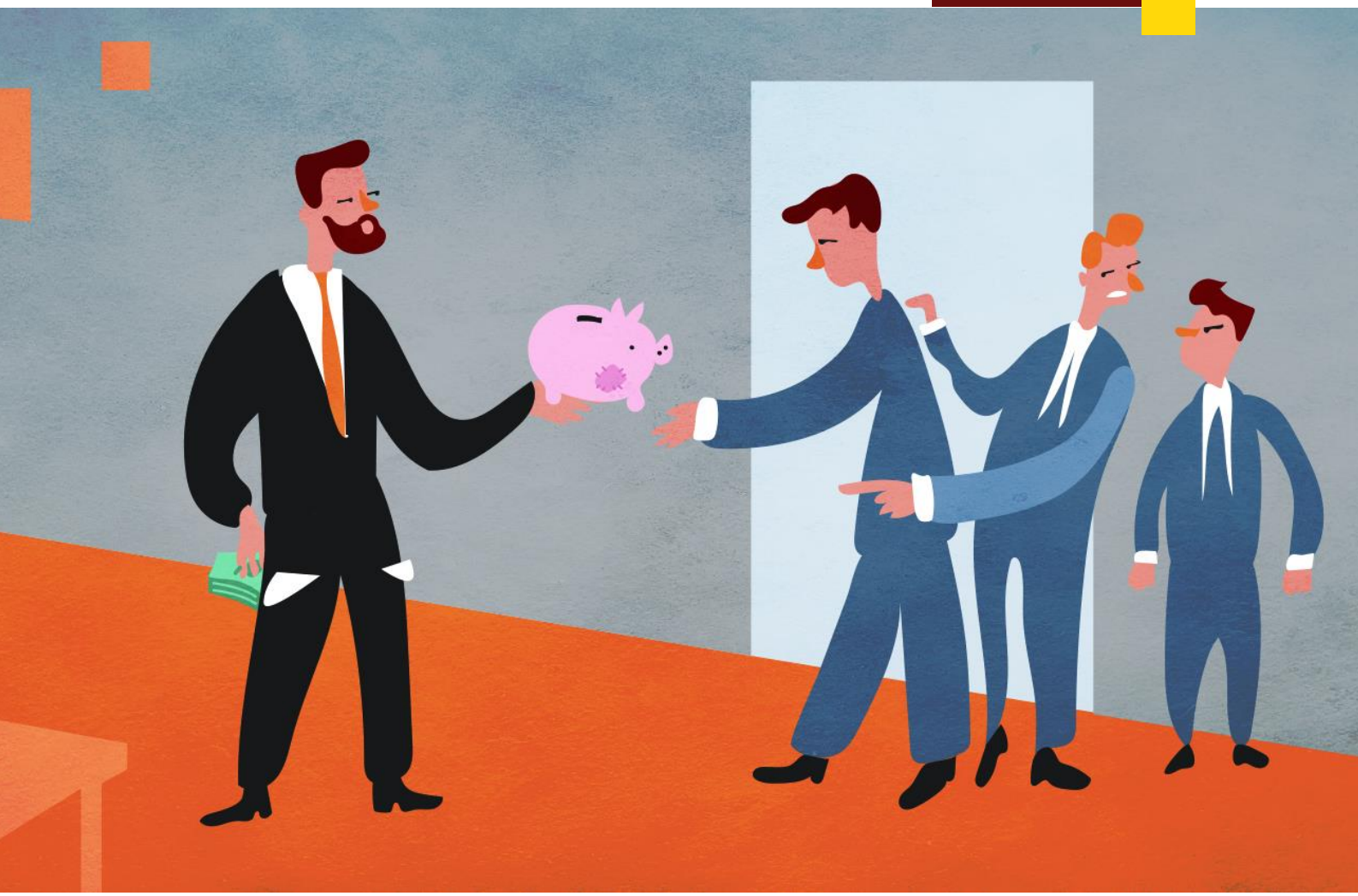
Andrey Gorodissky & Partners



Analytical Overview of Legislation

Secondary Liability and Bankruptcy Moratorium

Risk Analysis

13 April '20

In connection with the outbreak of the coronavirus disease in the territory of Russia and the resulting necessity of imposition of quarantine, Federal Law N 98-ФЗ "On Amendment of Certain RF Laws and Regulations Concerning Emergency Situations Prevention and Recovery" (the «Federal Law»)[1] was enacted on 1 April 2020, which law establishes specifics of the declared moratorium on bankruptcy of legal entities and individual entrepreneurs whose business was affected by the quarantine.

Please see our general review of legislative novelties in our first overview posted on AGP website on 06 April 2020[2].

In this overview we are considering in more detail secondary liability which CEOs of companies may incur during and after the moratorium term.

What is the point of declaring of the moratorium and how businesses will benefit from it?

The 6-month moratorium implies a ban on filing by creditors of bankruptcy petitions against their debtors. This measure is intended for the prevention of mass bankruptcies and enabling companies worst affected by the coronavirus pandemic to survive its peak without hard pressure from creditors, to endeavor to regain their financial standing. In our pervious memorandum dated 06 April 2020[3] we considered in detail key aspects of the moratorium, however we would like to emphasize that the moratorium applies only to those legal entities

[1] https://rg.ru/2020/04/03/fz98-chs-dok.html

[2] http://agp.ru/analitika/vvedenie-moratoriya-na-bankrotstvo-organizatsiy-i-individualnykh-predprinimateley-v-2020-godu-obzor-/

[3] http://agp.ru/analitika/vvedenie-moratoriya-na-bankrotstvo-organizatsiy-i-individualnykh-predprinimateley-v-2020-godu-obzor-/

and individual entrepreneurs whose businesses are included in the list[4] of organizations worst affected by the quarantine.

Thus, in the event a company, based on the types of business activities it is authorized to engage in (i.e. OKVED codes), falls within the moratorium, it gets immunity from bankruptcy initiated upon creditors' petitions.

What will be the impact of suspension of filing by creditors of bankruptcy petitions against certain companies on secondary liability of such companies' CEOs? Will risks be mitigated?

In our opinion generally risks associated with imposition of secondary liability remain the same and depend on company management's specific acts (omissions), especially where they are connected with withdrawal of assets from the company shortly before its bankruptcy.

It is highly probable that not all companies which are entitled to benefit from the moratorium will be able to overcome the economic crisis caused by the coronavirus and many of them will eventually go into bankruptcy upon lifting of the moratorium. Since a claim for imposition of secondary liability is filed by creditors and /or bankruptcy manager practically in every bankruptcy case, there is no reason to believe that in future this tendency would be reversed.

Furthermore, creditors and bankruptcy managers will put special emphasis on contesting of transactions made by the debtor during the moratorium term, understanding that non-bona fide managers may be tempted to take advantage of the moratorium to withdraw assets from their distressed companies.

[4] You can check whether your company is covered by the moratorium at the website of the Russian Federal Tax Service at: https://service.nalog.ru/covid/

The Federal Law provides that deals made during the moratorium term shall be held void in case they go beyond the scope of debtor's normal business activities and their value exceeds 1% of the book value of company's assets, which will increase the likelihood of contesting thereof in future.

Therefore, if a transaction was qualified as a major one and was not typical for the company, then in case of bankruptcy its creditors would claim invalidation of such transaction referring to unfair business practices of the company's management who defied the said restriction and deteriorated thereby the financial situation of the company. Thus, the moratorium does not mitigate the risk of imposition of secondary liability for causing harm to creditors.

In our following overviews we will analyze perspectives of contesting of transactions made during the moratorium period.

Does the general director remain obligated to file for bankruptcy to mitigate the risk of incurring secondary liability?

During the moratorium period the general director of a company falling within the bankruptcy moratorium may but is not obligated to file a bankruptcy notice. In case the company is not eligible for the moratorium, such obligation continues to apply and a failure to meet such obligation entails secondary liability.

We remind that generally the general director of a company must file a bankruptcy notice within one month of the date when he became (or should have become) aware of the company's objective inability to repay its debts to creditors. If in such situation the general director does not take turnaround steps, makes new deals, it is held that he thereby inflicts harm on company's new creditors because they are unaware of real financial situation of their contracting party and will not be able to have their claims satisfied. Consequently, all liabilities incurred by the company and not met upon expiry of the one-month bankruptcy notice filing

term shall be taken into account for the purpose of determining of the size of general director's secondary liability.

However in case the company is eligible for the moratorium, then this obligation of the general director is suspended for the duration of the moratorium to enable the company to raise additional financing, despite of its showing signs of objective bankruptcy[5], to continue its operations without fear of imposition of secondary liability on persons who control the company.

We believe that additional liabilities which the company will incur when being insolvent (having insufficient assets) should not be taken into account for the purpose of determining of the size of secondary liability, provided that they were incurred during the moratorium. However for the time being it is not clear how the case law associated with such transactions will develop.

It is highly likely that in future court proceedings the question may be raised as to the efficiency and relevancy of assuming by the company of new liabilities for the purpose of regaining of its solvency and prevention of bankruptcy, or the company's managers did not have a clear-cut financial action plan and assuming of the new liabilities resulted in just the increase in the number of creditors and in the amount of outstanding liabilities.

What shall be taken into consideration before assuming new liabilities during the moratorium?

One of the prospective approaches that may be taken by courts will be based on the following: debtor's general director, despite of the fact that he is not obligated to file a bankruptcy notice, must not incur additional liabilities in the circumstances of company's

[5] Objective bankruptcy means the point when a debtor becomes unable, due to the excess of its liabilities over the actual value of its assets, to fully satisfy creditors' claims, including for mandatory payments (section 4 of Resolution of the Plenum of the Supreme Court of the Russian Federation dd. December 21, 2017 N 53 "On Certain Issues Relating to Imposition of Secondary Liability on Persons Controlling the Debtor in Course of Bankruptcy Proceedings").

insolvency (insufficiency of assets) in case there is no economic rationale for entering into such transactions and those transactions are not intended to keep up the ordinary course of the company's business and/or restore its solvency.

In our opinion, to mitigate the risk of imposition of secondary liability on companies' managers (especially general directors) anti-crisis plans which are currently being developed by practically every business should include rationale supporting measures which are going to be taken in case the company would show signs of insolvency (insufficiency of assets).

Such anti-crisis plans should contain detailed description of reasons for assuming new liabilities in the circumstances of insolvency, expected effect from new transactions and specify how that effect would influence (or should influence) the restoration of the company's solvency.

Companies that are currently show signs of objective bankruptcy should also suspend making of major transactions with price exceeding 1% of book value of company assets and make sure that such transactions do not go beyond the scope of the company's normal activities, i.e. that the transactions are typical of that company. Failing which such transactions may be held invalid in case of company's bankruptcy and management's conduct in connection with entering into of such transactions may be held unfair, which would increase the risk of imposition of secondary liability.

What is anti-crisis plan and what should it include?

According to the case law that evolved several years ago, a general director is released from liability for failure to file a bankruptcy notice, if he proves that he acted in accordance with an economically justified crisis overcoming plan[6].

[6] Paragraph 2 of section 9 of Resolution of the Plenum of the Supreme Court of the Russian Federation dd. December 21, 2017 N 53 "On Certain Issues Relating to Imposition of Secondary Liability on Persons Controlling the Debtor in Course of Bankruptcy Proceedings".

If your company is facing serious economic difficulties, we recommend preparing and having approved such plan that would describe in detail specific thoroughly considered steps focused on overcoming of the crisis by the company.

It is not sufficient for the plan just to contain a list of certain targets that may potentially eliminate signs of insolvency, but is should set out specific measures conductive to the attainment of such targets and timelines for taking thereof as well as persons in charge thereof and the expected economic effect promoting elimination of the signs of insolvency.

However it is important to bear in mind that the mere fact of having of such plan in place cannot always prove sufficient reasonableness of anti-crisis actions taken by company's management. Especially important is the proof of taking of active steps aimed at implementation of such plan, e.g. official correspondence with contracting parties, using of a part of raised funds for partial debt repayment, etc. Otherwise courts are highly likely to take skeptical attitude towards the plan, especially if that document looks hastily made and is not economically motivated.

It is also advisable to have the plan considered and approved by all competent managing bodies of the company (eg., the meeting of shareholders, board of directors, if any).

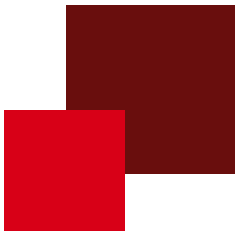
Proceeding from analysis of secondary liability cases in which courts rendered decisions in favor of CEOs, an anti-crisis plan may include the following measures:

- Conducting of a pretrial financial and economic due diligence that would determine whether signs of insolvency exist, whether they are temporary or non-reversible, identify specific reasons for arising thereof, assess efficiency of company's business processes, possibility of their optimization, etc.;
- Assessment of economic feasibility of deals that are planned to be made during the bankruptcyc moratorium, including expected economic effect thereof and the way such effect would be used for elimination of signs of objective bankruptcy;
- administration of claims for collection of receivables;
- Increasing the charter capital, attraction of borrowed funds from shareholders, credit institutions and investors to finance operations with detailed description of purposes

they are going to be applied for and the expected economic effect (eg., expanding enterprise's production facilities);

- Active negotiations with contracting parties about allowing of installment payment or deferral of payments, debt restructuring;
- Evaluation of assets for the purpose of sale and repayment of debts to creditors;
- Staff redundancy, transfer of employees to distant work, outsourcing of some companies' processes.

Business leaders should pay serious attention to testing of their companies for signs of insolvency (insufficiency of assets), thorough assessment of economic expediency of transactions planned to be made during the moratorium, especially after its lifting, because the general director's obligation to file for bankruptcy of his company will be restored upon expiry of the moratorium period. Therefore, if after lifting of the moratorium the company continues to assume new liabilities amid persisting signs of objective bankruptcy, the risk of imposition of secondary liability increases.



Contacts

Dmitry Yakushev

Attorney

Areas of practice:
Dispute Resolution/ International Arbitration,
Insolvency and bankruptcy

Tel.: +7 (495) 933 7567
E-mail: dmitry.yakushev@agp.ru

Andrey Gorodissky & Partners

Znamenka 13, bldg. 3, 3rd floor
Moscow, 119019, Russia

Tel.: +7 (495) 933-75-67
E-mail: office@agp.ru

www.agp.ru