

Insolvency law related to credit organisations in the Russian Federation

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1. Introduction

This document sets out the general features of the insolvency law applicable to credit organisations in the Russian Federation. In particular, it aims to provide fundamental details of this distinctive regime, the procedures it entails, the supervisory role of the Central Bank of the Russian Federation (“**CBR**”) and recent changes in legislation.

1.1. How this insolvency regime differs to the corporate insolvency regime

Unlike the corporate insolvency procedure, the CBR plays a primary role in credit organisation insolvency proceedings. The supervisory and observational powers of the CBR display considerable control over the actions of a credit organisation, a regulatory feature not present in connection with corporate insolvency.

In connection with corporate insolvency, preventative measures may be implemented following application to court to declare a corporation insolvent. However, regarding credit organisations, preventative measures may be obliged to be implemented (depending on the relevant grounds) by the credit organisation prior to an application of insolvency or at the instigation of the CBR.

Although following a similar structure to that for corporate insolvency, the insolvency regime applicable to credit institutions provides a separate claim order of priorities on bankruptcy.

1.2. Governing legislation

The legislation governing the insolvency regime of credit organisations includes:

- (a) Federal Law No. 127-FZ, on insolvency (bankruptcy), 26 October 2002 (the “**Insolvency Law**”). This is the principal legislation on insolvency in the Russian Federation; and
- (b) Federal Law No. 40-FZ, on insolvency (bankruptcy) of credit organisations, 25 February 1999 (the “**Credit Organisation Insolvency Law**”). This legislation focuses on the specific insolvency regime applicable to credit organisations.

Federal Law No. 395-I, on banks and banking activities, 2 December 1990 (the “**Banking Law**”) and Federal Law No. 175-FZ, on additional measures to strengthen the stability of the banking system through 31 December 2011, 27 October 2008 (the “**Additional Measures**”) also apply to the insolvency regime of credit organisations.

1.3. What is a credit organisation?

A credit organisation (*kreditnye organizatsii*) in this context is a legal entity entitled to carry out specific banking operations for a profit, on the basis of a banking licence granted by the CBR. In this context, credit organisations encompass the activities of banks and non-banking credit organisations:

In broad terms, banks carry out the following banking operations:

- attracting deposits from its “**Customers**” (both legal entities and individual persons);
- investing deposits for its benefit on the basis of returning payments by maturity; and
- opening and operating bank accounts for its Customers.

Non-banking credit organisations carry out certain banking operations as specified and regulated by the CBR.

In this document, the following definitions are also useful:

- “**Mandatory Payments**” are the obligations of the credit organisation as an independent taxpayer to pay towards budgets deemed appropriate and in compliance with the Insolvency Law. It is also the duty of the credit organisation to perform instructions to transfer Mandatory Payments from its customer accounts to relevant budgets.
- “**Monetary Obligations**” are the obligations of a debtor to pay a specific outstanding amount in a civil transaction governed by the civil and budgetary regime of the Russian Federation.

2. Insolvency related measures

The Credit Organisation Insolvency Law separates insolvency related measures applicable to credit organisations in two categories:

- Preventative measures, which seek to prevent insolvency; and
- Insolvent liquidation, which seek to realize assets of, and terminate, the credit organisation.

3. Preventative measures

The following measures may be implemented in order to prevent the insolvency of a credit organisation:

- Financial rehabilitation (*finansovoe ozdorovlenie*);
- Provisional administration (*vremennaya administratsiya*); and
- Reorganisation (*reorganizatsiya*).

These measures may only be taken prior to the withdrawal of the banking operations licence (except where a provisional administration is instituted following such withdrawal, as discussed in section 3.3.4). In general terms, the objective of these procedures is to prevent further decline in the financial condition of the credit organisation whilst allowing its business to continue. Continuation of business will be under greater observation by the CBR, and the credit organisation will be obliged to provide the CBR with notification of specified meetings, disposals and other transactions.

3.1. When may preventative measures be implemented?

The Credit Organisation Insolvency Law requires credit organisations to implement preventative measures where significant financial or regulatory problems appear in the credit organisation, but which are not deemed serious enough to initiate the revocation of a banking licence.

The grounds that may result in the application of preventative measures differ slightly, depending on which party is to initiate or carry out the preventative measure. Listed below are certain general grounds for implementing preventative measures (“**General Grounds**”). The grounds for initiating provisional administration differ and are listed in section 3.3.2 (“**Provisional Administration Grounds**”).

3.1.1. General Grounds

Preventative measures are to be carried out if a credit institution:

- (a) has repeatedly failed to discharge:
 - (i) Monetary Obligations to its creditors over a prior six month period; and/ or
 - (ii) its Mandatory Payments within a three day period from their due date owing to an insufficiency of funds in its correspondent accounts;
- (b) fails to discharge:
 - (i) Monetary Obligations to its creditors; and/ or
 - (ii) its Mandatory Payments,

in either case for a period greater than three days from their due date owing to an insufficiency of funds in its correspondent accounts;
- (c) allows a reduction of at least 20% in the value of its capital resources (from the maximum value achieved over the preceding 12 months), whilst concurrently violating a mandatory ratio established by the CBR;
- (d) breaches a CBR ratio concerning the sufficiency of capital funds;
- (e) breaches the CBR ratio concerning current liquidity by at least 10% over the last one-month period; or
- (f) allows a decrease in capital resources (established by monthly accounts) below its authorised capital, as instituted by the registered constitutional documents of the credit organisation.

3.1.2. General Ground (f)

Ground (f) does not apply to credit organisations within two years of receiving a banking licence.

If the capital resources of a credit organisation do not fulfill its authorised capital value at the close of its second and any subsequent financial year, it is obliged to decide upon liquidating itself. If unable to reach a decision within three months of the financial year-end, the credit organisation must apply to an arbitrazh court for its own liquidation. However, the recent legislative changes mentioned in section 8 should be kept in mind in this regard.

Should shareholders of the credit organisation fail to apply for liquidation by this deadline, they risk being attributed secondary liability in respect of all outstanding obligations arising after this date.

3.2. Financial rehabilitation

Where General Grounds exist in relation to a credit organisation:

- its shareholders and the credit organisation itself are obliged to carry out steps to achieve financial rehabilitation;
- its Chief Executive Officer (“**CEO**”) is obliged to initiate the process to implement financial rehabilitation; and
- the CBR is entitled to demand that the credit organisation implements measures to achieve financial rehabilitation.

The following measures may be implemented to achieve financial rehabilitation of a credit organisation:

- shareholders may render financial assistance through the provision of preferentially-rated loans or guarantees;
- restructuring assets and liabilities;
- bringing authorised capital and capital resources in line;
- restructuring the organisation; and/ or
- taking other measures to observe CBR and federal regulation.

Where financial rehabilitation is undertaken by CBR demand the credit organisation is also restricted from making distributions to its shareholders. A notice confirming withdrawal of this demand is required to terminate financial rehabilitation measures and restrictions.

If financial rehabilitation is undertaken without CBR demand, restrictions are lifted from the credit organisation once the grounds triggering preventative procedures are no longer applicable.

3.3. Provisional administration

3.3.1. Appointment

The provisional administration is a special management body appointed by the CBR to the credit organisation for a period of no more than six months. Further, the credit organisation’s executive body powers will be limited or suspended throughout provisional administration.

3.3.2. Provisional Administration Grounds

Provisional Administration Grounds arise from circumstances indicating a more serious financial condition than those in connection with financial rehabilitation and reorganisation (to some extent excluding CBR demand to implement the latter). Provisional administration is to be carried out if a credit institution:

- (a) has failed to discharge:
 - (i) Monetary Obligations to its creditors; and/ or
 - (ii) its Mandatory Payments within seven days from their due date owing to an insufficiency of funds in its correspondent accounts;
- (b) allows a reduction of at least 30% in the value of its capital resources (from the maximum value achieved over the preceding 12 months), whilst concurrently violating a mandatory ratio established by the CBR;
- (c) breaches the CBR ratio concerning current liquidity by at least 20% over the last one-month period;
- (d) fails to comply with CBR requirements to replace members of their management or to perform financial rehabilitation or reorganisation within an established timeframe; and/ or
- (e) grounds exist to revoke the credit organisation's banking licence, in accordance with the Banking Law.

Where Provisional Administration Grounds exist, the CBR only is entitled to appoint a provisional administration to the credit organisation.

The CBR may also apply a moratorium upon the satisfaction of creditor claims where provisional administration has been appointed for the purposes of Provisional Administration Ground (a), and the management powers of the credit organisation have been suspended. This moratorium may apply for up to three months and would cover Monetary Obligations incurred prior to the appointment of the provisional administration.

3.3.3. Termination

Provisional administration may be terminated once the grounds triggering the procedure are no longer applicable. In such case, the powers of the executive body are reinstated.

If any Provisional Administration Grounds remain after six months, the provisional administration is obliged to petition the CBR for the revocation of the credit organisation's banking licence.

The provisional administration retain their appointment when a credit organisation's banking licence is revoked. This appointment persists until an arbitrazh court decides that insolvency proceedings are to be initiated, that a liquidator should be appointed, or upon the elimination of the reasons for which provisional administration was originally instituted.

3.3.4. Revocation of the banking licence

The CBR may appoint a provisional administration following revocation of a credit organisation's banking licence. In this circumstance the provisional administration is obliged to petition the CBR to apply for the recognition of the credit organisation's insolvency. The provisional administration will manage the credit organisation until a decision is reached.

3.4. Reorganisation

Credit organisations may be reorganised in the form of a takeover (*sliyanye*) or merger (*prisoyedinenye*).

Where General Grounds exist in relation to a credit organisation:

- its shareholders and the credit organisation itself are obliged to carry out steps to achieve reorganisation; and
- its CEO is obliged to initiate the process to implement reorganisation.

Where Provisional Administration Grounds (a) – (c) exist:

- the CBR is entitled to demand that the credit organisation implements measures to achieve reorganisation.

Following this CBR demand, the executive body of the credit organisation is provided ten days in which to inform the CBR of their decision to reorganise.

4. Insolvency proceedings

An arbitrazh court will consider the insolvency case of a credit organisation. This case must be determined within two months of the arbitrazh court's acceptance of an application (inclusive of the time for preparing and settling the case).

In contrast to the corporate insolvency regime, procedures such as supervision, financial rehabilitation, external administration and voluntary arrangement, do not apply to credit organisations following an application for the declaration of its insolvency.

4.1. Application to commence insolvency proceedings

An application to an arbitrazh court to declare a credit organisation Insolvent may only be filed by:

- the credit organisation itself;
- a creditor, including individuals with bank deposits or accounts;
- a federal executive body authorised by the Government of the Russian Federation (an **“Authorised Body”**); and
- the CBR.

Creditors and Authorised Bodies acquire the right to file an application to an arbitrazh court only after the withdrawal of a credit organisation's banking licence.

In the event of a credit organisation displaying signs of insolvency, all applicants (excluding the CBR) are obliged to direct applications for the withdrawal of a credit organisation's banking licence to the CBR. Should the CBR fail to provide an answer within two months, or refuse to withdraw the credit organisation's banking licence, the aforementioned applicants are entitled to apply directly to an arbitrazh court to declare the credit organisation insolvent.

If the credit organisation displays signs of insolvency following the revocation of its banking licence, the CBR is obliged to file for the credit organisation's insolvency. The CBR must implement this within five days of publishing its decision to withdraw the banking licence.

4.2. Grounds to accept an application

An arbitrazh court may only accept an insolvency application to consider a credit organisation's status when:

- the CBR has withdrawn the credit organisation's banking licence;
- the credit organisation is indebted by a multiple of at least 1,000 times the minimum wage (currently set at a nominal 100 Roubles, which multiplied by 1,000 and converted to Euros is approximately EUR 2,500); and
- claims for the credit organisation's indebtedness have not been satisfied within 14 days of their due date or the value of the credit organisation's assets are deemed insufficient to discharge creditor claims and Mandatory Payments (following licence revocation).

Where an arbitrazh court accepts an application to consider a credit organisation's insolvency status, it will issue a ruling to that effect.

4.3. Insolvent liquidation and associated measures

Insolvent liquidation and associated measures are triggered upon the declaration of a credit organisation's insolvency. These measures are introduced for a maximum term of up to one and a half years. The decision of an arbitrazh court to commence these measures has immediate legal force.

The effects of an arbitrazh court declaring a credit organisation insolvent and commencing insolvent liquidation and associated measures are:

- revocation of the credit organisation's banking licence. Resulting restrictions from this revocation remain ongoing;
- information concerning the credit organisation's financial state will no longer be classified as confidential or a commercial secret;
- all transactions related to the alienation and transfer of the credit organisation's property are governed by the credit organisation insolvency procedure;
- creditor claims (excluding a specified few) are governed by the credit organisation insolvency procedure;
- the liquidator will receive all necessary writs of execution to enforce court decision;
- any restrictions on the disposal of the credit organisation's property shall be lifted to effect the liquidation;
- the credit organisation's outstanding obligations are to be satisfied in accordance with the Credit Organisation Insolvency Law; and
- the powers of the executive body of the credit organisation will be terminated (excluding contractual decisions on funding agreements to discharge outstanding obligations).

A liquidator will be appointed to manage the insolvency proceedings and to exercise the powers of the executive body of the credit organisation.

Creditors are entitled to file claims at any time during insolvency proceedings. The liquidator is obliged to maintain a register of creditor claims, which must remain open for at least 60 days following the declaration of a credit organisation's insolvency.

4.4. Solvent liquidation

A credit organisation may also apply for voluntary liquidation by a decision of its shareholders and upon application of the CBR. The procedure is similar to that of insolvent liquidation.

However, if it is established during the course of these proceedings that the value of the credit organisation's assets are insufficient to satisfy creditor claims, both the CBR and creditors are able to apply for the insolvency of the credit organisation. Further, the liquidator is obliged to apply for the credit organisation's insolvency within a period of ten days.

5. Invalid transactions

The validity of transactions occurring prior to the onset of insolvency proceedings can be challenged in several ways. The Insolvency Law provides the ability to challenge transactions with interested parties and transactions entailing preference for all entities.

The Credit Organisation Insolvency Law provides a further circumstance in which credit organisation transactions can be set aside. An arbitrazh court may deem transactions implemented by a credit organisation in the three-year period preceding the appointment of provisional administration as invalid. The provisional administration, liquidator, creditor or a bank that has had its authorised capital reduced in line with the Additional Measures, may apply to have a transaction set aside where the contractual terms differ significantly to similar transactions, but to the detriment of the credit organisation.

6. Claim order of priority

All property available as at the commencement of insolvency proceedings and discovered during its course is deemed the bankrupt estate. Differing rules of distribution apply dependant upon whether the value of the estate is sufficient to satisfy all creditor claims.

The Credit Organisation Insolvency Law provides a specific order of priority in which claims will be met from this estate. This order differs to the regime applicable to corporate insolvency procedures, but does share the similarity of providing three priority tiers combined with a current claim category:

- (a) Current obligations of the credit organisation (generally operational expenses);
- (b) Claims ranked within the 'first priority':
 - individual claims for personal injury;
 - individual claims under bank deposits or accounts;
 - Deposit Insurance Agency ("DIA") claims for individual bank deposit and accounts, transferred to the it under Federal Law No. 177-FZ, on insuring the deposits of natural persons made with banks of the Russian Federation, 23 December 2003; and
 - CBR claims resulting from payments made for the bank deposits of individuals at insolvent banks that were not party to the mandatory deposit insurance scheme;

- (c) Claims ranked within the 'second priority': severance benefits, wages and copyright royalties;
- (d) Secured claims (to be satisfied from the proceeds of the secured asset); and
- (e) Claims ranked within the 'third priority': individual claims for a loss of profit and/or financial sanctions under bank deposit or account agreements.

7. Potential liability

Specific to the event of a credit organisation being declared insolvent, an arbitrazh court may also impose secondary liability in respect of the credit organisation's obligations onto:

- shareholders;
- the board of directors; and
- executives of the organisation, e.g. a CEO and Chairman of the Board of Directors.

Secondary liability is incurred where it is established that these persons gave instructions that directly or indirectly caused the credit organisation's insolvency. Additionally, executives may also incur liability where they failed to implement obligatory actions to prevent the credit organisation's insolvency.

The penalty for incurring secondary liability for the insolvency of a credit organisation is the responsibility for its outstanding obligations. Further:

- shareholders may be prohibited from acquiring shares amounting to more than 5% control in another credit organisation for ten years;
- members of the board of directors and executives may be deprived of holding senior positions in other credit organisations; and
- the CEO of the credit organisation may be brought to account where s/he failed to take preventative and mandatory measures to avoid insolvency.

8. Recent legislative change

The Additional Measures will have application until 31 December 2001. Their application would appear to support stability in the Russian banking system and protect the interests of bank depositors and creditors by working to divert the onset of insolvency.

Specifically, the DIA, as well as the CBR, is provided authority to implement measures to prevent the onset of insolvency in banks that are members of the mandatory deposit insurance scheme.

In particular circumstances the CBR is afforded the ability to alter the authorised capital of a bank to its fair value. Where the fair value of a bank is negative, the CBR may reduce the authorised capital to a singular ruble. Further, where this reduction is applied a bank is not required to liquidate if its capital value falls below the legislative minimum.

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