Russian Supreme Court practice review: intra-group creditor claims in bankruptcy (equity creditors and equitable subordination)

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On 29 January 2020, the Presidium of the Russian Supreme Court (the **Court**) issued its review of judicial practice (the **Review**) on disputes involving creditor claims of entities that control and/or are otherwise affiliated with debtors in bankruptcy proceedings (together, **equity creditors**).

The Court outlined a number of key principles in the Review, which Russian courts are expected to follow in future bankruptcies.

Equity Creditors Generally

Statutory subordination of equity creditors in bankruptcy, especially shareholders, is an accepted concept in many developed countries (the concept can be found in the legal systems of Denmark, Germany, Greece, Slovenia, Portugal, Austria, Spain and others).

The laws of these countries implicitly recognize that the *special position of a shareholder in and of itself justifies scrutiny* in a subsidiary's insolvency, especially regarding *loans* made by a shareholder to its subsidiary. [1]

In the United States, courts can recharacterize shareholder loans as equity under state laws, including treatment of interest payments as dividends subject to avoidance and recovery (e.g., in the case of inadequate capitalization of a legal entity or inadequate documentation). Moreover, Section 510(c) of the US Bankruptcy Code also has special provisions on "equitable subordination" of individual creditor claims to the claims of all creditors where such creditors (including shareholders) have, by their wrongful or oppressive conduct, interfered in the management or business of the debtor to the prejudice of other creditors.

Not all developed countries have approached this issue the same way. For example, there is no provision for subordination of shareholder loans in France, nor do the laws of England recognize equitable subordination as such.

The Russian Bankruptcy Law (No. 127-FZ of 26 Oct. 2002; the **Law**) is formally silent on the concepts of equity creditors and equitable subordination. The Law does have express provisions on shareholder claims, although these provisions are generally understood to mean claims related to *equity* interests. The Law also has special provisions on interested and/or controlling parties, e.g., as regards antecedent transactions (suspect and/or preferential transactions) and vicarious liability for obligations of the debtor.

The Review therefore represents a major step forward in crystallizing Russia's judicial practice on equity creditors, permitting debt recharacterization and/or statutory subordination of claims of *both controlling and other non-controlling affiliates*.

According to the Court, the legal basis for this approach is properly found in the Russian Civil Code's rules on so-called sham transactions (*mnimye sdelki*) (Article 170 (1)). Recall that Article 61.1 of the Law expressly permits bankruptcy administrators to challenge the validity of creditor claims generally under the Russian Civil Code.

[1] See Philip R. Wood, *Principles of International Insolvency* (2007), Chapter 11-069.

Practitioners will note, by virtue of Article 126 of the Russian Constitution and the Federal Law on the Russian Supreme Court, the Review will be binding on Russian courts. The courts can thus be expected to follow the Review carefully when deciding the fate of equity creditor claims in bankruptcy proceedings. We can also anticipate that the appearance of the Review will encourage a more robust motion practice surrounding equity creditor claims generally.

Below, we outline some of the key principles addressed in the Review.

Key Principles

• **No Automatic Subordination.** As a general rule, an equity creditor's claim cannot be subordinated to third-party creditors' claims *solely due to the mere existence* of control of, or affiliation with, a debtor. The Court expressly states, where intra-group financing is carried out *in good faith* and *does not infringe the rights and legitimate interests of third-party creditors*, the claim will not be automatically subordinated.

• **Burden of Proof "Shifted".** However, an equity creditor will nonetheless now be *bound to rebut any reasonable doubts* raised by third-party creditors as to whether the financing was a sham transaction (*mnimaya sdelka*) in terms of Article 170(1) of the Russian Civil Code Article. This new position appears to *"shift" the burden of proof*, such that equity creditors must now effectively *prove their own innocence where the latter has been put into doubt* – in other words, they must provide the court with additional, convincing evidence of a *bona fide* debtor-creditor relationship. Given the other concepts elaborated in the Review (see below), this may be no simple task. In the Court's words, the bankruptcy court "must exhaustively uncover all material circumstances concerning [1] the conclusion and performance of the [disputed] loan transaction, [and [2]] the grounds for further intra-group redistribution of monetary funds, having [convinced itself] that such redistribution is consistent with genuine business relations, the granting of a loan and further operations founded on rational economic reasons."

• **Risk During Start-Up Period.** An equity creditor's claim for repayment of a loan made during *the initial (start-up) period* of the debtor's business activity may be subordinated unless the reason for choosing debt over equity was *not mere reallocation of risk*. In other words, there must be an underlying business rationale for the debt, as opposed to equity.

An equity creditor's claim may be subordinated if, at the initial (start-up) stage:

(1) it was aware that the debtor was unable to conduct normal business activities; and
(2) it intentionally under-capitalized the business with equity, choosing instead to finance the entity with debt.

• **Risk During Financial Distress.** An equity creditor's claim may be subordinated if the financing was granted to the debtor during a period of *"financial distress"* (*imushchestvenny krizis*), that is, at a time when the debtor met any of the criteria under Article 9(1) of the Law obliging it to file for bankruptcy.

An equity creditor trying to "breathe new life" into a borrower's business by providing debt at such a time will bear all associated risks in the debtor's subsequent bankruptcy. The Court defines loans and other forms of debt from an equity creditor made during the debtor's financial distress as "compensatory financing" (*kompensatsionnoye finansirovaniye*), i.e., financial assistance intended to help stabilize the debtor's financial condition.

When a debtor is in financial distress, a court may treat any one or more of the following equity creditor actions (*taken during such time*) as compensatory financing and hence subordinated in bankruptcy:

(1) de facto abstaining from recovery / enforcement of a loan;
(2) entry into a formal standstill agreement; or
(3) in case of a non-monetary contract (that is, a transaction other than a formal loan, e.g., a sale, lease and/or other commercial transaction):

- *entry into / performance of a credit sale (as opposed to cash against delivery),*
- *granting a payment extension,*
- *granting a deferral of payment / grace period, or*
- *rescheduling of payments.*

An existing claim *transferred by a third-party creditor* to an equity creditor may also be treated as compensatory financing (and thus subordinated), where the claim transfer took place during the debtor's financial distress.

• **Influence by Controlling Creditor.** Notably, the Court extends these principles to other intra-group member claims (not just controlling entities, but also entities under common control). A claim of a creditor affiliated with a controlling entity may be subordinated where that affiliate *provided compensatory financing to the debtor, as it is presumed that it did so due to the influence (control) of the controlling entity.*

• **Underlying Purpose of Control to Guide Analysis.** The Court appears to have created a possible safe-haven for banks and credit institutions controlling debtors as a result of their security arrangements. A controlling creditor's claim may not be subordinated unless it *expects to participate in the distribution*

of the debtor's profits. The burden of proving such controlling creditor's intention is *on third-party creditors*. Should a bank, for example, become a controlling creditor by virtue of obtaining voting rights in a borrowing entity through a share pledge provided as security to such financing, it is presumed that such bank, acting as controlling creditor solely for the purposes of ensuring proper use of funds (preventing leakage), has no intention to participate in the distribution of the debtor's profits.

• **Selection of Administrator.** The Court has now interpreted the Law to disqualify equity creditors entirely from participating in the vote of the meeting of bankruptcy creditors to select the administrators (the Law does not expressly provide this). Only unaffiliated third-party bankruptcy creditors will be counted in such vote.

Conclusion

The Court's crystallization of the judicial practice on equity creditors marks a step forward in the development of Russia's bankruptcy system.

From a practical standpoint, investors structuring intra-group financial arrangements (which may lead to the position of equity creditor vis-à-vis a group entity) must be prepared to justify such arrangements and bear the potential risk of subordination in case of an entity's insolvency.

By the same token, senior lenders will no doubt wish to consider the implications of the new rules when structuring holdco financings and considering how best to achieve recourse against Russian group obligors. In Russian insolvency proceedings, senior lenders (and other third-party creditors) will now wish to scrutinize intra-group financial arrangements more carefully, as a potential area for improving returns on their claims.

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