Financial recovery as a means of restoring solvency of bankrupt debtor: special provisions in Russian civil law

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Abstract. The relevance of this study is due to the uncertainty and high degree of turbulence of economic processes in the country and, therefore, the growing number of insolvent business entities. At the same time, in the case of bankruptcy procedures applied to debtors, one of the most optimal for both the debtor and his creditors is the procedure of financial rehabilitation, the purpose of which is to restore the solvency and effective economic activity of the debtor. The key figure in the financial recovery procedure is the administrative manager, whose purposeful implementation of recovery measures in relation to the debtor's property and debts will allow the latter to continue carrying out business activities in full and with profit, as well as with the payment of mandatory payments to the state budget – taxes, fees, excise duties. However, this procedure is the least popular among administrative managers and creditors of the debtor, since it is the only provision in the Law "On Insolvency (Bankruptcy)" that provides for the preservation of the authority for the debtor's management bodies and their relative independence from the administrative managers and creditors when making decisions on material issues of debtor's activities. The authors consider it necessary to increase the applicability of financial rehabilitation in relation to other bankruptcy procedures.

1. Introduction

Regardless of the types of economic, political and social formations, entrepreneurial, like any other economic activity, is associated with the risk of insolvency, bankruptcy of the business entity involved in a specific type of business activity. In modern economic realities, the bankruptcy procedure is a fairly popular legal instrument that allows to settle relations arising between an insolvent debtor and creditors, while focused on

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maintaining a balance of interests of both – the debtor and creditors. Currently, most authors agree that “the main purpose of the institution of insolvency (bankruptcy) is to ensure the stability and development of the market economy” [1] as well as to provide the balance of interests of the debtor, creditors and the company [2]. The institution of bankruptcy itself was created as a rehabilitation procedure, the purpose of which is to release a person who has unfulfilled obligations from accounts payable that the debtor is unable to satisfy.

It is worth noting that the institution of bankruptcy from the point of view of law is a fairly flexible set of elements and various procedures that can be applied to the debtor depending on his financial condition, which allows optimizing the processes of releasing such a debtor from accounts payable, taking into account the interests of creditors themselves.

At the same time, depending on the procedure applied to the debtor, its goals may change.

In practice, one of the rarest procedures is the procedure of financial recovery.

2. Research Methods

The main method of cognition relied on in this study is the materialist dialectic. In addition, other research methods were used: analysis and synthesis; empirical and formal-logical; statistical method; comparative law and others.

Abstracting from industry problems, the study analyzed the general provisions, concepts and features of financial recovery as a restorative procedure within the framework of the institution of insolvency (bankruptcy), the specifics of its legal regulation, and also identified its problems.

3. Basic research

For the purposes of introducing a financial recovery procedure in relation to an organization, it is necessary to confirm that it has sufficient reserves to settle with all creditors whose claims were declared as part of the monitoring procedure, as well as other creditors to whom the debtor has unfulfilled obligations. It should be noted that in order to introduce a financial recovery procedure, it is necessary to comply with a number of statutory obligations, such as, for example, providing a debt repayment schedule.

To support the financial recovery procedure, the court, following the results of the creditors' meeting, approves a key figure – an administrative manager, whose duties are as follows:

1. Keep a register of the debtor's creditors' claims in the prescribed form;
2. Convene a meeting of creditors for purposes of reporting on their activities;
3. Review reports on the progress of the debt repayment schedule and financial recovery plan;
4. At the creditors' meeting (or the creditors' committee, if such a form was approved by the creditors' meeting during the monitoring procedure), provide information on the progress of the debtor's fulfilment of its obligations according to the debt repayment schedule;
5. Monitor the fulfilment of current creditors' claims and the financial recovery plan;
6. Monitor the timeliness and completeness of funds transfer in order to repay debts to creditors;

The Bankruptcy Law allows bankruptcy creditors to establish their claims during the financial recovery procedure, therefore, when introducing the procedure, creditors and founders of the company must take into account not only the already established requirements, but also requirements that may be declared in the next procedure.

Since the repayment of the debt is made at the expense of the debtor's reserves and property and the original repayment schedule provides for the repayment of only those creditors whose claims were declared during the monitoring procedure, the presence of "new" creditors in the bankruptcy case may lead to difficulties in fulfilling obligations.

The construction of financial recovery by itself has similarities with the approval of a debt restructuring plan in the insolvency (bankruptcy) procedures of citizens.

Thus, within the framework of these procedures, the debtor is given the right to fulfil obligations without negative consequences provided for by bankruptcy legislation.

At the same time, the debtor's activities are constantly monitored in order to prevent artificial delaying of the bankruptcy procedure, illegal withdrawal of liquid assets, conclusion of suspicious transactions and causing harm to bankruptcy creditors. Similar principles underlie the financial recovery procedure in the insolvency laws of other states, including the CIS [3].

Thus, as part of the financial recovery procedure, significant restrictions are introduced for debtor's management bodies in terms of concluding transactions. Debtor's management bodies are obliged to obtain a consent of the creditors' meeting (creditors' committee) for transactions involving an increase in the debtor's credit burden, as well as his assets decrease (issuance of loans, guarantees).

Also, regarding the alienation of the debtor's property, there is a ban on the sale of property, the value of which is higher than five percent of the book value of the debtor's assets as of the last reporting date preceding the date of the transaction.

The conclusion of the above-mentioned transactions is possible only with the consent of the administrative manager, who, in turn, must take all measures depending on him to establish the purity of the concluded transactions and their financial feasibility.

Another type of restrictions on the conclusion of transactions is transactions for which the consent of the administrative manager is required. They include transactions entailing an increase in the debtor's accounts payable by more than five percent of the amount of creditors' claims included in the register of creditors' claims on the date of the introduction of financial rehabilitation.

A consent is also required for the conclusion of contracts for the assignment of the right of claim and the receipt of loan or loans (Article 81 of the Federal Law "On Insolvency (Bankruptcy") dated 26.10.2002 No. 127-FZ).

The procedure of financial rehabilitation is the only available way to preserve the powers of debtor's management bodies, since their actions are terminated under other procedures [4]. This is one of the main differences between the financial recovery procedure and, for example, the external management procedure.

At the same time, in practice, the financial recovery procedure rarely ends successfully as to satisfying creditors' claims.

Unfortunately, in the practice of Russian law enforcement, recovery procedures of legal entities and individuals (sole proprietors) in the vast majority of cases do not end
with the fulfilment of obligations, but lead to the application of procedures to debtors involving the sale of assets and a complete removal of debtor's management bodies.

The established law enforcement practice sceptically sets up judges of arbitration courts to introduce recovery procedures. As a rule, preference is given immediately to the liquidation procedure in the form of bankruptcy proceedings.

Despite the fact that the procedure following the supervision is chosen by the creditors' meeting, the courts, seeing the low efficiency of the debtor – which is difficult to restore during the period of open insolvency – introduce a liquidation procedure.

In itself, the restoration of solvency is a difficult process, which implies the restoration of activity, including search and continuation of cooperation with counterparties. At the same time, prudent participants in civil turnover, acting reasonably and in their own interests, do not cooperate with enterprises with respect to which a bankruptcy case has been initiated.

In addition, the sale of debtor's assets for the purpose of fulfilling obligations (for example, a sale of immovable and movable property) may also be delayed for a long time.

The bankruptcy procedure introduced in relation to the organization alarms counterparties and potential purchasers, forcing them to choose other persons with whom cooperation will be conducted in order to avoid possible financial losses or non-fulfilment of obligations.

In connection with the above-mentioned, the procedure of financial recovery is not so effective in practice.

Moreover, the introduction of a recovery procedure and the retention of their powers by governing bodies makes it possible for the right to be abused by the head and beneficiaries of the debtor.

In the practice of bankruptcy disputes, there is often a mechanism for challenging suspicious and insignificant transactions of the debtor, as well as bringing managers to subsidiary responsibility for the obligations of a legal entity. The withdrawal of liquid property from the bankruptcy estate is aimed at creating conditions under which the sale of property for the purposes of settlements with creditors is impossible.

To restore the rights of persons participating in the case, the possibility of challenging such transactions has been created. At the same time, despite the specified mechanism of protection of rights, it can be difficult to foreclose on property. So, it can be exported outside the Russian Federation, sold or hidden from the arbitration manager in other ways. In this case, as part of the financial recovery procedure, debtor's management bodies have reserve time for the gradual alienation of liquid assets and the transfer of property in the form of cash in favour of affiliated organizations under the pretext of carrying out financial and economic activities.

In addition to the introduction of a financial recovery procedure with an illegal purpose, the problematic aspect of such a procedure is the late filing of a bankruptcy application by management bodies.

One of the most common grounds for bringing persons controlling the debtor to subsidiary liability is the failure to file a bankruptcy petition to the arbitration court. This ground is the most common in the court practice.

Within the framework of this study, this directly suggests that bankruptcy procedures are introduced at stages when the solvency of an organization is almost impossible to restore, and the share of accounts payable significantly exceeds assets of the debtor.
At this stage, the restoration of solvency is either impossible or requires considerable time, which is not available in bankruptcy cases. In the case of prompt application for bankruptcy, the restoration of solvency takes place, but in practice this practically does not occur.

Moreover, within the framework of the bankruptcy case, the number and amount of current payments associated with the activities of the administrative manager are growing significantly. In addition to the remuneration established by the Bankruptcy Law, arbitration managers bear the costs of publishing, sending correspondence, publishing messages on the website of the Unified Federal Register of Bankruptcy Information (EFRSB).

The period of introduction of financial rehabilitation has a 2-year term. During the specified period of time, it is difficult to restore the solvency of the organization due to the growth of current payments and to a property crisis.

According to Fedresurs statistics, in 2022, the courts introduced 140 procedures for external management and financial recovery.

The share of rehabilitation procedures (external management and financial rehabilitation) for all procedures, except supervision, decreased from 1.8% in 2019 to 1.6% in 2022.

Table 1. The share of rehabilitation procedures among all bankruptcy procedures.

<table>
<thead>
<tr>
<th>Procedure</th>
<th>2019</th>
<th>2020</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bankruptcy proceedings</td>
<td>12401</td>
<td>9 930</td>
<td>10 317</td>
<td>9 055</td>
</tr>
<tr>
<td>Supervision</td>
<td>10 134</td>
<td>7 775</td>
<td>8 575</td>
<td>5 227</td>
</tr>
<tr>
<td>External management</td>
<td>209</td>
<td>150</td>
<td>157</td>
<td>140</td>
</tr>
<tr>
<td>Financial recovery</td>
<td>19</td>
<td>23</td>
<td>22</td>
<td>9</td>
</tr>
<tr>
<td>Rehabilitation Procedures</td>
<td>1.8%</td>
<td>1.7%</td>
<td>1.7%</td>
<td>1.6%</td>
</tr>
</tbody>
</table>

Based on statistical data, in terms of the introduction of financial recovery procedures, there is a clear decline associated with the lack of effectiveness of rehabilitation procedures.

The reluctance to introduce and make a choice in favor of the financial recovery procedure may also be due to the lack of the developed law enforcement practice on this issue. Statistics show that the number of procedures is critically small, and therefore no serious disputes are being conducted, and judicial practice is not being developed.

For many practitioners, the procedure of financial recovery is poorly studied and underused, and therefore the choice in its favor is significantly low. A good alternative to financial recovery is external management [5]. This procedure is introduced by the courts much more often, respectively, law enforcement practice is much broader than that of financial recovery.

At the same time, a significant number of cases relate to liquidation procedures, which, despite their thoroughness and simplicity, lead to a decline in the economy, since the vast majority of the Russian economic system is represented by small and medium-sized businesses.

The liquidation of organizations, despite the simpler and more expeditious way, leads to a reduction in the number of business entities.

4. Conclusion
Thus, based on the statistical data provided on the bankruptcy procedures being introduced and the analysis of existing regulations that have a clear pro-creditor bias, it is possible to identify the above-mentioned problem of the application of bankruptcy legislation in terms of the introduction of recovery procedures in relation to debtors. This problem is caused by a combination of negative factors, ranging from the general economic situation to imperfections of the current legislation. In this regard, there is the need for a more detailed study of financial rehabilitation in the Russian Federation in order to develop judicial law enforcement practice, develop economic relations and reduce the risky nature of entrepreneurial activity.

The introduction of bankruptcy proceedings entails the emergence of the obligation of the debtor's head to bear responsibility for unfulfilled obligations with his property within the framework of bringing him to subsidiary responsibility, the liquidation of a large number of organizations whose solvency could be restored.

However, we should not forget that the purpose of the bankruptcy procedure is not only the proportionate satisfaction of creditors' claims, but also the restoration of solvency and financial stability, which is expressed in the release of persons from a high debt burden.

References


