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CHANGES IN THE REGULATION OF LIABILITY IN CASES OF BANKRUPTCY

In July 2017, the Federal Law dated 26 October 2002 No. 127-FZ "On Insolvency (Bankruptcy)" (the "**Bankruptcy Law**") was supplemented with provisions introducing, among other things, subsidiary liability of persons de facto controlling a bankrupt company (the "**Debtor**") in the event that the Debtor's assets are insufficient to settle the claims of its creditors¹. On 21 December 2017, the Supreme Court of the Russian Federation issued a detailed resolution clarifying the implementation of these new Bankruptcy Law provisions in practice.

CONTROLLING PERSONS

According to the amended Bankruptcy Law, a person is deemed to be controlling the Debtor if it has or had, within a period of up to three years preceding the bankruptcy, the actual capacity to give mandatory instructions to the Debtor, or to otherwise determine its course of actions, for instance:

- (a) based on shareholding;
- (b) based on a job function of the relevant person (the Debtor's CEO, CFO, chief accountant, etc.) or any other legal authority to act on behalf of the Debtor, based on a power of attorney, on the provisions of law or otherwise;
- (c) based on kindred relationships between the controlling person and the Debtor (its corporate bodies); or
- (d) otherwise, including by compelling the Debtor or its authorities to act in a specific way or otherwise influencing their decisions.

The above is only a suggested list of categories of persons to consider when deciding on the list of those controlling the Debtor. As clarified by the Supreme Court, a controlling person is one that has actual control over the Debtor, irrespective of any formal or legal criteria of its affiliation with the Debtor. A court, considering the matter must decide on this on a case-by-case basis, considering the level of involvement of the relevant person into the Debtor's activities or management of the Debtor. If actions/transactions that influenced the economic and/or legal future of the Debtor are made under the influence of a certain person, or if a person has significantly benefitted from illegal or unfair actions of the Debtor's management, then such a person must be deemed to be controlling the Debtor and may be brought to subsidiary liability over its debts.

¹ Federal Law No 266-FZ dated 29 July 2017 "On Amendments to the Federal Law "On Insolvency (Bankruptcy)" and the Russian Code of Administrative Breaches".

The Supreme Court also clarified that the “nominal” management of a Debtor (persons, appointed to management positions, but following someone else’s instructions instead of taking management decisions themselves), as well as anyone holding management positions who have transferred the management functions to someone else (e.g. by means of a power of attorney) are not released from their liability, and also have to be considered to be controlling the Debtor along with the actual management, as they still retain the formal capacity to manage the Debtor.

SUBSIDIARY LIABILITY WHERE THE DEBTOR IS UNABLE TO SETTLE ITS DEBTS

Where the Debtor cannot settle the claims of its creditors within the bankruptcy in full, due to the actions (inaction) of its controlling persons, the latter bear subsidiary liability for the Debtor’s remaining debts. Although this does not directly follow from the Bankruptcy Law provisions, the Supreme Court has clarified that such actions (inaction) only refer to those that have triggered the bankruptcy (e.g. material management decisions taken not in good faith or unreasonably, instructing the Debtor to operate at a loss, appointing individuals to management positions despite them not having sufficient knowledge/capacity to manage the Debtor, or where those whose management decisions would not be in the interests of the Debtor, etc.) The Court must consider the actions (inaction) of a controlling person and their relevance to the Debtors bankruptcy on a case-by-case basis.

A controlling person is also liable as above if its actions (inaction), although did not trigger the bankruptcy and undertaken after the start of the bankruptcy, have worsened the financial status of the Debtor.

According to the amended Bankruptcy Law, the liability of a controlling person is assumed if, for instance:

- (a) significant damage is caused to creditors’ interests due to transactions between such a person and the Debtor, transactions of the Debtor in favour of such a person or transactions entered into further to its instructions;
- (b) the accounting documents of the Debtor are not in compliance with the requirements of the effective legislation of the Russian Federation or are incomplete, which impedes bankruptcy proceedings (e.g. formation of bankruptcy estate);
- (c) the documents that the Debtor is obliged to keep due to the requirements of applicable laws are missing or are corrupted; or
- (d) as of the date of launching bankruptcy proceedings, the respective notifications of the registering authority are not done, are not done properly, or contain incorrect information; etc.

If there are several controlling persons, they, as a general rule, are jointly liable for the Debtor’s debts.

RELEASE FROM LIABILITY

A controlling person is not liable for the debts that the Debtor is unable to settle, if:

- (a) its actions (inaction) that lead to the negative consequences for the Debtor were within the limits of normal entrepreneurial risk and were not aimed at damaging the interests of the Debtor’s creditors; or
- (b) its actions (inaction) did not lead to bankruptcy or worsening of the financial status of the Debtor after the bankruptcy started.

The court may decrease the amount of liability of the controlling person, if, along with the actions (inaction) of such persons within the bankruptcy, there were external unrelated factors that also contributed to the Debtor's bankruptcy or its financial status (e.g. a flood that damaged the Debtor's assets, etc.).

The court may decide to decrease the amount of liability of members of corporate bodies of the Debtor or its shareholders, or even release them from liability, if they:

- (a) prove that they had no actual control over the activities of the Debtor (e.g. nominal management); and
- (b) disclose sufficient information to identify the de facto controlling persons or hidden assets of the Debtor or such persons.

SUBSIDIARY LIABILITY AND LIABILITY FOR DAMAGES

The newly introduced subsidiary liability of controlling persons does not exclude bringing the relevant persons to general liability for causing damage to the Debtor by their actions. Irrespective of which type of liability is claimed by the applicant in court, the court must delineate the general liability for damages and subsidiary liability independently, based on the following general tests, as clarified by the Supreme Court:

- (a) if actions (inaction) of a controlling person have served as a necessary cause of the bankruptcy, that person has to be brought to subsidiary liability in accordance with new Bankruptcy Law provisions;
- (b) if damage caused to the Debtor could not reasonably be expected to trigger the bankruptcy, then the above persons are liable for damages based on general provisions of the Civil Code.

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