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BANKRUPTCY OR RESTRUCTURING?

The Dilemma of a Creditor and a Debtor in Kazakhstan

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Creditor's Dilemma

Contribute in the restoration the debtor's solvency through debt restructuring

Collect the debt as soon as possible, having often doomed the debtor to bankruptcy?

Often the choice is between bankruptcy, (accelerated) rehabilitation and contractual debt restructuring.

When the management and members of the company do no longer seek to move the company beyond its difficult financial situation, act in bad faith towards its creditors, and there are debtor-creditor long battles usually resulting in bankruptcy.

Bankruptcy is a procedure implemented in order to meet creditors' claims **on account of the assets** of the bankrupt party in the procedure specified by the laws of the Republic of Kazakhstan.

Duration of the bankruptcy procedure is determined by the court decision and **cannot exceed nine months.**

Bankruptcy

**In Astana, about 100 enterprises go bankrupt every year, which is 0.15% of the total number of registered taxpayers.*



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Bankruptcy Grounds

- The ground for the **creditor's claim** to the court for recognition of the debtor as a bankrupt is the debtor's **insolvency**.

Insolvency Features

- A debtor is **insolvent** in one or more of the following cases:.....
- obligation to other creditors have not been performed during **three months** after the due date and are totalling to **at least one thousand Monthly Calculated Indices**, as established for the relevant financial year by the law on republican budget, - **for legal entities**.

Recognition as a Bankrupt

The ground for recognition of a debtor as a bankrupt through the **court proceedings** is its insolvency.

Insolvency is the debtor's **inability established by the court to fully satisfy the claims of creditors** on the monetary obligations, to settle payments to persons working under employment contract, to ensure payment of taxes and other obligatory payments to the budget, social contributions to the State Social Insurance Fund, and mandatory pension contributions and mandatory professional pension contributions.

Recognition as a Bankrupt (Practical Experience)

Pursuant to Article 45 of the Law “On Rehabilitation and Bankruptcy” (the “**Law**”), the creditor’s application for recognition of the debtor as a bankrupt shall be accompanied with the documents confirming, inter alia, **the validity of the creditor’s claims** (execution documents, court decision or written recognition by the debtor of the creditor’s claim).

Thus, in practice **to file an application** for recognition of the debtor as a bankrupt, the sole court decision entered into force **is not sufficient. Enforcement proceedings are also required in this case**; and only subject to the evidence that the enforcement proceedings fell through (for instance, no funds at the debtor's account), the creditor has the right to file the bankruptcy application to the court.

This indicates that in fact **commencing the bankruptcy proceedings is not so easy in practice**, because even the court decision being entered into force does not grant the rights to the creditor to apply to the court, when there were no enforcement proceedings.

Recognition as a Bankrupt (Practical Experience 2)

Under Article 48.4.2 of the Law, when the bankruptcy case has been commenced upon the creditor's or prosecutor's application, the court ruling on the appointment of **the interim trustee** shall also contain the indication that the interim trustee, within **one month** after the appointment, collects information on the financial state of the debtor and submits an opinion to the court as per the from specified by the competent authority.

*In practice, collection of information of the debtor's financial state takes a long time, and **interim trustees cannot** stay within the period established by the law, thereby opinions on the debtor's financial state are prepared cursorily, **conclusions therein are often hasty and improper.***

Recognition as a Bankrupt (Case Study)

Court decisions recognizing the debtor as a bankrupt **must** contain information of the **actual financial state** of the debtor, as well as the **reasonable assessment of the debtor's solvency** on merits:

“Insolvency of individual entrepreneur “J” was not supported with reliable information. The civil case file **only has certificates on lack of funds on bank accounts**, vehicles and agricultural equipment registered for the debtor's name. Meantime, one of the **proof of debtor's solvency** was **assets belonging to the debtor**: mini-market pledged to the Bank and a land plot. The debt amount being a ground for the bankruptcy application and a market value of the real estate owned by the debtor **were incommensurable**”.

Grounds for Invalidation of Transactions

- the price of the transaction committed and (or) other conditions **essentially differs for the worse** of the debtor from the price and (or) other conditions, under which **similar transactions are committed in comparable circumstances**, when the transaction consequences led to financial losses;
- the transaction does not correspond to the activities of the debtor limited by legal acts of the Republic of Kazakhstan, foundation documents, or has been committed with violation of the competence determined by the charter;
- the property has been transferred (including for temporary use) for free or **at the price which is essentially differs for the worse** of the debtor from the price for the identical or homogeneous goods under comparable economic conditions or without valid reasons to the detriment of creditors' interests;
- if the transaction committed within six months prior to the bankruptcy and (or) rehabilitation proceedings, **entailed preferable satisfaction of claims of one creditors before others**;
- gift agreements for property of the debtor, except for those entered into within regular commercial operations, if such a transaction essentially differs from the transactions committed one year prior to the rehabilitation or bankruptcy proceedings.

Grounds for Invalidation of Transactions (2)

- An application for invalidation of transactions is filed by the **administrator** in time established by the **creditors' committee**.
- When the transaction is invalidated, the **defendant shall return everything received under the transaction**; when it is impossible to make the return in kind - compensate for the cost of the relevant property, works performed or services rendered. In this case, the defendant acquires the right to claim against the debtor, which is subject to satisfaction according to the procedure provided by the Law.

What Does Intentional and False Bankruptcy Mean?

Intentional bankruptcy is the **intentional** creation or increase of insolvency, resulting from the actions (omission to act) of the **founder (participant), official, bodies of a legal entity**, as well as an individual entrepreneurship for personal interests or for the interests of other persons

False bankruptcy is a **deliberately false** announcement resulting from the actions and (or) decisions made by the **founder (participant), official, bodies of a legal entity**, as well as an individual entrepreneurship on the insolvency in order to mislead the creditors to postpone or to spread the payments to creditors or discount the debts, as well as for non-payment of debts.

Intentional and False Bankruptcy (case study)

Director of LLP “A” (names have been changed) and the founder of LLP “A” in anticipation of bankruptcy **in order to increase credit insolvency** of LLP “A”, has made an assignment of the debt of seven economic entities to LLP “B” and thereby has caused damage to creditors totalling to 27.6 mln tenge.

Chairman of the Board of JSC “A” in anticipation of bankruptcy in order to increase insolvency in June 2001 entered into a **deliberately disadvantageous** consignment contract with LLP “B” and thereby caused damage to JSC “A”.

Intentional and False Bankruptcy (Liability)

- **The founder (participant) and (or) officials** of the debtor shall be **subsidiarily** liable to the creditors of the insolvent debtor for the bankruptcy by the property they possess for intentional bankruptcy.
- **An official** of the bankrupt legal entity **shall compensate** the damages caused to the owner of its property for the deliberate making the debtor insolvent.
- If a bankruptcy application has been filed by the debtor to the court for the purpose of false bankruptcy, **the creditors** are entitled to require the debtor to pay compensation for the losses caused and apply to the court for making persons, who made the relevant decision, **subsidiarily liable**.

Intentional and False Bankruptcy (Liability 2)

- If in the course bankruptcy proceedings the signs of deliberate bankruptcy are revealed, **the bankruptcy manager must within a month and the creditors may file to the court a claim against the relevant person for the recovery of amounts claimed by the creditors and being outstanding due to the lack of bankrupt's property after the bankruptcy proceedings.**
- **Within a month after the signs of **deliberate or false bankruptcy** have been revealed, as well as in cases of recognition as a bankrupt upon the prosecutor's application under **Article 47.1.1** of the Law, the **administrator must apply to the law enforcement authorities** to make the relevant persons liable as provided by the laws of the Republic of Kazakhstan (e.g. Article 238 of the Criminal Code of Kazakhstan).**

Priority of Distributing the Assets:

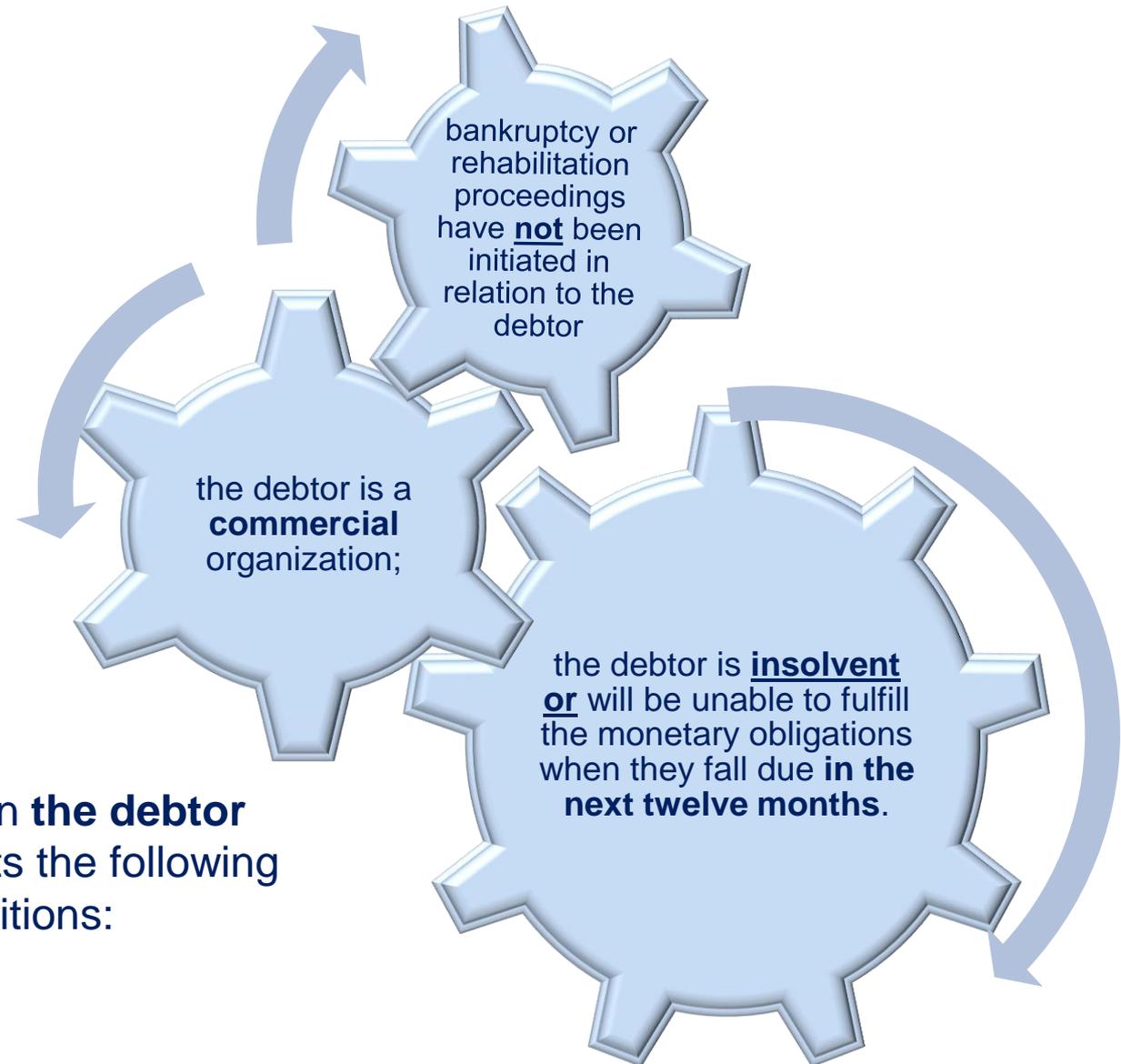
The Law provides for the new priority of distributing the bankruptcy assets:

- claims for compensation of the harm to the life and health; alimony recovery; labour remuneration; compensations under employment agreements; social contributions to the State Social Insurance Fund; mandatory pension contributions; mandatory professional pension contributions; compensations under author's agreements;
- creditors' claims for obligations **secured with pledge**;
- debts on taxes and other obligatory payments to the budget;
- claims of **other unsecured creditors** on commercial agreements;
- claims for indemnification and collection of penalties.

What Does Accelerated Rehabilitation (AR) Proceeding Mean?

- This is a procedure applied to the debtor judicially under the **rehabilitation plan** agreed upon with the creditors **in the out-of-court procedure**;
- *Equivalent to a Standstill Agreement*
- Term - not more than 2 years (with an option of single extension for 6 months)

When the AR Can Be Applied?



When **the debtor** meets the following conditions:

Who Can Initiate the AR Proceedings?

If it is **possible to restore** solvency, to **prevent insolvency**, the debtor may **apply to the court** for application of the accelerated rehabilitation proceedings.

Practice: AR is a good way for the debtor to avoid liability to the creditors.

What Should Be Done prior to the AR Initiation?

The debtor's application shall enclose:

- rehabilitation plan;
- the minutes of a meeting and (or) a written confirmation of the approval of the rehabilitation plan by the creditors, the amount claimed by which is **more than fifty per cent** of the total amount of claims of **each** group(s) of homogeneous creditors **included in the rehabilitation plan.**

Can the Court Refuse to Apply the AR?

The court rejects initiation of the AR proceedings in the following cases:

- in the trial proceedings, the **debtor has failed to confirm its insolvency and (or) inability** to repay future payments in timely manner;
- the debtor has failed to meet the requirements of Article 32.4 of the Law and to prove the impossibility to notify the creditor because of his absence at the location;
- the notice of initiation of proceedings sent to the creditors does not meet the requirements of Article 32.3 of the Law;
- property interests of the creditors, who did not agree to the accelerated rehabilitation proceeding, are not covered by the rehabilitation plan;
- the rehabilitation plan changes and involves the rights of creditors, who are not the members of the group of homogeneous creditors agreed the rehabilitation plan;
- the documents provided by the debtor do not confirm the approval of the rehabilitation plan by the creditors, the amount claimed by which is more than fifty per cent of the total amount of claims of each group of homogeneous creditors included in the rehabilitation plan.

The Effects of Commencement of AR Proceedings

Since commencement of the AR proceedings:

- the owner of the debtor's property (authorized body), founders (participants), all the bodies of the legal entity are prohibited to use and sell the assets outside of the ordinary commercial operations;
- **execution of the previous decisions of courts, arbitration courts on claims from creditors** being members of the group of homogeneous creditors and **included in the rehabilitation plan**, as well as the owners of the debtor's property (persons authorised by them), founders (participants) in respect of the property shall be **suspended** until the court decision on termination of the AR proceedings;
- **no bankruptcy proceedings may be commenced** upon the application of creditor(s) being member(s) of the group of homogeneous creditors and **included in the rehabilitation plan**;
- no recovery of money from the bank accounts of the debtor under the claims of creditors involved in the AR proceedings, including the claims to be satisfied by uncontested (acceptance-free) procedure, as well as no foreclosure of the debtor's property is allowed.

The Effects of AR Application

Settlements with the creditors **included in** the rehabilitation **plan** are made according to the repayment schedule provided by the rehabilitation plan.

Settlements with **other** creditors not involved in accelerated rehabilitation proceedings are made within regular commercial operations.

What Does Rehabilitation Procedure (RP) Mean?

This is a **judicial** procedure, under which reorganisational, organizational-economic, managerial, investment, technical, financial-economic, legal and other measures not contradicting the legislation of the Republic of Kazakhstan are applied to the insolvent debtor **to restore its solvency** of the debtor in order to avoid its liquidation.

When the PR Can Be Applied?

The ground for the creditor's application to the court for the rehabilitation procedure is the debtor's insolvency.

The ground for filing by the debtor an application to the court for rehabilitation procedure is its insolvency **or the threat of insolvency**, when the debtor will be unable to meet financial obligations as they fall due **within the next twelve months**, with a possibility of solvency recovery.

The court rejects to apply the rehabilitation procedure, **if in the course of trial proceedings the debtor** has failed to prove its insolvency **or** inability to fulfill monetary obligations, which become due **within the next twelve months**.

Who Can Initiate the RP?

The rehabilitation proceedings are initiated in the court based on the application of the **debtor or creditor(s)**, except for creditor on taxes and other obligatory payments to the budget, subject to the grounds, specified in *Article 5 of the Law*.

The Effects of Commencement of Rehabilitation and Bankruptcy Proceedings

Since commencement of the rehabilitation or bankruptcy proceedings:

- the owner of the debtor's property (body authorized by it), the founders (participants), all the bodies of the legal entity are prohibited to use and sell the assets outside of the ordinary commercial operations without prior coordination with the interim trustee;
- execution of the previous decisions of courts, arbitration courts, state revenue authorities, as well as the owners (founders, participants) or bodies of the debtor in respect of the property shall be suspended, except for the payments to citizens, to whom the debtor is liable for damage to life or health without taking into account the claims for moral damage;
- any claims of creditors against the debtor may only be brought within the bankruptcy or rehabilitation proceedings, provided for by the Law, except for claims for execution of guarantees and sureties by third parties and enforcement of pledge in cases when the pledgor is a third party;
- no recovery of money from the bank accounts of the debtor under the claims of creditors, state revenue authorities and other competent authority engaged in the calculation and (or) collection of obligatory payments to the budget, including the claims to be satisfied by uncontested (acceptance-free) procedure, as well as no foreclosure of the debtor's property is allowed;
- alienation of shares or participatory interests in the debtor's charter capital is prohibited.

The Effects of RP Application

After rendering the court's decision on initiation of the rehabilitation procedure, the following consequences occur:

- it is prohibited to commit transactions with the assets outside of the ordinary commercial operations without the prior coordination with the interim administrator;
- **accrual of penalties (fines, penalties) is terminated** on all types of debts of the debtor, as well as the interest on the loans received;
- **execution of decisions of courts**, arbitration courts, state revenue authorities, as well as the owners of the debtor's property (authorised bodies), founders (members) in respect of its property **is suspended**, except for the payments to citizens, to whom the debtor is liable for damage caused to life or health excluding the claims for moral damages, the due date for which occurs after application of the rehabilitation procedure;
- taxes and other obligatory payments to the budget calculated by the tax payer in accordance with the tax reporting, assessed by the tax authority upon the results of tax audits for the tax period, following the tax period in which the rehabilitation procedure was applied, shall be paid.

Does the Management Reserve the Control over the Company in case of RP?

At the request of the owner of the debtor's property (body authorised by it), founders (participants) **based on the decision of the creditors' meeting**, the court retains the right to manage the property and affairs of the debtor since approval of the rehabilitation plan to the owner of the debtor's property, body authorised by it, founders (participants).

In case the creditor's meeting decides **to cancel the ownership right of the owner** of the debtor's property, founders (members) to manage the property and affairs of the debtor, the creditors' meeting shall nominate its candidate as a rehabilitation manager from the persons registered with the competent authority.

Rehabilitation Plan

The rehabilitation plan shall include specific measures for restoration of the debtor's solvency (rehabilitation measures) and a **schedule of repayment of debt** to the creditors.

The term for implementation of the rehabilitation plan shall not exceed **five years**.

What Do Creditors Think?

Bankruptcy is not an option (5 priorities).

Debts recovery and pledge sale through the court is a time and funds consuming option (3% court duty) and bank loses a client.

Extra-judicial sale of the pledge - the pledge value may not cover the entire debt, and the borrower can oppose the sale of pledge.

Restructuring (work-out)?

If the management of the company or participants thereof seek to resolve the problems, to make gradual debt repayment and to restore its solvency, the creditors as a rule make advances and agree to the restructuring.

Example: Astana Finance JSC

Multilateral Offset

- “Perfect alternate”: there are counter-claims of creditor and debtor that are due (see Article 370 of the Civil Code).
- Multilateral Offset: a creditor owes to a third party, which is in debt to the debtor.
- The transaction can be drawn up in a trilateral agreement, but it would be preferable to do in stages (debts assignment - offset - offset).

Pay Off and Novation

- If there are no ways for offset, pay off and novation can be applied (Articles 369 and 372 of the Civil Code).
- Condition is the presence of the debtor's property, which it agrees to provide in payment of the debt and which is of interest to the creditor.
- Novation is safer for the creditors since courts may interpret the pay off agreement not as an undertaking but as the debtor's right to perform obligation in a different way.

Debt for Equity Swap

This option is not applicable (at least directly), if the debtor is an LLP (see Article 59.1 of the Civil Code).

Expected

- The Draft Law of the Republic of Kazakhstan V “On the Introduction of Amendments to Some Legislative Acts of the Republic of Kazakhstan on Rehabilitation and Bankruptcy”
 - *introduces the concept of “amicable agreement”*
- Draft Resolution of the Supreme Court of Kazakhstan

THANK YOU FOR YOUR ATTENTION!



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