

A Practical Guide to Russian Restructurings

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This Guide provides a general overview of the position of a commercial lender where its Russian borrower is in financial distress or insolvency.

Contents of This Guide

Sections I, II and III review the applicable legal background, with a focus on the implications of the Russian insolvency regime on the lender's bargaining power to achieve a favourable, consensual restructuring, as well as on certain foreign law measures which, if available, can enhance the lender's position.

Section IV analyses six hypothetical restructuring scenarios. In respect of each scenario, we briefly discuss, among others, the ability of a lender to (i) cancel the obligations of a borrower in exchange for shares of the borrower; (ii) provide additional financing and strengthen its position as a creditor in the event of default; and (iii) obtain control over the borrower.

A more detailed table of contents follows this page. Readers familiar with the relevant legal framework may wish to skip directly to Section IV.

Certain Assumptions

For the purposes of this Guide we have assumed that the borrower (or debtor) is a Russian legal entity, and that where the lender's claim against the borrower is for indebtedness under a loan, the loan was made in the ordinary course of business.

We assume that the governing law clause of the relevant finance documentation follows customary market practice, being Russian law for rouble bond documents and, generally, English law for loan agreements and other debt instruments. In respect of security interests, we assume that the security is validly given under Russian law (or such other law as the context indicates), the secured property is not subject to other liens, and the secured claim is not subject to subordination.

Further Legal Advice

The information contained in this Guide should not be construed as legal advice. Should further analysis or explanation of the subject matter be required, or if you wish to discuss the subject further, please contact any of the Latham & Watkins attorneys listed at the back of this Guide.

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I. LENDER'S POSITION AND BARGAINING POWER WHERE RUSSIAN BORROWER IS IN FINANCIAL DISTRESS

A. Position of Creditors Before Initiation of Russian Insolvency Proceedings

1. Unsecured Creditors

Before insolvency proceedings have been initiated against a Russian debtor under the Russian Bankruptcy Law,¹ the rights of a lender as an unsecured creditor include (i) contractual rights under the transaction documents for the loan, and (ii) statutory rights under Russian law on the rights of debtors and creditors, primarily the Civil Code,² and on the enforcement of court judgements under the Enforcement Law.³

(a) Contractual Rights and Remedies

A debt instrument such as a loan agreement sets out a number of rights for the unsecured lender. Typically, the most important of these are the right to accelerate the loan, *i.e.*, to demand immediate repayment in full, upon the occurrence of one or more events of default, and to receive interest at a higher rate on defaulted payment amounts. An unsecured lender may also have a right to require the borrower to provide it with new security over property (rendering it a secured creditor), or new or additional quasi-security, *e.g.*, a guaranty of a third party. Loan agreements and other debt instruments often include a number of other provisions designed to protect the creditor, such as a right to receive more detailed financial, operational and other information about the borrower than would otherwise be available to the creditor in the ordinary course.

(b) Statutory Rights and Remedies

An unsecured lender's statutory rights naturally include the right to sue for breach of the loan agreement. If it wins a judgement but the debtor fails to pay, the lender may seek a writ of execution from a court permitting the assets of the debtor to be attached and, potentially, foreclosed upon.

To enforce the writ, the lender generally must present it to the court bailiffs service which will initiate enforcement proceedings, including identification and attachment of the debtor's assets. If the debtor fails to satisfy the writ within five days, the bailiffs service can foreclose on the attached assets, remitting the proceeds to the creditor up to the amount of its claim.

Generally, the debtor's cash must be the first assets liquidated to satisfy the claim. If the creditor knows of a bank account of the debtor, either the creditor or the court bailiffs service may present the writ to the debtor's bank, which will be required to arrest (*i.e.*, freeze) the debtor's account. If the writ so provides, the bank must debit the account up to the amount of the claim and remit the proceeds to the creditor.

Similar remedies exist under Russian law in respect of other forms of property, although the particular rules may vary. In particular, the creditor has no self-help remedy in relation to property other than bank accounts. Instead, only the court bailiffs service may enforce a writ over such property.

Notwithstanding the availability of these remedies under Russian law, however, their exercise in practice may be time-consuming, costly and ultimately unsuccessful for the creditor.

¹ Federal Law No. FZ-127 of 26 October 2002 on Insolvency (Bankruptcy).

² The Civil Code of the Russian Federation, Parts 1, 2, 3 and 4.

³ Federal Law No. FZ-229 of 2 October 2007 on Enforcement Proceedings.

2. Secured Creditors

In addition to contractual and statutory rights broadly similar to those of unsecured lenders, secured lenders have the rights associated with their security. In the commercial debt market, the most common forms of Russian security interest are the pledge over movable property such as equipment, shares and other personal property, and the mortgage over immovables, *i.e.*, real property and fixtures.⁴ The holder of a Russian pledge or mortgage has the rights and remedies provided under the Pledge Law⁵ or the Mortgage Law,⁶ as the case may be, as well as under the Civil Code, the Enforcement Law and other applicable legislation.

Recent amendments to these laws have significantly enhanced the secured creditor's rights and its prospects for recovering value, by making the out-of-court enforcement agreement a meaningful self-help remedy as an alternative to traditional enforcement by court order. However, the secured creditor's rights and remedies are subject to the terms of the transaction documents, which may limit or, in some cases, expand the rights provided by law. In particular, the specific terms of the out-of-court enforcement remedy must be set out in the documents expressly. Careful legal due diligence of such documents is therefore required at the outset to ensure that the lender has the rights it believes it bargained for.

(a) Traditional Statutory Rights and Remedies

The essential rights of the secured creditor under Russian law are (i) to enforce the security upon the occurrence of an event of default or other event specified in the security agreement and (ii) to have its claims satisfied out of the secured property ahead of the claims of other creditors. Except to the extent it has a valid right of out-of-court enforcement, as discussed in Section I.A.2(b)(*Out-of-Court Enforcement Agreements*), the secured creditor may enforce Russian security only in accordance with a court order (or writ of execution) permitting enforcement. The court bailiffs service, and not the creditor itself, must carry out the enforcement by seizing the secured property, arranging for its sale at a public auction and remitting the proceeds to the secured creditor in an amount up to the value of its claim. A portion of the proceeds is reserved for certain enforcement costs.

(b) Out-of-Court Enforcement Agreements

The recent amendments to applicable laws on Russian security breathe life into the secured creditor's self-help remedy under an out-of-court enforcement agreement, a right which was of very limited utility before the change in law. Under the amendments, a secured creditor may enforce a pledge or mortgage without recourse to a court, so long as it does so in accordance with a valid agreement permitting out-of-court enforcement which is signed by the security provider and complies with the laws on security. The parties may memorialise such agreement in the security agreement itself or in a separate document entered into at

⁴ This is of course not an exhaustive list of the kinds of property which can be subject to a pledge or mortgage, and other types of liens exist or are recognised under Russian law. The legal position in relation to Russian security over different kinds of property, and to other forms of security, may vary.

⁵ Federal Law No. 2872-1 of 29 May 1992 on Pledge.

⁶ Federal Law No. FZ-102 of 16 July 1998 on Mortgage (Pledge of Immovable Property).

any time.⁷ Previously, such an agreement in respect of a mortgage was valid only if entered into after default.

The out-of-court enforcement agreement must specify in detail the permitted methods of enforcement, which are limited to those set out in the applicable statute. For a pledge, the agreement may provide for enforcement by public or private auction, by sale under a commission arrangement, or by strict foreclosure, *i.e.*, the transfer of title to the secured property to the secured creditor. For a mortgage, the secured creditor may arrange for sale of the secured property by public (and in some cases private) auction and, in certain circumstances, may purchase the property for itself or third parties. If the secured creditor wishes to use another method to enforce a pledge or mortgage, or if the method provided is ineffective or incapable of satisfying the creditor's claim, the creditor may enforce the security only pursuant to a court order.

In the commercial context, enforcement will usually require valuation of the secured property by a licensed appraiser. The general rule is that, in order to establish a starting price for the sale of secured property upon enforcement, the agreement must specify a deemed value for the property or a means for determining the starting price. However, the valuation must instead be determined by a licensed appraiser where the secured property falls within any of several categories (including real property, securities not quoted on an exchange and book debts being sold at auction), or if its deemed value as stated in the security agreement is greater than 500,000 roubles.

To initiate the enforcement procedure under an out-of-court enforcement agreement, the secured creditor must send a notice⁸ to the security provider, and wait until expiry of a grace period, at which time it may enforce the security. In the case of a pledge, under certain circumstances, a pledgor may petition a court to stay enforcement for a period of up to one year, but such a petition will not be granted where the delay in enforcement could give rise to (i) a material increase in the risk of loss or damage to the secured property, (ii) a risk of a significant decline in the value of the secured property in comparison to the initial foreclosure price, or (iii) a material adverse effect on the financial position of the secured creditor.

Together, the recent changes in the law significantly reduce the ability of a security provider to use legal process as a means of obstructing or delaying enforcement of security. If the security provider refuses to honour the terms of the agreement, the secured creditor may obtain an "executive endorsement" of the security agreement by a Russian notary, and submit it to the court bailiffs service for execution of the security. The amendments also give the secured creditor authority to enter into transactions and execute documents necessary to effect the sale of the secured property, and a power of attorney from the security provider is not required.

Enforcement is generally not permitted where the breach of the secured obligation is immaterial (*i.e.*, a payment default which has continued for less than three months) and enforcement would be disproportionate to the injury caused by the breach (*i.e.*, the amount of a defaulted payment is less than 5 percent of the value of the secured property).⁹ The court may lift the prohibition in certain cases, such as where, during any 12-month period,

⁷ If the security is a pledge of movables by an individual, or is a mortgage, the agreement must be accompanied by the notarised consent of the security provider, which consent may likewise be given at any time.

⁸ The form and substance of such a notice differ somewhat depending on whether the security is a pledge or mortgage.

⁹ The examples cited apply to pledges, but roughly similar criteria apply to mortgages.

three or more payments are overdue under a secured obligation to make periodic payments.¹⁰

B. Position of Creditors in Russian Insolvency Proceedings

1. Priority of Claims in Insolvency

Where a borrower has entered into insolvency proceedings under the Russian Bankruptcy Law, creditors' claims must be paid in accordance with the order of priority set out in the Law. No claim can be paid until all claims of higher priority have been paid in full. Claims of equal priority are generally paid on a *pro rata* basis.

(a) Pre-petition Unsecured Claims

Unsecured claims which became due and payable before the initiation of insolvency proceedings must be satisfied in accordance with the following order of priority set out in the Bankruptcy Law:

- **First priority claims** are those arising out of the debtor's liabilities to individuals for harm to life or health or for "moral injury".
- **Second priority claims** arise out of the debtor's obligation to pay wages, salary or other amounts under a labour contract or to pay fees or royalties to the creator of intellectual property.
- **Third priority claims** are all other pre-petition unsecured claims, including (i) claims of a commercial lender in respect of the debtor's indebtedness under a loan and (ii) "mandatory payments", defined as taxes, duties and other charges payable to the budget of the Russian Federation, other relevant levels of Russian government, or to budgetary funds of the state, including fines, penalties and other sanctions in respect thereof.

The status of mandatory payments as third priority claims is misleading, however, because to the extent that any mandatory payments remain outstanding when the liquidation phase is initiated, they will effectively have super-priority over all other pre-petition unsecured claims.¹¹ Theoretically, their super-priority only applies in liquidation, but this rule can have a major effect on other creditors' bargaining power and likelihood of recovery. Where a debtor has substantial unpaid tax obligations, as is often the case for a Russian company in insolvency, the possibility that the debtor may enter liquidation raises the spectre of its commercial lenders and other creditors becoming automatically subordinated to the claims of the tax authorities. The risk of that outcome substantially increases the debtor's leverage in threatening to proceed to liquidation.

(b) Current Claims

Current claims are claims which arise after the initiation of insolvency proceedings against the debtor. Current claims are satisfied "outside the statutory order of priority" applicable to pre-petition unsecured claims, meaning that current claims have super-priority in relation to pre-petition unsecured claims. The various categories of current claims and their priority of payment in relation to other current claims are as follows:

¹⁰ This relief from the prohibition on enforcement is not applicable to pledges and to mortgages.

¹¹ The recent amendments to the Bankruptcy Law do not make entirely clear what priority such mandatory payments would have in relation to secured claims and to current claims, other than mandatory payments.

- **First priority current claims** are those in respect of court costs for the insolvency proceeding, or the fees of the arbitration manager or certain persons retained by it.
- **Second priority current claims** are those in respect of wages, salary or other amounts payable under a labour contract, or fees of certain persons retained by the arbitration manager.
- **Third priority current claims** relate to amounts owed for certain utility services, or for operational expenditures which are necessary for the continued operation of the debtor's business.
- **Fourth priority current claims** are all other current claims, including claims in respect of post-petition unsecured financing.

Under the Bankruptcy Law as recently amended, it is not clear whether a claim in respect of post-petition secured financing would be treated for priority purposes as a current claim or a secured claim.

(c) Secured Claims

In the insolvency context, secured claims have a first-priority right to payment out of the proceeds of sale of secured property, although this first-priority status extends only to the first 70 percent of the proceeds (80 percent, where the claim is that of a lender under a credit agreement). Of the remainder, 20 percent (15 percent for a credit agreement claim) is reserved for payment of pre-petition unsecured claims of first or second priority, to the extent the debtor's estate is insufficient to satisfy such claims in full; and 10 percent (5 percent for a credit agreement claim) is reserved for court costs and fees of the arbitration managers and persons it has retained.

However, the recent amendments to the Bankruptcy Law do not make clear how to determine whether the debtor's estate is sufficient to satisfy first and second priority claims, since that will be known only upon liquidation. It may be that courts will make such determination at the time of enforcement on the basis of an estimate or projection of the value of the debtor's unencumbered assets, but the Law gives no tools for the court to reach such an interim valuation, or for creditors to contest one. It is therefore possible that secured creditors will have to wait until liquidation to receive their share of any excess left after satisfaction of such claims.

(d) Uncertainty as to Priority Conflicts

As noted above, ambiguities and lacunae in the Bankruptcy Law continue to exist even after the recent amendments (and in some cases as a result thereof) in respect of the rules for determining priority among competing claims in certain circumstances. In particular, notwithstanding their complexity, the priority rules do not adequately take account of priority conflicts which can arise in transactions, especially in sophisticated debt financings.

2. Limitations on Enforcement of Claims

A lender's ability to pursue and enforce its claim against a debtor is limited in the insolvency context, principally in the following ways.

(a) Suspension of Creditors' Rights (Moratorium)

Immediately upon the initiation of insolvency proceedings,¹² the Bankruptcy Law imposes a stay (or moratorium) on creditors' claims, other than current claims, first and second priority claims and certain other claims. The stay does apply to pre-petition claims of commercial creditors. Under the stay, creditors may make demands against the debtor for repayment, enforce their security or otherwise exercise their rights against the debtor in relation to the claim only to the extent and in the manner permitted under the Bankruptcy Law. The stay lasts until the end of the relevant phase of the insolvency proceedings, but a similar stay comes into effect at the beginning of each subsequent phase.

(b) Clawback Risks

A variety of transactions of the debtor are subject to invalidation or avoidance in the course of insolvency. These include, among others, transactions with any creditor or other person which (i) were agreed or completed within six months prior to the filing of the insolvency petition in respect of the debtor and (ii) involve preferential satisfaction of the claims of one or more creditors in relation to those of other creditors. Other transactions may also be subject to challenge, such as certain transactions with interested persons of the debtor.

(c) Limitations on Enforcement of Security

Even where enforcement of security in the course of insolvency proceedings would otherwise be permitted, a court will not grant leave to a secured creditor to enforce its security if the debtor shows that enforcement will render impossible its return to solvency. Whilst the Bankruptcy Law does not set any standards or give guidance as to the scope of this provision, this limitation on enforcement would seem, ironically, to impose a greater risk on a creditor holding security in assets critical to the debtor's business.

3. Limitations on Protection of Debtor's Going-Concern Value

A major stated policy of the Bankruptcy Law is to give the debtor the best possible opportunity to return to solvency. However, the Law falls short of this objective because it offers inadequate post-petition protection for the going-concern value of the debtor's business, and for creditors willing to lend new money to the debtor as it attempts financial rehabilitation. Indeed, it is fair to say that these implications of the Bankruptcy Law create a bias toward liquidation.

(a) Lack of Stay on Termination of Contracts by Trade Creditors

Unlike the insolvency regimes in the US and some European jurisdictions, the Bankruptcy Law does not effectively prevent suppliers, customers and other trade creditors from terminating contracts on the sole grounds that the debtor has entered into insolvency. As a result, when the debtor enters into insolvency proceedings, it may no longer be able to rely on counterparties and relationships which are critical to its business. Depending on the nature of the business and its underlying assets, this factor can make a financial or operational turnaround much more difficult, or even impossible, for the debtor.

(b) Insufficient Protection for New Money Creditors

The Bankruptcy Law also does not give sufficient protection to parties who would be willing to lend new money to the debtor after insolvency proceedings have commenced. This is true

¹² The proceedings are initiated when the arbitration court issues a decision accepting the petition for initiation of the proceedings and starting the supervision phase.

even though such a loan would normally be a current claim with superpriority over pre-petition unsecured claims (as discussed previously). In the international markets, new money lenders are often willing to lend only where they will be fully secured with a first-priority security interest in commercially advantageous property of the debtor. However, a debtor in insolvency is likely to have little or no property which is free of other creditors' security interests, and the Bankruptcy Law does not provide that the new money creditor's claims will have priority of pre-existing secured claims.

By contrast, in the United States, the US Bankruptcy Code allows the claims of a post-petition financier to "prime" the pre-existing secured claims of other creditors in certain circumstances, regardless of whether those claims arose before or after the insolvency proceedings began. This feature has not only made such post-petition financing commercially feasible, but it has given rise to "DIP financing"¹³ as a special market for lending.

(c) Absence of Shareholder Cramdown

There is no mechanism in the Bankruptcy Law that enables creditors to coerce a debtor or its shareholders into a plan of reorganisation whereby, in exchange for extinguishing the indebtedness, the creditors would either receive the outstanding shares of the debtor from the pre-existing shareholders, or receive newly issued shares in an issuance that would be highly dilutive to the pre-existing shareholders. Any such arrangement would require the consent of the shareholders, as well as the court and, in some cases, the arbitration manager. See Section II.B.1 (*Shareholder Consent Required*) for details.

Because the Bankruptcy Law does not give creditors the ability to coerce shareholders to accept such an arrangement, it *de facto* gives shareholders the ability to hold out in insolvency proceedings, making their lack of consent an obstacle to the creditors' recovery of value. Where the business is a good one with a short-term liquidity problem, shareholders may use this tactic in the hopes that the passage of time will allow the business to recover. Where the business is unsalvageable, the shares are worth little or nothing, and shareholders stand to lose nothing by threatening to let the debtor fall into liquidation.

Accordingly, the absence of shareholder cramdown in Russian insolvency creates a significant risk that creditors will lose control of the process and experience significant delay in recovery or reduction of the amount recoverable if no consensual restructuring can be agreed.

(d) Long Horizon for Exit from Insolvency or Liquidation

Russian insolvency proceedings can be protracted, increasing the risk of non-recovery and the cost of the process for a creditor. Where a debtor ultimately undergoes liquidation, it could conceivably remain in insolvency proceedings for up to 43 months in total, spending up to seven months in supervision, up to 24 months (combined) in financial rehabilitation and external administration, and up to 12 months in liquidation. The length of the proceedings can exacerbate the other risks and limitations of the insolvency regime, further shifting the balance of power to debtors.

¹³ Under the US Bankruptcy Code, a debtor-in-possession (or **DIP**) is a debtor whose pre-petition management has not been removed in the bankruptcy case and continues to manage the debtor's business.

4. Limitations of the Insolvency Regime and Implications for the Lender

Taken together, the above factors make it risky for commercial creditors to initiate bankruptcy proceedings. Instead of improving the likelihood, timing and amount of recovery for such creditors, the initiation of bankruptcy proceedings may erode the value of the assets out of which the creditors expect to be paid, under circumstances where shareholders may have little to lose from exploiting their consent rights to delay or otherwise obstruct creditors' recovery. With these forces propelling the debtor toward a distant and decreasingly valuable liquidation, one might reasonably expect the cost of consent fees to be higher in Russia than in jurisdictions such as the US, the UK or certain other European countries, where some form of cramdown, or other alternative to shareholder consent, is available.

II. STRUCTURAL ISSUES IN REFINANCING AND RESTRUCTURING CONTEXT

This section discusses the implications of certain Russian law issues on the mechanics of the restructuring transaction itself, whether through amendment of debt instruments, provision of equity financing or a debt-for-equity swap.

A. Restructuring Debt Instruments

A borrower will normally seek one or a combination of concessions from lenders, depending mainly on their current and projected cash flows. These may include, for example, temporary relief from making payments; a postponement of the maturity date; other changes in the payment schedule; forgiveness of part of the indebtedness; waiver of breaches of covenant; releases from certain financial or other covenants; standstill provisions, *i.e.*, creditors' agreement not to exercise certain rights or remedies; and provision of additional financing.

Agreeing such concessions requires the borrower to negotiate with all necessary parties in relation to each debt instrument. To implement the concessions, the parties and their legal advisers must enter into appropriate agreements, and the borrower must file and publish any documents required by applicable securities or other laws.¹⁴

1. Negotiating and Implementing Modifications to Debt Instruments

Negotiating and implementing concessions in a debt restructuring is much easier where (i) there is a small number of creditors whose consent is required and (ii) it is feasible to amend the existing debt instrument under applicable law.

Where indebtedness arises under a loan or credit agreement, the mechanics for restructuring that particular indebtedness are usually relatively straightforward. In such cases, the borrower normally only must deal with a small number of lenders, or with an administrative agent empowered to negotiate on lenders' behalf, so long as a sufficient majority of lenders approve the terms of the restructuring. Once the concessions are negotiated, the parties can implement them simply by entering into appropriate agreements.

Where there are many creditors, as is often the case with bonds, negotiations may involve a large group of investors with disparate interests. Accordingly, bond documentation will generally provide that a trustee will represent those investors, or a core group of investors will form and act through a committee, and the smaller number of parties at the table can streamline the negotiation process. But the borrower must nevertheless ensure that any concessions are approved by a sufficient majority of bondholders.

¹⁴ Any restructuring of a debt instrument must comply with applicable securities laws, which may impose requirements on the issuer to prepare documents for publication or filing with the relevant securities regulator.

Some debt instruments cannot be amended without significant difficulty, or at all. Unlike European-style high-yield bonds, which can normally be amended as described above, US-style bonds are more difficult to amend, and some amendments cannot be made as a matter of law if the bonds are subject to the US Trust Indenture Act of 1939, as amended. To restructure such US bonds, issuers use other mechanisms, such as purchases of the outstanding bonds through market buybacks or cash tender offers or through exchange offers for new bonds containing the revised provisions.

As discussed more fully below, rouble bonds issued in Russia cannot be amended under existing law, which limits the parties' options to restructure rouble bond indebtedness. The parties may be able to find work-arounds which achieve an acceptable result, but the process is nevertheless likely to be difficult and to entail significant risks.

2. Limitations on Amending Terms of Rouble Bonds

It is effectively impossible to amend the terms of a rouble bond. Such terms are set out in the issuer's decision on issuance and in the prospectus for the bond, both of which must be registered with the Federal Service for the Financial Markets (the **FSFM**). No procedure exists for the amendment of such terms or the documents registered, so once issued, the terms of the bond are fixed for the life of the instrument.

In recent Russian rouble bond restructurings, the issuer and a critical mass of bondholders have instead simply entered into side agreements setting out negotiated concessions and other terms. Because rouble bonds generally are widely held, do not provide for a trustee or a fiscal agent and do not contemplate mechanics for holders to negotiate jointly, a single bank is typically appointed by the issuer to act as organiser to gather and co-ordinate a group of bondholders sufficiently large to make a restructuring agreement commercially feasible. As part of the agreement on restructuring, the issuer will normally agree to buy back immediately a portion of the outstanding bonds held by the holders who sign the agreement, and the remainder in accordance with a schedule. The signing bondholders agree to accept performance on the new terms and not to enforce their rights under the bond documentation.

Notwithstanding the foregoing, the terms of the rouble bonds as registered with FSFM remain in effect, and it is an open question whether the courts will enforce the agreement against signing bondholders.

3. Limitations on Buybacks of Rouble Bonds

FSFM regulations on rouble bonds permit issuers to repurchase bonds if and to the extent provided in the bond documents, and contain provisions setting out a permitted means for conducting such buybacks. Effectively, those provisions amount to tender offer requirements. The regulations do not clearly state whether such provisions are the exclusive means to carry out bond buybacks, but in our view, which is widely held by practitioners, those provisions are mandatory where an issuer wishes to buy back its own bonds.

To effect a buyback under these regulations, the issuer must make an outlay of cash to pay the purchase price, and it is likely to need outside financing to obtain enough cash. Given that the issuer is already in financial distress, such a financing arrangement must be structured as far as possible to mitigate the additional credit risk involved.

The cash buyback is, of course, subject to acceptance by individual bondholders, and to the extent they do not accept the price, they will retain their bonds on the original terms. To incentivise bondholders to sell, issuers usually set the offer price at a premium to the trading price. It is also common for the issuer to set a threshold for the minimum (or maximum)

number of bonds it will repurchase. The issuer may have a right to repurchase the bonds on the terms of a call option set out in the bond documents, but callable rouble bonds have historically been rare.

4. Limitations on Exchange of Old Rouble Bonds for New Rouble Bonds

A possible alternative to a buyback for cash is an exchange offer, i.e., the issue of a new rouble bond, on re-negotiated terms, in exchange for the old one. The exchange offer is subject to the same tender offer rules as a buyback for cash. In addition, the issuer must prepare, publish and register with the FSFM the documents for the new bonds, which extends the timing of the process.

Given that the issuer is in financial distress, investors accepting new bonds should seek to minimise the risk of other creditors challenging the validity of the new bonds on the grounds that their issue constitutes a preferential transfer to one class of creditors at the expense of others. Principally, this risk would arise where the issuer is insolvent or the issue of bonds would render it insolvent. The risk could potentially arise where the value of the old bonds could be construed as lower than that of the new bonds (such as where the issuer has defaulted on payment of the face amount of the bonds), and therefore insufficient value has been given in exchange for them. Under the Bankruptcy Law, preferential transfers are generally subject to avoidance where they are carried out in the six-month period prior to the initiation of insolvency proceedings against the issuer.

B. Debt-for-Equity Swaps and Equity Financing

Restructurings frequently involve one or more creditors obtaining an equity stake in the debtor, either as part of an exchange of shares for forgiveness of part or all of debt, or in connection with new money being invested into the debtor. In a debt-for-equity swap, debt forgiveness may be in exchange either for existing shares of the debtor or newly issued shares, whilst equity financing normally contemplates a subscription for new shares. In the Russian context, the acquisition by a creditor of shares via either method raises several issues which must be dealt with for the transaction to succeed.

1. Shareholder Consent Required

A debt-for-equity swap of either kind described above generally requires some form of consent of the debtor's shareholders. As discussed in Section I.B.3(c) (*Absence of Shareholder Cramdown*), a subscription for new shares requires the approval of the debtor's shareholders, whether before or during insolvency proceedings. Moreover, even in bankruptcy, a controlling shareholder cannot be compelled to give up its existing shares of the debtor, except in limited circumstances, such as where the shares are subject to enforcement of a security interest.

If, however, the lender has a pledge over a controlling interest in the debtor's shares or in the shares of the debtor's controlling shareholder, the creditor may be able to effect a coercive debt-for-equity exchange by enforcing that security upon an event of default. This may be especially effective in the (not uncommon) case of a pledge over a controlling interest in the shares of an offshore holding company that in turn controls the Russian debtor, if the creditor may appropriate the shares under the security documents, a self-help remedy discussed in Section III.B (*Right of Appropriation*). Indeed, the mere ability to threaten such enforcement may be sufficient to persuade the debtor and its controlling shareholder to accept terms for a consensual debt-for-equity exchange that are more favourable to the creditor.

2. Consensual Debt-for-Equity Swaps

Under Russian law, the purchase price for the subscription of new shares in a company cannot be paid through the forgiveness of indebtedness, including by set-off. Where the parties want the economics of the transaction to involve an exchange of shares for forgiveness of the loan, the transaction can be structured so that the lender pays the subscription price, and the debtor then repays the indebtedness. However, this requires the lender to commit the cash amount of the purchase price and take the risk of non-payment. Some of the non-payment risks could be mitigated by structuring the transaction so that the cash is paid into an escrow or other account which the debtor cannot access, and then immediately repaid to the lender. But if the debtor becomes insolvent, the repayment is subject to avoidance as a preferential transfer to a creditor at the expense of others.

As an alternative, a debt-for-equity swap can be structured such that the debtor's controlling shareholder agrees to transfer to the lender some or all of the shares of the debtor, in exchange for the lender's forgiveness of some or all of the debtor's indebtedness.

3. Regulatory Approvals Required

An acquisition of shares of a Russian debtor may require a number of governmental notifications or approvals, the most common being anti-monopoly approval. Where the debtor is a "strategic enterprise" or "natural monopoly" or is engaged in certain heavily regulated industries such as banking or airlines, special governmental approvals may be required or limitations may apply, particularly where the acquirer is a non-Russian person.

III. POSITION OF LENDER WITH OFFSHORE SECURITY

Banks lending to Russian businesses often take security (often a pledge) over shares of the Russian borrower's offshore parent company or controlling shareholder. Where this structure is properly documented, such offshore security can give a lender significant advantages, either in negotiating a restructuring or in protecting its position in the borrower's insolvency. Before enforcing such security, however, the lender should consider certain factors which may reduce these advantages in a given case, as discussed below.

A. Security over Shares in Debtor's Offshore Parent Company

Russian market practice normally dictates that an agreement on such a security interest should be governed by English law or by the law of the parent company's jurisdiction of incorporation, frequently Cyprus, or the British Virgin Islands (the **BVI**).¹⁵ Generally, a creditor holding such security may sell the relevant shares upon the occurrence of an event of default and apply the proceeds of sale toward satisfaction of the secured obligation. Such a security interest may be valuable to a creditor not only in providing a source of funds for repayment through enforcement of the security, but also in that the ability to threaten enforcement enhances its bargaining power to achieve outcomes in the restructuring process which may be more valuable than enforcement itself.

The security's utility must be balanced against the fact that, as a practical matter, enforcement can be costly and time-consuming. A borrower or other obligor may raise defences to enforcement or bring other claims in an effort to defeat or delay enforcement, and the resulting litigation may be protracted. Any delay increases the creditor's exposure to

¹⁵ Other common jurisdictions for such parent companies include the Cayman Islands, Bermuda, the Channel Islands and the Netherlands.

the risks of non-recovery and, in the worst cases, asset-stripping of the debtor or other malfeasance.¹⁶

B. Right of Appropriation

The right of appropriation under English or Cyprus law, and the laws of other EU countries,¹⁷ may be one of the most powerful levers giving a creditor its bargaining power. Where a security agreement governed by the laws of such a jurisdiction provides for a right of appropriation, the secured creditor may take immediate ownership of the shares upon the occurrence of a specified event, such as an event of default. No notice or court order is required for the exercise of the right, and enforcement can often be accomplished in a matter of hours, if not minutes.

A security agreement may also provide for a right of appropriation in respect of a BVI company's shares, so long as the security interest is governed by English law, as was the position in the ground-breaking BVI case *Alfa Telecom Turkey Limited v Cukurova Finance International Limited*.

The appropriation right must be expressly provided for in a written agreement, and the scope of the right is subject to the terms of the security documents. So, as with any other contractual right or remedy, it is important to ensure that the documentation properly provides for appropriation.

C. Offshore Security Enforcement as Means to Control Russian Debtor

If the secured shares represent a controlling interest in the debtor's parent company, then successful appropriation or execution of the security could give the secured creditor effective control over the Russian debtor. This can be highly useful for several reasons, although the extent of such control depends significantly on whether the debtor's parent holds all of the voting shares of the debtor, as discussed below.

1. Benefits of Control

Where the parent company holds all the voting shares of the debtor, appropriation would allow the lender to control the voting of the Russian debtor's shares, and thereby overcome the absence of shareholder cramdown under the Bankruptcy Law. As discussed in section I.B.3(c) (*Absence of Shareholder Cramdown*), the Law requires consent of a debtor's shareholders to a number of significant transactions, including for example issues of shares and sales of substantial assets. Such control would also allow the secured lender to oust existing management, if for example it is not co-operative with the lender or otherwise fails to turn the debtor's business around.

In insolvency, such control is not unfettered. If the debtor is already in external administration, management's control over the business will still be subject to the broad powers granted to the arbitration manager. In addition, actions of the debtor in any phase of

¹⁶ Where actual malfeasance is involved, the law provides remedies in principle, but in practice they may be ineffective to protect creditors' interests.

¹⁷ The right of appropriation is available under the laws of England, Cyprus and other EU jurisdictions which have implemented the Financial Collateral Directive (Directive 2002/47/EC of 6 June 2002 on financial collateral arrangements). Because the focus of this Guide is on a creditor's rights under existing security, and not on issues to be considered in structuring and documenting a security interest, the requirements for the creation of an enforceable right of appropriation are beyond the scope of this Guide, and we assume that the requirements have been met.

insolvency proceedings may require consent of the arbitration manager, the arbitration court, the creditors meeting or a combination thereof.

2. Limitations under Interested Party Transaction Rules

If, however, the parent company holds less than all of the debtor's voting shares and is an "interested party" in relation to the debtor, it will not be able to vote such shares in relation to transactions which involve the debtor and to which the parent company, or any of its affiliated or connected persons, is a party or beneficiary. Even if the secured creditor would otherwise obtain a controlling interest in the debtor through enforcement of the security, the rules on interested party transactions would erode, and could eliminate, the creditor's ability to compel the debtor to take actions or enter transactions necessary for the creditor to achieve its goals in restructuring.

(a) Definition of Interested Party

The debtor's parent company would constitute an interested party¹⁸ of the debtor under the Joint Stock Companies Law¹⁹ if the parent, individually or together with its affiliated persons, holds more than 20 percent of the voting shares of the debtor.²⁰ If the debtor has entered insolvency proceedings, the Bankruptcy Law would impose an expanded definition of "interested party" and rules governing interested party transactions which would apply in addition to those under the Joint Stock Companies Law.

(b) Requirement of Approval of Majority of Disinterested Shareholders

For a debtor to carry out an interested party transaction, it must obtain (i) under the Joint Stock Companies Law, and subject to certain exceptions, the approval of a majority of disinterested shareholders of the debtor,²¹ and (ii) under the Bankruptcy Law, if the debtor has entered into insolvency proceedings, the approval of the creditors meeting. In external

¹⁸ The scope of persons who may be interested parties in relation to a Russian company, or affiliated or connected to an interested party, under the Joint Stock Companies Law is complex, and that definition of interested parties is expanded for the purposes of the Bankruptcy Law. The 20 percent voting threshold noted here is simply one means by which a person may be deemed interested, and the secured creditor or parent company may be an interested party as a result of other factors. The details of these rules are beyond the scope of this Guide. We would be pleased, however, to advise you separately on the detailed application of these rules.

¹⁹ Federal Law No. 208-FZ of 26 December 1995 on Joint Stock Companies.

²⁰ The Bankruptcy Law would deem a company to be an interested party in relation to a debtor if that company holds a majority interest in the debtor or can by agreement or otherwise determine the corporate actions taken by the debtor, but this is largely subsumed by the 20 percent voting threshold under the Joint Stock Companies Law.

²¹ The Joint Stock Companies Law provides that if the debtor has fewer than 1,000 shareholders, a majority of the company's disinterested directors (if they are sufficient in number to form a quorum) must approve the transaction. However, only a majority of disinterested shareholders can give such approval if the transaction or a series of related transactions (i) has a value equal to 2 percent or more of the book value of the debtor's assets as recorded on its balance sheet prepared under Russian accounting standards, or (ii) involves the issuance, by subscription, of voting shares or securities convertible into voting shares, or secondary market sale of such securities, in an amount exceeding 2 percent of the debtor's issued voting shares. In addition, in the context of insolvency proceedings, the Bankruptcy Law deems all of the debtor's directors to be interested parties, and so disinterested shareholder approval would be required for all interested party transactions contemplated during such proceedings.

administration, the arbitration manager would carry out such transactions, and so his or her approval would implicitly be required as well.

In the context of a creditor with security in shares of a Russian debtor's parent company, these rules effectively mean that where the debtor has shareholders other than the parent, the creditor's acquisition of the parent shares through security enforcement will not necessarily give the secured creditor effective control. Instead, it will need to obtain the cooperation of the debtor's other shareholders to the extent that they are not interested parties in relation to the transaction which the creditor wants the debtor to carry out, or unless an exception applies.

(c) Exceptions to the Requirement

The Joint Stock Companies Law does not require disinterested shareholder approval in relation to certain interested party transactions which may be relevant in the restructuring context, *i.e.*, those where (i) all shareholders of the debtor are deemed interested in such transactions, (ii) the transactions arise from the repurchase, whether mandatory or not, by the debtor of its issued shares, or (iii) the transactions arise from the shareholders executing their pre-emptive rights to purchase newly issued shares of the debtor, from the repurchase by the debtor of its issued shares, or from the debtor's merger with another company.²² Each of these circumstances may exist in relation to a proposed restructuring, and if so, they would relieve the secured creditor of the need to obtain such approval.

(d) Avoiding the Requirement Through Tender Offer and Minority Squeeze-Out

Another avenue for the secured creditor in this scenario is to effect a squeeze-out of the minority shareholders, rendering the secured creditor (or the debtor's parent company) the sole shareholder of the debtor. This method requires using a two-step process under the tender offer rules set out in the Joint Stock Companies Law and FSFM regulations, and it is only available if the debtor is an open joint stock company.

The first step is to carry out a tender offer by which the secured creditor directly or indirectly (*e.g.*, through the debtor's parent company) acquires more than 95 percent of the debtor's voting shares. A person may make a tender offer if it intends to acquire more than 30 percent of the company's voting shares (counting, for these purposes, voting shares already owned by such person and its affiliates). The offer price must be not less than the weighted average market price of the shares over the six-month period preceding the filing of the tender offer with the FSFM. Once the tender offer is complete, and assuming the 95 percent threshold is met, the person who acquired the shares in the tender offer may squeeze out the debtor's other shareholders by requiring them to sell their shares at the higher of the tender offer price and the highest price paid by that person for its acquired shares.

The minority squeeze-out thus makes it possible for the secured creditor to eliminate other shareholders, and avoid the requirement for disinterested shareholder approval of interested party transactions. However, a successful squeeze-out requires that the secured creditor fund or obtain financing for the tender offer, and that in the tender offer stage, other shareholders accept the offer to sell a sufficient number of shares for the secured creditor to cross the 95 percent threshold.

²² Disinterested shareholder approval is also not required where (i) the debtor has a single shareholder who acts as the sole executive body of the debtor (although such shareholder would presumably vote to approve in any event), or (ii) the debtor is required to enter into the transactions under Russian law, and to conclude them on the basis of fixed prices and tariffs set by a government regulatory body.

D. Ability to Effect Migration of COMI to More Favourable Jurisdiction

Once the lender has acquired a controlling interest in the debtor's parent, the lender may be able to migrate the "centre of main interests" (or **COMI**) of the parent company to a jurisdiction such as England, where insolvency laws provide greater flexibility for achieving a restructuring than the laws of Russia or the parent's jurisdiction of incorporation.

E. Issues to Consider Before Enforcement

Even where it seems urgent to take immediate action to enforce its security in the parent company's shares, the creditor should consider whether execution or appropriation under the security could have unfavourable consequences, and weigh those consequences against the benefits. The lender should seek advice of legal advisers such as Latham & Watkins in respect of such issues, examples of which are set out below.

1. Control

If the debtor has shareholders other than its parent company, the lender should beware that the rules on interested party transactions may limit or preclude the parent company's ability to vote its shares in the debtor on key transactions. See Section III.C.2 (*Limitations under Interested Party Transaction Rules*). In such case, enforcement may not give the lender sufficient control over the debtor.

As a due diligence matter, the lender should ask its legal advisers to review relevant documentation, such as the parent company's memorandum and articles of association, to ensure that enforcement will give the lender sufficient voting rights to control the parent, and in turn, to vote the shares of the Russian debtor. The relevant public register of companies and security interests in them should also be checked to ensure no other party has made any filings which could restrict the lender's rights over the shares, when acquired.

2. Structural Subordination

Where the lender retains the shares rather than satisfying its claim out of the proceeds from selling the shares, it has effectively (i) converted its debt investment into an equity interest and (ii) traded its super-priority position as a secured creditor for a last-priority position as the debtor's shareholder. If the lender has no other security, enforcement would structurally subordinate the lender's outstanding claims to those of other creditors, which could leave the lender significantly worse off.

3. Cross-Defaults and Other Contractual Triggers

Enforcement of the security may trip contractual provisions which put the borrower, its parent company or its other co-obligors²³ in default or breach under obligations to other creditors. For example, the documentation for such an obligation may contain cross-default or cross-acceleration provisions which deem the obligor in default upon the occurrence of any such enforcement (or certain other insolvency-related events). Similarly, the lender's acquisition of control over the borrower as a result of enforcement may breach restrictions on changes of control under the borrower's agreements—whether financial or commercial—with other counter-parties.

²³ *E.g.*, a subsidiary or other affiliate of the Russian borrower, such as the parent company of the debtor's immediate parent. Where the security for a loan to a Russian borrower includes a security interest in the shares of its immediate parent company, that security interest is granted by the latter's parent company, typically as security for its guarantee of the borrower's obligations.

4. Regulatory Approvals

The change of control caused by enforcement may also require approval from or notification to relevant government regulators. Normally, an acquirer of direct (and in some cases indirect) control over a Russian company must make the appropriate filings with the Federal Anti-monopoly Service in advance of the acquisition. In addition, where the debtor is a strategic enterprise, natural monopoly or specially-regulated entity such as a bank, additional regulatory requirements and restrictions may apply.

IV. ANALYSIS OF SIX HYPOTHETICAL RESTRUCTURING SCENARIOS

This section gives a brief analysis of the legal position of a creditor and options for restructuring the relevant debt in each of the following six hypothetical restructuring scenarios:

Scenario A: Unsecured Creditor

Scenario B: Secured Creditor—Single Russian Lender

Scenario C: Secured Creditors—One Russian Lender, One Foreign Lender

Scenario D: Debt-for-Equity Swap in Bankruptcy

Scenario E: Eurobond Issued by Offshore Parent and Guaranteed by Russian Operating Subsidiary

Scenario F: Non-convertible Interest-Bearing Rouble Bond

A. Unsecured Creditor

Scenario: Borrower is a Russian legal person and creditor is a Russian bank. Obligations are entirely unsecured.

1. Assumptions

Credit Agreement: We assume the obligations arise under a credit agreement.

2. Position Prior to Insolvency Proceedings

(a) *Contractual Rights and Remedies:* Lender's rights are subject to restrictions set out in the loan documents. Lender may be able to use leverage against borrower by threatening to declare default or accelerate the loan, potentially tripping cross-default or cross-acceleration provisions in other credit facilities. Lender may have a right to require new security for outstanding loan, but this is useful only to extent borrower has valuable unencumbered assets.

(b) *Statutory Rights and Remedies:* Lender may be able to sue on the debt and, if successful, seek a writ of execution allowing it to recover claim out of borrower's assets. But this is useful only to extent borrower has valuable unencumbered assets. Also, it may permit other creditors to put borrower into insolvency in circumstances where lender prefers to avoid it.

3. Position During Insolvency Proceedings

- (a) *Priority of Claims:* Unsecured commercial lender has very low priority. Where substantially all of borrower's useful assets are encumbered, as is often the case in financial distress scenarios, unsecured claims are likely fully impaired. Unsecured creditors may also stand behind substantial tax claims.
- (b) *Suspension of Rights and Remedies:* Unsecured lender may exercise rights and remedies only to extent permitted by Bankruptcy Law.
- (c) *Creditors Meeting:* Unsecured lender has right to vote and attend, but must register its claim.
- (d) *Clawback Risks:* Payments made during six-month preference period may be voidable, if they constitute preferential transfers.

4. Debt-for-Equity Swaps

- (a) *Absence of Shareholder Cramdown:* Bankruptcy Law provides no shareholder cramdown mechanism, so a lender cannot acquire equity in borrower without shareholder consent.
- (b) *Consensual Debt-for-Equity Swaps (D4E):* If shareholder consents to D4E in principle, exchange of existing shares for forgiveness of indebtedness may be preferred mechanism. Subscription for new shares requires complex structure, since a Russian company cannot accept debt forgiveness as consideration for newly issued shares. Where borrower is in insolvency proceedings, D4E is likely to require approval of the creditors meeting, the arbitration manager and possibly the court. Lender should consider risks and limitations of acquiring equity, such as (i) interested party transaction requirements where borrower has shareholders other than its parent, (ii) minority squeeze-out to avoid requirement of disinterested shareholder approval, and (iii) structural subordination, each as discussed in Section III.E (*Issues to Consider Before Enforcement*).

5. Additional Financing or Refinancing

- (a) *Pre-petition Financing:* Lender and borrower have more flexibility to agree new financing before insolvency proceedings commence. Lender will likely want security for the new financing, but a borrower in financial distress may have insufficient valuable and unencumbered assets. Lender can seek credit support in form of guarantees from borrower's subsidiaries, parent company and other affiliates. Lender should beware that taking new security in an insolvent debtor and guarantees from its affiliates (especially subsidiaries) may be subject to clawback risks and risk of transaction being deemed made at undervalue.
- (b) *Post-petition Financing:* Lender will likely want security for the new financing, but in Russian insolvency, new money cannot prime existing security interests and the borrower is unlikely to have sufficient unencumbered assets. If loan is for new equipment or the like, lender may be able to take security in it. Lender can seek credit support, same as with pre-petition financing. Post-petition financing will be a "current claim" with super-priority over pre-petition unsecured claims, but it will rank in the lowest category of current claims.

6. Taking Control of Management of Debtor

- (a) *Generally:* Control can be obtained either through acquiring a controlling stake in the borrower or its parent company (which has same issues as D4E), or to a limited extent in Russian insolvency proceedings. In all phases of insolvency proceedings, certain transactions and other corporate actions by the borrower require consent of the arbitration manager and, in some cases, the court, which effectively reduces the control held by management and shareholders.
- (b) *Limited Control through External Administration:* The borrower's management stays in place in all phases of insolvency proceedings, except external administration, where management is supplanted by the arbitration manager and the powers of shareholders as a management body of the debtor are limited to approvals of certain major transactions.
- (c) *Control via D4E:* Otherwise, taking control of management requires the lender to acquire and exercise the powers of the borrower's shareholders using the mechanisms applicable to D4E. Where shareholders do not consent, the lender's options are limited to enforcement of its security interests over shares, if any. Where D4E is effected through enforcement of security, consider implications of interested party transaction rules where borrower has shareholders other than its parent.

B. Secured Creditor—Single Russian Lender

Scenario: Borrower is a Russian legal person and creditor is a Russian bank. Obligations are secured by (i) guarantee from the offshore (Cyprus or BVI) parent company of the borrower, (ii) pledge of shares in the parent, (iii) pledge of the assets of the borrower. Borrower is not able to pay the principal or interest.

1. Assumptions

We assume that the borrower is the provider of the relevant secured property (and not, *e.g.*, an affiliate), and that the insolvency proceedings are to be or have been, as the case may be, initiated against the borrower.

2. Position Prior to Insolvency Proceedings

- (a) *Generally:* Position similar to that described in Scenario A (*Unsecured Creditor*), plus the following.
- (b) *Contractual Rights and Remedies:* Secured lender's rights in relation to its security are as set out in the security documents. They may be able to use leverage against borrower by threatening to enforce the security, which may trip cross-default or cross-acceleration provisions in other credit facilities. They may have a right to require additional security for outstanding loan, but this is useful only to extent borrower has valuable unencumbered assets.
- (c) *Statutory Rights and Remedies:* Secured lender's rights under the security arrangement are also subject to applicable Russian law, which give secured lender a first-priority right to proceeds of sale of secured property.
- (d) *Enforcement Rights:* Lender may enforce security upon event of default by obtaining a court order carried out by court bailiffs service. Or, if and to the extent provided in a written agreement with the borrower, the lender may

enforce through out-of-court foreclosure through a public or private auction or sale, and the secured lender may in some cases bid for or purchase the foreclosed property.

3. Position During Insolvency Proceedings

- (a) *Priority of Claims:* Secured lender has priority right to proceeds of sale of secured property, although this extends only to the first 70 percent (or 80 percent if the claim arises under a Russian credit agreement (*кредитный договор*)) of such proceeds, the remainder of which is reserved for payment of certain “preferred claims” and costs of the proceedings.
- (b) *Suspension of Rights and Remedies:* Secured lender’s rights to enforce are suspended during insolvency proceedings, and lender may exercise rights and remedies only to extent permitted by Bankruptcy Law. During financial rehabilitation and external management, lender may seek leave of court to enforce, but the court will permit enforcement only where the borrower fails to show that enforcement will render impossible the debtor’s return to solvency.
- (c) *Creditors Meeting:* Secured lender may attend but has very limited rights to vote. Secured lender may vote in financial rehabilitation and external management only where it has waived its right to enforce its security during the relevant phase.
- (d) *Clawback Risks:* Payments made during six-month preference period may be voidable, if they constitute preferential transfers.

4. Debt-for-Equity Swaps

- (a) *Generally:* Position as to absence of shareholder cramdown and consensual D4E is similar to that described in Scenario A (*Unsecured Creditor*), plus the following.
- (b) *Enforcement of Security:* The secured lender may be able to acquire shares of borrower or its parent company through enforcement of its security interest in such shares, thereby giving itself the ability to procure shareholder consent. Particularly effective where lender has English law security with right to appropriate shares of borrower’s offshore parent company. Lender should consider potential risks and issues involved in acquiring equity, such as structural subordination and regulatory requirements, as discussed in Section III.E (*Issues to Consider Before Enforcement*).

5. Additional Financing or Refinancing

- (a) *Generally:* Position similar to that described in Scenario A (*Unsecured Creditor*), plus the following.
- (b) *Future Advances:* Where the original security agreement grants a security interest covering future advances under the loan agreement, as well as the initial amount borrowed, any new financing given as such a future advance will have the same security. The lender should ensure that (i) the value of the secured property is at least equal to the sum of the debt outstanding under the loan and the amount of the future advance and (ii) the secured property is not subject to competing security interests.

6. Taking Control of Management of Debtor

- (a) *Generally:* Position similar to that described in Scenario A (*Unsecured Creditor*), plus the following.
- (b) *Control through Insolvency Mechanisms:* Even though management of the borrower remains subject to the restrictions imposed by the Bankruptcy Law, the secured lender may have less influence over the insolvency proceedings due to limitations on its voting rights in the creditors' meeting.
- (c) *Control via Enforcement of Security:* Secured lender may be able to take control over the borrower's management through enforcement of its security interest in shares of the borrower or its parent company.

C. Secured Creditors—One Russian Lender, One Foreign Lender

Scenario: Same facts as for Scenario B (*Secured Creditor—Single Russian Lender*), except that a foreign bank is also a creditor holding the same security jointly with the Russian creditor.

1. Assumptions

We assume that the two creditors can only exercise their security rights jointly.

2. Position Prior to Insolvency Proceedings / Position During Insolvency Proceedings

Generally: Position similar to that described in Scenario B (*Secured Creditor—Single Russian Lender*).

3. Debt-for-Equity Swaps

- (a) *Generally:* Position similar to that described in Scenario B (*Secured Creditor—Single Russian Lender*), plus the following.
- (b) *Restrictions on Foreign Investment:* Such restrictions may apply where the borrower is a strategic enterprise, natural monopoly or certain other type of entity, and the security includes shares of the borrower or, in some cases, its parent company. In broad terms, where enforcement of the security would result in the acquisition by a non-Russian person of control over the borrower, such acquisition will require prior approval by the relevant Russian regulator.

4. Additional Financing or Refinancing / Taking Control of Management of Debtor

Generally: Position similar to that described in Scenario B (*Secured Creditor—Single Russian Lender*).

D. Debt-for-Equity Swap in Bankruptcy

Scenario: Borrower is in the midst of insolvency proceedings. Creditor wants to receive shares of borrower in exchange for forgiveness of the debt.

Our analysis of D4Es is discussed previously in Scenario A (*Unsecured Creditor*), Scenario B (*Secured Creditor—Single Russian Lender*) and Scenario C (*Secured Creditors—One Russian Lender, One Foreign Lender*).

E. Eurobond Issued by Offshore Parent and Guaranteed by Russian Operating Subsidiary

Scenario: Default on Eurobonds by foreign company (Cyprus or BVI), whose obligations are secured by a guarantee/suretyship from the Russian operating company.

1. Assumptions

- (a) *Identity of Parties:* We assume that the foreign issuer of the Eurobonds (the **issuer**) has lent the proceeds of the issue to the Russian operating company (the **borrower**), as part of the typical structure for Russian companies' Eurobonds.
- (b) *Structure and Applicable Securities Laws:* Except as noted below, we assume that the Eurobond has been issued pursuant to a trust deed governed by English law; that it was initially offered and distributed in compliance with exemptions from registration under the Securities Act; and no previous exchange offer has been made in relation to the Eurobonds.

2. Position of Bondholder as Unsecured Creditor

- (a) *Generally:* Holders of an unsecured Eurobond have a legal position (both prior to and during insolvency proceedings) broadly similar to that described in Scenario A (*Unsecured Creditor*), except as noted below.
- (b) *Bondholders' Rights and Obligations:* These will be set out in and subject to the provisions of the trust deed and the loan agreement between the issuer and the borrower. Bondholders will have certain rights in relation to the adequacy of the disclosure in the offering memorandum. Bondholders will also have certain rights under the laws of the jurisdiction where the bonds were issued or offered and, if applicable, under the rules of the securities exchange where the bonds are listed.
- (c) *Security:* Eurobond holders are typically not secured creditors, insofar as they do not hold a security interest in property. Instead, they often get credit support in the form of guarantees, as in this scenario.
- (d) *Priority and Subordination:* Eurobonds are normally contractually subordinated to bank and other senior debt via payment blockage and standstill provisions.

3. Key Considerations for Eurobonds

- (a) *Negotiation Dynamics:* Eurobonds may be widely held by a disparate group of investors, making it more difficult for the issuer and borrower to negotiate a restructuring. However, under the trust deed for the bonds, the trustee has the power to take certain actions on behalf of all bondholders, so long as a sufficient majority of holders support the particular action.
- (b) *Voting Thresholds:* Voting thresholds are set out in the trust deed and vary depending on the action proposed. Modification of payment terms normally requires approval by a two-thirds (sometimes three-quarters) majority of holders by value present and voting.
- (c) *Application of US Securities Laws:* Transactions in Eurobonds, particularly those issued to US investors in reliance on an exemption under Rule 144A,

may be subject to a variety of US securities laws. A discussion of such requirements is beyond the scope of this Guide, but we would be pleased to advise on any situation where US securities laws may be applicable.

4. Repurchasing the Eurobond

- (a) *Generally:* Where the issuer has or can obtain sufficient funding, it may be able to repurchase some or all of the bonds outstanding.
- (b) *Market Buyback:* The issuer (or affiliate) can buy back Eurobonds on the market, so long as the buyback programme complies with applicable law on trading in own securities, e.g., the Market Abuse Directive.²⁴ Acquisitions over certain thresholds may require a tender offer under applicable law.
- (c) *Cash Tender Offer:* The issuer may also make an offer to bondholders to repurchase the bonds, up to a stated amount, at a fixed price or a price determined by a formula. Tender offers must be carried out in compliance with applicable law.
- (d) *Exchange Offer:* As a variation on the cash tender offer, the issuer may offer new debt securities in exchange for the original bonds. The issue of the new securities must comply with applicable securities laws, and may require publication of an offering memorandum or prospectus.
- (e) *Buyback via Call Option:* The bond documents may permit the borrower to repurchase the bonds by exercising a call option in accordance with the documents.

5. Debt-for-Equity Swaps

- (a) *Generally:* Effectively, a D4E involving a Eurobond is simply an exchange offer where part of the consideration is equity rather than cash or new debt.
- (b) *Securities Law Requirements:* The offer of shares as consideration must comply with applicable securities laws, and may require publication of an offering memorandum or prospectus.

6. Taking Control of Management of Debtor

Generally: The disparate nature of bondholders and their investment objectives are likely to make it impractical or undesirable for bondholders to seek control of management. Nevertheless, if the group of bondholders is small enough to co-operate effectively, they would have a similar position to that described in Scenario A (*Unsecured Creditor*).

F. Non-convertible Interest-Bearing Rouble Bond

Scenario: The issuer of non-convertible interest-bearing rouble bonds has defaulted on its obligation to buy back bonds in accordance with holders' put rights. Some of the holders have brought suit, the others are negotiating with the issuer on restructuring the debt.

²⁴ Directive 2003/6/EC of 28 January 2003 on insider dealing and market manipulation (market abuse). Bond buybacks are not subject to the provisions on buyback programmes set out in the Buyback and Stabilisation Regulation (Commission Regulation (EC) 2273/2003 of 22 December 2003), which apply only to shares.

1. Position of Bondholder as Unsecured Creditor

Generally: Holders of an unsecured rouble bond have a legal position (both prior to and during insolvency proceedings) broadly similar to that described in Scenario A (*Unsecured Creditor*), except as noted below.

2. Key Considerations for Rouble Bonds

- (a) *Inability to Amend Terms of Rouble Bond:* The terms of a rouble bond cannot be amended or modified. Bondholders and the borrower may enter into a side agreement containing revised terms, but the enforceability of such an agreement is an open question.
- (b) *Negotiation Dynamics:* Bonds may be widely held by a disparate group of investors, making it difficult for the borrower and key bondholders to negotiate a restructuring at any stage. Unlike with Eurobonds, rouble bonds have no trustee and contain no mechanisms for holders to co-operate or to negotiate with the issuer.
- (c) *Race to the Courthouse:* Where some bondholders have filed suit, the others will likely want to do the same in order to preserve their rights. For example, the earliest to file will, if successful, be the first creditors able to obtain court orders permitting attachment of the issuer's assets and, potentially, to foreclose on them.

3. Repurchasing the Rouble Bond

- (a) *Generally:* The borrower may be permitted to, and in some cases required to, repurchase rouble bonds from holders. Any repurchase requires an outlay of cash, for which the borrower may require outside financing, depending on the size of the buyback.
- (b) *Market Buyback:* The borrower can buy back rouble bonds on the market so long as acquisitions are permitted by the bond documents and are made in accordance with FSFM regulations on bond tender offers.
- (c) *Cash Tender Offer:* The borrower can offer to repurchase the bonds, up to a stated amount, at a price determined by the borrower. The legal position is the same as for market buybacks, *i.e.*, the offer must comply with the bond documents and FSFM regulations.
- (d) *Mandatory Buyback:* The bond documents may require the borrower to repurchase bonds upon the exercise of put rights by holders on the terms of the bond documents.
- (e) *Buyback via Call Option:* The bond documents may permit the borrower to repurchase the bonds by exercising a call option on the terms of the bond documents. However, rouble bonds rarely include a call feature.

4. Restructuring the Rouble Bond via Exchange Offer

- (a) *Generally:* As a variation on repurchases for cash, the borrower can offer a new bond with revised terms as consideration under the tender offer.
- (b) *Financing Required:* The borrower cannot accept forgiveness of indebtedness, including its own bonds, as payment for newly issued

securities. Transaction must be structured around this rule, which may require the borrower to borrow the funds to repurchase the old bonds, and then repay the loan with the proceeds of the subscription for new bonds. This movement of funds may raise clawback and other credit risks.

- (c) *Timing:* Issue of a new rouble bond may take a significant period of time to complete, because it requires taking all required corporate actions to adopt a decision on issuance, prepare a prospectus and file the same for approval by the FSFM.

5. Debt-for-Equity Swaps

- (a) *Generally:* Effectively, a D4E involving a rouble bond is an exchange offer where part of the consideration is equity rather than cash or new debt.
- (b) *Determining Which Bondholders Get Shares:* A consensual D4E involving an exchange of rouble bonds for shares is likely to be carried out through the borrower's parent company transferring existing shares of the borrower to a substantial majority of bondholders, but not to all holders. The borrower must either repurchase those other holders' bonds or leave the bonds in place.

6. Taking Control of Management of Debtor

Generally: The disparate nature of bondholders and their investment objectives are likely to make it impractical or undesirable for bondholders to seek control of management. Nevertheless, if the group of bondholders were small enough to co-operate effectively, they would have a similar position to that described in Scenario A (*Unsecured Creditor*).

Latham & Watkins Russian Restructuring Team

Moscow

Ulitsa Gasheka, 6, Ducat III, Office 510
Moscow 125047
Russia
Tel: +7.495.785.1234
Fax: +7.495.785.1235

Mark Banovich

Tel: +7.495.644.1910
E-mail: mark.banovich@lw.com

Chris Smith

Tel: +7.495.644.1908
E-mail: chris.smith@lw.com

Yulia Dementieva

Tel: +7.495.644.1906
E-mail: yulia.dementieva@lw.com

Yulia Garteiser

Tel: +7.495.644.1920
E-mail: yulia.garteiser@lw.com

London

99 Bishopsgate
London EC2M 3XF
United Kingdom
Tel: +44(0)20 7710 1000
Fax: +44(0)20 7374 4460

Christopher Hall

Tel: +44(0)20.7710.1152
E-mail: christopher.hall@lw.com

Tracy Edmonson

Tel: +44(0)20.7710.5810
E-mail: tracy.edmonson@lw.com

Jackson Taylor

Tel: +44(0)20.7710.5815
E-mail: jackson.taylor@lw.com

Abu Dhabi
Barcelona
Brussels
Chicago
Doha
Dubai
Frankfurt
Hamburg
Hong Kong
London
Los Angeles
Madrid
Milan
Moscow
Munich
New Jersey
New York
Northern Virginia
Orange County
Paris
Rome
San Diego
San Francisco
Shanghai
Silicon Valley
Singapore
Tokyo
Washington, D.C.