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B2B: Observing Bankruptcy Law: A Prerequisite for a Company's Success

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It is a common but mistaken belief that bankruptcy law needs to be applied only when there is nothing to be done with a business but to bury it. Such an approach leads to extremely negative consequences, because it gives rise to material risks in a company's ongoing activities and deprives it of the ability to use many options.

In the light of bankruptcy law, compliance is especially important for assessing the risks inherent when transactions are completed. Managers do not always analyze the financial position of counterparties and, even if they are aware of a potential partner's financial difficulties, do not assess these from the standpoint of potential bankruptcy.

However, if a contract is entered into with a party which shows signs of insolvency or having insufficient property, the risks are relatively high. This is because such a counterparty may subsequently be declared bankrupt and its transactions may be challenged on specific grounds. Usually, the transactions that may be called into question involve assets being divested or priority being given to satisfying the claims of one creditor over others. It is particularly notable that challenges put forward in a bankruptcy case can result in the setting aside of transactions entered into within the three years before the bankruptcy case was initiated. For instance, a contract entered into in April 2015 may be invalidated on certain grounds until as late as October 2019, if in April 2018 a lawsuit for a counterparty's bankruptcy is initiated (this takes into account the statutory timeframes for implementing the supervisory procedure and receivership proceedings).

If a transaction with a counterparty is invalidated, the company will have to return to the debtor's bankruptcy estate everything obtained under the contract. This enables the possibility to include claims in the register of the debtor's creditors. At the same time, if it is proved that the relevant person was aware or might have been aware that the counterparty was showing signs of insolvency when the transaction was made, then such a person's claims will be satisfied after creditors' claims included in the register have been settled in full. Moreover, income or interest not received by the debtor for the entire period (starting from the date the contract was made) may be recovered.

These risks may be managed if, apart from traditional standards, additional criteria are introduced for checking whether counterparties are showing signs of insolvency.

It is crucial that, during a company's activities, it monitors the status of its debtors, taking into account any bankruptcy lawsuits that are likely to be initiated. Bearing in mind that claims against a debtor may be raised promptly in order to be included in the register of creditors' claims, it is advisable to ensure that checks are made of at least the most important counterparties, using the Unified Federal Bankruptcy Register (the "UFBR"). This register contains mandatory information about any entity, which has had procedures from bankruptcy cases placed upon it.

Importantly, now the UFBR will also incorporate information about debtors who are individuals. In some cases, information must be published about the intention of a debtor or its creditors to petition for bankruptcy. Thus, the counterparties of such a debtor will be able to take this factor into account when deciding whether to do business with the debtor.

Since individuals quite often act as sureties or pledge-givers in relation to third parties' liabilities, vetting such individuals when entering into a security transaction will make it possible subsequently to mitigate the risks related to the non-performance of obligations.

It is especially important that credit institutions should check potential individual borrowers in terms of whether any procedures used in bankruptcy cases are being applied against them. Considering that there may be a gap of several months between the decision to grant a loan and the funds actually being released, it is advisable to make check-up immediately before the loan is disbursed.

Another way bankruptcy law may be applied to a company's ongoing activities is when it acquires the assets of a bankrupt company. Knowledge of how the property is sold during receivership proceedings and how such bidding processes are conducted may help assets to be bought on very attractive terms, i.e. at a significant discount. An additional advantage of acquiring the property of a bankrupt company is that, under new rules which came into force on 1 January 2015, there is no need to pay value-added tax.

It is especially important to comply with bankruptcy law from the standpoint of liability for a company's controlling persons. Such persons include not only the heads and members of a company's executive bodies, but also its liquidators, beneficial owners and any persons acting on behalf of the company by virtue of a power of attorney. The main options for preventing the risks of controlling persons facing liability are tied in with the rules for reacting to a company showing signs of insolvency, as well as to transactions being completed (including accepting performance from counterparties).

For a business to develop in the context of a crisis, it is vital for that business to be properly restructured in good time. This may include bankruptcy for companies that are part of the same group. This allows the most efficient enterprises to be kept intact, available assets used more efficiently and dead wood cut away. At the same time, any risks that there may be challenges to transactions of the company being wound up, and that controlling parties might be held liable, should be taken into account.

Our experience shows that very often 'abandoned' or 'problem' companies within a group can become footholds for an illegal takeover (using bankruptcy proceedings) or other unlawful acts in relation to the parent company. A bad-faith creditor that has a valid, or, sometimes, a fake claim, initiates the bankruptcy of such debtors, ensures that an administrator with links to the creditor is appointed and, under its own full control, performs actions aimed at damaging the owners' business.

These risks may be avoided if a tight rein is constantly kept on the activities of each company within the group, starting with measures to ensure that correspondence is received properly, and through to timely restructuring using, among other things, bankruptcy proceedings.

If a company ensures that it complies with bankruptcy law day-to-day, this will not only help it to avoid significant risks, but also will offer legal advantages it can use to further develop the business.