

## Prospects of the Extrajudicial Settlement by Enforcement Authorities of Bankruptcy Procedures

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### Abstract

This article is concerned with prospects of the legal regulation of bankruptcy procedures. It has been established that the debtor's management intending to rehabilitate its enterprise can be prosecuted if it submits a bankruptcy petition in advance. To initiate a procedure for declaring bankruptcy, a debtor is obliged to prove the existing circumstances that testify their future inability to pay off monetary obligations to creditors and make mandatory payments to budget and off-budget funds. Successful rehabilitation and circumstances indicating the impossibility to fulfil monetary obligations in the future directly depend on the time left before the debtor's insolvency. The earlier the debtor's management foresees an impending bankruptcy, the greater are the chances that the company's solvency will be restored.

**Keywords:** Legal regulation; Bankruptcy; State; Management; Procedure; Rehabilitation; legislation.



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### 1. Introduction

Modern bankruptcy laws should aim not only to fully satisfy the claims of creditors but also to preserve enterprises as an economic unit forming gross domestic product (GDP) of any given state, providing employment and keeping the balance of private and public interests. Nowadays developed countries of America and Europe further improving healthy market relations and post-industrial economy use bankruptcy laws that are based on rehabilitation procedures unlike twenty years ago. This trend also applies to countries with pro-creditor bankruptcy laws (the UK and Germany).

The use of rehabilitation procedures in the USA, England, France and Germany indicate that their effectiveness can be much higher. However, these indicators are not always achieved by infringing on the rights of creditors. For instance, a debtor in the UK or Germany can be rehabilitated only with the consent of their creditors. It is worth mentioning that effective rehabilitation provides a greater socioeconomic effect than the liquidation of a legal entity and the sale of its property.

In Russia, rehabilitation procedures are rather ineffective. About 90% of bankruptcy cases result in bankruptcy proceedings despite the fact that bankruptcy legislation has a clearly pro-debtor bias and contains a very large number of rehabilitation standards. This state of affairs is abnormal due to the dominance of liquidation procedures in the course of insolvency and a harmful influence exerted on the economy and social sphere of any given state.

Versotskii and Yukhnevich (2017), Makarov (2017), Martynov (2018), Mikhnevich (2010), Tlyakov (2013), Frolov (2013), and other scientists studied prospects of the legal regulation of bankruptcy procedures in their works. Despite a large number of academic papers directly or indirectly concerned with the legal regulation of rehabilitation procedures, the Russian scientific doctrine has not thoroughly studied them as a legal phenomenon, including with the help of a comparative legal method.

### 2. Methods

The methodological basis of the article comprises general scientific methods, including formal and dialectical logic. Throughout the research, the authors also used the methods of comparative law and interpretation of legal norms to evaluate standards of the Russian and foreign legislation systems. To study the evolution of the legal regulation of rehabilitation procedures, the authors applied the historical method. The system method enabled the

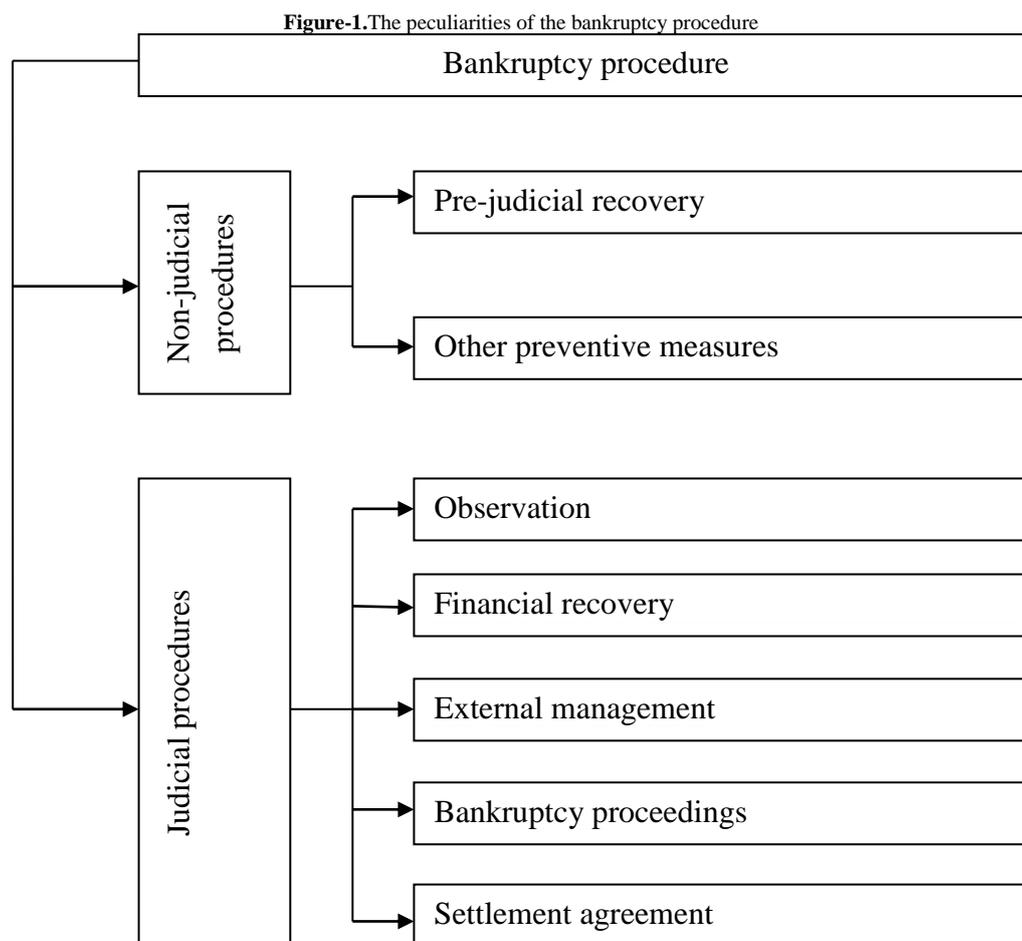
authors to consider the legal relations under study as a complex and evaluate the effectiveness of rehabilitation procedures in Russia and abroad. To develop an adequate legal mechanism for applying rehabilitation procedures, the legal modeling method was also used during the research.

The information base of this study is legislative and regulatory legal acts, statistical materials of state authorities and local self-government, scientific works of Russian and foreign scientists on the legal regulation of bankruptcy procedures (Anasenko *et al.*, 2018); (Mukhlynina *et al.*, 2018); (Zavalko *et al.*, 2018).

While studying this problem, the authors of the article plan to justify specific features of the legal regulation of bankruptcy procedures in modern conditions and systematize consequences of the company's insolvency. In addition, they aim to substantiate approaches to reducing the level of bankruptcy, identify and determine the main activities of public authorities in this sphere.

### 3. Results

As practice has shown, bankruptcy laws are more likely to protect the debtor's rights. Most economic entities initiating bankruptcy proceedings cease their activities and their property is sold in parts. At the same time, basic rehabilitation measures prescribed by bankruptcy laws are difficult to apply, therefore the main bankruptcy procedure remains bankruptcy proceedings (Figure 1).



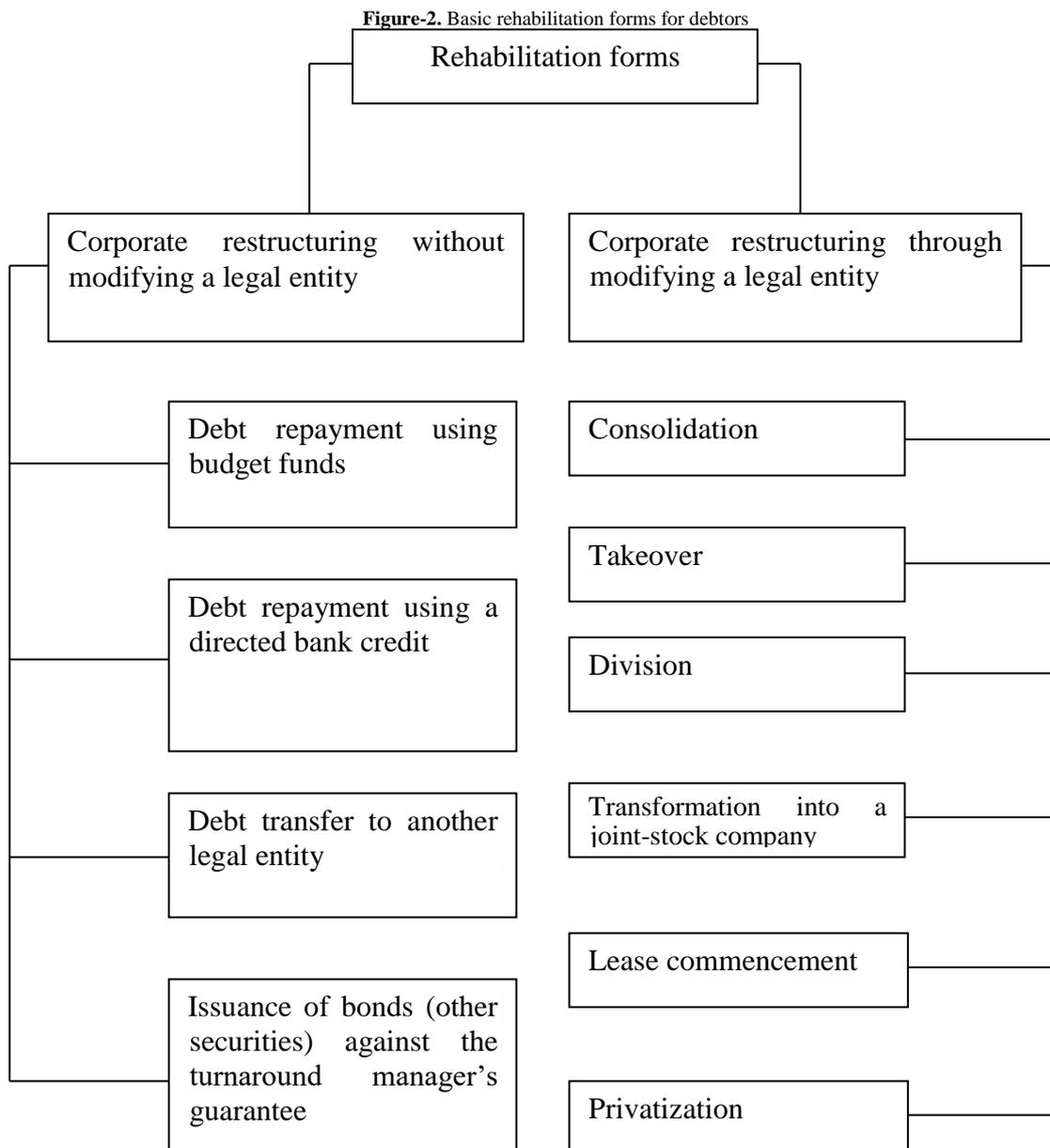
The authors of the article have singled out the following problems debtors face when going through bankruptcy procedures: an excessively long period of bankruptcy connected with the need for an introductory procedure (observation); the insufficient legislative regulation of measures to save business; the high cost of administrative overheads; the lack of an economically sound method of deciding whether it is possible to rehabilitate a debtor; the untimely initiation of the bankruptcy procedure and, consequently, rehabilitation procedures; a low level of responsibility among members of legal entities; the ineffectiveness of some rehabilitation procedures due to their legislative limitations (financial recovery); insufficient powers of creditors and debtors to independently determine the terms and procedure of rehabilitation.

Studies demonstrate that for creditors time is money, and they try to return it as quickly as possible. Thus, a creditor will vote for the scenario which helps to receive compensation faster. Creditors are more inclined to initiate bankruptcy proceedings even against those debtors which can be rehabilitated since bankruptcy proceedings are predictable procedures and creditors will be able to receive most of their money.

If a creditor votes for the initiation of rehabilitation procedures, they will be able to get all their money back under favorable conditions. In case of unfavorable conditions, a creditor will get a smaller compensation than the one guaranteed by bankruptcy proceedings. Indeed, the application of rehabilitation procedures may lead to different results, but this peculiarity is mostly concerned with rehabilitation rather than reorganization.

According to the Russian legislation, any rehabilitation procedure under bankruptcy laws is more of a restorative nature, with the exception of external management that enables to substitute the debtor's assets. A peculiarity of rehabilitation procedures of a restorative nature is their duration. External management and financial recovery can last up to two years, and a settlement agreement is not time-limited. Is it profitable for a creditor to initiate rehabilitation procedures which are characterized by low effectiveness? In this case, the answer is obvious.

The practice has shown that the debtor's rehabilitation can be conducted in two ways: either by restoring solvency or reorganizing the business. However, the latter rehabilitation method is not widely used in Russia, which significantly affects the efficiency of the debtor's rehabilitation. First of all, the debtor's rehabilitation using reorganization measures will be more interesting to creditors in view of 1) the possibility of a faster refund (since the business should be sold as quickly as possible, preferably to the buyer chosen in advance, because the total value of the company's assets decreases daily during bankruptcy); 2) the amount of compensation to creditors will be no less or even more than the one in case of bankruptcy proceedings. This tendency can be explained by the fact that a working business can be sold at a higher price than a company sold in parts (Figure 2).



In Russia, the implementation of survival proceedings is hindered by the lack of the corresponding legal regulation. The current bankruptcy laws comprise only one survival proceeding, i.e. the replacement of the debtor's assets after observation procedures. Since this simple action is conducted for a long period it becomes ineffective. In other countries, most survival proceedings are used at early stages of bankruptcy. Furthermore, preparations for these proceedings and the search for a potential buyer begin before a judicial procedure. A legal entity or its business should be sold quickly since the value of their assets decreases every day, and the debtor's problems become more and more obvious.

Another problem is closely connected with the previous one. It is a high cost of administrative overheads for carrying out rehabilitation procedures in lieu of bankruptcy. While conducting rehabilitation procedures, one should

take into account that each enterprise has its own safety margin. For instance, it is necessary to carry out the above-mentioned procedures in relation to small and medium-sized businesses faster than usual since their funds are very limited, and in case of failure creditors will get a much smaller compensation.

In this regard, researchers should pay attention to the experience of lawmaking in the Republic of Kazakhstan with the introduction of streamlined rehabilitation procedures. These procedures can be approved even if a debtor is not insolvent at the time of submitting the corresponding application. However, there is a high probability that a debtor will not be able to fulfill monetary obligations on the maturity date during the next twelve months. Thus, two goals are achieved: survival proceedings are implemented much faster, and therefore the cost of administrative overheads also decreases.

One more problem of rehabilitation procedures in lieu of bankruptcy can be their unreasonable application. When approving rehabilitation procedures, the court immediately evaluates their validity. To determine the validity of the debtor's rehabilitation, the following two criteria are singled out: material (actual) and procedural (formal). If one of these criteria is determined incorrectly, a rehabilitation procedure is likely to be ineffective since there are no real prerequisites for its application.

It is vital to properly determine a material (actual) criterion for each case of bankruptcy. This process is very complex and requires in-depth economic knowledge. To simplify the correct definition of a material criterion, one would need an economically justified method to decide whether it is possible to preserve a debtor (legal entity). If a debtor is properly analyzed from the financial perspective, it can be rehabilitated. If the debtor's capabilities for rehabilitation are overestimated, the rehabilitation procedure will not have the desired effect. Therefore, financial analysis prior to the procedure is of high priority. Only if the analysis is carried out correctly, rehabilitation procedures will be effective.

At the same time, the existing rules for conducting financial analysis are excessively regulated, which cannot help a debtor in carrying out rehabilitation. The need of many preliminary examinations for financial analysis due to bankruptcy assets results in its reduction and, consequently, a decrease in the level of refund to creditors. Therefore, the analysis of the debtor's financial condition should be simplified without affecting its quality. When a debtor, creditors or other parties do not insist on rehabilitation procedures, it is possible to refuse the idea of financial analysis.

Retrospective and prospective methods can be used to evaluate the debtor's current state and weigh the possibility of rehabilitation instead of detailed and costly financial analysis. To conduct rehabilitation procedures, the debtor's activity must meet the following two criteria: 1) throughout rehabilitation procedures in lieu of bankruptcy the debtor's activity must be profitable; 2) the received profit should be enough to fulfill the existing and registered obligations taking into account the calculation of all interests. If these two conditions are met, a rehabilitation procedure will be successful because there are no signs of insolvency.

It should be noted that a debtor can meet only the first condition. In this case, a legal entity reaches the break-even point but the profit received during rehabilitation procedures is insufficient to pay off debts to creditors. Financial recovery or external management will not bring the desired result due to the limited validity of these procedures. On the contrary, a settlement agreement has no time limits.

Therefore, if received profits are deemed to be insufficient to fulfill the existing and registered obligations in a two-year period (the aggregate term of external management and financial recovery), a debtor has the opportunity to conclude a settlement agreement with bankruptcy creditors. However, a settlement agreement cannot ensure the full control of creditors over a debtor since the debtor's management is elected by its participants while a settlement agreement is in effect. There is no administrative manager in the framework of this procedure.

## 4. Discussion

The approaches to prospects of the legal regulation of bankruptcy procedures presented above are deemed reliable since entrepreneurs and businessmen running companies try to get out of crises independently and do not use rehabilitation measures of bankruptcy laws (Markova *et al.*, 2018); (Vinogradova *et al.*, 2018); (Zavalko *et al.*, 2017). This anti-crisis management is mostly inefficient and a legal entity initiates bankruptcy procedures without any chance of rehabilitation.

There are two reasons for bankruptcy being not prevented by rehabilitation procedures: 1) a low level of responsibility among members of a legal entity; and 2) no clear distinction between the concept of a fictitious bankruptcy and measures taken by the debtor's management to prevent the debtor's bankruptcy. Therefore, the prevention of bankruptcy is a very important rehabilitation tool since it is much easier to rehabilitate a debtor at early stages of bankruptcy. However, Article 8 of Bankruptcy Law, which grants a debtor the right to file a bankruptcy petition in case of an impending insolvency, does not work in real life.

The debtor's management is not in a hurry to use bankruptcy laws to rehabilitate a debtor. One of the reasons is the risk that the debtor's managers will be held responsible for a fictitious bankruptcy. In practice, it is very difficult to distinguish when the debtor's management submits a bankruptcy petition in advance or makes an obviously false statement. The anticipation of bankruptcy is an evaluation category, i.e. the debtor's management can make mistakes. Moreover, some entity can be held administratively liable or even be prosecuted due to an unclear definition of the term "foreseeing bankruptcy".

## 5. Conclusions

Summing up, the authors of the article note that the debtor's management intending to rehabilitate its enterprise can be prosecuted if it submits a bankruptcy petition in advance. The creditor's damage caused by the debtor's bankruptcy may rise beyond 1.5 million rubles in a few days but is it unclear whether the debtor's management is to be blamed if it tries to save a debtor.

To initiate a procedure for declaring bankruptcy, a debtor is obliged to prove the existing circumstances that testify their future inability to pay off monetary obligations to creditors and make mandatory payments to budget and off-budget funds. Successful rehabilitation and circumstances indicating the impossibility to fulfil future monetary obligations directly depend on the time left before the debtor's insolvency. The earlier the debtor's management foresees an impending bankruptcy, the greater are the chances that the company's solvency will be restored.

At the same time, the earlier the debtor's management foresees an impending bankruptcy, the less are the objective circumstances that indicate the impossibility of fulfilling monetary obligations in the future. Thus, the sooner a debtor submits a bankruptcy petition, the greater are the chances that the company will be rehabilitated and less likely that bankruptcy proceedings will be initiated.

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