CLIENT NOTE

The Danger of Bankruptcy During a Crisis: How to Deal with the Domino Effect?

OVERVIEW

The purpose of this Client Note is to inform you on one of the best possible ways to get through the devastating repercussions of COVID-19, as well as ensure the prosperity of your business life. The "Danger of Bankruptcy" is a unique instrument for distressed but vital businesses!

Companies under the state of emergency in Armenia, for reasons beyond their control, incur losses due to factors such as the rapid spread of the COVID-19 pandemic, the decline in overall economic activity, a global economic crisis and the unpredictability of its prevention or elimination. At the same time, governments and international organizations are still discussing steps to take in order to prevent this economic crisis or eliminate or reduce losses. Experience shows that the delay of these steps being put into action results in companies going bankrupt and that support becomes futile. Rapid deterioration of the financial condition of businesses during global crises usually result in a domino effect and often lead to mass bankruptcies (even for those sectors of the economy that at first sight do not fall under the crisis "wave").

This rapid development of events often requires aggressive actions, one of which may be the implementation of an intervention that can prevent submission of claims against companies and provide time for them to "breathe."

In 2016, important amendments were made to the Armenian Bankruptcy Law and the institute of the "Danger of Bankruptcy" was introduced, which enables entrepreneurs to regain that "breath" and avoid the negative consequences of a crisis.

WHAT IS THE "DANGER OF BANKRUPTCY?"[1]

In 2016, as a result of amendments made to Armenia's bankruptcy law, the notion of the "Danger of Bankruptcy" was introduced into the Armenian legal system. It enables entrepreneurs to apply measures directed to the restoration of their insolvency and improvement of their financial condition, such as; attracting new investments and/or loans, modifying and negotiating the terms and conditions of outstanding liabilities, adoption of a financial recovery plan, etc. It is worth mentioning, that for the purpose of the enforcement of actions outlined above, the basic logic of the current regulations does not necessarily require entrepreneurs to have signs of bankruptcy, it is sufficient for them to predict the likelihood (or probability) of bankruptcy.

For that reason, the "Danger of Bankruptcy" toolkit is considered an effective and useful way of responding to challenges in crisis situations. The aforementioned statement is reflected in both the UNCITRAL Legislative Guide on Insolvency Law[2]. and in the Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings[3]. In particular, Paragraph 10 of the said regulation suggests that "the laws of the Member States shall extend to proceedings which promote the rescue of economically viable but distressed businesses, and which give a second chance to entrepreneurs." Such procedures shall, in particular, meet the following requirements:

(a) initiation of such procedures is conditioned by the likelihood of the appearance of grounds of insolvency; and
(b) a person against whom the proceedings of the "Danger of Bankruptcy" is initiated shall not wholly or partially lose control of their assets or management of their affairs.

[1] Since 2016, only one bankruptcy case has been examined by the RA courts. Link: http://moj.am/storage/uploads/0AM02.pdf.
[2] https://uncitral.un.org/sites/uncitral.un.org/files/media-documents/uncitral/en/05-80722_ebook.pdf.
[3] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015R0848&from=en.

WHAT ARE THE CHARACTERISTICS OF THE "DANGER OF BANKRUPTCY" AND HOW ARE THEY TRIGGERED?

In order to initiate proceedings of the "Danger of Bankruptcy," the following conditions must be simultaneously met, in particular:

(a) with appropriate forecasts, it is obvious that the debtor's obligations (making appropriate payments for the delivered goods, etc.) will be equivalent to or more than AMD 1,000,000, or

(b) with appropriate forecasts, it is obvious that the debtor's obligations under public legal monetary claims (for example, the amount of a fine applied by a tax authority, or the amount of another administrative penalty, etc.) will exceed the value of the debtor's assets[4].

If the grounds mentioned above exist, the debtor-business entity (under the current regulations, other creditors are deprived of filing an application for the "Danger of Bankruptcy") submits the relevant application on the "Danger of Bankruptcy" to the competent court, along with other conditions, attaching the financial recovery plan in compliance with the requirements prescribed by the law.

THE CLEAR DEADLINES SET BY ARMENIAN LEGISLATION FOR CONSIDERATION AND RESOLUTION OF THE PROCEEDINGS OF THE DANGER OF BANKRUPTCY

The flexibility of the proceedings under this regulation is that upon the receipt of the debtor's application of the "Danger of Bankruptcy." The judge files the proceeding and appoints judicial hearings within a month[5] to scrutinize the credibility of the information contained in the presented financial recovery plan, and the probability (likelihood) of its execution. Based on the outcomes of the judicial hearings, the duration of the financial recovery plan approved may not exceed 36 months, which may be extended on the basis and in accordance with the procedure established by the current legislation[6].

THE MAIN ADVANTAGES OF THE PROCEEDINGS OF THE "DANGER OF BANKRUPTCY"

The main advantages of the law regarding regulations related to the "Danger of Bankruptcy" are as follows:

(a) It allows entrepreneurs to avoid the general complex bankruptcy procedure.

[4] Article 3 (2.2) of the RA Law "On Bankruptcy"
[5] Article 15.2 (1) of the RA Law "On Bankruptcy"
[6] Article 59 (2) of the RA Law "On Bankruptcy"

(b) It will allow many debtors to avoid impending bankruptcy and, due to the support of the bankruptcy administrator, overcome difficulties and return to their ordinary course of business[7].

(c) It is of flexible[8] and safe nature, since it, unlike bankruptcy, does not lead to the dissolution of the debtor.

(d) The claims of the entities who have financed the debtor under the "Danger of Bankruptcy" will be prioritized. The latter assumes that the entity providing financing to an entrepreneur within the framework of a financial recovery plan (bank, credit institution, other investor, etc.) has priority over all other creditors, including the bankruptcy administrator's expenses and administrative expenses. Therefore, the financing provided to the debtor in this respect may be viewed as a source of profit, given that in the case of priority, the probability of satisfaction of the claim is high[9].

(e) Entrepreneurs have relative independence in issues of the disposal and management of their property. Thus, once the court approves the application for the "Danger of Bankruptcy," the financial recovery plan becomes effective, and the debtor's manager acts under the supervision of the bankruptcy administrator. However, the powers of the debtor's management bodies to manage and dispose of the debtor's property are limited. In particular, the manager (the director or any other competent authority) of the debtor is prohibited from disposing the debtor's property or performing any action entailing a property obligation for the debtor, unless otherwise the bankruptcy administrator has provided its consent thereupon. Meanwhile, during the course of bankruptcy proceedings, in particular, after the relevant decision on dissolution is rendered, the debtor is completely deprived of the rights to dispose and manage the property[10].

(f) Approval of the application on the proceedings of the "Danger of Bankruptcy" and confirmation of the financial recovery plan, suspends the accrual, payment or charging of the debtor's monetary liabilities and payments. This also includes fines/penalties and other financial sanctions subject to accrual, payment or collection for non-performance or improper performance of obligations under tax duties, statutory duties and other payment obligations. Simply put, the satisfaction of creditors' claims will be suspended. This is also an important guarantee for the rehabilitation of a financially impaired entrepreneur that has suffered losses[11].

WHAT TO DO?

(a) Implement a financial forecast for the purpose of revealing the grounds of bankruptcy, that is, to disclose the ratio of liabilities of the debtor and the values of its assets.

[7] http://www.parliament.am/drafts.php?sel=showdraft&DraftID=8199&Reading=0.
[8] Under the law No. 294-N adopted on December 12, 2019 (effective April 15, 2020) by the National Assembly, debtors will be entitled to submit nominations for their preferred bankruptcy administrators (which will later be appointed to the court), in contrast to the present regulations, whereby the court appoints a bankruptcy administrators solely as a candidate nominated by a self-regulatory organization of bankruptcy administrators, and the right of the debtor to nominate a bankruptcy administrator is not provided.
[9] Article 15.7 (1)(2) of the RA Law "On Bankruptcy"
[10] Article 15.4 (4) of the RA Law "On Bankruptcy"
[11] Article 15.5 (1)(4) of the RA Law "On Bankruptcy"

(b) Develop a clear strategy for carrying out measures for the financial recovery of the debtor (issuance/allocation of new shares, conversion of existing liabilities and debts with securities) through the involvement of legal and financial specialists.

(c) Develop a financial recovery plan in compliance with the requirements of the Law through the involvement of legal and financial specialists.

(d) Get legal representation with the assistance and guidance of legal counsel and protection of the legal interests of the entrepreneur.

NOTE: This material is for general information only and is not intended to provide legal advice

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