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PROTECTION OF BOND HOLDERS' RIGHTS . WHAT COULD BE DONE IN CASE OF DEFAULT?

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The Russian corporate bonds market traces its history from 1999 when Lukoil and Gazprom launched their pilot bonds issues intended primarily for those foreign investors whose money was "locked" in Russia as a result of the 1998 default. Since that time, the market has come a long way and demonstrated essential increase of the market volume, more developed structures for the bonds issues and expansion of second and third tier borrowers into the corporate bonds market. Respectively, the market could be characterized as mature except for the lack of practical conduct by the issuers and the investors in the crisis times since until recently this market never survived any default! From the practical standpoint, this means that either of the investors, governmental bodies or courts have no idea of the actual problems which the market may be faced with when certain actions are to be undertaken thereby. This article contains a brief analysis of the legal nature of the relations between borrowers and investors and describes alternative patterns of investors' conduct when a default occurs providing for that end some practical recommendations for the investors .

According to the analysts' forecasts, Russian companies will have to pay \$15.5 billion as bonds' principal and accrued interest in 2008 – 2009. In the light of the financial crisis many borrowers are likely to fail with the proper and due performance of their obligations thus provoking numerous defaults.

Unfortunately, defaults on bonds have already come true. Up to now 14 defaults on Russian bond market were noted.

Legal Framework for Corporate Bonds

Any company is entitled to place bonds for the total value not exceeding the amount of its charter capital. Historically Russian companies do not have substantial charter capital and respectively are to provide some additional collateral with the view to issue bonds in the needed amount.

The list instruments, which can serve as collateral, is set by law and includes bank guarantee, government or municipal guarantee, surety and pledge.

As a rule, pledges are used for the purposes of getting the loans from the banks, guarantees not accessible for the borrowers with a lower credit risk ratio; therefore, surety is the most widespread form of collateral for corporate bonds of Russian companies.

The most simple and effective form of borrowing structure for bonds is a bond issue secured by surety|

As a matter of fact, this scheme enables any borrower to place its debt backed only by its own credit risk, without providing investors with any additional "outside" collateral. For that end

formally the bonds are issued by a special purpose company, usually a wholly owned subsidiary of the ultimate borrower, which is granted with no assets and is not expected to pursue any business activities. Since Russian law sets no specific requirements for the financial condition of the surety although prescribes for any issued securities to be backed by respective collateral, such a subsidiary places the bonds secured by the suretyship of its shareholding company, thus formally complying with the referred rules.

Default as It Is

Default is defined as a failure by the borrower to perform its obligations towards the creditor as to the due and proper payment of interest and/or the principal.

Legal nature of relations between the creditor and the borrower in connection with the bonds circulation and with regard to the performance of a loan agreement seem to be almost the same, whereas the status of the creditor in the both cases will be substantially different.

The discrepancy is mainly predetermined by the set of remedies immediately available to the lender on the basis of a loan agreement when the financial condition of the borrower starts worsening. Particularly, the lending bank can demand an early loan repayment in the event that the borrower attracts new funds on the more advantageous conditions for the new creditors or if the borrow fails to comply with any of the covenants, which according to the loan agreement trigger the early redemption.

Whereas, Russian bonds generally grant no similar rights for the bond holders for claiming early bonds redemption before maturity.

As a result, corporate bond investors in many respects lack the preventive remedies against worsening financial condition of the borrower.

In this connection, an investor may successfully handle with the defaulted bonds only when it has the capability to forecast and reveal any signs of such a default so that as soon as the default actually occurs it can immediately react being far beyond all the other creditors.

There are several sources of information indicating that the crisis is approaching. Default could be forecast by using methods of technical analysis, tracking information published by specialized news agencies (e.g. CBonds), monitoring news lines and the corporate Internet sites of bonds issuers (mandatory channels for providing the market with information on issuers, e.g. www.akm.ru, www.interfax.ru). Notwithstanding this requirement to promptly disclose information on the essential events affecting financial condition of the issuer, including default, in the mass media (within one day) and at the web site of the issuer (within two days), it shall be taken into account that the issuer may not fulfill such prescription since the obligation is binding on the issuer rather than on its officials, which in no way can be held criminally liable or similarly punished once the delayed disclosure takes place and are not mandatorily motivated to follow the disclosure rules in such cases.

Along with the concept of "default", the bonds legislation operates with the "technical default" concept, which is believed to be a delay of payment of an accrued interest or principal for the term of up to 7 and 30 days respectively (upon the expiration of that period the default ceases to be deemed technical and turns into an actual one). Bond investors should be well aware that legally the conduct of an issuer who fails to honor its payment obligations within the terms set by

the prospectus is considered to be a breach of contractual undertakings irrespective of the delay duration, which immediately makes available for the investor all the accessible remedies inclusive of the claim service to the court of jurisdiction.

As a form of default there can be specifically mentioned a failure of the issuer to redeem the bonds presented for the early repurchase by the bondholders at the terms specified in the prospectus. Such a failure represents a default on bonds and it shall be distinguished from the seemingly similar situation when the offer for the redemption of bonds is made and not duly performed by a third party (not by the issuer). In the first case, the consequences of a non-performance are similar to the issuer's default on redeeming its bonds, whereas in the second case it comes to the breach of contractual obligations by the offeror resulting in no recourse by the bondholders to the issuer whose bonds were promised to be repurchased.

Alternative Actions of the Investors Upon the Default Occurrence

It is only natural when the investor tries to sell its bonds after learning about the default. Obviously, low liquidity and decreasing quotes will hinder this process. Being unable to sell the bonds at any acceptable price, the investor should attempt to satisfy its claims by using some alternative methods.

Obviously, bringing of a claim to the court is a basic one. Alternatively there can be reached an acceptable solution with the debtor without resorting to the court proceeding. Arrangements in the latter case can vary from the consideration to be provided by the issuer up to the entry by the bondholders into the equity of the debtor and joint operative management of its business.

However, for the purposes of either the effective litigation or of the extrajudicial negotiations the investor has to combine the maximum amount of claims since otherwise the investor risks to remain an unnoticed creditor. Besides, it is important to understand that sometimes litigation and enforcement procedure costs could be rather significant which means that in the case of minor claims for small amounts, legal costs might be comparable in size with the claimed amount.

Unfortunately, at present all the possible methods of claims consolidation (provision with the respective powers of attorney for the court proceeding, transfer the bonds in trust management or conditional sale of bonds with the deferred payment performance upon the receipt of the due proceeds from the issuer) are not absolutely effective since the person who is trying to consolidate the authorities shall gain the trust of the bondholder and to the extent that the claims consolidator depends on the will of bondholders the combination of claims may not always attain the sought result.

Russian legal system is not familiar with the institution of the class action suit known in the Anglo-Saxon legal system. Whereas this institution enables a preliminary appointed process agent in the event of default to bring a claim in the court in the name and on behalf of all the holders of defaulted bonds.

A close analogue of such a tool can be found in the Russian Federation Law "On Protection of Rights and Legitimate Interests of Capital Market Investors". According to Article 14 of the said Law, the Federal Financial Markets Service of the Russian Federation (FFMS) has the right to take legal action to protect investors' interests. However several factors prevent the realization of this legal opportunity, the main one being the lack of any judicial practice of the referred law rule application, specifically, it is not clear who will be the plaintiff in such a claim (according to existing practice, only a concrete person can be the plaintiff, but not a class of persons as in our case all the bondholders of a concrete bonds issue would serve on the part of the plaintiff), in

whose name the writ of the court award enforcement will be issued, etc. It looks like the FFMS as the stock market regulator should work out the amendments to the legislation which will ensure the practical application of the referred provision of the Law.

Investors expecting to actually receive funds as a result of litigation should clearly understand that such actions can be successful only when a favorable court judgment is issued before the debtor is declared bankrupt. Otherwise, the claims of the bondholders will be added to the bulk of other third priority claims and will compete with the unsecured claims of all other creditors thus making the full redemption of such claims to be not likely.

Considering other difficulties to be faced with by the investor in any litigation (including different jurisdictions of courts considering claims raised by individuals and by legal entities, substantial timing needed for the hearing of cases in the courts of general jurisdiction, extended period of the enforcement proceeding, prohibition for new plaintiffs to join the existing process, remote chances to consolidate cases containing similar claims to the same issuer), the timing factor acquires paramount significance for the success of any actions in the view to the recovery of debt.

Therefore, our main recommendation to investors experiencing a default of the held bonds' issuer is to seek legal action against the issuer immediately after the technical default occurrence.

Additional recommendations are as follows:

- claims should be presented to all parties who are liable (i.e. the surety), not just to the issuer;
- to file an application to engage the FFMS as a third party in the litigation because the FFMS position will simplify the understanding of the case by the court;
- to apply to the court for the injunction measures such as the arrest of the funds or other property of the issuer and other liable parties;
- to involve professional organizations (law firms, investor rights protection associations, etc.) to protect your interests.