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Simplification of Insolvency Proceedings in Kazakhstan

By JOEL BENJAMIN, MAKSIM GREKOV *and* ALFIYA SHARIPOVA

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Introduction

“These numbers are tremendous, and might not even show the whole picture. The actual numbers might be even higher”.

Alkikhan Smailov

“Today there are around 4,000 legal entities in Kazakhstan that are undergoing bankruptcy proceedings and around 400 enterprises that are in the process of rehabilitation,” said Alkikhan Smailov, the Minister of Finance. “These numbers are tremendous, and might not even show

the whole picture. The actual numbers might be even higher”. In order to simplify and speed up the processes of bankruptcy and rehabilitation applicable to unsuccessful businesses, the Law on Rehabilitation Procedure and Bankruptcy dated March 7, 2014, No. 176-V (the “Old Law”) and related legal acts were recently amended by the Law dated December 27, 2019, No. 290-VI (the Old Law, as amended, the “Amended Law”).

The Amended Law is a product of a compromise between the interests of debtors and creditors reached as a result of two year debates and drafting. We have highlighted below the most significant changes that the Amended Law introduced to the bankruptcy regulations in Kazakhstan.

Report Regarding Financial Stability of a Debtor

Prior to adoption of the Amended Law, in order to determine a debtor's financial status the courts were burdened with analyzing the debtor's financial statements in each bankruptcy case. This task has now been shifted to insolvency administrators with the hope to make the courts more efficient in reviewing bankruptcy cases. Under the Amended Law, insolvency is determined by a court on the basis of the report regarding the financial stability of a debtor ("FS Report"). This means that while the FS Report per se is not a conclusive evidence, a court would unlikely make a decision that is not in line with the FS Report unless there is strong evidence to the contrary.

FS Reports are prepared by insolvency administrators. Under the Amended Law, an insolvency administrator (further, an administrator) may be represented by either a temporary manager, a temporary administrator, a rehabilitation manager or a bankruptcy manager (depending on the stage of the proceedings). These are qualified individuals admitted to be administrators by an authorized governmental institution (the State Revenue Committee of the Republic of Kazakhstan), subject to certain exceptions.



Below is a brief description of their obligations, way of appointment and involvement in the proceedings:

Name	Key Duties	Insolvency Stage for Appointment	Way of Appointment
Temporary Manager	<ul style="list-style-type: none"> – Preparation of the FS Report; – Preparation of the list of creditors; 	<ul style="list-style-type: none"> – Appointed upon initiation of bankruptcy proceedings and, in the event a debtor is declared bankrupt, until a bankruptcy manager is appointed 	<ul style="list-style-type: none"> – Appointed by either the debtor or the creditors, depending on who initiated the proceedings
Temporary Administrator	<ul style="list-style-type: none"> – Convocation of the first creditors meeting 	<ul style="list-style-type: none"> – Appointed upon initiation of rehabilitation proceedings and, in the event rehabilitation proceedings are authorized by a court, until rehabilitation manager is appointed 	
Rehabilitation Manager	<ul style="list-style-type: none"> – Managing the company during the rehabilitation stage; – Preparation of the FS Report upon completion of rehabilitation 	<ul style="list-style-type: none"> – Appointed upon approval of a rehabilitation plan 	<ul style="list-style-type: none"> – Appointed by the meeting of creditors from the list of admitted administrators and appointed by the authorized state body
Bankruptcy Manager	<ul style="list-style-type: none"> – Composition of the bankruptcy estate (including finding and returning the debtor's assets improperly transferred to third parties and sale of the debtor's assets to satisfy creditors' claims); – Preparation of the FS Report, provided there are grounds for switching from bankruptcy to rehabilitation 	<ul style="list-style-type: none"> – Appointed upon declaration of a debtor insolvent 	

The FS Report determines the category of financial stability of a debtor. Categorization under the Amended Law is as follows:

Class of Debtors	Class I	Class II	Class III
Definition	– Financially stable debtors	– Debtors who are associated with financial risk, but have the potential to restore their financial stability	– Financially unstable debtors
Applicable Financial Coefficients / Ratios¹	– $Z1 \geq 2.99$ (2.99 and higher);	– $1.81 \leq Z1 < 2.99$ (from 1.81 to 2.99);	– $Z1 < 1.81$ (less than 1.81);
	– $Z2 \geq 2.90$ (2.90 and higher)	– $1.23 \leq Z2 < 2.90$ (from 1.23 to 2.90)	– $Z2 < 1.23$ (less than 1.23)
Legal Consequences	– This class of debtors does not need to undergo rehabilitation or bankruptcy proceedings.	– Rehabilitation proceedings are applied to this class of debtors.	– Rehabilitation proceedings may be applied to this class of debtors under certain circumstances, provided a consent of the creditors' meeting is obtained. Otherwise the bankruptcy proceedings are applied.

Insolvency Tests

The Amended Law adds clarity to the insolvency test. Previously the insolvency was defined as “inability of a debtor to pay its debts”.

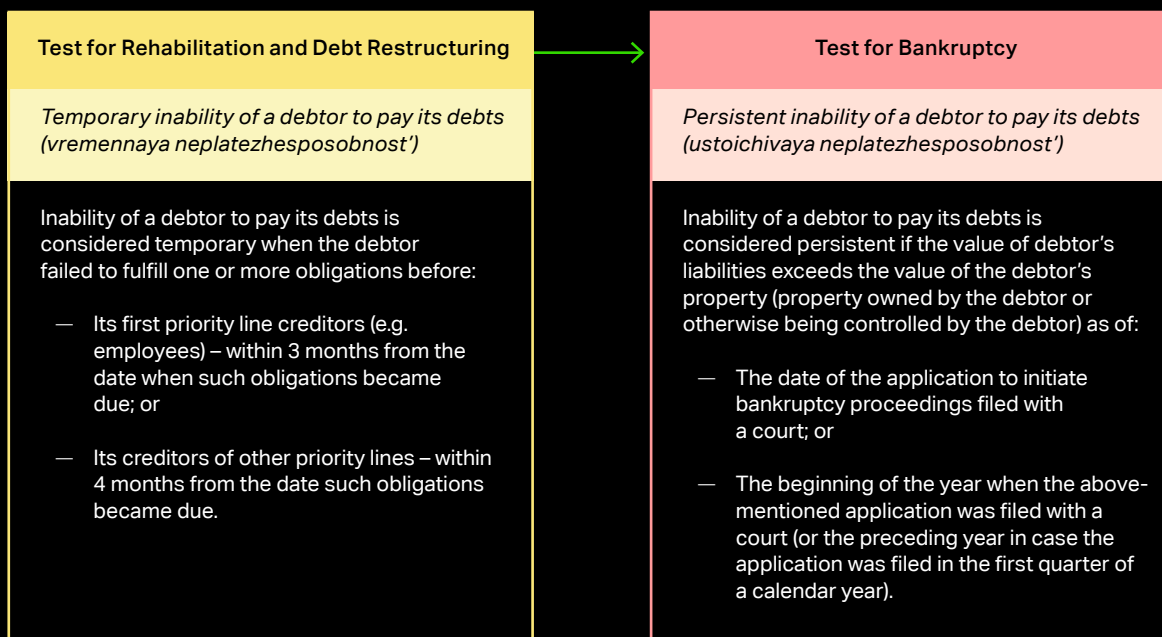
Under the Old Law, the insolvency test was the same for rehabilitation and bankruptcy proceedings. The test used to be structured in a way that in order to be qualified for the proceedings a debtor needed to fail fulfilling its payment obligations when due (i) for certain periods of time; and (ii) for an amount exceeding certain thresholds (both periods and thresholds depended on the priority of the creditors involved). The Old Law had no ‘negative capital test’ that is currently used for bankruptcy

proceedings. This change regarding the insolvency tests which:

- Eliminated thresholds on one side; and
- Introduced a ‘negative capital test’ (widely used worldwide) on the other side,

was made to decrease the number of documents to be submitted to court for the purposes of initiating insolvency proceedings. It is expected that the new tests will work better in identifying potential bankrupts and will simplify the insolvency proceedings.

The Amended Law Introduced Two Different Categories of Insolvency Tests:



Removal of Accelerated Rehabilitation Procedure

The Amended Law now excludes from available insolvency options the “accelerated rehabilitation procedure”. This mechanism used to be one of the options available for debtors who satisfied the old insolvency test. This procedure (i) was intended to cover only a part of outstanding liabilities of the debtor, i.e. this part was to be formed by one or more groups of homogenous liabilities; and (ii) could be initiated only by a debtor that secured approval of its creditors having more than 50% of claims within each such group. The intention of the accelerated rehabilitation was to simplify the insolvency procedures, but due to the lack of procedural clarity this option was not widely used in practice. Also, there were certain major drawbacks of this procedure, e.g. (i) minority creditors were prevented from putting forward their claims to the debtor; and (ii) in the course of accelerated rehabilitation the debtor’s management remained in place with their powers not in any way limited or controlled by a court or an administrator.

The removal of the accelerated rehabilitation procedure aims at supporting minority creditors in the course of rehabilitation procedure.

New Collateral Takeover Rules

Pursuant to the Amended Law, secured creditors may now choose whether to accept the collateral in-kind or receive a payment instead in the 2nd priority line as a secured creditor. However, certain procedures shall be followed and conditions must be met in order for a secured creditor to be able to keep the collateral:

An appraiser should determine the price (value) of the collateral as follows, if:

1. **[Price for the collateral] minus [paid salaries] (as per para. below)** is more than the amount of secured obligations

the difference should be paid by the secured creditor or to the bankruptcy estate; or

2. **[Price for the collateral] minus [paid salaries] (as per para. below)** is less than the amount of secured obligations

the difference should be paid to the secured creditor or in the 4th priority line of claims²,

in other words, the secured creditor becomes an unsecured creditor for the amount of the difference;

If the debtor has no other property that may be used in order to pay for these claims, prior to obtaining title over the collateral, the secured creditor shall pay the salaries to the debtor’s employees working on the basis of labor contracts in the amount equal to the minimum wage applicable under KZ law* for the respective year and for a period of not more than 3 months, in total not exceeding 15% of the value of the collateral. *KZT 42,500 (approx. USD 112)

This is a rather positive development that was made and is to the secured creditors' advantage. Since the adoption of the Old Law in 2014, the rules on secured creditors were amended three times. The previous versions of the law were less pro-creditor and made it more difficult for a secured creditor to keep the collateral: the secured creditor was required to pay all first-line creditors without any cap and obtain the prior consent of the creditors' meeting in order to be able to keep the collateral. The current version of the rules applicable to the collateral

in-kind and secured creditors is hoped to be beneficial for all parties involved.

Changes in Claim Priorities

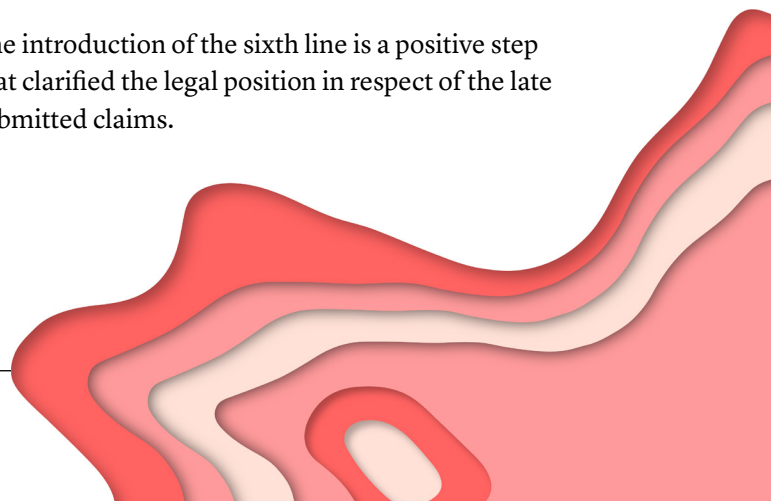
The Amended Law introduced a new (sixth) category of claims: late submitted claims which come after all other lines, but before distributions of remaining assets to the debtor's shareholders. As a result, the waterfall of creditors under the Amended Law is as follows:

Category of Claims	Description of Claims/Payments
1st Line of Creditors Claims	– Capitalized payments to individuals for harm caused to their life and health, payments of deducted alimony, labor remuneration and compensation, arrears in social deductions, accrued pension (including professional pension) deductions and author's (copyright) awards
2nd Line of Creditors Claims	– Payments due to secured creditors in respect of obligations secured by the pledged assets within the value of the collateral (including the claims of a creditor who agreed to take the collateral in-kind and claims resulting from a loan obtained by the bankruptcy manager for the purposes of the bankruptcy proceedings and during the bankruptcy process)
3rd Line of Creditors Claims	– Indebtedness under tax liabilities and other mandatory payments to the budget (i.e., taxes accrued but unpaid prior to initiation of the bankruptcy proceedings)
4th Line of Creditors Claims	– Payments due to other creditors, including payments to a secured creditor if the value of the collateral was insufficient. Unsecured claims of trade/finance/other creditors (except for losses/indemnities) would generally fall in this line of claims
5th Line of Creditors Claims	– Payment of losses (indemnities would likely be considered as losses), penalties and fines
6th Line of Creditors Claims	– Late submitted claims

The time period for submission of all claims is one month following the publication of the announcement on the procedure for submission of claims. Late claims of all priority lines except for the first priority line currently fall under the sixth line. The first priority line claims (salaries, salary-related claims and certain other payments) that are submitted late may still be repaid ahead of other creditors if filed before the final settlement with all other creditors. Please note that administrative expenses, on-going wages and current tax payments should be paid prior to any distributions

to creditors. After the satisfaction of all priority lines of creditors, any remaining funds/assets are distributed to the debtor's shareholders.

The introduction of the sixth line is a positive step that clarified the legal position in respect of the late submitted claims.



Other Notable Developments

The Amended Law introduced the other following positive changes:

- A number of the grounds under which the management of the debtor is obliged to file for bankruptcy was decreased from three to one: the debtor is now obliged to file only if the owner of the debtors' property (the body authorized by the owner) and/or the corporate body of the debtor having respective authority in accordance with constitutional documents, made a decision to liquidate the debtor and the debtor does not have sufficient assets to satisfy claims of all creditors in full.
 - The Amended Law provides for a number of notable exceptions from general claw back provisions (where undervalue or preference transactions entered into within a certain period of time prior to initiation of insolvency proceedings may be challenged in court after the initiation). Currently, the following transactions are expressly excluded:
 - Project finance and securitization (presumably, entered into under Kazakhstan law);
 - Open trades entered into through a trading system of a stock exchange; and
 - Customary commercial operations.
- This clarification aims at ring-fencing certain transactions which should not fall under scrutiny by their nature.
- The Amended Law specifically requires that under a rehabilitation plan³ all creditors of the same priority line are treated equally. This is a non-controversial provision on the one side, as it enhances equal treatment of creditors, but on the other side, there are types of claims which while being formally in the same priority line have different nature, for example, unsecured bank credit lines (financial credit) and unsecured indebtedness to suppliers (trade credit) which are formally in the same 4th line.
 - The Amended Law expressly provides that all limitations and attachments on the debtor's assets should be removed once the rehabilitation plan is approved by the court and the debtor applied for such removal. Under the Old Law, it was very difficult to remove such limitations and attachments. Prompt removal of such limitations is crucial as they prevent the debtor's business from operating in ordinary course and preserving the value of the business as a going concern (arguably, thus, increasing potential recoveries for the creditors and/or increasing chances of the business recovering).
 - The Amended Law extends the authority of creditors' committee to include the following rights: (i) to approve the plan of an asset sale, (ii) to put assets for sale on electronic auction, (iii) to approve amounts due to the debtor as being not possible to collect, and (iv) to write off lost assets. This is a positive development which accelerates bankruptcy proceedings.

COVID-related Amendments to Insolvency Proceedings



Unlike many other countries, Kazakhstan did not introduce a full moratorium on the initiation of bankruptcy proceedings during the Covid-19 pandemic.

Unlike many other countries, Kazakhstan did not introduce a full moratorium on the initiation of bankruptcy proceedings during the Covid-19 pandemic. Although in May 2020 an intention to introduce such a moratorium was announced by Kazakhstan President, the limitations were further introduced only to suspend the right of state bodies and quasi-sovereign entities in their role as creditors to make filings for recognition of debtors. These limitations were set out in the Government of Kazakhstan enacted its Resolution on the suspension of initiation of bankruptcy proceedings dated 14 July 2020 No. 443 (the “**Resolution**”). This Resolution did not affect the rights of other creditors and the rights of debtors themselves to file for bankruptcy. The limitations expired on 1 October 2020 and were not prolonged afterwards.

Conclusion

The amendments described above benefit all participants of insolvency proceedings, including foreign investors. Kazakhstan Government intends to continue monitoring the implementation of these amendments and insolvency legislation overall from a practical perspective and to remain engaged in making amendments of Kazakhstan bankruptcy legislation to streamline insolvency proceedings.



▼ **Joel Benjamin, Managing Partner, Kinstellar** Joel Benjamin is the Managing Partner Central Asia practice of Kinstellar and manages its offices in Almaty, Nur-Sultan and Tashkent. Joel advises international and local clients in various industries, including oil and gas, mining, banking, telecommunications and media.

Joel has broad experience in corporate and commercial transactions with a particular specialism in banking and finance, where he has developed top rankings within Kazakhstan and Central Asia. He has played a leading role in numerous transactions including bilateral and syndicated loans, trade finance, project finance, and equity / debt capital markets matters. Joel has built a strong corporate practice including work on numerous M&A transactions across sectors including oil and gas, mining, telecommunications and banking.

He comes highly recommended by Legal 500, Chambers Global, IFLR 1000, Who's Who Legal and Best Lawyers in Kazakhstan. Joel has been named as "Lawyer of the Year" for Banking and Finance and Capital Markets Law in the 2017-2018 edition of the annual directory Best Lawyers in Kazakhstan. Joel is recognised by Chambers and Partners, Global Guide, 2020 and 2021 as the only Eminent Practitioner in Corporate and Finance.



▼ **Maksim Grekov, Of Counsel, Kinstellar** Maksim Grekov is Of Counsel in the Almaty office. Maksim has over 25 years of experience advising major international and local companies in Kazakhstan and other Central Asian countries spanning a wide range of practice areas, including M&A and general corporate, banking and finance, including debt & equity

capital markets, derivatives and other financial products. He is often engaged in high-value financial transactions for major banks, funds and corporations. Maksim is ranked among the top practitioners in Kazakhstan by global legal guides such as Chambers Global and IFLR1000.

For a number of years Maksim has been consistently recognised by Chambers & Partners as a leading lawyer in the Corporate & Finance. Maksim Grekov is singled out for his attention to detail and his legislative knowledge, as one source explains: "He brings his attentive and meticulous approach to project financing mandates, often in the natural resources sector, where he advises international financial institutions," Chambers & Partners, Asia Pacific 2020 and 2021. Maksim holds a Diploma with honours in Commercial Law from Adilet Higher Law School.



▼ **Alfiya Sharipova, Legal Assistant, Kinstellar** Alfiya Sharipova is a Legal Assistant in Kinstellar's Almaty office. Before joining Kinstellar, Alfiya acted as a legal intern in Astana International Exchange advising clients on laws and regulations of the AIFC. In addition, Alfiya was a part of winning team at the first Republican Moot Court Competition organised

by the AIFC Court and the International Arbitration Centre. She also participated and led pro-bono "Ask a Lawyer" project held by KIMEP Legal Clinic and IS Paragraph that aimed to give online legal consultations on various matters.

1. Rules for calculation of financial coefficients' and the limitations for the classes of financial stability approved by the Decree of the First Deputy Prime Minister of the Republic of Kazakhstan, i.e. Minister of Finance of the Republic of Kazakhstan No. 372 dated 9 April 2020. The guidelines for calculation of coefficients are as follows:
 - Z1 (applicable to joint stock companies the shares of which are placed on the securities market) equals to $1.2 * K1 + 1.4 * K2 + 3.3 * K3 + 0.6 * K4 + 0.999 * K5$;
 - Z2 (applicable to all other entities) equals to $0.717 * K1 + 0.847 * K2 + 3.107 * K3 + 0.42 * K4 + 0.998 * K5$.

Ratios K1-5 are calculated as follows: K1 is short-term assets to total assets, K2 is retained earnings/uncovered loss to total assets, K3 is income before tax to total assets, K4 is, for joint stock companies whose shares are placed on the securities market market value of shares to total liabilities and, for other entities net worth (total assets minus total liabilities) to total liabilities, and K5 is sales to total assets.
2. It should be noted that 4th priority line creditors receive on average around 1 per cent. of their claims, thus, a secured creditor should carefully assess whether to follow such course of actions.
3. Rehabilitation plan is a document which is obligatory for all creditors undergoing rehabilitation. It is approved at the creditors' meeting and then in court.



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