

DRAFT

The Constitutional Court has explained the procedure of using pledged items to pay tax obligations during bankruptcy

FAO legal entities, officers of financial, tax and legal departments, and court-appointed administrators

Pepeleiev Group advises that the Russian Constitutional Court (the 'Constitutional Court') has adopted Resolution No. 16-P dated 9 April 2024¹. The Court checked whether article 138(6) of the Law on Bankruptcy² was constitutional with respect to the order of priority for paying tax obligations connected with a pledged item in bankruptcy cases.

The grounds for adopting the Resolution were a gap in the legislation as well as the formation of contradictory court practice regarding the payment of current debts in bankruptcy and late payment interest under property taxes connected with an item that has been pledged.

The Constitutional Court recognised that [article 138\(6\)](#) of the Law on Bankruptcy is not at variance with the Russian [Constitution](#) insofar as it provides for such claims to be satisfied out of funds generated from using and selling the pledged property prior to settlements with the pledge creditor starting.

Below are the main provisions of the Resolution with our comments.

Limitations on applying the Resolution

Before assessing whether the rule in question was constitutional, the Constitutional Court made two reservations:

¹The Russian Constitutional Court's Resolution No. 16-P dated 9 April 2024 "On a case concerning checking whether clause 6 of article 138 of the Federal Law "On insolvency (bankruptcy)" is constitutional further to a complaint of Sberbank of Russia PJSC and "Trading House 'Agrotorg' LLC.

² The Federal Law No. 127-FZ "On insolvency (bankruptcy)".

- 1) The order of priority in which property taxes connected with a pledged item are paid is not subject to Resolution No. 28-P³ of the Constitutional Court dated 31 May 2023 on the order of priority of profit tax payments because:
 - it explains in what order of priority tax obligations are discharged when the entire mass of a bankruptcy estate is sold, which is intended, primarily, for settlements with creditors;
 - a pledge creditor accepting security has an opportunity to assess its value and bears the risks connected with this, including the risks relating to such value changing in future.
- 2) The Constitutional Court does not assess article 138(6) of the Law on Bankruptcy in terms of how claims to pay current arrears on property taxes connected with the pledged item correlate with claims of other persons that may be settled out of funds generated from selling the pledge item.

The procedure of selling a pledged item to pay taxes and default interest

Property taxes connected with pledged property and assessed over the bankruptcy period as well as the interest incurred on them are to be paid out of the funds generated from using and selling the pledged item before settlements with the pledge creditor start.

Unlike the rule established by the Bankruptcy Law lowering the order of priority of any default interest, which the Constitutional Court itself has supported on a number of occasions, another rule is formulated for property taxes connected with a pledged item. The order of priority of default interest assessed in connection with a failure to pay tax must be in line with the category and order of payments of this tax, because default interest derives from the main tax obligation.

³ Resolution No. 28-P of the Constitutional Court dated 31 May 2023 "On a case connected with examining whether articles 248 and 249, article 251(1) and 271 of the Russian Tax Code, as well as articles 5(1) and 5(3) and article 134(2) of the Federal Law "On insolvency (bankruptcy)", are constitutional in connection with a request of the Russian Supreme Court and a complaint of limited liability company "Enterprise for construction works in the energy sector" ("Resolution No. 28-P"). This Resolution introduces a temporary procedure whereby claims to pay profit tax assessed in connection with the sale of a bankruptcy estate are satisfied along with registered claims of third-level creditors.

Pepeliaev Group's comment

The Constitutional Court has, in practical terms, approved the Supreme Court's legislative drafting activity. Article 138(6) of the Bankruptcy Law names only expenses on ensuring the security of property and selling it at auction as the obligations that are to be discharged before the proceeds are distributed from the sale of the pledged item. However, the Constitutional Court assessed this rule as meaning that the expenses connected with the pledged item (i.e. any expenses) must be covered out of the sale proceeds. As a result, the Constitutional Court decided that such a "supplement" eliminates legal certainty.

The priority of the discharge of tax obligations extends so that it applies to income from a lease or other use of the pledged item

The Constitutional Court has extended its rule for distributing proceeds also to income from a lease (or from other use) of the pledged item. In the Constitutional Court's opinion, there would otherwise be a lack of balance. Expenses arising in connection with a lease of pledged property will be allocated among all the creditors. The proceeds from the lease will be remitted only to the pledge creditor.

Exceptions from the priority procedure for satisfying tax claims

The court may refrain from the Constitutional Court's procedure for allocating proceeds from the sale (use) of the pledged item and may distribute such proceeds proportionally between the pledge holder and the tax authority, if:

- the payment of taxes will actually lead to the pledge losing its economic sense for the creditor;
- the tax debt having emerged has no link to the pledge creditor's actions.

When determining whether distribution is commensurate, account must be taken of:

- to what extent the relevant amounts being paid to regional and local budgets will affect the performance by the relevant public bodies of their social obligations and
- whether the pledge creditor not receiving the funds from the use and sale of the pledged property results in continuing its operations being impossible (in bankruptcy).

If the above circumstances are in place, default interest may be fully excluded from the list of claims that are satisfied before proceeds from the sale of the pledged item are distributed.

Pepeliaev Group's comment

In a bankruptcy, the state is granted preferences that are not established by law. Despite this, the Constitutional Court could not disregard how the rules it was confirming adversely affected the pledge function, as well as the interests of investors and creditors. The declared exceptions are an insignificant concession against a backdrop of the devaluation of the pledge and, as the Constitutional Court itself acknowledged, the implications of the established rule can be factored in when the value of credits is formed (for which, read 'increased').

The commensurate distribution of proceeds between the pledge holder and the state budget will undoubtedly give rise to considerable difficulties, because courts will have to determine the criteria for such distribution on their own. Meanwhile, taking account of the pro-government approach of the courts and the benchmarks they have set, there is little chance that the above exceptions will be applied.

What to think about and what to do

Pledge holders need to procure as best they can that the measures required for property to be sold during bankruptcy are taken as soon as possible. Otherwise, the expenditure arising in connection with the pledged item may considerably reduce the degree to which claims are satisfied.

If it is impossible to sell the pledged property quickly, one needs to think how to use the property effectively (for instance, to lease it out). Given that only 26% of the claims of pledge creditors were satisfied in 2023, we recommend taking this factor into account along with the rules that are formulated in the Resolution when security is put in place for the loan obligations.

Help from your adviser

The lawyers of Pepeliaev Group have extensive experience in providing protection across the board of the interests of creditors, pledge creditors among them. An important aspect of the protection that we provide is overseeing that payments during bankruptcy, including payments relating to tax obligations, are paid under the proper order of priority.

We are ready to provide legal support in handling individual disputes that involve having disagreements with the receiver and the authorised body examined. We also work on appeals against the actions of and suspension of the receiver, and recovering losses from the receiver owing to a breach of the order of priority for obligations and their discharge.

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