

The New Bankruptcy Law in Russia

By Ben Branch

Professor of Finance, Isenberg SOM, University of Massachusetts Amherst

Natalya Goncharova

MBA Class of 2003, Isenberg SOM, University of Massachusetts Amherst

Konstantin Sonin

Assistant Professor at the New Economic School/CEFIR, Russia

2003

Content

Content	2
Introduction	3
Part I. Evolution of Bankruptcy Law in Russia	5
Bankruptcy Legislation before the 1917 Revolutions	5
Bankruptcy in Russia during the Soviet Era	5
Bankruptcy Law of 1992	6
Bankruptcy Law of 1998	6
Part II. Economic Analysis of the 1998 Law, 1998 – 2002	9
Part III. The 2002 Law: Current Bankruptcy System	10
The Demand for a New Law	10
Provisions of the 2002 Law	10
Arbitration Courts	10
Bankruptcy Process/Mechanism	10
Bankruptcy definitions	10
Arbitration Managers	10
Self-Regulated Organizations of Arbitration Managers.....	10
Federal Service for Financial Recovery and Bankruptcy.....	10
Bankruptcy of an Individual	10
Bankruptcy of Credit Institutions	10
Part IV. Law of 2002 versus Law of 1998	10
Conclusion	10
Appendix: A Case Study	10
Description of the Situation	10
Order of Events	10
Discussion of the Case	10
References	10
Laws	10
Articles, Manuscripts	10

Introduction

Bankruptcy procedures are in a state of flux in the Russian Federation (RF). As one of the major components of a market economy, bankruptcy proceedings influence almost all aspect of Russia's economic, political and social life. The development of the current Russian bankruptcy system¹ has taken place over three periods: Law of 1992², Law of 1998³, and as this paper is written, the new law on bankruptcy (Law of 2002⁴) has just recently been approved by the Russian Parliament and signed by the President.

Experts had predicted that the introduction of 1998 Law would lead to a flood of bankruptcies. Before 1998 most Russian companies have accumulated large arrears to federal and regional budgets as well as to private creditors. Indeed, the number of bankruptcies did dramatically increase after the implementation of the new law. Growth in bankruptcy cases has been interpreted by many experts as an evidence that budget constraints of Russian enterprises have hardened. It soon appeared, however, that the aggregate statistics of initiated bankruptcies did not allow one to reach conclusions about the effectiveness of the 1998 law. One needs to know what companies went bankrupt and what happened to these companies after bankruptcy was initiated in order to understand the law's impact. In-depth research supported the view that the 1998 law has not served its goals of protecting outside creditors and creating appropriate incentives for managers. Political capture appeared to be a major problem: governors of Russian regions have subverted the institution of bankruptcy, fearing massive lay-offs in insolvent, but politically important enterprises and extracting rents from managers of inefficient enterprises in exchange for protecting them from bankruptcy.

¹ Here we mean the bankruptcy system since the break of the Soviet Union. A brief historical overview of the Russia bankruptcy Law prior to the USSR break is given at the end of the paper.

² Federal law On Insolvency (Bankruptcy) of Enterprises,. 'Vedomosti S'ezda Narodnykh Deputatov Verkhovnogo Soveta R.F'. (1993) No. 1, item 6.

³ Federal law On Insolvency (Bankruptcy), No. 6-FZ, January 8, 1998, Sobranie zakonodatelstva R.F. (1998) No. 2, item 222.

⁴ Federal Law On Insolvency (Bankruptcy) No. 127-FZ, October 26, 2002 ⁴ (This law came into force on December 3, 2002).

Overall, the 1998 law engendered countless cases of illegal bankruptcies, and bankruptcies upon request. At the same time, many insolvent and loss-plagued enterprises continued to operate. The political demand for a new law was evident. The new law (Law of 2002) is, however, unlikely to change the existing situation, or at least not fix its major problems. In fact, this recently enacted Law raised more questions than provided answers to metamorphoses with bankruptcies that were carried out under the force of the 1998 Law.

This paper introduces the reader to the current state of bankruptcy procedures in Russia (based on the Law of 2002). The law on bankruptcy will be reviewed as it outlines the bankruptcy proceedings; relates to the parties involved in the bankruptcy process; protects the rights of debtors and creditors; as well as considers the rights of foreign investors. The new law of 2002 will also be compared to the previous one (Law of 1998). The practical results of the 1998 Law enforcement will be reviewed.

The paper is organized as follows. Part I presents the evolution of bankruptcy legislation development in Russia. Part II examines the application of the bankruptcy law of 1998 in practice. Statistical data and real life examples are presented to illustrate the current state of bankruptcy processes in Russia. Part III introduces readers to bankruptcy procedures as they are outlined in the new law. It explores the major components of the current bankruptcy system in Russia, i.e. legislation on bankruptcy matters, bankruptcy proceedings, roles of the main parties involved in bankruptcies: debtors, creditors, bank trustees, specialized courts, and state bodies in charge of regulating bankruptcy issues. This part will also compare the new law and the previous one. Part IV compares Laws of 1998 and 2002 and examines the issues resulted in issuing a new law. Part V concludes. A case study is provided at the end of the paper to illustrate the complexity and vagueness of the Russian bankruptcy proceeding. This practical example is based on the application of 1998 law. The results of the 2002 law application have yet to be seen.

Part I. Evolution of Bankruptcy Law in Russia

Bankruptcy Legislation before the 1917 Revolutions

The institute of bankruptcy in Russia has its roots in the III–V centuries. The first full-fledged regulation on bankruptcy was approved in 1740. Between 1740 and the 1917 Revolutions the bankruptcy legislation went through many changes. In 1800 the Statute on Bankrupts and in 1832 the Statute on Insolvency were enacted. Pre-revolutionary Russian bankruptcy regulations focused primarily on the insolvency of individuals rather than legal entities. Russian bankruptcy legislation for the period before 1917 reflected the goals and objectives of bankruptcy as one of the main institutions of the market economy.

Bankruptcy in Russia during the Soviet Era

The Russian Soviet Federative Social Republic (RSFSR) Civil Code of 1922 included many articles related to the insolvency of organizations and individuals. Then, in 1923 this code was changed to the RSFSR Civil Judicial Code, which did not regulate bankruptcy procedures. It was amended in 1927 and 1929 by three articles regulating the bankruptcies of individuals, legal entities, state enterprises, and joint-stock companies. Bankruptcy legislation of that time was designed to protect working people and the state in contrast to the pre-revolutionary goals of protecting creditors.

While the roots of the planned economy became stronger and stronger, the significance of bankruptcy procedures diminished. As a result of the legislative reforms of the early 1960s, articles on bankruptcy were excluded from the Civil Judicial Code. By the late 1980s, several bankruptcy regulations had been enacted. In practice, however, these regulations were rarely, if ever applied. Russia had no real bankruptcy institution at this time. Unprofitable and technically insolvent companies were subsidized by/from the state budget, either directly or through artificially low state prices for energy and other inputs. These enterprises continued producing goods and/or services that had little or no demand (or at least insufficient demand to provide revenues equal to costs). No legal procedure existed to facilitate withdrawal of insolvent companies from the economy. The absence of a viable bankruptcy system resulted in the instability of credit relationships and increasing misallocation of resources throughout the entire economy.

After many years of neglect, the legal process dealing with bankruptcy began to be revived in Russia in the early 90s. The process of economic and political reforms heightened the need for reestablishing an effective system for dealing with bankruptcy.

Bankruptcy Law of 1992

The Supreme Soviet of the Russian Federation passed the first bankruptcy law on November 19, 1992. This law named “the Law of the Russian Federation on Bankruptcy (Insolvency) of Enterprises” was signed by the president and came into force on March 1, 1993.

The bankruptcy law of 1992 covered only insolvency issues as they related to legal entities, not individuals. Moreover, it established excessively complicated procedures. To initiate a bankruptcy process, the total amount of outstanding debt had to exceed the total book value of company’s assets. To avoid being put into bankruptcy, the company’s management could issue sufficient amount of worthless debt to their own company in order to “create” the appearance of solvency. Therefore, creditors had virtually no ability to initiate bankruptcy proceedings unless they had the consent of the current management. In this respect, the law did not provide managers with any ex-ante incentives, and thus had virtually no impact on the investment climate in Russia.

Between 1992 and 1998 several legislative acts related to bankruptcy and creditors rights were approved. They included a new Civil Code (Part I), dated November 30, 1994, a new Criminal Code, dated March 24, 1996, the Law “On the State Registration of Rights to Immovable Property and Related Transactions”, dated July 21, 1997, and the Law “On Executory Procedure”, also dated July 21, 1997 (concerning the enforcement of judicial decisions). During this period of more than five years, Russia’s companies, courts, and tax collectors struggled with the imperfections of the substance and procedure of Russian bankruptcy legislation. The next Bankruptcy Law incorporated some of the lessons learned as a result of this experience.

Bankruptcy Law of 1998

The second bankruptcy law (Federal Act No. 6-FZ) was approved on January 8, 1998. This law significantly changed Russian bankruptcy practices. ‘Between March and June of 1998, 800 claims were submitted to the court (80 cases were rejected). By early November 1998, the number of claims grew to 8,000 cases (10 times its earlier level),

and the arbitration courts appointed over 3,000 external managers. On the whole, according to the Federal Service for Insolvency Affairs (FSIM), in 1998 there were 12,781 claims to recognize debtors as bankrupts, including 4,573 cases on filing of industrial companies bankruptcy (including 1,462 companies under observation proceeding, 4,720 - under external management, 2,006 – under production tenders, and 80 companies reached amicable settlements between creditors and managers)⁵. Table #1 illustrates the significant growth of bankruptcy cases after the 1998 law was issued.

Table #1

Dynamics of bankruptcy trials in Russia, 1993- 1998⁶

Bankruptcy cases	1993	1994	1995	1996	1997	1998
Number of trials	< 100	240	1,108	2,618	5,810*	12,781*
Bankruptcy verdicts	50	N/a	469	1,035	2,600 **	4.747**

* Claims submitted to the arbitration court.

** In 1997 external management was introduced by 850 cases. According to the data as of early November 198, arbitration courts appointed over 3,000 external managers.

Notwithstanding, all the positive trends, the Law of 1998 had several loopholes that allowed assets, during the course of bankruptcy proceedings, either to be hidden or sold to politicians, friends, or to management at less than their fair market value. The new law of 2002 and the separate law governing the insolvency of banks and financial institutions are presumably designed to strengthen the procedural aspects of the insolvency process.

The application of the 1998 law revealed its further weaknesses. First, the law on bankruptcy was an abstract model introduced from the outside. It was not the product of specific Russian economic conditions and law enforcement actions. As a result, adaptation of this law to the practical reality of the new Russian economy became a primary task. Second, a bankruptcy system performs its functions properly only in a well-tuned market economy; the strained Russian economy of the transition period limited the spectrum of this law’s application. Third, the primary accumulation of capital,

⁵ Source: ‘Bankruptcy Procedures in the Conditions of Financial Crisis’, A. Radygin, http://www.iet.ru/trend/05-99/7_e.htm

distribution and re-distribution of the privatized property significantly influences the mechanisms of the bankruptcy legislation. The law of 1998 did not take account of these peculiarities of the Russian economy of that time. Fourth, the application of bankruptcy procedures assumes intrusion into the insolvent company's activities with the goal of making wise decisions in such matters as whether to liquidate or reorganize. The complicated nature of business requires competent and well-qualified approaches. Russia did not accumulate such experience during the soviet years of the planned economy. As a result, frequently the court became the companies' gravedigger issuing verdicts of insolvency; while it was supposed to be the doctor helping companies either to reorganize or to rebuild their financial positions⁷. Table #2 provides an illustration of processing of bankruptcy cases since the approval of the 1998 Law.

The practical result of this Law will be reviewed in Part III.

Table # 2

Processing of Bankruptcy Cases

Year	1998	1999	2000	2001
Opening Balance	4,210	10,171	15,211	21,080
Petitions accepted during the year	8,337	10,933	19,041	37,916
Total considered during the year (1+ 2)	1,2547	21,104	34,252	58,996
Executed during the year	2,628	5,959	10,485	16,194
Ending Balance	9,919	15,145	23,767	42,802
Ending Balance as a percentage of the annual turnover of all petitions (%)	79	72	69	73

Original Source: Arbitrage Statistics 1998-2000, Bulletin of RF Higher Arbitration Court, #3, 2001. Secondary Source: 'Role of Bankruptcy in the Russian Transition Economy': Assessment of Groundlessness of the Bankruptcy Law', Simachev, 2002.

⁶ Sources: Federal Securities Commission, Comments to the RF Law 'On Insolvency (Bankruptcy)', Moscow. 1998; Finansovye Izvestia, 1999, March 2, P. II. http://www.iet.ru/trend/05-99/7_e.htm

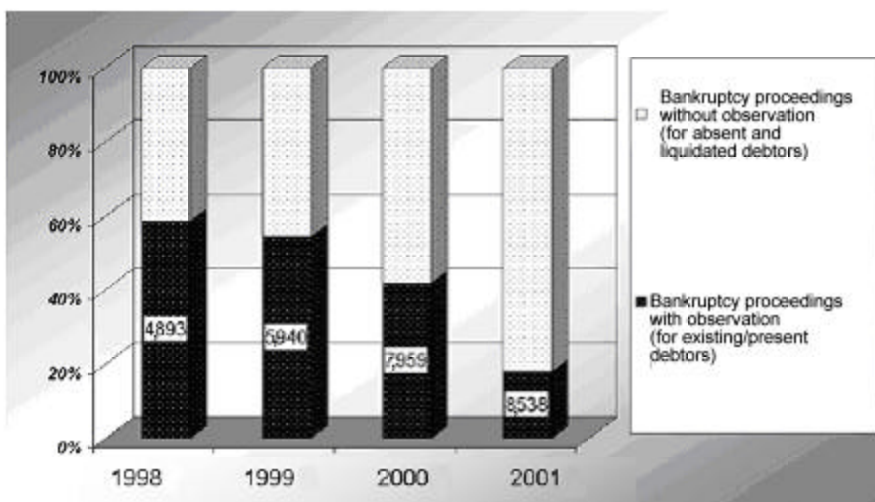
⁷ Sonin, K., Zhuravskaya, E., "Economics and Politics of Russian Bankruptcies" (in Russian), <http://www.nes.ru/~ksonin/interest.htm>.

Part II. Economic Analysis of the 1998 Law, 1998 – 2002

To evaluate the potential performance of the current (2002) bankruptcy law, we start with analysis of the 1998 law. The text of the bankruptcy law enacted in March 1998 matched modern academic standards. The law has allowed any creditor of a company holding a small amount of three-months-overdue debt to file the debtor for bankruptcy. This revision could have been a great improvement over the 1992. It was now possible to bankrupt insolvent companies and, therefore, potentially provide appropriate incentives for managers. However, this potential has not been realized in many instances: large inefficient enterprises were not being liquidated and financial discipline for the managers has not been improving. Frequently, bankruptcy proceedings have not been used to impose greater financial and tax discipline, induce restructuring or redistribute assets to more efficient owners. Instead, many bankruptcies served as a mechanism for redistribution of control rights over enterprises to the regional administrations and for protection of regional managers from federal tax obligations and outside creditor claims. The reason for these shortcomings lies deep in the problem of institution building in an environment with a poor rule of law. In order to understand what was wrong with the 1998 law, one needs to look closely at the procedures specified by the law and how they have been applied.

The 1998 law assumed the following formal procedure. First, a temporary manager, appointed by an arbitration judge, collected information about the claims against the company and organized a creditors meeting, where the creditors decided if they preferred to liquidate or reorganize the company. Second, the judge, taking into consideration the resolution of the creditors meeting, decided for either liquidation or reorganization of the company and appointed an auction manager in the case of liquidation or an external manager in the case of reorganization. The reorganization procedure itself was called an external management procedure. The judge did not necessarily need to follow the creditor's requests on the liquidation/reorganization decision or on personal nominations for bankruptcy managers. Initiation of either procedure removed the existing management from control of the firm unless one of the members of his/her team was appointed as an external manager. Exhibit #1 illustrates the growth of differed kinds of bankruptcy proceedings for the period from 1998 till 2001.

Exhibit #1 Dynamics of Bankruptcy Proceedings

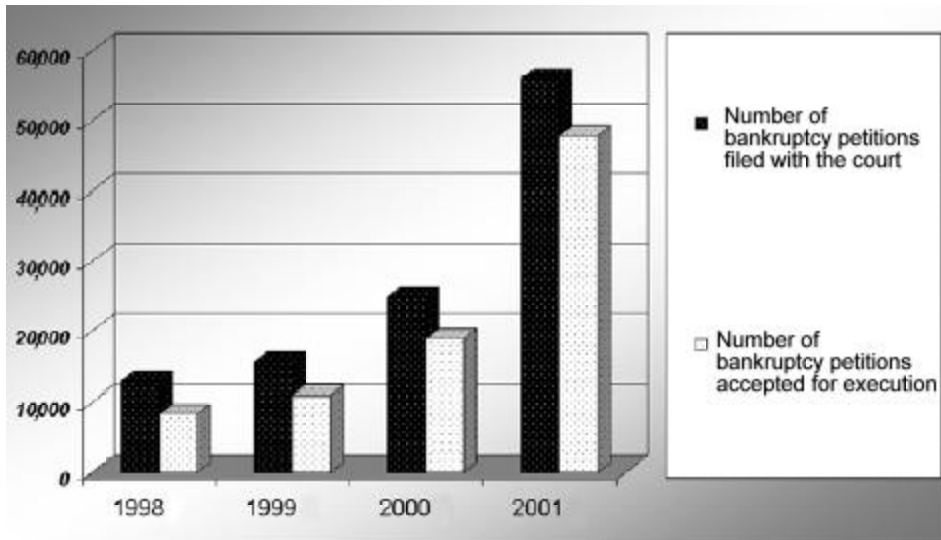


Source for all exhibit in this article: 'Demand for Bankruptcies: Major "Consumers", Motivation, Mechanisms, Results, and Limits, Y. Simachev, 2002.

This law gave a lot of discretion to the arbitration judges because the drafters of the law wanted to avoid any bias in favor of either creditors or debtors in bankruptcy. If the judge acted in the social interest, the Russian bankruptcy law would, on the one hand, have scored very high in creditors protection and, on the other, would not allow inefficient liquidation.

Many experts had predicted that the introduction of this law would cause a flood of bankruptcies. Before 1998 (as there was no bankruptcy pressure), most Russian firms had accumulated large tax arrears to federal and regional authorities as well as to private creditors. Indeed, the number of bankruptcies has dramatically increased since the 1998 law was adopted. See Exhibit #2 below for an illustration of the growth in bankruptcy filings since 1998.

Exhibit #2 Dynamics of Number of Bankruptcy Petitions



Growth in bankruptcy cases has been interpreted by many experts as evidence that budget constraints of Russian enterprises have hardened since the introduction of this law. However, a systematic analysis of the available data suggests that the 1998 law has not served its goals of protecting outside creditors and creating appropriate incentives for managers.⁸ Very often the regional governors in alliance with managers of large regional enterprises used the bankruptcy institution as a mechanism for effective expropriation of assets of the federal government and outside investors.

The mechanism of this expropriation has been based on two components: First, the 1998 law gave a great deal of discretionary power to arbitration judges in decisions about appointments of arbitration (e.g. temporary, liquidation, or external) managers. Second, these arbitration judges have tended to be controlled by regional administrations. Voluminous anecdotal evidence suggests that the decisions of the judges in the regional arbitration courts were often politically captured by the regional governments. According to the Russian legislation, all arbitration courts are in the federal jurisdiction and, thus, supposedly independent of the regional governors. However, the practice diverges from the law: Lack of federal financing of arbitration courts and, the large political and physical distance from the federal center for many jurisdictions make arbitration courts highly dependent on regional politics. Many well-

⁸ See Lambert-Mogiliansky, Sonin, and Zhuravskaya (2000).

publicized examples in the media of regional administrations directly financing regional courts have been reported.

Under the threat of bankruptcy, interests of the managers of large insolvent regional enterprises, on the one hand, and the governors, on the other hand, may become aligned: neither the managers, nor the governors are genuinely interested in restructuring or liquidation. They would generally prefer to pursue the status quo. The managers may offer benefits (in the form of regional tax payments, excessive employment, regional public goods provision, bribes, and other kinds of benefits) to the regional administrations in exchange for protection from losing control in bankruptcy.⁹ As a result, the outside investors and the federal government are not able to force restructuring or liquidation on these enterprises through bankruptcy. The governor can, in exchange for a favor, use his/her influence on the judge to leave the current manager in control. Upon the governor's request, the judge may order an external management procedure, appoint the current manager or someone from his/her team to be an external manager and suspend all the creditor's claims for the period when the firm is in bankruptcy.

Therefore, the following situations have often emerged during the period from 1998 to 2002: the outside creditors were not having their claims to the large regional enterprises treated fairly; the federal government did not receive the federal tax payments that they were due; managers of large regional enterprises were not forced to restructure since they were protected by the regional administration; and the regional administration enjoyed private favors from the managers, inefficiently high employment, and a disproportionate regional share of tax revenues.

The same logic applies to the large regional enterprises, whether they are profitable or unprofitable. The governors would protect only those enterprises from the outside claimants that were worth (to the governors) protecting: the enterprises that have large federal tax obligations (regional administration does not want revenues to

⁹ There are many different mechanisms for managers to provide favors to the regional governors. These favors may come in the form of monetary contributions, barter, political support, etc. A so-called 'governors' off-budget fund', formed in 1997 in Kemerovskaya oblast, can serve as an example of the well-established mechanism for monetary contributions. Each enterprise in the region has been ordered by the governor to make contributions to this fund. According to the Russian nation-wide

leave the region), large cash flows, or are politically important (e.g. have large employment). The interests of the governors most likely do not include much of a consensus of small and medium size enterprises. Thus the bankruptcy pressure is greater for smaller enterprises. Empirical evidence suggests that the alliance between the managers of large enterprises and the regional governors used bankruptcy very effectively to expropriate the assets of both outside investors and the federal government. At the same time, the political interests of the regional administrations does not seem to have affected bankruptcies of small enterprises. In fact, Lambert-Mogiliansky et al (2000) empirical findings show that external management procedures have been initiated in very large enterprises. Differences in size are large both in terms of output and employment. In particular, the mean output for firms with external management is five times greater than the mean output for all firms in the registry of Russian industrial enterprises.

Summing up, the 1998 bankruptcy law was intended to provide creditors with more protection, thus promoting investment. However, the practice of the 1998 law showed that powerful leaders of sub-federal units used their control over the regional judiciary to subvert the procedure: most enterprises that went into bankruptcy in the 1998 – 2002 period ended up in the hands of their regional administration. Though this might be desirable from the standpoint of social efficiency, it departs from economic efficiency. Worst of all, this scenario, once it becomes known to potential investors, leaves such investors with little incentive to invest, and thereby increases the cost of capital for debtors.

newspaper 'Izvestia' (16 September, 1999), the deeply troubled West-Siberian Metallurgy Kombinat (ZapSib) has regularly contributed to this fund while accumulating large federal tax arrears.

Part III. The 2002 Law: Current Bankruptcy System

The Demand for a New Law

As was stated in the Official Explanatory Note¹⁰ to the draft of the new bankruptcy law, the practice of the 1998 Bankruptcy Law clearly indicated inadequate protection of rights and legal interest of different parties participating in the bankruptcy process. It also revealed gaps that allowed the use of the bankruptcy process as a mechanism to eliminate competitors, avoid taxation, and illegitimately redistribute property to favored parties.

As a result, the bankruptcy processes encountered the following major problems:

- Infringement of debtor and debtor-founders' rights. In many instances a bankruptcy petition was filed based on fictitious documents or an insignificant amount of debt without giving the debtor an opportunity to pay such debts.
- Lack of opportunity for debtor-founders to carry out measures to rebuild a company financially under the creditors' control after a bankruptcy petition has been filed.
- Infringement of rights of minority shareholders in bankruptcy procedures.
- Inadequate protection of creditors whose claims are backed by collateral.
- Infringement of rights of the state as a creditor of tax payments.
- Lack of transparency in bankruptcy proceedings.
- Inadequate regulation of bankruptcy procedures such that they allow arbitration managers and other parties to abuse the rights of creditors.
- Sale of debtor assets in favor of the interests of certain creditors and the detriment of others.
- Lack of effective mechanism to call unprincipled arbitration managers to account

This list of the problems that were encountered in the practice of bankruptcy procedures is by no means exhaustive.

¹⁰ Official Explanatory Note to the Draft of the Federal Law 'On Insolvency (Bankruptcy)' (new edition)
<http://www.bankr.tsr.ru/proekt/pojasnit.shtml>

The Law of 2002 has gone through several stages on its way to enactment. It was developed and approved by the Duma; rejected by the Russian President, Vladimir Putin, returned by the President with many amendments; reviewed by the Duma again with most of the amendments made by Putin being adopted, and taken to the President for the second try for his approval. Finally, the Law came into force on October 26, 2002 after almost two years of rigorous debates between many parties involved/interested in the bankruptcy processes.

Provisions of the 2002 Law

Many terms stated in the Russian Law on Bankruptcy either do not have equivalents or do not correspond to the conventional definitions used in the US law. All terms in this article will be defined as they are in the Russian legislation.

Arbitration Courts

The Russian judicial system consists of: the RF Supreme Court, republic supreme courts, okrug¹¹ courts, regional courts, Moscow and Saint Petersburg city courts, autonomous regions' courts, autonomous okrug courts, district (city) courts and military courts. The RF Supreme Court is a higher judicial body dealing with civil, criminal, administrative and other cases considered to be within their authority by general jurisdiction courts supervising their activity.

Bankruptcy cases are tried by the arbitration courts. Arbitration courts are specialized courts for resolving economic, property, and commercial disputes between enterprises. They also consider land and other disputes arising from administrative, financial and other legal relations. Finally, the arbitration courts consider cases involving foreign parties.

The system of arbitration courts is divided into three tiers¹². The first tier is made up of the Federal arbitration courts of the constituent parts of the Russian Federation. These comprise the arbitration courts of the republics, territories, regions, cities with the

¹¹ **Okrug** - territorial division of the Russian Federation for administrative, legal, military etc. purposes; corresponds with English for region, district. Russia has 10 federal okrugs, which were defined by the President of Russia in his decree No. 849 dated May 13, 2000. Each okrug includes several regions (Russia has 89 regions) and defined based on geographical location. These okrugs have been established to strengthen the federal authority in the regions. In the overall, Russia has five territorial layers or administrative divisions. They include: external boundary, 10 federal okrugs, 89 oblasts, about 2,400 rayons (districts), and about 2,400 cities, towns, and others.

¹² The system of arbitration courts in the Russian Federation; <http://www.arbitr.ru/eng/sysac.htm>

federal status (Moscow and Saint Petersburg), autonomous areas, and the autonomous region. They hear cases as courts of first instance and fully re-examine cases on appeal if the decision has not yet come into effect. There are 82 arbitration courts of first instance.

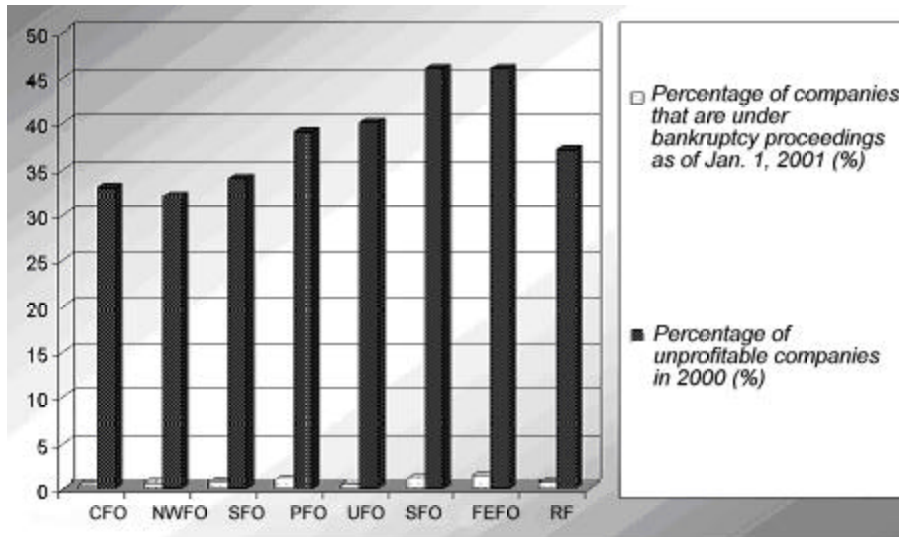
The second tier is formed by 10 Federal district arbitration courts, each of which functions as a court of cassation (second appellate) with regard to a group of arbitration courts making up one court district. These courts of the second appellate review the decisions of the arbitration courts from the viewpoint of due application of the norms of substantive and procedural law. These courts are named on the basis of the names of the okrugs they are located in. They are as follows:

- 1) The Federal Arbitration Court of the Moscow Region,
- 2) The Federal Arbitration Court of the Northern-Western Okrug,
- 3) The Federal Arbitration Court of the Volgo-Vyatka Okrug,
- 4) The Federal Arbitration Court of the East Siberia Okrug,
- 5) The Federal Arbitration Court of the Far East Federal Okrug,
- 6) The Federal Arbitration Court of the West Siberia Okrug
- 7) The Federal Arbitration Court of the Povolzhie Region,
- 8) The Federal Arbitration Court of the North Caucasus Okrug,
- 9) The Federal Arbitration Court of the Ural Okrug,
- 10) The Federal Arbitration Court of the Central Okrug.

The frequency of bankruptcies undertaken in federal okrug during 1998-2002 period depended on the economic development of the particular okrug, availability of natural resources to fight for, existence of companies in strategic industries (f. e. oil and gas industries), power of local regional authorities, and a number of other factors. In many cases, as shown in this article, the regional authorities played a major part in managing bankruptcies to favor their own interests. For an illustration of the Scale of Bankruptcies Proceedings in Federal Okrugs, see Exhibit #3 below.

Exhibit #3

Scale of use of Bankruptcy Proceedings Applied to Companies by Federal Okrugs of Russia



The third tier is represented by the Supreme Arbitration Court of the Russian Federation. The internal procedures of the arbitration courts and interrelations among such courts are regulated by the Rules of Arbitration Courts Procedure endorsed by the Supreme Arbitration Court of the Russian Federation and binding on all the lower arbitration courts.

Bankruptcy Process/Mechanism

In accordance with the 2002 Law insolvency (bankruptcy) refers to a debtor's inability, recognized by an arbitration court, to satisfy fully creditors' claims on pecuniary obligations and/or make mandatory payments.

Russian Bankruptcy Law distinguishes bankruptcy of legal entities from that of individuals. An individual is deemed to be unable to meet the creditors' claims on pecuniary obligations and/or to make mandatory payments if the respective obligations have not been fulfilled for a three-month period and if the amount of his or her obligations exceeds the value of property belonging to him.

A legal entity is deemed to be unable to meet the creditors' claims on pecuniary obligations and/or fulfill the duty of making mandatory payments if the respective

obligations and/or duties have not been fulfilled within three months of the date set for fulfillment thereof ¹³.

An arbitration court may institute a bankruptcy case if claims to an indebted legal entity total at least 100,000 rubles (an equivalent of approximately \$ 3,225¹⁴) and those to an indebted individual, at least 10,000 rubles (an equivalent of approximately \$ 322).

If a debtor is unable to meet the claims on pecuniary obligations, then any of three parties have a right to file a bankruptcy petition: the debtor, a creditor,¹⁵ or the public prosecutor. Table #3 provides an illustration of the structure of bankruptcy petitions by categories of plaintiffs.

Table#3

Structure of bankruptcy petitions by categories of plaintiffs

Category	Number of bankruptcy petitions filed by a particular category as a % of the total number of petitions *		
	1998	1999	2000
Debtor	20 (30)	20(33)	14(25)
Creditors	27(40)	23(39)	19(35)
Tax Authorities	31(0)	38(0)	44(0)
FSFO	16(23)	11(18)	14(26)
Other Authorized Authorities	3(4)	4(7)	7(12)
Prosecutor	2	2	1
Others	3	2	0
Total	100	100	100

* In parentheses the number of petitions excludes petitions filed against absent debtors

Original Source: Arbitrage Statistics 1998-2000, Bulletin of RF Higher Arbitration Court, #3, 2001. Secondary Source: 'Role of Bankruptcy in the Russian Transition Economy': Assessment of Groundlessness of the Bankruptcy Law', Simachev, 2002.

¹³ Article 3 of Bankruptcy Law, 2002

¹⁴ Hereinafter the exchange rate used for calculations is 31 rubles for \$1.

¹⁵ The set of potential initiators of bankruptcy does not include employees of the firm, though they have priority in debt repayment.

To avoid bankruptcy, the debtor must either repay its liabilities, or provide the court with proof that the claims of the creditors, taxing authorities, or other authorized public agencies are unjustified.

Each and every debtor's liabilities (creditors' and tax authorities' claims) will be deemed to be proven if confirmed by an arbitration court decision or by a document indicating that the debtor has recognized the amount. The debtor can contest all other claims. In such cases, the court must determine the validity of the claim. Claims not contested by the debtor are treated as undisputed.

A bankruptcy case must be considered by the arbitration court within seven months from the moment when a bankruptcy petition is filed¹⁶.

If evidence of bankruptcy is not adduced, the arbitration court will refuse to proceed with the bankruptcy filing against the debtor. However, proving evidence of bankruptcy (i.e. the debtor is unable to cover money liabilities in the amount and terms mentioned earlier), does not automatically mean that the debtor will have to be liquidated. Aside from the bankruptcy proceedings implemented in case of the debtor's liquidation, other procedures – such as pretrial adjustment, observation, external management, amicable settlement.

The law recognizes the peculiarities of the Russian economy among legal entities. In particular, it distinguishes bankruptcy cases of town-forming companies, agricultural companies, banks and other credit organizations, insurance companies, firms - professional participants in the securities market. With regard to individuals, the law distinguishes bankruptcies of individuals, individual entrepreneurs, peasant holdings (farms).

Bankruptcy definitions¹⁷

Pretrial readjustment refers to measures taken prior to a bankruptcy filing. The purpose of pretrial readjustment is to restore the debtor's solvency and thereby avoid the bankruptcy proceeding. These measures can be implemented by the owner of property of an indebted unitary enterprise, or by the founders (participants) of an

¹⁶ Article 51, RF Law on Bankruptcy, 2002.

¹⁷ Article 2, RF Law on Bankruptcy, 2002

indebted legal entity, or by the debtor's creditors, and by other persons. This procedure is similar to the U.S. procedure called *informal workout*.

Observation is a bankruptcy procedure applied to a debtor during the time between the bankruptcy filing and the court decision. The purpose of the observation is to protect the creditors rights to the debtor's property (prevent misappropriation) and to perform a financial analysis of a debtor's position. The execution of these tasks is assigned to the *interim arbitration manager* appointed by the arbitration court. At the same time, the debtor's manager is not removed from his or her position and continues to perform his or her usual duties. However, certain transactions, which may lead to the alienation of immovable and other property, may only be executed with the approval of the interim manager.

In general, observation begins upon submission of a bankruptcy application which must be completed before the end of the bankruptcy case hearing in the court. If the court finds a debtor to be insolvent, based on the decision of the first assembly of creditors, the court will either (i) appoint an administrative manager and place the debtor under financial recovery; (ii) appoint an external manager and place the debtor under the external management; (iii) begin bankruptcy proceeding; or (iv) approve an amicable settlement with creditors.

Financial recovery is a bankruptcy procedure applied to a debtor to restore its (his/her) solvency where the authority to manage the debtor's activities has been given to an *administrative arbitration manager*. The ultimate purpose of this procedure is to establish a plan of debt repayment and to repay all debts in accordance with this plan. This is a new addition to the law in comparison with the Law of 1998.

External management is a bankruptcy procedure applied to a debtor to restore its (his/her) solvency where the authority to manage the debtor's activities has been assigned to an *external arbitration manager*. During this proceeding an external manager develops a plan designed to improve the debtor's financial position. This plan might include measures on: changing the debtor's activities profile, closure of unprofitable parts of the debtor's business, factoring of the debtor's claims, partial sales of the debtor's property; satisfaction of claims to the debtor by its founding organization

or a third party; sales of the whole debtor's business, and other measures focused on rebuilding the debtor's solvency.

Amicable settlement is a bankruptcy procedure that can be initiated at any stage of the bankruptcy case with the purpose of closing the case by achieving an agreement between a debtor and its creditors.

Order of priority in satisfying creditors' claims¹⁸

Prior to paying any creditors' claims, first, the following expenses must be paid: legal expenses related to payments of fees to arbitration managers, debts for the use of public utilities, operating expenses, and all creditors' claims that appeared during the observation procedure, external management and bankruptcy proceeding.

Creditors' claims are satisfied in the following order of priority:

- first priority: claims of individuals to whom the debtor caused harm with regard to their lives and health;
- second priority: severance pay to employees and emolument/royalties under author's agreements;
- third priority: creditors' claims secured by the debtor's collateral;
- fourth priority: claims on mandatory payments to the federal and regional budgets, and non-budgetary funds;
- fifth priority: all other claims.

As under U.S. law, the Russian bankruptcy law provides that debtors who go through bankruptcy proceedings would receive a discharge upon the ending of the process if the creditors and the judge agree to do so. That is, their debts are wiped out once the process is complete and they then get a fresh start. The creditors get whatever is available in the bankrupt estate and whatever is left unpaid is discharged.

Arbitration Managers

The central player in all bankruptcy proceedings is the arbitration manager. This term does not correspond to the term used in the US. The closest US term is bankruptcy trustee. An arbitration manager¹⁹ (arbitration manager) is a RF citizen

¹⁸ Article 134, RF Law on Bankruptcy, 2002 and Article #855, RF Civil Code.

¹⁹ Article 2, RF Law on Bankruptcy, 2002

appointed by the arbitration court to carry out other responsibilities specified by the bankruptcy law.

Under the 2002 Law, the requirements of the arbitration manager are approved by the Creditors' Meeting²⁰. The Creditors' Meeting also chooses a self-regulating organization that will present candidates for the position of arbitration manager to the arbitration court. Upon such presentation, the arbitration court approves one of the recommended candidates.

Depending upon the type of the bankruptcy proceeding to which an arbitration manager is assigned, both responsibilities and title vary. The arbitration manager can be an interim manager for the observation proceeding, external manager for the external management proceeding, administrative manager for the financial recovery, or bankruptcy manager for bankruptcy proceeding.

In accordance with the 2002 law, the arbitration manager²¹ must be a citizen of the Russian Federation registered as an individual entrepreneur. To qualify for an arbitration manager, one must:

- Have a higher law or economic education, or an education pertinent to the debtor's business education,
- Have management experience of at least 2 years,
- Have passed a theoretical exam on the program of arbitration managers' education,
- Have had practice as an assistant to an arbitration manager for at least 6 months,
- Have not been charged and found guilty of an economic crime,
- Be a member of one of the self-regulated organizations,

An arbitration manager assigned to a particular proceeding must have management experience in the field pertinent to the debtor's business.

In order to protect the debtor's assets better, the new law provides for obligatory insurance for all arbitration managers. After the arbitration court makes a decision to

²⁰ Article 12, RF Law on Bankruptcy, 2002

²¹ Article 20, RF Law on Bankruptcy, 2002

assign a particular arbitration manager to a bankruptcy proceeding, this arbitration manager must enter into an insurance agreement for at least one year with an obligatory prolongation of the insurance agreement for a second year (if the case continues). Such an insurance agreement represents a form of financial coverage for the arbitration manager's obligations.

The minimum amount of insurance coverage cannot be less than three million rubles a year (an equivalent of about \$95,000). Within ten days from the court appointment to a particular bankruptcy proceeding, an arbitration manager must additionally insure his or her responsibility for financial damage to the debtor. The amount of this insurance depends upon the book value of the debtor's assets in the amount that it was estimated to be before the bankruptcy proceeding was initiated. In particular, this amount of insurance is determined as follows:

- 3% of the debtor's asset book value from 100 million rubles (\$3.22m) to 300 million rubles (\$9.68m).
- 6 million rubles (\$193.5 k) and 2% of the debtor's asset book value from 300 million rubles (\$9.6m) to one billion rubles (\$32.25m).
- 20 million rubles and 1% of the debtor's asset book value exceeding one billion rubles (\$32.25m).

Remuneration²² for the arbitration manager usually includes two parts. For each month of the arbitration manager's work, remuneration is determined at the creditor's meeting and approved by the arbitration court. This remuneration is paid from the debtor's funds. Also, an arbitration manager might receive a bonus that is based on the results of his/her work. This bonus is paid out of the creditors' funds and subject to approval by the arbitration court.

Under the 1998 Law the arbitration managers were given enormous authority, discretion, and responsibility. At the same time they worked under pressing circumstances. Regarding the social security issues, the manager appointed in the bankruptcy case had the same powers as the manager of the debtor organization.

Self-Regulated Organizations of Arbitration Managers

²² Article 26, RF Bankruptcy Law, 2002

The law of 1998 did not have a provision for and/or definition of a self-regulated organization. Prior to 2002, arbitration managers could work on their own and did not have to belong to a self-regulated organization. The law of 2002 brought this concept to life with the goal of providing a better protection of creditors' rights.

A non-profit organization receives the status of a self-regulated organization from the date when it is included in a single state registry of self-regulated organizations of arbitration managers. To be included in a state registry of self-regulated organizations of arbitration managers, a non-profit organization needs to meet the following requirements:

- Have at least 100 members that meet the above listed requirements.
- Have a compensation fund or some asset placed as collateral with a society of mutual insurance. This fund must be formed exclusively in cash by payments from members, with each member contributing at least 50,000 rubles (an equivalent of \$1,333).

A self-regulated organization of arbitration managers carries out the following functions:

- Ensures compliance with the RF legislation by its members
- Protects the rights and legal interests of its members
- Provides information transparency of its members' activities and bankruptcy procedures.
- Assists its members in improving their professional skills

Federal Service for Financial Recovery and Bankruptcy

RF Federal Service for Financial Improvement and Bankruptcy (FSFO²³) is a federal executive authority. It both performs the function of licensing and control of arbitration managers and represents interests of the state during bankruptcy cases. This situation leads to a conflict of interests in this federal body and increases pressure from FSFO on arbitration managers.

²³ This abbreviation corresponds to the Russian abbreviation for consistency purposes

For four years, while the 1998 law was in force, FSFO played a major part in many, if not most, bankruptcy proceedings in Russia. It was blamed by many parties for unfair treatment of debtors and independent arbitration managers. First, it issued a rule about licensing for arbitration managers; according to this rule there were three categories of arbitration manager qualifications. To reach the next level, a manager needed to have training and pass certain qualification exams. Only an arbitration manager of the third (highest) category could manage a bankruptcy proceeding of a socially important enterprise. FSFO, at the same time was responsible for approving the program of training and exams for arbitration managers. Even though there was a rule about the qualification of the third category, no such exam was approved by FSFO. As a result, no arbitration manager could meet the requirements of the third (highest) category. FSFO appointed its own employees to manage bankruptcy proceedings of socially important enterprises. This led to a conflict of interests where the agency responsible for control, was involved in managing actual bankruptcy cases. At a later point, after a court decision about non-constitutional substance of this licensing system, this licensing system was cancelled. After the approval of the 2002 bankruptcy law, the government decided to consider the elimination of this agency and assign the same responsibilities to existing one of the existing ministries. Yet, as this article is being written, this decision has not been made.

Bankruptcy of an Individual²⁴

A bankruptcy petition against an individual debtor can be filed in an arbitration court by an individual debtor, creditor, public prosecutor, and also by a fiscal and other authorized agency. Creditors having claims for compensation for damage caused to the life and health, for recovery of alimony, and other claims of a personal nature, have the right to present their claims can also file a bankruptcy petition. Claims of such creditors not presented during the bankruptcy proceeding remain in force after the completion of the bankruptcy proceeding.

An individual debtor may enclose with his petition a plan for repayment of his debts; its copies are sent to the creditors and other persons participating in the

²⁴ Chapter 12, RF Law on Bankruptcy, 2002; Source for partial translation: 'Bankruptcy in Russia on www.Bankrot.ru', <http://www.bankrot.ru/english.php3?doc1=006025&doc2=094>

bankruptcy case. If the creditors have no objections, the arbitration court may approve the plan of debt repayment, which serves as a ground for suspension of bankruptcy proceedings for a time of not longer than three months. If as a result of fulfillment by the debtor of the debt repayment plan, the creditors' claims have been fully satisfied, the bankruptcy proceedings may be terminated.

With regard to valuing the assets of the individual debtor, the liquidation, and not the going concern value, is applicable. Simultaneously with the receipt of the bankruptcy petition, the arbitration court takes control of the individual's property, except the property against which no recovery may be made under the RF civil procedure. At the individual debtor's request, the arbitration court may release the individual's property to the debtor if a guarantee for the fulfillment of his or her obligations is provided by a third party.

Upon the individual's application, the arbitration court may postpone hearing of the bankruptcy case for not more than a month so that the individual can settle accounts with the creditors or reach an amicable agreement. If within one month, the individual debtor fails to present proof that the creditor's claims have been satisfied and if within this period an amicable agreement has not been reached, then the arbitration court rules to deem the individual bankrupt and open a bankruptcy proceeding. The decision of the arbitration court to deem the individual bankrupt and open a bankruptcy proceeding and the writ of execution against the individual's property is sent to the bailiff-marshal of the court for the sale of the debtor's property. The entire individual debtor's property is subject to a sale, except the property not included in the bankrupt's estate under the Bankruptcy Law.

If management of the individual's immovable property or valuable movable property is necessary, then the arbitration court shall appoint a bankruptcy trustee and determine the amount of his or her remuneration. In this case, the individual's property is sold by the bankruptcy trustee. The money received from the sale of the property is deposited with the arbitration court.

Before satisfaction of creditors' claims, the arbitration court the expenses related to the bankruptcy case are covered.

The creditors' claims are satisfied in the following order of priority:

- first, claims of the individuals are satisfied to whom the individual debtor responsible for having caused harm to their life and health, as well as claims for recovery of alimony;
- second, settlements are made to pay severance wages and remuneration of labor to persons working under a labor agreement, including under a contract, and to pay royalties under author's agreements;
- third, all other creditors' claims in the order of priority described above.

Claims of each priority are satisfied after those of the preceding priority have been fully satisfied. If the monetary funds are insufficient to satisfy all claims, they are distributed among the creditors of the respective priority proportionally to amounts of their allowed claims.

After settlements with the creditors have been completed an individual debtor is discharged from fulfillment of creditors' claims presented during the procedure. Creditors' claims for compensation for harm caused to the life and health, claims for recovery of alimony, as well as claims of a personal nature not satisfied in executing the decision of the arbitration court remain in force and may be presented after the completion of proceedings.

A bankruptcy case may not be instituted for the second time upon an individual's petition during five years after he was deemed bankrupt. If an individual is deemed bankrupt for the second time when so petitioned by a creditor, a fiscal or other authorized agency in connection with claims relating to mandatory payments during five years after the completion of settlements with the creditors, the individual is not discharged from further fulfillment of creditors' claims.

Bankruptcy of Credit Institutions

The bankruptcy of banks and other credit organizations is conducted in accordance with the Federal Law on Insolvency (Bankruptcy) of Credit Institutions, #40-FZ, dated February 25, 1999, amended in January 2, 2000.

The norms of the Law on Insolvency, however, apply by default in the absence of specific rules. When the bankruptcy procedures of banking and other credit organizations were regulated by the former Law on Insolvency of Enterprises, the specifics of establishing and monitoring the activity of credit organizations were not yet

formulated. Insolvency (bankruptcy) of a credit institution is deemed to result from its inability as recognized by the Arbitration Court to satisfy in full creditors' claims with respect to monetary obligations and/or to perform its obligation to make mandatory payments (hereinafter referred to as bankruptcy).

A credit institution will be deemed unable to satisfy creditors' claims with respect to monetary obligations and/or to meet an obligation to make mandatory payments if it failed to meet the corresponding obligations within one month from their due date.

To prevent bankruptcy of credit institutions the following measure can be implemented:

- 1) Financial readjustment of the credit institution;
- 2) Appointment of provisional administration to manage the credit institution
- 3) Reorganization of the credit institution.

Part IV. Law of 2002 versus Law of 1998

The overall impact of 2002 law on bankruptcies efficiency is as yet unclear. On the one hand, the new procedure is more transparent and leaves less room for subversion. In particular, the Law of 2002 contains a number of technical provisions aimed at increasing transparency and making the manipulation of the proceeding more difficult. Specifically, the new law provides a detailed blueprint for an arbitration manager . These and some other technical provisions reduce the likelihood that minor creditors will be exploited by the larger ones. Also, a takeover by a powerful but less efficient agent is less likely. On the other hand, the proceeding becomes more costly for creditors, and this can deter investment and result in an increase in the cost of capital.

Goskomstat²⁵ data show that in 2000, 37 percent of all industrial enterprises in Russia were losing money, while bankruptcy proceedings were initiated against 0.67 percent of all industrial enterprises. That is only 1.8 percent of loss-plagued enterprises were involve in bankruptcy proceedings. Lambert-Mogiliansky et al (2000) show that in 1998-1999 many industrial firms did not go into bankruptcy and yet had worse performance compared to the firms that went into external management: 30.7 percent of firms had higher costs per ruble of output and 47.7 percent of firms had lower labor productivity than the median firm where external management was imposed.

The same study showed that firms under external management were distributed unevenly across industries.²⁶ About 80 percent of externally managed firms' outputs is produced by firms just in three industries: oil and gas (54.5 percent), chemical (9.4 percent), and ferrous metallurgy (16.5 percent). The output of all firms in these industries accounted for 30 percent of total industrial output. Furthermore, firms under external management produced 24 percent of the output in the oil and gas industry. At the same time, liquidation proceedings are most frequent in light industries. Almost half of all liquidation proceedings were initiated in logging (21 percent), wood-working (16 percent), and textiles (7 percent). (Totally, 15 percent of all industrial firms operate in these industries.) Industries in which external management proceedings are more frequent are the best performing in terms of cash flows and technical efficiency.

²⁵ State Statistics Committee

²⁶ Lambert-Mogiliansky et al (2000) database covers more 80 percent of Russian industrial output.

An important problem of the in 1998 law in actual practice was subversion of arbitration courts by regional administrations. In this respect, the 2002 law improves upon the 1998 version, since it gives arbitration courts less discretion, and provides a more formal description of the procedures. At the same time, a broad federalist system reform implemented by the Russian government in 2000-2001 has significantly increased the power of the federal center, and thus reduced the governors' abilities to influence regional branches of arbitration courts. Since regional capture has been a significant source of inefficiency, that bankruptcy proceedings are expected to become more efficient.

The role of the provision that arbitration managers must be members of a self-regulated organization is as yet unclear, since a law defining the scope and rules by which self-regulated organizations operate is still to be approved by the Parliament.

As described above, the new bankruptcy law requires arbitration managers to enter into an insurance agreement that covers his/her activity. Some economists argue that this new provision will not actually work as intended. The problem is that enforcement of the insurance contracts is likely to be as inefficient as enforcement of the bankruptcy law provisions themselves, including those that prohibit an arbitration manager from stripping assets from the company. This in turn, does not allow insurance companies to provide coverage for a reasonable price. While the new Bankruptcy Law obliges arbitration managers to purchase insurance, the insurance contracts will probably often be fabricated.

A major change is the new role for government in bankruptcy proceedings. In Russia, the government, both at the federal and regional level, is a major creditor in most bankruptcy cases. Under the 1998 law, the government representatives voted in the first creditors' meetings, and did not participate in the subsequent creditors meeting. In exchange, the government claims had priority over claims of commercial creditors. The 2002 Law removes this priority status, but makes the government more active participant: specifically, government's representative vote at all creditors meetings, including the one that specify requirements for the arbitration manager.

Conclusion

Having adopted the third law on bankruptcy since the Soviet times, Russia is not settled with regard the development of its bankruptcy law. With all these legislation developments and internal country factors influencing the situation, the Russian bankruptcy system is far from being efficient. It does not provide a mechanism for effective managers to take over non-performing companies, but rather it opens doors to various kinds of inappropriate use of rights and responsibilities of parties involved in bankruptcy. In many instances it even leads to fraud.

In a market economy, bankruptcy laws are supposed to solve most important problems of corporate governance: they provide appropriate incentives for managers, release assets from an inefficient use, and secures rights of creditors, thus promoting investment.

As research of 1998 law application indicated, this law has not served its goals of protecting outside creditors and creating appropriate incentives for managers. Instead, it catalyzed the fights of various political and commercial forces involved in bankruptcies. This law also engendered countless cases of illegal bankruptcies. Among illegal bankruptcies, bankruptcies upon request appeared to be major ones. Bankruptcy proceedings were initiated not to rebuild the debtor's position or repay claims to creditors but to rearrange property from weaker in political sense parties to stronger ones. Many enterprises that needed restructuring were not restructured, while a number of efficient firms were allegedly taken over by politically powerful rivals. This became possible as the current Russian legal system is faulted by the political capture of regional divisions of Arbitration courts by the regional governors.

In several regions Russia governors have subverted the institution of bankruptcy. Rather than pursuing a goal of creating healthy financial environment in their regions by enforcing the law, in a fear of loosing their power, governors influenced the course of bankruptcy proceedings. At the same time, evidence is known where oligarchs bribed judges and captured significant plants and companies by buying them at a price well below their market value.

With all the intent to improve the existing situation, the new law (Law of 2002) is, however, unlikely to change the system sufficiently. The new provisions for insurance of arbitration managers and creation of self-regulated organizations of arbitration managers continued to leave room for the capture of bankruptcy cases by those parties that can afford to purchase such insurance. Many of the existing professional arbitration managers will not be able to afford significant insurance coverage. The effect of the provision that gave the federal government a right to vote in the Creditors Meeting is yet to be seen. This might lead to an appropriate use of responsibilities by government official, or it might not. Time will tell.

A supposedly balanced provisions of the new, 2002 Law, under the absence of the rule of law have transformed into a law that allows regional governors in alliance with the incumbent managers of the large regional enterprises to leave other claim-holders unsatisfied. In particular, outside creditors, even the major ones, like the large Moscow banks and the federal government, have no legal mechanism for collecting their claims. The political dependence of Arbitration courts on regional governments harms prospects of Russian economy for restructuring, investment, and solving budgetary problems independently of the world oil price.

At the same time, the approval of the new law indicates that the Russian Government acknowledges the existing problems with the bankruptcy legislation and practice. Continued revisions, amendments, and improvements of the law do take place in Russia. This gives a hope that eventually Russian will become a more predictable economy where the rights of creditors and investors will be protected by a stable reliable law.

Appendix: A Case Study²⁷
Bankruptcy Case of Tomsk Petrochemical Plant (TPP)
(Russian Name: Tomsk Neftehimichvsky Kombinat)

Description of the Situation

Primary activities: TPP is one of the largest producers of petrochemical products in Russia. The plant, located in the City of Tomsk, Western Siberia, is classified among the socially important enterprises. It has two production cycles: production of methanol and production of polypropylene. The plant began its operation in 1986 with imported equipment valued at approximately \$100m. TPP employs 6,000 people.

Ownership:

- 67.94% of the stock belongs to "Apparat Upravleniya' Corporation (83% of this company belongs to State Company 'Siberia Chemical Plant' that is under the RF Ministry On Nuclear Energy jurisdiction)
- 20% belongs to "Eastern Oil Company" Corporation
- 12.06% belongs to other shareholders (each holds less than 1%).

Observation procedure started in March of 1997.

The External management proceeding started on July 11, 1997 and continued for 1.5 years. On March 12, 1999, the external management proceeding was prolonged for one year based on the petition of the Administration of Tomsk oblast. In December of 2000 the external management was prolonged on the Tomsk oblast Administration bail

The Arbitration Manager was changed four times. The first two arbitration managers represented interests of State Company 'Siberia Chemical Plant' (see relationship to this company above). The last two arbitration managers represented interests of Tomsk oblast Administration, large creditors and suppliers. (They were 'Siberia Ural Oil-Gas Company' Corporation and 'EastGasProduction' Corporation).

²⁷ This case was also provided in the manuscript of one of the co-authors of this article: 'Capture Of Bankruptcy: Theory And Evidence From Russia', Ariane Lambert-Mogiliansky, Konstantin Sonin and Ekaterina Zhuravskaya, 2002

Creditors' Claims as of March 30, 2001

Creditors	Amount (in thousands of dollars)
I turn	0
II turn	0
III turn	0
IV turn	84,541
V turn	193,863
Total	278,404

Source: Minutes of Creditors' Meeting dated 03/30/2001 and Report of External Manager

During the period of external management the current accounts payable increased from 528.1 mln rubles to 2.352.5 mln of rubles. The accounts payable that are due for repayment by 2004 total 2,114.03 mln of rubles.

TPP's Financial position

There were two evaluations on the financial position of the company. These evaluations were arrived at by Tomsk oblast Administration and FSFO in September-November of 2000. The opinions contained in these two documents differ radically; this reflects the attitude Tomsk oblast Administration and FSFO to the TPP's financial position.

FSFO Opinion (evaluation dated 09/28/2000): The value of net TPP's assets was positive. It decreased by 90 times over the period 07/01/97 to 01/01/00. During the same period the debt security decreased by 3 times. In 1999, the payments using bills and barter led to exhaustion of funds from Tomsk Petrochemical Plant's turnover. The cash payments accounted only for 4% in 1999, and for 1% - during the first six months of 2000. The absence of cash was compensated by bills issues. As of 04/01/2000 the obligations on bills totaled 951 mln. rubles.

Balance Sheet Structure

Period	Change in Accounts Payable, (%)	Change on Accounts Receivable, (%)	Coefficient of Current Liquidity	Losses from Operations, (K of rubles)
1997	+30	-45		615,353
1998	+75	+45	0.2	1,376,360
1999	+22	+45	0.23	1,680,877
First 6 months of 2000	-53	+31	0.39	1,556,606

FSFO's Conclusion: The bills-barter payments led to the exhaustion of TPP's own funds.

Position of Tomsk oblast Administration: The value of the company's assets increased by 19.8% during 1999 and by 10.4% during the first six months of 2000 and totaled 2,550 mln rubles. This was due to the increase of accounts receivable and inventory. In 1999 the TPP's working capital increased by 107.9% and during the first six months of 2000 it increased by 33.9%. From 01/01/97 until 01/01/00 the long-term debt was constantly increasing in the structure of borrowed funds. It increased from 15.2% of the total borrowed funds to 95.1%.

The losses from operations resulted from the instability of raw materials supply under ceaseless production that does not allow for a conservation of raw materials. The dynamics of output in 2000 in natural units is positive. The accounts receivable turnover was increasing and the accounts payable turnover was decreasing (a positive factor). The coefficient of coverage of all obligations by liquid assets increased from 0.3 (as of 01/01/99) to 0.72 during the first six month of 2000. The yield of capital investments was increasing.

Conclusion: There are positive trends in the payments structure. This leads to a hope that obligations to creditors will eventually be paid off.

Order of Events

1997: TPP and its Subsidiary 'TPP-4' that is engaged in polymers production (the TPP's ownership in TPP-4 accounts for 70%) started experiencing financial difficulties. The

debts for salary and budgetary payments were increasing. The Federal State Unitary Company 'Siberia Chemical Plant' (SCP) bought a controlling interest and portion of debts in TPP using funds allocated by the state for the conversion of military production. SCP asserts that it spent the following

- 115,188 K rubles to buy a controlling interest in TPP,
- 28,976 K of rubles for a purchase of TPP's bills,
- 66,100 K of rubles for a purchase of 10% in TPP-4.

1998-1999: The external management proceeding was started at TPP. The external arbitration manager undertook asset restructuring. To repay a debt, the methanol production was transferred to 'EstGasProduction' Corporation – the main supplier of TPP. The polymers production was allocated to TPP-4, TPP's subsidiary.

12/30/1999: On Tomsk oblast Administration's advice, 'Sibur' Corporation and 'EastGasProduction' Corporation came to TPP to 'feed' it with funds.

January of 2000: SCP places its own stock and its share in TPP and TPP-4 with 'Alliance Group' Corporation for a short-term management.

02/14/2000: Alliance Group' Corporation initiated the signing of an amicable settlement. This action met a preliminary approval of FSFO and Ministry of Taxes. However, the Tomsk oblast Administration objected this. The case got dragged out and did not make it to the arbitration court.

10/19/2000: By the arrangement of the external arbitration manager, the assets for polymers production got transferred to a subsidiary, 19.4% of which belonged to "Sibur" Corporation.

10/20/2000 The Tomsk Oblast Administration concluded a general cooperation agreement for the period of the TPP's external management. This agreement was signed by the Head of the Tomsk Oblast Administration, President of 'Sibur' Oil Corporation, and the external arbitration manager of TPP. .

12/18/2000: The TPP's external manager was dismissed for his professional misconduct. An employee of Tomsk oblast FSFO was appointed as a new external arbitration manager. "Eastern Oil Company" Corporation was excluded from the creditors lists by an order of the previous arbitration manager.

December of 2000: The external management was prolonged on the Tomsk oblast' Administration bail.

03/11/2001: The assistant to the arbitration manager was appointed. This assistant represented the interests of 'Sibur' Corporation and Tomsk Oblatst Administration.

03/30/2001: With the approval from Tomsk oblast' administration, the external arbitration manager concluded an agreement on bringing the managing company 'Sibur' Corporation to the external management of TPP. The agreement stated that the managing company had the right for to a short-term management agreement with regard to the TPP's property. In exchange for this, 'Sibur' Corporation commits to repay debts to 'VostokGasProduction'. As such, Sibur' has to repay the debts to itself, and to a company of which it is a subsidiary.

04/20/200: FSFO sought to cancel the agreement with the managing company as it is in conflict with the legislation.

04/23/2001: The external arbitration manager request to be relieve of his responsibilities at TPP. A new external arbitration manager was appointed. He was concerned with the Tomsk oblast' administration and "Sibur' Corporation. Prior to this appointment he was an assistant to the previous external arbitration manager

04/25/2001: The court observation action was brought against the arbitration manager that represented interests of FSFO.

06/13/2001: FSFO issued an order to the external arbitration manager to vacate his office due to the absence of the license of the third category²⁸ that gives a right to manage socially important companies.

Result: Confrontation of FSFO, TPP, 'Alliance Group' Corporation, and the Ministry of Nuclear Energy on one side and Tomsk oblast' Administration, 'Sibur' Corporation, and 'EastGasProduction' Corporation on the other side goes on. The Parties carry on negotiations to regulate mutual claims.

Discussion of the Case

The Law of 1998 provided arbitration judges with substantial discretion over the fate of an enterprise. At the same time, the existing federalist mechanisms have not been providing arbitration judges with appropriate incentives. Governors in alliance with

firms' management have used their influence to affect judicial decisions at the local level, while outside investors (e.g. Moscow banks and foreign investors) have employed their political connections at the federal level. Consequently, many bankruptcy cases have been characterized by a large number of court decisions contradicting each other. Often a court of a higher tier issues a decision that is contradictory to a decision of a court of lower tier (see the court system in Part III). The case of Tomsk Petrochemical Plant illustrates the confusion that takes place during bankruptcy proceeding in Russia. During the first year of bankruptcy, the arbitration manager was replaced four times! Both regional administration and outside creditors tried to pursue their own interests that of course were in conflict. Yet, there was little or no concern about the financial position of the debtor.

Addressing the question of how the bankruptcy conducted according to the new 2002 Law, little would have been changed. First, the new law (is intended to) provide arbitration managers with less possibilities to strip assets from the firm. So, incentives to have 'own' arbitration manager are lower than under the 1998 Law. Second, the state now has its say on all the creditors meetings.

References

Laws

1. Federal law On Insolvency (Bankruptcy) of Enterprises,. 'Vedomosti S'ezda Narodnykh Deputatov Verkhovnogo Soveta R.F'. (1993) No. 1, item 6.
2. Federal law On Insolvency (Bankruptcy), No. 6-FZ, January 8, 1998, Sobranie zakonodatelstva R.F. (1998) No. 2, item 222.
3. Federal Law On Insolvency (Bankruptcy) No. 127-FZ, October 26, 2002, <http://www.msk.arbitr.ru/doc/85181/85181-002.htm>
4. Federal Law on Insolvency (Bankruptcy) of Credit Institutions, #40-FZ, dated February 25, 1999, amended in January 2, 2000.
5. President Decree No. 849 dated May 13, 2000.

Articles, Manuscripts

1. 'Role of Bankruptcy in the Russian Transition Economy': Assessment of Groundlessness of the Bankruptcy Law' " (in Russian), Simachev, 2002; <http://www.icss.ac.ru/materials/old13.pdf>.
2. Sonin, K., Zhuravskaya, E., 'Economics and Politics of Russian Bankruptcies' (in Russian), <http://www.nes.ru/~ksonin/interest.htm>.
3. Federal Securities Commission, Comments to the RF Law "On Insolvency (Bankruptcy)", Moscow, 1998; Finansovye Izvestia, 1999, March 2, P. II. http://www.iet.ru/trend/05-99/7_e.htm.
4. 'Demand for Bankruptcies: Major 'Consumers', Motivation, Mechanisms, Results, and Limits, " (in Russian), Y. Simachev, 2002, <http://www.icss.ac.ru/materials/new23.pdf>.
5. Official Explanatory Note to the Draft of the Federal Law 'On Insolvency (Bankruptcy)' (new edition) <http://www.bankr.tsr.ru/proekt/pojasnit.shtml>.
6. Arbitrage Statistics 1998-2000, Bulletin of RF Higher Arbitration Court, #3, 1999.
7. 'Capture Of Bankruptcy: Theory And Evidence From Russia', Ariane Lambert-Mogiliansky, Konstantin Sonin And Ekaterina Zhuravskaya, 2002.
8. The system of arbitration courts in the Russian Federation, <http://www.arbitr.ru/eng/sysac.htm>.
9. 'Development of the Russian Law on Insolvency (Bankruptcy) and Practice of its Application', V. Vitryansky (in Russian), Bulletin of RF Higher Arbitration Court, #3, 2001, <http://www.vestnik-vas.ru/statfree.asp?ID=377>.
10. Insolvency (Bankruptcy): Historical Aspect, V. Yudin (in Russian), Bulletin of RF Higher Arbitration Court, #3, 2001 <http://www.vestnik-vas.ru/statfree.asp?ID=987>

11. Paper on 'Bankruptcy: Law and Legal Practice', <http://bankr.tsr.ru/referats/praktika.shtm.l>
12. 'The Economics of Bankruptcy Reform, Journal of Law, Economics, and Organization', 8, 523-46, Aghion, P., Hart, O., and Moore, J., 1992.
13. 'Relative Capture of Local and Central Governments', Bardhan, P. and Mookherjee, D., 2000.
14. 'The Post-Soviet Russian Economic System: An Industrial Feudalism', Ericson, R., 2001.
15. 'Difference Approaches to Bankruptcy', HIER Discussion Paper, Hart, O., 2000.
16. 'Seize the State, Seize the Day: An Empirical Analysis of State Capture and Corruption in Transition', Hellman, J., Jones, G., and Kaufmann, D., 2000.