The Journal of Comparative Economic Studies, Vol. 1, 2005, pp. 59-78.

The Development and Performance of the Bankruptcy System in Contemporary Russia[1]

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Abstract: This paper investigates the working of the Russian bankruptcy system. The Russian bankruptcy system does not succeed in accelerating the withdrawal of inefficient enterprises from the market or reinforcing payment discipline. However, this is not entirely due to the faults of the bankruptcy system. A large share of debt owed to the state and the large influence of the state as an owner of strategic enterprises seriously distort a functioning of the bankruptcy system. Besides, the high rate of loss-making enterprises and the resistance of regional governments make the bankruptcy system difficult to work more effectively. Although these conditions are basically originated in state control of the economy under the Soviet Union, the Russian government also deliberately exploits its position as a creditor or an owner in relation to a lot of enterprises. All these conditions are characteristics peculiar to Russia, than common to transition countries.

Keywords: Russia, Transition, Bankruptcy system

JEL Classification Numbers: K49, P52

1. Introduction

An important institution in market economies, the bankruptcy system is expected to promote the withdrawal of inefficient companies from markets, redistribute assets from inefficient to efficient companies, and improve corporate governance by spurring the replacement of poorly performing managers.

At the micro-economic level, bankruptcy performs the fundamental functions of necessitating financial discipline, making risk more predicable for creditors and protecting creditors' rights. As going concerns, companies are not usually threatened by bankruptcy, but investors and managers must always consider the risk/possibility of bankruptcy as the final stage of the life of a company.

Bankruptcy systems vary widely between societies, even in defining their central terms. For example, in Japan, the term 'business failure' is commonly used to denote a critical state of financial distress. A debtor is banned from conducting banking transactions for failing to honor promissory notes twice within six months. Such suspensions of banking privileges are insurmountable obstacles to doing business, and generally lead to voluntary arrangements between 'failed businesses' and

creditors.[2]

In contrast, insolvency in contemporary Russia, with its short recent history of market economy, is mainly resolved through legal proceedings, with one law governing all procedures relating to rehabilitation and liquidation.[3] Under Russian law, the term 'insolvency' is defined as synonymous with 'bankruptcy' (Gavrilova, 2003, pp. 27-28). This paper uses the terms synonymously.

Generally, a key decision to be made in all bankruptcy proceedings is whether to attempt to rehabilitate a bankrupt business or to repay its creditors by liquidating the business. There are no clear, common criteria by which viable companies can be distinguished from nonviable ones. Hence, bankruptcy systems in different countries vary between those that are creditor-oriented and rehabilitation-oriented. The Russian bankruptcy system can also be seen from this perspective. However, this paper mainly examines the Russian bankruptcy system from a viewpoint how it is actually working.

In transition economies, the study of the development and performance of the bankruptcy system is important in two respects.

First, the overall inefficiency of enterprises under the socialist system was closely related to the absence of a threat of liquidation/bankruptcy, which, in turn, derived from the paternalism of the socialist state. J. Kornai developed 'economics of shortage' which explained the nature of the planned economy in terms of the 'soft budget constraint' (Kornai, 1980). In this context, the development of the bankruptcy system can be regarded as an important barometer of the establishment of the market economy.

Second, the existence of a great number of potentially insolvent enterprises in the early stage of transition required their restructuring. This process should be stimulated through the bankruptcy system as well as through privatization.

The comparison of bankruptcy systems between transition economies is helpful in understanding the Russian bankruptcy system as one of the issue inherent in transitions. There are several studies on bankruptcy systems in Central and East European countries.[4] However, they differ by period, angle of analysis and so on, and further investigation is required.

As it is usually understood, the Russian bankruptcy system developed in three stages shaped by the adoption of three pivotal laws, as follows:[5]

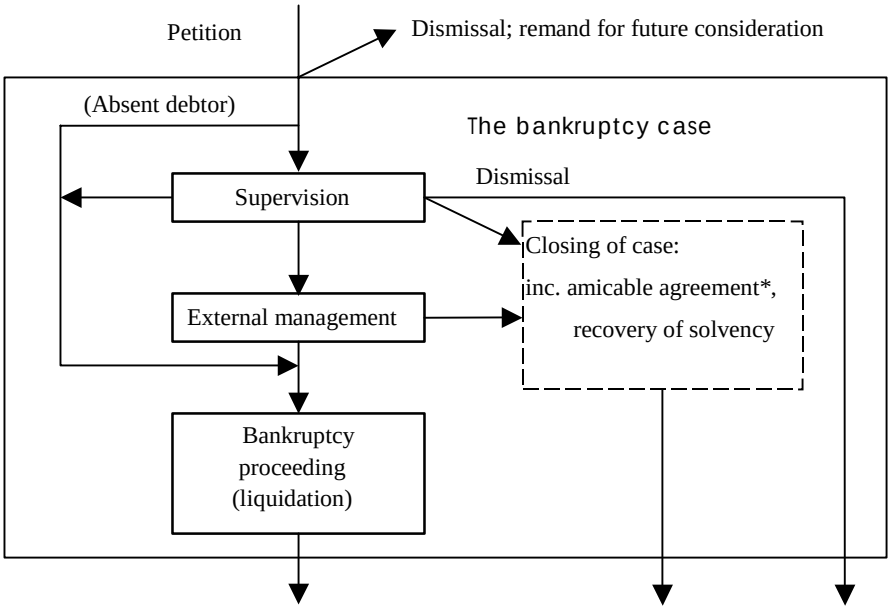
1) The first stage (1993-1997), which began with the adoption of the Federal Law 'On Insolvency (Bankruptcy) of Enterprises' (No. 3929-1 from 1992.11.19; hereafter the '92 law), which went into effect on 1993.1.8.
2) The second stage (1998-2002), which began with the adoption of the Federal Law 'On Insolvency (Bankruptcy)' (No. 6-FZ from 1998.1.8; hereafter the '98 law), which went into effect on 1998.3.1.
3) The third stage (2003 to present), which began with the adoption of the Federal Law 'On Insolvency (Bankruptcy)' (No. 127-FZ from 2002.10.26; hereafter the '02 law), which went into

effect on 2002.12.3.

Flowcharts of bankruptcy proceedings under the ’98 and ’02 laws are presented in Figures 1 and 2, respectively.

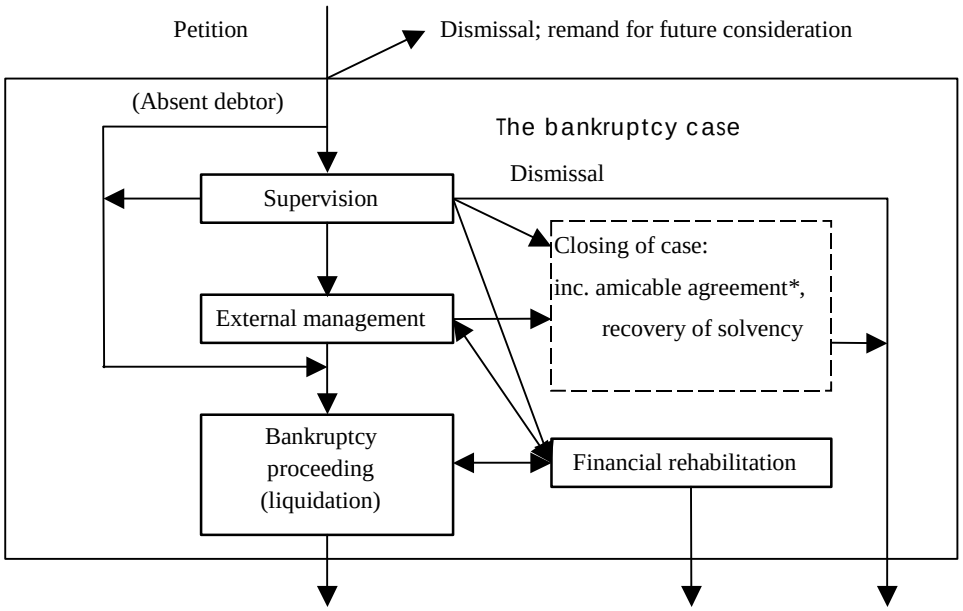
After briefing the development of the bankruptcy system under the first and second stages in the next section, I consider arguments under the second stage in Section 3, pointing to related amendments in the ’02 law. Section 4 presents new tendencies in the third stage. Finally, I conclude with a brief overall assessment of the Russian bankruptcy system.

Figure 1 Flowchart of bankruptcy proceedings under the ’98 law



* Amicable agreement: cases closed by negotiated voluntary settlement

Figure 2 Flowchart of bankruptcy proceedings under the ’02 law



* Amicable agreement: cases closed by negotiated voluntary settlement

2. Characteristics of the first stage and the second stage

2.1. The first stage

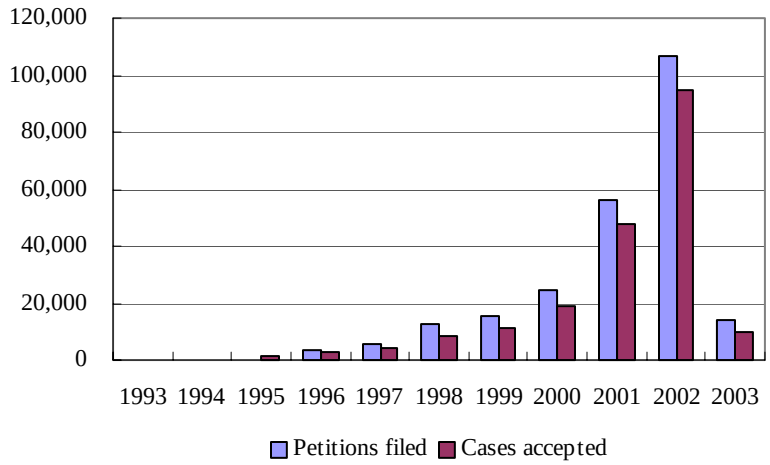
During the 1990s, the Russian economy experienced a sharp decline in output and consequently the financial performance of numerous enterprises deteriorated. As shown in Table 1, the rate of enterprises/organizations suffering losses temporarily exceeded 50%, and the level remains high. Under the ’92 bankruptcy law, however, bankruptcy proceedings were not very common, although a rise in the number of cases is evident from 1995 to 1997 (Figure 3).

Table 1 Annual share of organizations operating at a loss (%)

1992	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
15.3	32.5	34.2	50.6	50.1	53.2	40.8	39.8	37.9	43.5	41.3

Sources: Federal’naya Sluzhba Gosudarstvennoi Statistiki, *Rossiya v Tsifrakh*, 2003, p. 300, 2004, p. 333.

Figure 3 Annual petitions filed and cases accepted



Sources: *Bulletin of the Federal Service of Russia on Financial Rehabilitation and Bankruptcy, Bulletin of the Higher Arbitration Court of Russian Federation*. (various issues)

A number of factors impaired the development of the bankruptcy system under the '92 law, where the criterion of insolvency is that the amount of an enterprise's debt must exceed the total value of its assets according to its balance sheet. On the one hand, enterprises' difficulties in adapting to the new accounting system, hyperinflation, widespread arrears, and barter transactions by the mid-1990s made precise valuations of asserts difficult. On the other hand, enterprises could easily manipulate their balance sheets, enhancing the value of their assets by accumulating accounts receivable or book debits (thus, it was possible to stimulate arrears). As a result, balance sheets did not offer a sound basis for determining insolvency.[6] Moreover, even if enterprises did draw up forthright balance sheets, creditors had no easy means to gain access to them. The courts too were fundamentally limited in their ability to evaluate financial reporting, and this resulted in long delays before debtors could be declared legally bankrupt.

With the widespread recognition that the criterion of insolvency under the '92 law inhibited the development of an effective bankruptcy system, the '98 law offered a fundamentally different definition of insolvency. Under the '98 law, enterprises were deemed insolvent if they were unable to honor obligations to creditors for three months upon the maturity of such obligations, when the obligations amounted to 500 times the minimum statutory monthly wage or more. Because the minimum statutory monthly wage was set at a very low level,[7] almost every enterprise in Russia was thus in danger of bankruptcy under the '98 law.

2.2. The second stage

On the ground that the ’92 law could not have met the needs of bankruptcy, the ’98 bankruptcy law was enacted, with the result that bankruptcy proceedings became much more common. As shown in Figure 3, which shows petitions filed and cases accepted annually, the numbers rose sharply from 1998 to 2002. In 2001, the numbers of petitions and cases accepted show 125% and 151% increases, respectively (Table 2).

As shown in Table 3, petitions initiated by tax authorities in particular rose sharply during the second period. This suggests that tax authorities employed the bankruptcy system to pursue problematic tax arrears. Asserting that one purpose of petitions for bankruptcy is to threaten bad-faith debtors, A. Pochinok, the Minister for Taxation at that time, declared that bankruptcy petitions would be used for this purpose (*Vedomosti*, 1 March, 2000). In response, V. Yakovlev, the chairman of the Higher Arbitration Court at that time, said ‘the tax authorities could not distinguish petitions for bankruptcy from petitions to enforce debt collection’ (*Ekonomika i Zhizn’*, No. 25 (8823), 2000). In aggregate, petitions initiated by all state authorities in 2002 peaked at 85% of the total of all petitions.

Table 2 Trends in bankruptcy proceedings

	1998	1999	Growth in 1999 (%)	2000	Growth in 2000 (%)	2001	Growth in 2001 (%)	2002	Growth in 2002 (%)	2003	Growth in 2003 (%)
Petitions filed	12,781	15,583	21.9	24,874	59.6	55,934	124.9	106,647	90.7	14,277	-86.6
Cases accepted	8,337	10,933	31.9	19,041	74.2	47,762	150.8	94,531	97.9	9,695	-89.7
External managements	2,001	2,737	36.8	3,051	11.5	2,973	-2.6	2,696	-9.3	2,081	-22.8
Recoveries of solvency	69	66		50		52		21		28	
Ratio of recovery of solvency to external managements (%)	3.4	2.4		1.6		1.7		0.8		1.3	
Bankruptcy proceedings (liquidations)	4,747	8,299	74.8	15,143	82.5	38,386	153.5	82,341	114.5	17,081	-79.3
Unitary state enterprises	122	159	30.3	215	35.2	395	83.7	643	62.8	511	-20.5
Unitary municipal enterprises	145	283	95.2	336	18.7	498	48.2	1,055	111.8	623	-40.9

	1998	1999	Growth in 1999 (%)	2000	Growth in 2000 (%)	2001	Growth in 2001 (%)	2002	Growth in 2002 (%)	2003	Growth in 2003 (%)
Dismissals under supervision	135	235	74.1	246	4.7	258	4.9	241	-6.6	688	185.5
Amicable agreements	241	643		747		785		403		170	
Ratio of amicable agreement to closing cases (%)	9.2	10.8		7.1		4.1		0.9		0.3	
Petitions, complaints and claims	7,861	11,269	43.4	15,763	39.9	17,041	8.1	22,696	33.2	53,610	136.2
About dismissals of receiver										3,213	
About the sizes of creditors' claim										33,057	
Closing cases	2,628	5,959	126.8	10,485	76.0	18,993	81.1	44,424	133.9	56,440	27.0

Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 4, 2004, pp. 35-36.

Table 3 Annual breakdown of petitions by type of petitioner

number (percent of total)

	1998	1999	2000	2001	2002
Debtors	2,530(20)	3,097(20)	3,476(14)	4,654(8)	4,925(4)
Creditors	3,409(27)	3,622(24)	4,836(19)	5,608(10)	7,325(7)
Tax authorities	3,917(32)	5,922(39)	10,865(44)	37,767(68)	87,634(79)
FSFR*	1,983(16)	1,660(11)	3,603(14)	6,613(12)	5,526(5)
Other authorities	373(3)	645(4)	1,729(7)	866(2)	702(1)
Procuratorial authorities	202(2)	336(2)	365(1)	426(1)	535(0)
Total number of petitions	12,414	15,282	24,874	55,934	110,647

* Federal Service of Russia on Financial Rehabilitation and Bankruptcy

Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003.

Table 4 shows the types of subject petitions. The share of petitions for absent debtors rose steeply, from 9% of all petitions in 1998 to 76% in 2002. Even though a summary procedure is to be applied to bankruptcy for absent debtors, the '98 law was criticized for affording wide latitude to tax authorities to burden the arbitration courts and bankruptcy system.

Table 4 Annual breakdown of petitions by type of subject

	1998	1999	2000	2001	2002
City-forming organizations	151	116	56	36	57
Agricultural organizations	408	416	783	1,442	2,551
Insurance organizations	31	27	30	41	32
Participants in securities market	21	21	11	7	5
Individual entrepreneurs	124	148	197	700	1,180
Peasants (farmers)	44	79	256	616	2,128
Liquidating debtors	825	1,391	1,690	2,602	3,288
Absent debtors	1,177	3,216	9,351	34,764	81,251
(percent of all petitions)	(9)	(21)	(38)	(62)	(76)
Total number of petitions	12,414	15,282	24,874	55,934	106,647

Sources: *Bulletin of the Higher Arbitration Court of Russian Fedezation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003.

Table 5 Annual results of supervision

number (percent of total decisions)

	1998	1999	2000	2001	2002
Decisions	3,200(100)	5,938(100)	7,156(100)	8,412(100)	9,224(100)
Decisions to impose bankruptcy proceeding (liquidation)	1,896(59)	3,584(60)	4,776(67)	6,155(73)	7,292(79)
Decisions to dismiss	135(4)	235(4)	246(3)	258(3)	241(3)
Decisions to impose external management	699(22)	1,065(18)	996(14)	1,110(13)	931(10)
Decisions to close case	421(13)	925(16)	1,068(15)	835(10)	508(6)

Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003.

Now we consider the outcomes of each proceeding during this stage. Table 5 shows the results of supervision. The share of decisions resulting in bankruptcy proceeding (liquidation) rose continually to reach nearly 80% in 2002, whereas the share of decisions resulting in the imposition of external management declined steadily. The absolute number of 'amicable agreements'—cases closed by negotiated voluntary settlement—fell with its relative share of the total from 1999.

Table 6 Annual results of external management

number (percent of total decisions)

	1998	1999	2000	2001	2002
Decisions	695(100)	1,523(100)	2,135(100)	1,922(100)	1,695(100)
Decisions to impose bankruptcy proceeding (liquidation)	339(49)	514(34)	907(42)	929(48)	996(59)
Decisions to extend external management	321(46)	897(59)	1093(51)	808(42)	671(40)
Decisions to close case	141(20)	294(19)	397(19)	376(20)	171(10)
Amicable agreements	46(7)	197(13)	296(14)	324(20)	121(7)
Recoveries of solvency	69(10)	66(4)	50(2)	52(3)	21(1)

Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003.

Table 7 Annual results of bankruptcy proceeding (liquidation)

number (percent of total decisions)

	1998	1999	2000	2001	2002
Decisions	1,479(100)	5,818(100)	12,325(100)	22,752(100)	51,250(100)
Amicable agreements	46(3)	71(1)	84(1)	111(0)	137(0)
Decisions to extend bankruptcy proceeding (liquidation)	293(20)	1,862(32)	4,018(33)	6,644(29)	11,540(23)
Completed cases	1,140(77)	3,885(67)	8,223(67)	15,997(70)	39,573(77)

Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003.

Following decisions in external management (Table 6), the most likely final outcome for debtor-enterprises was bankruptcy proceeding (liquidation). Moreover, the share of such final outcomes increased throughout the period. While decisions to extend external management

represented a significant share of the total, the share of such decisions dropped from 59% in 1999 to 40% in 2002. Remarkably, the rapid drop of 'amicable agreement' in 2002 occurred after the gradual increase over four years. Ultimate recoveries of solvency also declined, for five years. Although external management proceeding was intended to rehabilitate debtor-enterprises, the clear conclusion to be drawn from actual outcomes during this stage was that they usually did not succeed.

Table 7 shows that majority (67%-77%) of bankruptcy proceedings (liquidations) ended with liquidation of assets and repayment of creditors. Extensions of proceedings declined slightly from 2000 to 2002, and cases reached 'amicable agreement' represent a small share of cases overall.

3. Some arguments under the second stage

3.1. The position of creditors

It is important here to distinguish debtor-creditor relations with relations between creditors.

In respect of debtor-creditor relations, the low barrier to petition for bankruptcy was mainly blamed for giving unequally strong power to creditors under the '98 law. However, the source of such problem was more complex: the '98 law permitted a single creditor with a small claim to initiate bankruptcy proceedings. Moreover, the arbitration courts were required to open bankruptcy cases immediately after accepting a petition. This left little room for debtors to defend themselves from accusations of insolvency.[8]

Under the '02 law, creditors are required to file petitions with documentary proof of their collection efforts, and debtors have ten days to submit documents in their own defense. Such measures in the '02 law set remarkably strict the conditions for opening bankruptcy proceedings.

When we turn to the relation between creditors, the '98 law is also ambiguous.

In many cases, the choice of receiver (particularly of the temporary receiver, who was appointed before the first creditors' meeting) was strongly influenced by particular creditors. Close relationships between receivers and creditors gave rise to high-handedness on the part of creditors. Such relationships made it difficult to guarantee equality between creditors. Conflicts arose wherein the claims of certain creditors were not recognized, or creditors were unable to attend creditors' meetings because of improper notification.[9] Under the '02 law, creditors can, in principal, propose candidates not for the receiver but for a 'Self-Regulated Organization', from which the court appoints a receiver.

A number of studies have shown that the process of concentration of ownership since the late 1990's has the character of a 'hostile takeover'.[10] In contrast to the law on joint-stock company, which has developed to restrict hostile takeovers, the law on bankruptcy provided more latitude, and this led to the widespread use of bankruptcy as an inexpensive means to acquire enterprises and their assets. This point was a main inducement to enact the '02 law. G. Gref, the Minister of Economic Development and Trade, remarked that 'today's bankruptcy procedure is not a mechanism to

co-ordinate the interests of the different parties involved in a case, but rather serves as a mechanism for bad-faith participants in the process to redistribute ownership' (Vasil'ev, Drobyshev and Konov, 2002, p. 9). According to T. Trefilova, the head of Federal Service of Russia on Financial Rehabilitation and Bankruptcy (hereafter FSFR), up to two-thirds of bankruptcy cases in the second stage were undertaken for the purpose of transferring ownership (*Nezavisimaya Gazeta*, special edition, 28 September, 2001).

3.2. The position of the state

In general, states are responsible for macro-economic policy to ensure the effectiveness of the bankruptcy system. In transition economies, states may also be creditors, as well as owners.

In Russia, the state plays a major role as a creditor with the tax and other obligatory payment arrears it is owed. At the end of 2002, the state held 59% of delinquent debt in the timber, woodworking and pulp-and-paper industries, 52% in light industry, and 49% in the machine manufacturing industry (Federal'naya Cluzhba Gosudarstvennoi Statistiki, *Rossiya v Tsifrakh 2004*, pp. 342-343). One analysis has shown that the state could have filed bankruptcy petitions for almost half of all enterprises in 2000 (Simachev, 2003a, pp. 122-123). But the behavior of the Russian state was not transparent and systematic in regard to tax arrears and bankruptcy under the '98 law. In fact, it would have been impossible for the state to act against all debtor-enterprises with sufficient arrears to justify a bankruptcy petition, although in individual cases the state can threaten debtor-enterprises with bankruptcy for collection purposes. This situation lowered the predictability of bankruptcy, and perhaps represented an obstacle to outside financing for enterprises.

Under the '98 law, the state had no vote at creditors' meetings, but at the same time, the claims of the state had priority over those of other creditors in bankruptcy proceeding (liquidation). The state's priority tended to discourage other creditors from petitioning for bankruptcy or, moreover, motivate creditors to remove assets from debtor-enterprises under bankruptcy proceedings, which the state's lack of a vote allowed them to do.

The '02 law made the state equal to other creditors both in the priority of its claims and its voice in creditors' meetings. Nonetheless, the potential for bad-faith and corruption concerning state authorities remains strong in the course of bankruptcy proceedings, because, for one thing, the claims of the state for tax arrears require no special certification and it remains easy for the state to file a bankruptcy petition, and for another, the state gets voting rights in creditors' meetings.

The role of the state as an owner was also problematic. To begin with, even though the number of state-owned enterprises comprised only 4% of the total, the state could exert its influence more frequently on enterprises, for the share of the state (and municipal) ownership in fixed assets still reached 40% in 2004 (Federal'naya Cluzhba Gosudarstvennoi Statistiki, *Rossiiskii Statisticheskii Ezhegodnik 2004*, p. 321).

State-owned enterprises complained of a lack of concern and understanding on the part of state

authorities for the enterprises' business.

In addition, there is also room for arbitrary selection by the state for enterprises to be bankrupted. For example, the federal law 'On Peculiarity of Insolvency (Bankruptcy) for Subjects of Natural Monopoly of the Fuel-energy Complex' gave the rigorous criterion of insolvency only to such complex, which revealed the criticism to be unfair.[11]

Chapter 9 in the '02 law defines the peculiarity of certain categories of debtors including city-forming organizations, strategic enterprises, and subjects of natural monopoly. It lessens the different treatment accorded enterprises in these 'peculiar' categories. Yet there are some clauses to restrain bankruptcy or liquidation, and in 2004 the government determined 1,131 enterprises as strategic enterprises, 591 of which were unitary state enterprises, 494 of which—joint stock companies, where the state took part in.

3.3. The resistance of regional governments to bankruptcy

Central to this issue is that if a debtor-enterprise has an economically and politically significant impact on its region, and in particularly, if the budget of its region is highly dependent on the enterprise, then the interests of the regional government coincide with those of the debtor-enterprise in the avoidance of liquidation. This intention of regional government was supported by arbitration courts which take the final decision on such matters as opening bankruptcy proceedings, imposing external management or bankruptcy proceeding (liquidation). The most important thing was the dependence of judges on regional governments which derives from several factors, including the financing of judges' salaries from the regional budget.[12] Control of regional arbitration courts enabled regional governors and enterprise managers to ignore the rights of creditors.

The provisions of the bankruptcy law governing so-called 'city-forming organizations' contribute for impeding the liquidation of inefficient debtor-enterprises. Under the '98 law, enterprises are recognized as 'city-forming organizations' if the number of workers and their workers' family constitutes 50% or more of the total inhabitants in the residential area concerned, or if their total number of workers exceeds five thousand.[13] Bankruptcies of such 'city-forming organizations' are governed by peculiar provisions, in view of the significant influence of such organizations on employment and other social factors affecting the well-being of the community in which the enterprise is located; specifically, such a debtor-enterprise can receive guarantees from regional or federal government, and if it does so, the period of external management imposed on its enterprise could be prolonged up to a maximum of ten years.[14] Such cases totaled 47 enterprises in 2000 and 31 enterprises in 2001.

4. New tendencies in the third stage

4.1. Changes in the third stage

As mentioned above, the '02 law brought about significant changes in the Russian bankruptcy system. The following subsections discuss other aspects of the third stage in the development of the Russian bankruptcy system.

'Self-Regulated Organization'

Under the '98 law, receivers were chosen by the arbitration courts based on a list of candidates submitted by creditors. FSFR was required to approve receivers as well as organize their training. Under a receiver licensing scheme set up by FSFR, for instance, a receiver holding a license of the lowest level category defined in the scheme could be appointed only in cases involving small or absent debtor-enterprises. Given the low stakes in such cases, FSFR devised this category simply to deal with the backlog of absent debtor cases (Simachev, 2003a, pp. 147-148). No receivers were licensed in the third, highest category defined under the scheme until the end of October 2001 and the number of licensed receivers in this category remained small thereafter, leading to the criticism that the state was using the scheme to maintain control of large enterprises. This scheme was abolished in June 2002, prior to the adoption of the '02 law.[15]

Under the new law, 'Self-Regulated Organizations' (hereafter SROs) are responsible for overseeing the activities of their member-receivers. Receivers are required to be members of a SRO, and the activities of SROs are registered with and monitored by Ministry of Justice.[16]

Enlargement of possibilities for enterprise rehabilitation

The '02 law provides a new 'financial rehabilitation' proceeding for bankrupt enterprises. In this proceeding, enterprises undergoing rehabilitation begin repaying creditors according to a 'recovery deferral plan' supported by insurance and financing from state, bank, creditors, or third party sources. Enterprises can elect to begin this proceeding at any point in the bankruptcy proceedings. Even if a creditors' meeting produces a decision not to petition for rehabilitation but rather for the imposition of external management or bankruptcy proceeding (liquidation), the court takes the enterprises prospects for financial rehabilitation into consideration, if the founders (participants) of the enterprise elect to begin this proceeding.

With regard to the controversial argument of additional stock issue,[17] the '02 law also provides management with the right to issue new stock under supervision, and also provides external management receivers with the right to include new stock issue in the external management plan aimed at restoring solvency.[18] These provisions of the '02 law can be understood as an enlargement of the possible measures for rehabilitating enterprises.

State initiatives

A significant repositioning of the state with regard to the bankruptcy system has occurred after the enactment of the '02 law in December 2002.

These changes led to clearer definitions and descriptions of the roles of a creditor, an owner and a regulator. As for the function of a creditor, the decision to petition for the bankruptcy of large enterprises was made by the government (or Prime Minister), and for other enterprises by FSFR. Basically, the sate was represented as an owner by Ministry of Property, and its function as a regulator was performed by FSFR.

Finally, functions of Ministry of Taxation, to which most functions of FSFR were transferred, and of Ministry of Property have been concentrated into Ministry of Economic Development and Trade (hereafter MEDT), which indicates the growing influence of MEDT on the bankruptcy system.

Since June 2004, the state has not in practice submitted petitions for bankruptcy. A series of new acts now being prepared by the government are intended to prescribe the functions of the state as creditor—including petitioning procedures, the selection of SRO, and voting procedures—more clearly. According to MEDT, the state will immediately present ten thousand petitions for bankruptcy once these new acts go into effect.

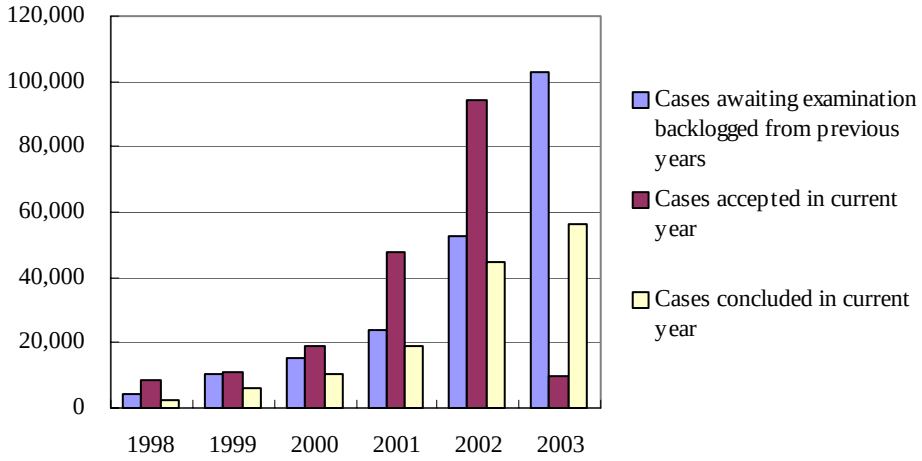
4.2. Results

Although more than two years have passed since the enactment of the '02 law, official data published in the Bulletin of the Higher Arbitration Court are available only through 2003 and these are far less detailed than in previous years. Moreover, because of the growth of backlogged cases (Figure 4), a large number of cases left over from the second stage were included in the 2003 data. Furthermore, as discussed above, a radical structural reform of the government was undertaken well after the enactment of the '02 law, with significant effects on the function of bankruptcy system. Accordingly, it is too early to assess the third stage in general.

Nonetheless, the 2003 data reveal certain recent trends.

First, as shown in Table 2, the number of petitions for bankruptcy declined shapely from 2002 (106,647) to 2003 (14,277; 13% of the 2002 level). This decline is explained mainly by the provision under the '02 law specifying that bankruptcy proceedings could be opened for absent debtors only if resources were allocated for such proceedings in the budget; yet no resources were allocated in the 2003 budget (nor were they so allocated in the 2004 budget).[19] However, bankruptcy proceedings for absent debtors may soon be resumed, on the grounds that the authorities have no other means for coping with the problem of absent debtors. The chairman of the Higher Arbitration Court described the present situation as 'the calm before the storm' (*Bulletin of the Higher Arbitration Court*, No. 4, 2004, p. 8).

Figure 4 Dynamics of backlogged cases by year



Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003, No. 4, 2004.

Second, as shown in Table 8, the number of petitions not involving absent debtors also dropped sharply from 2002 (25,396) to 2003 (12,277; 48% of the 2002 level). It may be partly explained by that the condition for opening bankruptcy proceedings has been strictly redefined under the '02 law.

Judging from these data not involving absent debtors, it is likely that the absolute number of petitions for purposes of 'redistributing ownership' have decreased. G. Gref, the Minister of MEDT, highly evaluated the present situation, pointing that 'the new bankruptcy law has essentially improved the situation in the field of bankruptcy and this mechanism ceased being an instrument for criminal redistribution of ownership'.[20] However, if the obstacle to petition lies simply in complicated formalities, petitions filed by creditors may increase in future.

Another marked change in the third stage is the growth of almost 36% in petitions, complaints, and claims from 2002 (22,696) to 2003 (53,610) (Table 2). Yet 62% of petitions, complaints, and claims are about the sizes of creditors' claims, indicating that a clear rule of the central problem ensuring the creditors' rights has not been established yet.

The declining share of enterprises on which external management was imposed of the accepted cases not involving absent debtors (Table 8, K) is no less significant a trend. The ratio of 'amicable agreements' to closing cases also decreased, to 0.3% (Table 2). Only 28 cases in which external management was imposed (1.3%) ended with the recovery of solvency. Moreover, the new 'financial rehabilitation' proceeding was applied in only 10 cases.[21]

Table 8 Annual numbers of petitions and cases not involving absent debtors

		1998	1999	2000	2001	2002	2003
A	Absent debtors	1,177	3,216	9,351	34,764	81,251	2,000*
B	Petitions filed	12,781	15,583	24,874	55,934	106,647	14,277
C	Filed petitions not involving absent debtors (B-A)	11,604	12,367	15,523	21,170	25,396	12,277
D	Growth rate over the previous year (%)		6.6	25.5	36.4	20.0	-51.7
E	External managements	2,001	2,737	3,051	2,973	2,696	2,081
F	Bankruptcy proceedings (liquidations)	4,747	8,299	15,143	38,386	82,341	17,081
G	Dismissals	135	235	246	258	241	688
H	Amicable agreements	241	643	747	785	403	170
I	Total cases (E+F+G+H)	7,124	11,914	19,187	42,402	85,681	20,020
J	Cases not involving absent debtors (I-A)	5,947	8,698	9,836	7,638	4,430	18,020
K	Percentage of external managements of cases not involving absent debtors (E/J*100)	34	32	31	39	61	12

* *Bulletin of the Higher Arbitration Court of Russian Federation*, 2004, No. 4, p. 8 (in round number).

Sources: *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 3, 1999, No. 3, 2000, No. 4, 2001, No. 4, 2002, No. 4, 2003, No. 4, 2004. (author's calculation)

As mentioned before (4.1.), the '02 law offers more possibilities for enterprises to rehabilitate at the initiative of debtor-enterprise management or its owners (stockholders). One factor behind the changes in the law toward to rehabilitation-oriented one was strong criticism of the '98 law inclined to liquidation, to the effect that it enabled bankruptcy for purposes of 'redistributing ownership' at the expense of managers' and/or owners' rights. However, the Russian reality shows that the likelihood of enterprises rehabilitating successfully small.[22]

5. Conclusion

An elaborate bankruptcy system functioning within a market economy has already developed in Russia. However, this system has far not performed the main function expected of bankruptcy systems in market economies. It does not succeed in accelerating the withdrawal of inefficient

enterprises from the market or reinforcing payment discipline. Considering the high ratio of enterprises operating at a loss to all enterprises (Table 1), bankruptcy cases are still exceptional in Russia. Besides, even though most cases ended in liquidation, the liquidation of large enterprises that have a major influence on the regional budget is prone to be avoided.

However, these problems are not entirely due to the faults of the bankruptcy system itself. The following conditions distort a functioning of the bankruptcy system.

First, the state remains a major creditor owed a large share of all debt, suggesting that paternalism of the state still exists to some extent. At the same time, it allows broad latitude to the state to petition for bankruptcy selectively.

Second, the state as an owner maintains control over enterprises which have a great importance for the national strategy. City-forming enterprises have also unique socio-economic features that preclude the straightforward application of the bankruptcy law to them. The future of these enterprises should be discussed within a wider framework such as the establishment of a social safety net or the desirable industrial structure.

What is more, the high rate of enterprises operating at a loss and the resistance of regional governments also make the bankruptcy system difficult to work more effectively.

In the sense that most of conditions mentioned above are originated in state control of the economy under the Soviet Union, transitional features of the economy from planned to market-oriented remain. However, they are not so evident at least for Central European countries such as Hungary, Poland and Czech Republics,[23] and the Russian government also deliberately exploits its position as a creditor or an owner in relation to a lot of enterprises. Therefore, it can be concluded that these may be characteristics peculiar to Russia, than common to transition countries.

Nonetheless, it should not be overlooked that there also remain problems within the legislations and institutions concerning the bankruptcy system.

Notes

[1] Thanks are due to Mr. Yu. Simachev for providing drafts of unpublished work. I also acknowledge useful comments from a reviewer.

[2] Nearly two-thirds of business failures in Japan are resolved by private procedures. However, as a result of new legislation, the share of formal proceedings of the total has grown in recent years.

[3] Such laws as the Civil Code, the Arbitration Procedural Code, and the Criminal Code play a role in cases involving insolvency. Moreover, bankruptcies of credit organizations are governed by the Federal Law ‘On Insolvency (Bankruptcy) of Credit Organizations’ (No. 40-FZ 1999.2.25), and bankruptcies of fuel-energy enterprises by the Federal Law ‘On Peculiarity of Insolvency (Bankruptcy) for Subjects of Natural Monopoly of the Fuel-Energy Complex’ (No. 122-FZ 1999.6.24). Due to special provisions on natural monopoly entered into force on 1 January 2005,

the latter was abolished.

[4] See, for example, Bonin and Schaffer (1999), Lizal (2002) and Kowalski *et al.* (2003).

[5] However, this study is not closely concerned with the peculiarities of bankruptcies in credit organizations, agricultural organizations, and organizations in other sectors with special status. For more on bankruptcy proceedings under the '98 and '02 laws, see my previous studies, Fujiwara (2001) and Fujiwara (2003). French bankruptcy law served as a model in the drafting of the '92 law. Although the German bankruptcy law influenced the '98 law, the '98 law had no clear model. The debates leading to the '02 law were driven to a significant extent by conflict between Ministry of Economic Development and Trade and Federal Service of Russia on Financial Rehabilitation.

[6] In this regard, ironically, the failure of the bankruptcy system to develop in this stage was not entirely negative.

[7] The minimum statutory monthly wage was about 15 dollars at the end of 2001.

[8] See Article 56 of the '98 law. On 12 March 2001, the Constitutional Court declared this article unconstitutional, pointing out that it did not sufficiently guarantee the rights of debtors.

[9] In order to avoid conflicts of the latter sort, the '02 law contains a special article (13) that specifies a clear notification procedure. Nevertheless, as discussed below, the size of creditor's claims remains a source of conflict.

[10] See, for example, Simachev (2003b, p. 69).

[11] For example, business conversions were not permitted for such enterprises, and the imposition of external management could be prolonged for up to five years.

[12] For more on this point, see Zhuravskaya and Sonin (2004). The authors examine a 'hypothesis of political capture'.

[13] Under the '02 law, the city-forming organization has been redefined as an enterprise, the number of workers of which constitutes no less than 25% of the working population of the concerned residential area, or an enterprise, the number of workers of which exceeds five thousand.

[14] The period of external management specified by the law for other enterprises was twelve months. If the local government guaranteed, the extension of external management was permitted up to one year.

[15] The scheme was interpreted to contrary to the Federal Law 'On Licensing of Individual Activities', the Civil Code and the Constitution. See Medvedeva, Timofeev and Ykhnin (2003, p. 166).

[16] The first SROs were established with the enactment of the '02 law. The number of SROs was raised from 18 in December 2002 to 38 in August 2004. Control over SROs was transferred from FSFR to Ministry of Justice in March 2003.

[17] Under the '98 law there was no clause that defined this procedure. In principle, the right to issue new stock had been given only to a general meeting of stockholders. Nevertheless, 'Leninglradskii Metallurgicheskii Zavod' made the precedent of additional stock issue in bankrupt enterprises.

[18] Article 114 of the '02 law specifies that stockholders have the right of first refusal.

[19] The Government Decree of 21 October 2004 defined the procedure of financing bankruptcy cases of absent debtors.

[20] www.finmarket.ru/20050120 (29 January 2005)

[21] This figure is from *Bulletin of the Higher Arbitration Court of Russian Federation*, No. 4, 2004, p. 8.

[22] Although the reason that rehabilitation is not a common case is unclear, Radygin *et al.* argued that the abilities of debtor-enterprise management and/or owners were overestimated. See Radygin *et al.* (2005).

[23] See, for example, Bonin and Schaffer (1999), Lizal (2002) and Kowalski *et al.* (2003).

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