

**RUSSIAN BANKRUPTCY LAW:
A FAILED OLIGARCH ATTEMPT**
(Russian Bankruptcy Law)

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INTRODUCTION

Privatization, together with macroeconomic stabilization, liberalization and development of market supporting institutions, is a prerequisite to transform planned economy to market economy.¹ The first post-socialist Russian government moved swiftly to start unprecedented privatization process to rescue itself from remnants of planned economy. However, from very beginning Russian privatization was extremely controversial because of limited competition, refusing foreign bidders to participate in process, and accumulation of immense wealth in hands of the few.

Starting with Russian privatization, the paper primarily concentrates on the Russian Law on Insolvency (Bankruptcy) as a tool designed by federal government-oligarch cooperation to grab hold of control over newly privatized regional insolvent enterprises. The central argument of the paper claims that adoption of biased Bankruptcy Law as an attempt to promote interests of federal government-oligarch coalition in regions failed due to strong regional governor-judge alliance.

In light of the argument, the paper starts with inspection of privatization in Russia. In this section two different privatization schemes – voucher and “loans for shares” – is discussed and the winners emerged after each privatization scheme is identified. In the second section the clashing interests and tensions between the emerged actors is analyzed. The actors are federal government, local governments (governors), newly privatized insolvent enterprises, commercial courts and Oligarchs. While disposing the interaction amongst afore-listed actors the overlapping interests of federal government and oligarchs against those of local governors is scrutinized deeply. The next section discusses specificities of 1998 Russian Bankruptcy Law making room for hostile takeovers in regions whilst promoting interests of the oligarchs. In the last part of the paper specific reasons behind failure of the Bankruptcy Law in the regions is exposed with a focus on rapprochement of local court judges and

¹ Islam Shafiqul, *Making Markets: Economic Transformation in Eastern Europe and the Post-Socialist States*. Council on Foreign Relations Press, 1993.

regional governors in containment of the oligarch attempt to control regional business.

PRIVATIZATION

The process of privatization in Russia began in mid-1991 when President Yeltsin signed the Privatization Law that created the State Property Committee (GKI) to manage transfer of state assets into private ownership. Anatoly Chubais, a young politician, was appointed by Yeltsin to lead the GKI.² Beyond doubt the Committee played utmost role in key issues as identifying pool of enterprises to be privatized, defining technical parameters to participate in auctions, and most importantly assigning auction management rights to companies. Many believe that weren't the controversial decisions of the Committee in place, famous Russian Oligarchs wouldn't be such a big phenomena attracting so much academic and journalistic attention.

Privatization of state owned enterprises in developed countries, by and large, is realized primarily through one company at a time auctions. Countries facing the transition from centrally planned to market economies had thousands of state owned enterprises to be privatized in short period of time, thus, one at a time cash auctions could not meet the shock therapists' schedule, and delayed auctions would raise the transaction costs as well.

Within first two years of "Big Bang" privatization program 14 000 medium and small state enterprises, 20 per cent of Russian industry, were transformed into joint-stock companies³ and in next two years around 40 million Russians owned shares in more than 15 000 medium and small scale enterprises.⁴ Already by mid 1995 more than half of 240 000 Russian enterprises had been privatized and the private sector employed nearly 80 per cent of the nation's non-agrarian workforce. Appealing to experience of the Eastern European transitory

2 "Anatoly Borisovich Chubais was a Russian politician best known for his role in Russian privatization and the creation of Russian oligarchs. Although the exact amount of his personal wealth is not known, he is often considered to be an oligarch himself. The 2004 survey by Price-Waterhouse Coopers and Financial Times named him the world's 54th most respected business leader. He is current head of UES (The Unified Energy System), Russia's state energy monopoly." "Anatoly Chubais", *Wikipedia*; For more information see, "Russian Privatization", *International Management Case Study*.

3 For more detailed information see Karla Hoff, Joseph E. Stiglitz, "After the Big Bang? Obstacles to the Emergence of the Rule of Law in Post-communist Societies", *The American Economic Review*, Vol 94, No.3. (June 2004). pp. 753-763; Roman Frydman, Katharina Pistor and Andrzej Rapaczynski, "Exit and Voice after Mass Privatization: The Case of Russia", *European Economic Review*, 40(3-5). (April 1996). pp. 581-588.

4 *Ibid.*.

countries first round of privatization in Russian was done through voucher privatization.

VOUCHER PRIVATIZATION: INSOLVENT ENTERPRISES MUSHROOMED

Well aware of imperativeness of the pace of privatization, the Russian government, inspired from its Czech peer, initiated the process as early as 1992. This stage of privatization transferred 51 per cent of shares to workers and managers of the company, while remaining 49 per cent were reserved for ordinary citizens in exchange with distributed vouchers.

Obviously the chief difference between Russian and Czech models was the marketability character of vouchers in Russia. Besides, it was the time when Russian economy was in verge of collapse, no pensioners and workers received their retirement payments and salaries, and on top of these, peoples' distrust towards privatization was in the highest. Herein, it was not hard to imagine how willing were the people to sell their vouchers in exchange for very small amount of money. Provided that more than 146 million vouchers were given out to citizens, a corrupted and lively voucher market emerged almost immediately. Little were particularly shocked when a single person collected 14 million of those vouchers in considerably short period of time.⁵

Enterprise employees, compared to voucher holding citizens, were more interested to keep their shares in enterprises. Nonetheless, the ownership structure and "...workers' passivity and ignorance of market economy..."⁶ allowed managers to grab control of most enterprises. In cases when employees resisted surrendering claims to shares they were simply intimidated by managers: "You sell me your stock I will shot you."⁷ Eventually firm directors accomplished controlling entire stocks.

Equally interesting feature of Russian voucher privatization was that if fewer vouchers bid for enterprise shares, then proportion of shares assigned per voucher is increased. With no doubt, managers and insiders employed all disposable means to discourage bidders from participating in auctions. In some

⁵ "Boris Jordan, a man of Russian parentage who grew up on Long Island and worked for Credit Suisse First Boston, went to Russia and managed to buy between 7.5 million and 14 million of the newly issued vouchers." Yuri Maltsev, "Privatization and Piratization in post-Communist Russia", *The Independent Review*, Vol.10. (Winter 2005) p. 425.

⁶ Bernard Black, Reinier Kraakman and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?", *Stanford Law Review*, Vol. 52 : 1731. (July 200). p. 1740.

⁷ Marshall I. Goldman, *Piratization of Russia: Russian Reform Goes Awry*, Routledge. (2003).

cases auction places were changed few hours to start; in other cases auctions were announced minutes before the process began.⁸

Two groups of actors, company managers and local governors, emerged as winners by the end of voucher privatization program finalized in 1994. Having consolidated their control over firms managers were faced with two available options to follow. Either increase value of the company (value-creating), or steal the existing value (self-dealing). Given weakness of the federal government, shaky institutional and legal infrastructure, firm manager with close links to local governors was in position to choose either of the options without much constraint. Since value-creating was an effort demanding lengthy process, majority of managers chose to strip assets in the first hand while they had absolute control over firms.⁹

Although legal infrastructure was extremely weak and federal enforcement almost non-existent, local government possessed considerable autonomy under Russian system that made its presence an important factor throughout transition period. In fact, local government was in position to impose its will, sometimes through use of force and intimidation, on newly privatized company managers. For that matter it was in sole interest of managers to establish close links with local governors.

Because, local auctions on regional enterprises were held under the supervision of local officials, regional governors were integral part of the voucher privatization from very beginning. Thus, local governors were key to determine outcome of auctions held in their jurisdictions. The governor-manager cooperation determined auction outcomes in first stage, whereas ensuring smoothness of asset stripping and value-stealing in the second stage. In effect, many managers were governors' personal "representatives" or in the case of contrary bribery used to silence governors.¹⁰

As a result, at the end of voucher privatization two classes, local governors and managers, were born and consolidated their positions in regions. While managers established a firm control over companies, local governors either

⁸ See Bernard Black, Reinier Kraakman and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?"

⁹ In their articles Black, Reinier and Tarassova lengthily discusses the dilemma into which controllers of firms fell, and explains how and why they chose asset stripping rather than value-creating. For detailed account of that issue see Bernard Black, Reinier Kraakman and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?"

¹⁰ For more information on the relations of politicians and newly privatized companies see Andrei Shleifer and Robert W. Vishny, "Politicians and Firms", *The Quarterly Journal of Economics*, Vol. 109. No. 4. (November 1994). pp. 995-1025; Timothy Frye, "Capture or Exchange? Business Lobbying in Russia", *Europe-Asia Studies*, Vol. 54. No.7. (November 2002). Pp.1017-1036.

directly controlled managers or received huge amounts as bribery to tolerate asset stripping in their territories.

Yet, because the largest and strategic enterprises were kept out of voucher privatization with special government regulations, new actors were to come out to scene with next round of privatization. In several important industries the government created hierarchical structures as giant oil holding companies like LukOil, Sidanko, Sibneft, Rosneft, Tyumen Oil, Yukos, and VNK. Valuable electric and telecommunication companies followed similar pattern.¹¹ In 1995 another privatization scheme, “loans for shares” auctions, was designed for privatization of those giants.

“LOANS FOR SHARES” AUCTIONS AND EMERGENCE OF KLEPTOCRATS

Subsequent to finalization of voucher privatization, government launched cash privatizations to accumulate cash money that is what Yeltsin administration was desperate for. In West the program was labeled as “loans for shares” auctions under which shares of the most attractive enterprises in energy, metallurgical and telecommunications sector were auctioned by the Yeltsin government. With a Presidential Decree Boris Yeltsin ordered all state-owned enterprises involved in heavy industry, extracting, refining and transportation of petroleum products to issue and then sell shares.

The idea was originated in spring of 1995 as a proposal from a group of Russian Banks¹² to provide loans to government for several years. Banks secured repayment with government stakes in precious enterprises that were kept out of voucher privatization. With exception of handful few, everyone was sure that government would not pay the loans, but transfer its shares to hands of big Moscow Banks. Indeed people turned out to be right about their expectations.

Official government version of the program, announced by Deputy Prime Minister Chubais in September, offered shares for credits via closed tenders. From a nonchalant point of view the decision was in line with legislation and no breach of law was done. But in reality the peculiar character of Russian auctions, symbolized with severe misdoing and corruptions, shocked even hard-

¹¹ Bernard Black, Reinier Kraakman and Anna Tarassova, “Russian Privatization and Corporate Governance: What Went Wrong?”.

¹² In the early 1990s playing with money was the best way to make money. Creation of thousands of banks and insurance companies within days were witnessed. For more information on the creation of banks in early transitional period, see Jan Svejnar, “Transition Economies: Performance and Challenges”, *Journal of Economic Perspectives*, Vol.16, No. 1. (2000).

line liberal privatization supporters advocated shock-therapy style mass privatization. Creation of Russian Oligarchs was finalized thanks to those peculiarities.

The most striking character of the auctions was supervision of auctions by Moscow Banks that made their fortune through managing government funds by paying no interest to government and re-investing them in market price.¹³ Given this opportunity, Banks with no much effort won bids and controlled shares in Russia's biggest enterprises. In this sense auction managing was literally equated with auction winning. "A tiny group of banks ran the auctions, disqualified their rivals, excluded foreigners, bid in the auctions and won the bids" was the way Goldman described the auctions.¹⁴ Bid rigging was inherent in the auctions, where higher bids were disqualified in the first hand on the basis of technicalities.

In specific cases foreigners were denied to participate by Presidential Decrees,¹⁵ in several others foreigners voluntarily refrained from taking part because of corrupted auctions. According to Anatoly Chubais, the head of the State Privatization Committee, Russian capitalists "... steal and steal and steal. They are stealing absolutely everything and it is impossible to stop them."¹⁶ Even the bid-winners themselves admitted that at times they paid 40 times less than the enterprises were worth.¹⁷ The biggest nickel and platinum producer in the world, Norilsk Nickel with \$1.2 billion profit in 1995, was bought by Vladimir Potanin in a closed auction that was supervised by his own bank Oneksimbank for only \$170.1 million. In the same auction a \$350 million bid was rejected on the basis of technical reasons by Oneksimbank. Gazprom, the biggest natural gas monopoly, was sold only to thousandth of its value that was \$228 million.¹⁸ In his account about Oligarchs Maltsev concluded that "...their fortunes

¹³ Vladimir Gusinski's MOST Bank managed the money for the Moscow city government; Potanin's Oneksimbank managed money for the Finance Ministry and the Foreign Trade Ministry; Fridman's Alfa Bank managed funds for the Customs Service; Khodorkovski's Bank Menatep dealt with the funds that Russia spent on its 1996 military operations in Chechnya. On Gusinski and Potanin, see Matt Bivens and Jonas Bernstein, "The Russia You never Met", *Demokratizatsiya*. (1999). ; "Russian Finance: Byzantium Inc.", *Economist*. (17 July 1999). On Fridman, see Graig Mellow, "The Oligarch Who Knew Better", *Institutional Investor*. (June 1999). ; On Khodorkovski, see "The Abuses of 'Authorized Banking'", *Radio Free Europe/Radio Liberty*. (January 1998), available at: <http://www.rferl.org/ca/special/rufinance/authorize.html>

¹⁴ Marshall Goldman, *Piratization of Russia: Russian Reform Goes Awry*, 2003.

¹⁵ In December 1993 Presidential decree limited foreign participation in privatization in the fields of energy, transportation and the military industry. For more information, see "IMI: Russia's Next Privatization: 'Loans for Shares' Not 'Shares for Foreigners'". (October 1995).

¹⁶ Marshall I. Goldman, "Piratization of Russia: Russian Reform Goes Awry", commented by William Podmore 2003.

¹⁷ Ibid..

¹⁸ Ibid..

represent the fruits of privatization rather than of any defensible privatization.”¹⁹ As early as 1997 five of those individuals were listed among the world’s richest billionaires on Forbes Magazine.²⁰

Provided that the government was desperate for cash it was in interest of the government to ensure transparent auctions where higher bids would win and comparatively more money would accumulate in the balance of the government. But what was the motto behind government policy to let the auctions be rigged so ruthlessly? The whole issue for the government, however, was not straightforward. Mainly two issues were in play: legitimacy and Presidential Elections of 1996.

As a Soviet legacy peoples in post-Socialist republics, particularly in Russia, had no principally positive view of foreigners, especially when it comes to rich Western Capitalist. Thus, the government argued that protection of key enterprises from foreign privatization could be possible if auction management rights were given to big Russian banks. It was maintained that big banks had the capacity to compete against foreigners in fair and competitive auctions. Indeed, government popularity was increased, at least initially, following the campaigns on Oligarch channels that nation’s assets were not being sold.

A presidential election of 1996 was more decisive in shaping governmental policy on privatization of giant enterprises. Harsh economic conditions, decreasing life expectancy, and declining faith in capitalism in mid-1990s turned communist Zyuganov into a favorite candidate for presidency, while Yeltsin’s popularity hit the lowest. Having no other option, Yeltsin appealed Oligarchs to promote his campaign in presidential elections. In exchange for support Oligarchs demanded auction management right in “shares for loans” auctions.

Thus, combination of several key factors like timing of elections, socio-economic conditions, lack of public control caused emergence of strong magnates after “shares for loans” auctions. Despite no legitimacy in the eyes of ordinary citizens, Oligarchs with strong ties to the federal government proved to be important actor to determine Russian transition.

¹⁹ Yuri Maltsev, “Privatization and Piratization in Post-Communist Russia”, *The Independent Review*, Vol. 10. (Winter 2005). p. 425.

²⁰ For Forbes listings, see <http://www.forbes.com/static/bill2005/LIRQXTX.html?passListId=10&passYear=2005&passListType=Person&uniqueId=OXTX&datatype=Person>

TENSIONS BETWEEN ACTORS

Under this section conflicting interests of winners of voucher and “shares for loans” privatizations will be displayed through study of Russian Commercial Courts and their application of Bankruptcy Law.

Starting from Gramsci numerous scholars perceived state as the process of hegemony in which classes struggle to secure their hegemony. Institutions are made and destroyed; laws are passed and over-ruled in this process of hegemony. After seizing the control hegemon creates an institutional design and passes key legislation that further promotes its interests. These institutions and laws not only cement the hegemonic groups stay in top of the hierarchy, but also make other actors, striving for hegemony, to play within the rules of the game. Departing from that point it is time to turn to Russian privatization actors with specific interests and measures to promote their interests.

NEWLY PRIVATIZED ENTERPRISES IN REGIONS

Most companies privatized prior to “loans for shares” were small and medium scale enterprises. Once the voucher privatization started managers easily controlled companies, provided that workers were disorganized and willing to exchange shares for small sums of money.

Due to lack of stable legal infrastructure and strong enforcement machine in the part of federal government managers chose to strip existing assets rather than creating value.²¹ Indeed that is the exact point where they had to establish close links with the local governors. Even before and during the privatization governors and managers already had close ties. In cont cases governors achieved to replace managers with the person of their choice.

Parallel to continued asset stripping meanwhile managers accumulated huge tax and wage arrears. For that matter managers tried each and every measure to complicate working of rule of law – particularly the bankruptcy law.²² Their relation with the local governments could save them from going bankrupt, and perhaps indictment of managers afterwards. Bribery played the ultimate role in

²¹ See Bernard Black, Reinier Kraakman and Anna Tarassova, “Russian Privatization and Corporate Governance: What Went Wrong?”

²² See Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, “Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant”, *Working Papers for Economic and Financial Research*, (March 2006); Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, “Capture of Bankruptcy: Theory and Russian Evidence”, *Working Papers for Economic and Financial Research*, (June 2003).

order to receive governor's service of protection against any bankruptcy proceedings and federal government.

Insolvent by now, many companies in the regions were at the same time struggling to escape from mortal paw of oligarchs, who were usually either creditors of those companies or closely related to federal authorities. Once again only local governments could provide protection through subsidization or intervening in the court proceedings. In court proceedings firms exploited local governors' influence to use re-organization procedure of bankruptcy law to avoid paying taxes to federal government and serving their debts to oligarch controlled "Moscow Banks".²³ In fact, they were content with the status quo that prepared appropriate conditions to strip assets and while doing that being able to keep local governors happy by bribes.

LOCAL GOVERNORS

Privatization of Russian enterprises in the regions could not be imagined free of local governors influence.²⁴ Governors from early on seized good deals in the voucher privatization either by placing their close circle as heads of new privatized companies or making sure those old managers pay their "obligations" when asked.

Because of social and political consequences of large scale unemployment local governors were interested in preventing insolvent firms from going bankrupt. Thus, governor's popularity increased dramatically after each time they were advertised as saviors of local firms. Depending on their popularity governors demanded more subsidies from the federal budget. No matter how limited taxes were, incoming taxes from the local firms was another fact solidified the close relation between local governors and regional enterprises.

Above and beyond social and political concerns, local governors were aware that it was possible to extract bribes from only insolvent or corrupt firms.²⁵ If it happened and oligarchs took control of firms, besides losing influence and control over managers, governors would also lose their source for bribery. From that point of view, interests of local governors and companies in their

²³ Although Moscow is just one of the 89 regions of Russia, the "Moscow Banks" were supplying 45 per cent of total credit to the Russian economy in 1997. For more information, see Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, "Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant"

²⁴ See Maxim Boycko, Andrei Shleifer, and Robert W. Vishny, "Privatizing Russia", *Brookings Paper on Economic Activity*, Vol. 1993, No. 2. (1993). pp. 139-192.

²⁵ Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, "Capture of Bankruptcy".

constituencies overlapped against those of federal government and oligarchs. Particularly, with their vast influence over Commercial Courts local governments was at least as influential as any other institution in the game of hegemony consolidation by oligarchs. In other words, local governors were the main barrier in front of enforcing bankruptcy law that was important part of oligarch's strategy.

OLIGARCHS

Following the successful re-election of Yeltsin as Russian President, relationship between federal authorities and oligarchs were rosy till the coming of Putin as the father of re-centralization. Having established solid control over Russia's most vital enterprises, next step taken by oligarchs was creation of huge media holdings, TV stations, and newspapers to promote their goals.²⁶ (For more details please see Table A).

With support of mass media and monetary power to influence politicians oligarchs started to campaign for enactment of legislation in their interests. Experts on Russian transition argued that the size, market power, and sector of companies were the most important characteristics in influencing or capturing politicians.²⁷ Without doubt, oligarchs with their omnipotent companies were the forerunners in all of these spheres. In the top of the list of the "Bankers' Lobby"²⁸ was protection of the market from foreign competition²⁹. In several episodes with persistent lobbying oligarchs achieved to get presidential level decrees limiting foreign participation in privatization process. (See above)

Although they were in control of crown jewels of Russian economy, in regions quite a number of enterprises were in wish-lists of oligarchs. Since most of those companies were controlled by previous managers and were deeply

²⁶ See Bernard Black, Reinier Kraakman and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?"; Floriana Fossato and Anna Kachkaeva, "Russian Media Empires III", *Radio Free Europe/Radio Liberty*. (26 May 1998). available at: <http://www.rferl.org/nca/special/rumedia3/index.html>

²⁷ See Annete Brown, Barry Ickes and Randi Ryterman, "The Myth of Monopoly: A New View of Industrial Structure in Russia", *World Bank Research Policy Paper 1331*. (August 1994); Andrei Shleifer and Robert Vishny, "Corruption", *Quarterly Journal of Economics*, Vol. 108, No. 3, (August 1993). pp. 599-617; Joel S. Hellman, Geraint Jones and Daniel Kaufmann, "Seize the State, Seize the Day: An Empirical Analysis of State Capture and Corruption in Transition Economies", *World Bank Policy Research Working Paper 2444*, (2000). pp. 1-41; Timothy Fyre, "Capture or Exchange? Business Lobbying in Russia", *Europe-Asia Studies*, Vol. 54, No. 7, (November 2002). pp. 1017-1036.

²⁸ Fyre, "Capture or Exchange? Business Lobbying in Russia", p. 1020.

²⁹ See Maxim Boycko, Andrei Shleifer, and Robert W. Vishny, "Privatizing Russia".

insolvent, the best way for an oligarch to seize them was lobbying the government to pass a bankruptcy law. Bankruptcy law was of particular relevance given that oligarchs and federal government were creditors of those regional insolvent companies. Interestingly enough, though oligarchs made their fortune mostly lack of rule of law during early and mid 1990s, by now they were pushing for establishment of rule of law in which they believed their future fortunes lay. Initially asset strippers and now wealthy magnates, oligarchs interested in promoting respect for property rights. Lack of rule of law was increasingly becoming an impediment for them while trying to invest in or acquire regional companies. New institutional design would be effective solution for the queries of oligarchs. Achieving the enactment of an advantageous Bankruptcy Law would be the first and perhaps easiest step to reach their goal. Yet, federal government was single most important actor in passing Bankruptcy Law.

FEDERAL GOVERNMENT

While federal government established close links with kleptocrats in which mutual benefit was observed, the same could not be said for the relationship between central authorities and insolvent regional enterprises. In fact throughout 1990s federal government played exterior creditor role vis-à-vis the insolvent companies, since by no means it was possible to extract tax arrears.³⁰ Given the fact that enforcement of federal decisions over companies with increasing tax arrears was supposed to be undertaken by local governments, federal authorities were limited to stop increase of tax arrears. At this point interests of local and federal governments were in tension. In substitute for constant bribes from companies regional governments were appealing to re-organizations clause “to freeze out federal tax claims”.³¹

Compared to local governments the federal government was clearly disadvantaged in dealing with regional insolvent enterprises. Simply put, bribes were going to pockets of local governors, while at the same time the federal government was trying to extract taxes desperately with hands tied. From this perspective adoption of a Bankruptcy Law was not only in the interests of oligarch, but also was in immediate interest of the federal government. In the second year of his re-election President Yeltsin finalized approval of new Bankruptcy Law.

³⁰ See Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, “Capture of Bankruptcy: Theory and Russian Evidence”.

³¹ *Ibid.*, p. 12.

RUSSIAN BANKRUPTCY LEGISLATION

Bankruptcy is an essential feature of market economy. Quite understandably during Soviet period Russia did not have bankruptcy law. In the aftermath of the collapse of regime, however, Russia's first bankruptcy legislation was passed in 1992. Among the experts there is a consensus that the 1992 Bankruptcy Law was exceedingly ineffective.³² Consequently, between the years 1992-1998 only handful of companies went bankrupt.³³ Hence, in practice one could not talk about the presence of operational bankruptcy legislation or institution before 1998.

BANKRUPTCY LAW OF 1998

By 1997 the share of loss-making enterprises was counted as 50 percent of the Russian GDP.³⁴ In that respect, authorities intended to restructure or close down loss-making enterprises by 1998 Bankruptcy Law, and supply creditors with effective tool for debt recovery. According to new Bankruptcy Law upon petition of creditors, first a temporary manager would be appointed by court to collect information and arrange meeting for creditors, and based on these judge would make a binding decision either on liquidation or re-organization. Depending on the decision either liquidation manager or external manager would be appointed to follow respective process.

In immediate aftermath of the 1998 law the number of bankruptcy cases initiated by creditors increased vastly.³⁵ Most of these cases were initiated mainly against small and medium scale enterprises. From that picture it could easily be anticipated that the Law was in interest of big business and to certain extent in interest of the federal government. Therefore, the following section will discuss how oligarchs aimed to use Bankruptcy Law as a tool to acquire regional insolvent enterprises.

³² See "Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, "Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant".

³³ See William Tompson, "Reforming Russian Bankruptcy Law", *I.C.C.L.R.*, Issue 4, (2003).

³⁴ See "Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, "Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant".

³⁵ *Ibid.*.

BANKRUPTCY LAW AS AN OLIGARCH INSTRUMENT

Normally the ultimate rationale of the bankruptcy law is to protect creditor and shareholder.³⁶ Both, the federal government and “Moscow Banks”, owned by oligarchs, were main creditors of regional insolvent enterprises. Federal government was interested to enforce bankruptcy law to reverse ever-increasing tax arrears. Oligarchs, however, was particularly ambitious to use bankruptcy law “as a takeover tool”.³⁷ In fact federal government, partly because it had close ties with oligarchs and partly because huge taxes would flow in, was keen to shift control of regional insolvent enterprises to oligarchs under legitimate shield of the Bankruptcy legislation of 1998.

According to earlier 1992 Bankruptcy Law a company was considered bankrupt if its total debts exceeded its total assets. Perhaps, although enterprises were insolvent and their assets were illiquid, this clause of the Law alone was enough to be rescued from going bankrupt.³⁸ Under Article 3 of the new Bankruptcy Law, however, a company could be declared bankrupt if it fails to meet its monetary commitment within three months after the obligations are due.³⁹ Given that “Moscow Banks” either directly or through the federal government channels were providing 45 percent of credit to whole Russian economy, including insolvent enterprises, it was quite visible how as a creditor they were advantaged by the 3rd article in relation to local enterprises.

Similarly, under Article 6 of the legislation now wider range of actors could initiate bankruptcy proceedings, including government bodies and tax authorities, whereas in the previous law this right was guaranteed only to creditors and public prosecutors.⁴⁰ Thus, the article evidently empowered the federal government to initiate bankruptcy proceedings as a creditor or tax authority. For oligarchs who could not supply credit to local companies, which either refused to be loaned to an oligarch or were protected by generous regional government subsidies, the Law provided a chance to control via federal government channel. Achieving a sweet deals with federal government could easily initiate a bankruptcy case against insolvent enterprises, which eventually be controlled by the oligarchs.

³⁶ See, Philippe Aghion, Oliver Hart and John Moore, “The Economics of Bankruptcy Reform”, *Journal of Law, Economics, and Organization*, Vol. 8, No. 3. (October 1992). pp. 523-546.

³⁷ “Using Bankruptcy As a Takeover Tool: Russian Law Puts Healthy Companies at Risk”, *New York Times*. (7 October 2000).

³⁸ Even in some cases insolvent enterprises created a fake list of debtors that have obligations against them to avoid bankruptcy proceedings, although it was contrary to law.

³⁹ See Lamb LeBoeuf and Macrae Greene, “New Bankruptcy Law”, *International Financial Law Review*, Vol. 17, No. 9. (September 1998). p. 67.

⁴⁰ *Ibid.*.

According to new legislation in order to protect rights of creditors, interested persons – managers, members of the board of the directors and their relatives – could not be appointed as an interim or external manager (Article 18 and 19).⁴¹ Indeed the same applies in Western capitalist countries with entrenched and well-developed bankruptcy laws. However, when scrutinized deeply revealed picture depicts another seized advantage for oligarchs. In regions, where oligarchs have limited presence, it was of particular interest for oligarchs to achieve appointment of outsider as the interim manager of insolvent enterprises by the court decision.

However, there were other aspects of new bankruptcy law that were not compatible with the Western bankruptcy regulations, such as favoring creditors over shareholders as it was the case in new Russian Bankruptcy Law.⁴² Interestingly enough, new legislation gave judges extensive discretionary power. The rationale behind empowering judges was twofold. Firstly, judges were federal employees and served to federal interests, at least theoretically. Oligarchs believed that it would be easy to influence judges to make favorable decision for them or for the federal government in bankruptcy cases. Secondly, related to the first one, in the case any proceeding initiated against oligarchs they wished to appeal to discretionary power of judges who could be bought by fat bribes. In reality, the structure of Russian federal governance system and key role of regional governors as well as their influence over judges barred the working of bankruptcy law as it was foreseen by federal authorities and oligarchs. From that perspective to understand Russian Court system is necessary.

RUSSIAN COMMERCIAL COURTS

Russian court system is composed of three separate courts: the courts of general jurisdiction, constitutional courts and *arbitrazh* courts.⁴³ The *arbitrazh* courts, known as commercial courts, are the focus of this paper. These commercial courts were created in 1991 to hear disputes between firms, and also between firms and government. These courts are federal bodies and their judges are

⁴¹ Ibid..

⁴² Another interesting fact that also relatively proves the bias of 1998 bankruptcy law toward oligarchs is the adoption of new bankruptcy law in 2002 right after Putin's taking of office. Enforcing re-nationalization and centralization policies everywhere, Putin speedily realized the need to pass new bankruptcy law to cut fortunes of oligarchs.

⁴³ For detailed information about Russian court system, see Peter H. Solomon, "Judicial Power in Russia: Through the Prism of Administrative Justice", *Law and Society Review*, Vol. 38, No.3. (2004). pp. 549-581.

selected by and also promoted by the president. Commercial courts have three tiers; 81 courts of instance in regions, 10 appellate courts and one High Arbitrazh Court. For this paper it is important to know the fact that law requires the applicant to file a suit to commercial court of the region where he or she is registered. So, there is not a competition between courts as the jurisdiction of courts coincides with the administrative border of the respective regions. Commercial courts have supreme authority in cases where the bankruptcy law was relevant. The decisions made in the regional commercial courts could only be over-ruled by either commercial courts of appellate or by High Arbitrazh Courts.

FAILURE OF BANKRUPTCY LAW IN REGIONS

With the adoption of bankruptcy law in 1998 it was expected that thousands of loss-making companies would go bankrupt. In this regard the law failed to meet these expectations. Even in year 2000 loss-making enterprises constituted 37 percent and only 2 percent of them were faced with bankruptcy cases.⁴⁴ Regional governors and commercial courts of first instance in regions were the main responsible actors for this outcome. The struggle was between regional governors and oligarchs that is nicely put by Sonin as “Regional governors were competing for influence over law enforcers with a wealthy and powerful coalition of Moscow-based banks owned by Russian ‘oligarchs’ and the federal government.”⁴⁵ But it is important to understand how the local judges sided with governors despite huge influence and wealth of oligarchs-federal government coalition.

Although Russian constitution empowers Russian President to appoint judges, careers of judges mainly depended on the regional authorities. Equally important was the fact that appointment of regional judges requires approval of local governors. Even after retirement those judges search their fortunes in the local administrations or in regional state enterprises as lawyers. Lack of federal financing to regional commercial courts and huge geographical distance made courts even more depended on the governors.⁴⁶ When met with resistance, local governors did desist to appeal intimidation and terrorizing. The widely known case was bankruptcy proceedings of the oil holding Sidanko and its key subsidiaries Chernogoneft and Kondopetroleum in 1999. Despite unanimous

⁴⁴ See Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, “Are Russian Commercial Courts Biased? Evidence from a Bankruptcy Law Transplant”; Goskomstat, 1998-2002, Statistical Yearbook.

⁴⁵ *Ibid.*, p.3.

⁴⁶ See Ariane Lambert-Mogiliansky, Konstantin Sonin, and Ekaterina Zhuravskaya, “Capture of Bankruptcy: Theory and Russian Evidence”.

decision of creditors, judge rejected Chernogoneft's offer to pay in full to all creditors and appointed a different candidate who was connected to another influential oil company Tyumen Oil.

Everything becomes clear when it turns out that the governor of Tyumen region is also Chairman of the board of Tyumen Oil. Bernard Black, who was advisor to Kondopetroleum, wrote: "Apparently...Tyumen didn't merely bribe judges, but threatened them as well."⁴⁷ In later episode Sidanko's official argued that if it was about only bribes they could play the game as well, but it was more than bribery.

As already mentioned in above section, bankruptcy law supplied judges by means of vast discretionary power with the assumption that judges would use it in favor of oligarchs and federal government. Under the bankruptcy law judges from very beginning had two options: reject the bankruptcy case or rule about the case. In the case of rejection plaintiff could go to Court of appellate for reconsideration. Although the decision of appellate court would not mean much since the enforcement of decision was depending on local governors, in fact regional courts almost never rejected bankruptcy cases. If they decided to take case and rule, then judges had two options: to decide on liquidation or appoint manager for reorganization. Very few judges decided for the liquidation of the marginal enterprises, many others chose the option of appointing "external manager" to re-organize the enterprise. Key factor was the ability of judges to appoint manager of their selection regardless of the decision of creditors. Despite the fact that newly selected managers could not be relatives of incumbent managers, after each appointment the new manager was someone with close ties to local governors.

Ironically, re-organization of enterprises was in interests of local firms and governors, but not in the interests of federal government and Moscow-based banks. According to the Law, the enterprise under re-organization freezes debts and taxes for defined period of time. Through re-organization procedure, however, enterprises with the assistance of court-governor alliance could reverse the bankruptcy proceedings in their favor.

⁴⁷ ⁴⁷ Bernard Black, Reinier Kraakman and Anna Tarassova, "Russian Privatization and Corporate Governance: What Went Wrong?", p. 1756.

CONCLUSIONS

TABLE A

OLIGARCHS (Known Political Connections)	PRINCIPAL COMPANIES	MEDIA OUTLETS
Mikhail Khodorkovsky (ties to former Prime Minister Yevgeni Primakov); former Fuel and Energy Minister Sergei Generalov)	Rosprom (holding company), Yukos and VNK oil and gas holding companies, various manufacturing, copper, chemical, timber, and retail companies.	Moscow Times, St. Petersburg Times, and Literaturnaya Gazeta newspapers.
Mikhail Fridman (ties to Kremlin chief of staff Alexander Voloshin)	Alfa Group holding company, Alfa Bank, Tyumen Oil (oil holding company), Alfa Cement, various real estate, construction and oil export companies.	Alfa TV, ORT television station (with Berezovski)
Boris Berezovsky (ties to the family of former President Boris Yeltsin; former Prime Minister Viktor Chernomyrdin; Kremlin chief of staff Alexander Voloshin)	Sibneft (oil and gas holding company), Logo VAZ (auto distributor), Aeroflot and Transaero airlines; Avtovazbank, Obyedinenni Bank.	ORT (with Fridman), TV6 (with Alekperov), and STS television stations; Vremya television program; NSN radio, Nezavisimaya gazeta, Novaya Izvestiya and Kommersant newspapers, Ogonek magazine.
Vagit Alekperov (ties to Moscow Mayor Yuri Luzhkov)	LUKOil (Largest Russian oil company); Bank Imperial (with Vyakhirev).	Izvestia newspaper (with Potanin); TV6 (with Berezovsky)
Vladimir Potanin (former Deputy Prime Minister, ties to former Deputy Prime Minister Anatoli Chubais)	Interrors holding company, Oneksimbank, RosBank, MFK Renaissance investment bank, various insurance companies, Norilski Nickel (nickel and other nonferrous metals), Sidanko (oil and gas holding company), Novolipetsk (steel), 25% of Svyazinvest (telephone holding company), Perm Motors (aircraft).	Izvestia (with Alekperov), Komsomolskaya Pravda (with Vyakhirev) and Russki telegraph newspapers, Ekspert magazine
Vladimir Gusinski (ties to Moscow Mayor Yuri Luzhkov)	Media Most Holding company, Most Bank	Segodnya, Novaya Gazeta (with Smolenski), Obshchaya gazeta, 7 dnei and Smena Newspapers; Ekho Moskvuy radio; NTV and NTV+ (with Vyakhirev), and TNT television stations, Itogi and Lisa magazines
Roman Abramovich (ties to Yeltsin's daughter Tatyana Putin's Chief of Staff Voloshin)	Sibneft, Russian Aluminium, 26% Aeroflot.	Not involved very much.

At first the adoption of bankruptcy law was perceived in the exclusive interests of federal government and oligarch controlled “Moscow Banks”. Through several clauses of the new legislation oligarchs were intended to use bankruptcy law as a takeover tool against regionally insolvent banks. Among the most important characteristic of the new Law was the delegation of enormous discretionary power to commercial judges in proceeding of bankruptcy cases. However, this was the point where local governors intervened and used their influence to achieve favorable decision. Therefore, the fortune of the federal government-oligarch coalition was cut by the alliance of local judges and governors.. Thus, as a general conclusion it could be argued that oligarchs failed to establish institutional design for solidifying their hegemony. The next blow to oligarch was when Putin came to power.

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SUMMARY

RUSSIAN BANKRUPTCY LAW: A FAILED OLIGARCH ATTEMPT (*Russian Bankruptcy Law*)

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The paper examines struggle of privatized regional insolvent enterprises against center supported oligarchs in realm of 1998 Russian Bankruptcy Law. Newly privatized insolvent enterprises mushroomed subsequent to earlier voucher privatization with a considerable backing and shelter of regional governors. Severely disputed "loans for shares" auction schemes of 1995 transformed giant energy and metallurgy state enterprises to private companies while crafting renowned Russian Oligarchs. A severe antagonism became inevitable when federal government-oligarch coalition set to seize control of small-medium scale newly privatized enterprises via recently adopted biased Bankruptcy Law. The central argument of the paper is that the federal government-oligarch coalition failed to control insolvent companies in the regions where commercial courts-regional governor alliance successfully reversed the Bankruptcy Law in the favor of regional insolvent enterprises. Consequently, largely because of discretionary power guaranteed to regional judges the struggle between center and periphery was won by regional governors and insolvent enterprises.