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# Bankruptcy Reform in Russia: The Case for Creditor Rights in Russia*

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**Abstract.** Russia at the dawn of the 21st century is experiencing a collapsing economy. In a world where healthy economies create and maintain capital, it is critically important that all efforts be made to assure all creditors and especially private direct investors that in the event of debtor-insolvency their business interests are protected. The role of bankruptcy law under a regime of what I call "creditor rights" is limited. The court system can be used to avoid a "creditors's race" to grab assets. Whenever the "going concern" value of a firm is greater than the sum of the assets sold separately a case can be made for a bankruptcy procedure as a way of protecting creditor rights. This paper examines the historical origins of the "creditor rights tradition" and advocates such a regime for modern Russia. This paper holds that especially with respect to Russia, we would do well to heed John Stuart Mill's advice and support reforms that favor creditors and protect the value of their rights. Those insolvent firms owned and managed by political oligarchs should be cut down, dismembered, and the assets they command transferred to new and more imaginative and solvent groups of managers.

**JEL Classification:** K22, G33

> "Every grant of credit is a speculative entrepreneurial venture, the success or failure of which is uncertain. The lender is always faced with the possibility that [it] may lose a part or the whole of the principal lent" (Ludwig von Mises 1963 [1949] *Human Action* p. 539).

> ". . . it is additional capital accumulation alone that brings about technological improvement, rising wage rates, and a higher standard of living" (Ludwig von Mises 1963 [1949] *Human Action* p. 851).

## I. Introduction

What is worse than a financial crisis in which the government has defaulted on its promises to pay its debt? What is worse than a financial crisis in which a currency falls by more than 400% against the currencies of its major trading partners? What is worse than a panic

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withdrawal of deposits from a region's banks by depositors eager to redeposit those funds in accounts stewarded banks outside Russia? What is worse—much worse—is a region experiencing massive disinvestment and a precipitous decline in living standards.

Massive disinvestment reflects the reluctance of plant managers and factory owners to reinvest in the repair, replacement, and purchase of equipment. According to Michael D. Intriligator, "Russian banks do not engage in long-term lending that would represent the responsibility of investment banks" because the interest rates are so high on short-term lending to the Russian government (Intriligator 1998:243). Even when repairs and new equipment purchases have been made, those apparent reinvestments are clever subterfuges by scheming plant managers to transfer funds out of the region, into banks outside of Russia.[1] In the event of a mass contagion of this sort, Russia's collapsing economy will experience a huge deficit on its balance of payments capital account and, with a falling ruble, an offsetting surplus on its current account.[2] This means that with disinvestment, the Russian people end up consuming only a fraction of their current level of production.[3] The rest of their production is exported. Such an economy experiences dramatic and horrific *secular* declines in living standards. Such a society is, in the words of the classical school of economics, "consuming its capital" or in point of fact, collapsing (Hayek 1962:346–350). Professor Michael D. Intriligator has named Russia a "collapsing economy" because throughout the decade of the nineties it has experienced each of these economic indignities (Intriligator 1998:24).

My characterization of a collapsing economy bears an uncanny resemblance not only to Russia but to the surrounding Republics where pilfaging managers are in control of many factories. World chess champion Gary Kasparov, writing in the *Wall Street Journal*, offered an important distinction between today's Russian tycoons and the legendary Robber Barons of the latter part of the American 19th century (Kasparov 1998). According to Kasparov, whatever their blemishes as law-abiding citizens, the Andrew Carnegies and Henry Fords were above all else builders and valuable job creators—they constantly revolutionized methods of production (Kasparov 1998). Kasparov did not quote from Karl Marx—who pointed out in 1848 that whatever the machinations and moral blemishes of the factory owners of his day they "created more massive and more colossal productive forces than have all preceding generations together" (Marx 1959:12). Marx was prescient because the same can be said of the Robber Barons that came years later. Indeed, even more finely-wrought distinctions can be made. Among the so-called Robber Barons of the late 19th century, Burton W. Folsom, Jr. pointed out in 1991, some were "political entrepreneurs" who tried to gain and maintain their wealth by seeking after special privileges, subsidies, and protections from government.

Governments provide monopoly privileges to favored groups and individuals in exchange for money. In 17th century England and France such exchanges were the rule and not the exception, contributing to what Ekelund and Tollison named the "mercantilist model" (Ekeland and Tollison 1981). According to Gary M. Anderson and Peter J. Boettke, the mercantilist model is especially relevant to the Russian communist state beginning in 1917 and continuing even after its collapse in 1991 (Anderson and Boettke 1997).

But many of the most important American Robber Barons were not robbers at all. At least one important subset—and Folsom's subset includes Cornelius Vanderbilt, James J. Hill, George Selden, Joseph Scranton, Charles Schwab, John D. Rockefeller, and Andrew

Mellon—were creators and builders of industry and opportunity. They were market entrepreneurs rather than political entrepreneurs who fought against monopolies, government subsidies, high protective tariffs, political favoritism, and back room corruption. Instead of mercantilist privilege they substituted high productivity and creative venturing, also capturing some part of the market value they created. We should heed Kasparov's suggestion and not call the worst of Russia's tycoons "robber barons." They are much worse. They are oligarchs who "have taken over state-owned companies at giveaway prices and have been bleeding them of cash, which they place abroad" (Kasparov 1998).[4] In some cases, they did not build and create, they disassembled, liquidated, and destroyed production structures. When finished they emigrate to new regions to enjoy their pilfered wealth.

In January 1992, Russian President Yeltsin adopted the "Washington Consensus" shock therapy approach to dismantling the older communist/mercantilist system (Wedel 1998). In addition to fiscal restraint and the removal of most price controls, shock therapy required the conversion of all state owned enterprises (SOE) to joint stock companies and then the bulk of the stock distributed to what was hoped to be a new class of solvent owners. The idea was to unite the rights to the cash flow generated by the combinations of business assets in the possession of the SOE with practical economic control of the property itself (Boycko, Shleifer, and Vishny 1997). Out of this unification was to come a more competitive customer-oriented economy such as exists in the United States and Europe. It is clear that not all happened as planned. Many former state-owned monopolies are now privately owned monopolies, suggesting that for all this trouble progress toward a market system has been limited. The politicians still wield powerful swords especially in places such as Moscow where they control the use of land and charge usurious rents and demand galactic bribes from the successful entrepreneurs in their midst. Capital which might have gone into productive activities gets diverted by the barrage of licences, permit fees, special assessments, and protection racket money payoffs.

Through the decade of the nineties, many huge SOEs found themselves short of cash especially when it came to paying their workers and outside investors or creditors. The firms demanded subsidies and loans guaranteed by the Russian state. The Russian government issued short-term debt and sold it to international investors in order to obtain a larger level of real foreign imports into Russia than might otherwise be possible. This swelling of government debt fanned speculation that the Russian government would either repudiate its debt or else engineer another dramatic hyperinflation that amounts to an implicit default since bond holders want to be paid in full valued rubles and not worthless paper.

As has been remarked from David Hume in the eighteenth century down to the present day, money printing presses are the simple and obvious way by which a national government legally repudiates its debts and legally (but immorally) defrauds its creditors (Hume 1985 [1742]). Hyperinflation is the limit of currency depreciation in an economy that remains open to foreign trade and exchange—the international value of the currency plummets towards zero. Hyperinflations can be stopped and have been stopped simply and expeditiously by shutting down the printing presses (Mises 1978:91). Subsequent currency reforms and the adoption of fiscal austerity can succeed in replacing a discredited currency. The logic of such reconstructions need not concern us here. What is most important to emphasize is that while the hyperinflation's damage can be repaired with much pain and effort, the consequences of disinvestment are tragic, traumatic, and longer lasting.

If I am correct in my speculations that what occurred throughout the nineties was Russia and many of the former USSR republics experiencing the twin diseases of a currency crisis coupled with dis-investment, then we have a transition economy in "meltdown" followed by a collapse into poverty (Wolf, Thornhill, and Fidler 1998; Intriligator 1998). It is now generally agreed by all commentators that simple-minded ideas about removing price controls and privatizing the factories without at the same time establishing the infrastructure of a "rule of law" embodying the customs and institutions of commercial society will not be enough to rescue Russia from poverty (Moss 1996; Boettke 1999). The higher market-determined prices balanced supply and demand and erased the long lines and product shortages but they did not at the same time generate the surge in productivity and new sources of supply that might have led to a sustained and extensive rise in living standards. Many insiders rigged the auctions surrounding privatization of the means of production and those insiders who gained control in others ways used their power to misappropriate the cash and other valuable assets, leaving bankrupt shells rather than viable going concerns (Simis 1982; Goldman 1998; Wedel 1998).

In this context I wish to explore two questions. First, what lessons can be learned from the older economic literature that might assist us in determining the future direction of Russian commercial law reform? Second, how well do the classical school prescriptions about the importance of creditor rights hold up when compared with the most current practitioner reports about the progress of commercial law reform in Russia? Let us begin with the classical school writers whose main contributions occurred between 1776 and 1865.

## II. "Creditor Rights": The Legacy of the Classical School

According to Adam Smith, "bankruptcy is perhaps the greatest and most humiliating calamity which can befall an innocent man. The greater part of men, therefore, are sufficiently careful to avoid it. Some, indeed, do not avoid it; as some do not avoid the gallows" (Smith 1976 [1776], Book II, pp. 342 and 348).[5] Smith might have gone on to add that some bankrupts actually do end up on the gallows.

A full account of the financial affairs of a certain Mr. John Perrott was published in London in 1761. The monograph relates the crimes and misdemeanors of Perrott as uncovered by the sleuth-like English Commission on Bankruptcy (Griffiths 1761). Perrott, an English merchant, summoned his creditors together on January 17, 1760 at the Half-Moon tavern to announce that he was in fact, bankrupt and could not meet his obligations to his creditors. At subsequent creditor meetings it became clear that the goods Perrott had ordered starting in 1758 and ending in 1761 were missing and unaccounted for. There was also the matter of the unexplained "destruction of [his business] papers" that would have aided the creditors in their search for the missing goods (Griffiths 1761, I:5). These facts suggested foul play. The Commission suspected that Perrott was feigning insolvency in order to cheat his creditors and steal the value of those goods. Subsequent investigations discovered that his debts amounted to 17,000 pounds—a huge sum for those times. At the time of his first creditors' meetings, Perrott claimed to not remember very much detail.

After a six week internment in London's rancid Newgate Prison, Perrott's memory predictably improved and he was able to reconstruct the missing accounts, but his account of where the missing funds ended up was most unsatisfactory. His story was hidden in a "labyrinth of prevarication and perjury" (Griffiths 1761, II:2). He admitted to spending some of the money on a woman of ill repute. This story could not be verified because this same women was recently deceased and unavailable for questioning. Happily for the creditors, another woman, Mary Harris, came forward. She was the servant of still another woman of loose moral character, Mary Fernie. Thanks to the testimony of Ms. Harris, Perrott's machinations were uncovered. The Commission learned that Mary Fernie and Perrott were both "bedfellows" and co-conspirators in an effort to hide the cash they raised by selling the creditors' goods. By splitting negotiable promissory notes in half and stashing the halves in separate locations—one set on his person and the other with Mary Fernie—Perrott hoped to emerge from bankruptcy and rejoin Mary Fernie (and the two halves of bills of exchange) to live happily ever after—both rich. The diligence of the Commission was too much for Perrott. The Commission foiled the plot and Perrott was summarily tried and hanged on November 11, 1761 at the Smithfield gallows.

The Commission of Bankruptcy, elated by their investigative success, allowed the full report, including the depositions and affidavits, to be published. This was intended to deter other businesspeople from defrauding their creditors though the subterfuge of what is called "false bankruptcy." Indeed on its opening pages the monograph explains how "future bankrupts may from these proceedings be convinced of the fallacy of that dangerous opinion, which supposes [that] the commissioners are obliged to receive for true whatever the bankrupt shall please to swear at his final examination" (Griffiths 1761, I:ii).

Agreeing with the fate of Perrott, John Stuart Mill also endorsed the principle that fraudulent bankrupts must be punished. In 1848, Mill discussed the problem of debtor insolvency in his erudite *Principles of Political Economy with Some of Their Applications to Social Philosophy*. Mill's *Principles* remained the authoritative treatment of economics for Anglo-American writers even after Alfred Marshall's *Principles of Economics* appeared in 1890 and subsequently replaced Mill's as the best treatment of economic science. Mill agreed that "what is technically called fraudulent bankruptcy, the false pretense of inability to pay [off the creditors], is, when detected, properly subject to punishment" (Mill 1965 [1848] Book V, p. 908). Mill went on to ask another question, "[D]oes it follow that insolvency is not the consequence of misconduct because the inability to pay [sometimes] may be real?" (Mill 1965 [1848] Book V, p. 908) What should be done in the case of a truly honest but insolvent debtor?

Mill agreed that "insolvencies do [sometimes] arise from causes beyond the control of the debtor, and that, in many more cases, [the debtor's] culpability is not of a high order" (Mill 1965 [1848] Book V, p. 910). In these sorts of cases, the law must be merciful and sometimes allow the debtor to emerge from bankruptcy with his debts completely discharged by the court. But even here Mill advocated that a searching investigation be conducted to learn the cause of the bankruptcy. The out-of-luck creditors deserve no less. The burden of proof, Mill said, should always be placed on the bankrupt to prove to his creditors that he has not engaged in either reckless or deceptive behavior (Mill 1965 [1848] Book V, p. 910). After all, Mill continued, "to have been trusted with money or money's worth, and to have lost or spent it, is prima facie evidence of something wrong [and if the debtor cannot prove to the creditors] by laying open the whole state of his affairs, and [show] that there has been no misconduct, or that the misconduct has been of an excusable kind" then he must be punished (Mill 1965 [1848] Book V, p. 910). In Mill's view nothing should be done to "approve a relaxed system of insolvency laws." In a nutshell, Mill supported the rights of creditors to be repaid. For this reason, Mill must be counted as a leading nineteenth century representative of the "creditor rights" tradition in business economics.

Credit is extremely important to a market system. In Mill's time shopkeepers needed to stock the goods first in order to pay for them later. The vendors—Mill's "dealers"—shipped the goods expecting payment. It was critically important that this supply channel be maintained if the market process were to proceed and help to raise living standards. Mill explained how credit is automatically created whenever goods are delivered, and "there would be much inconvenience in putting an end to this sort of credit" (Mill 1965 [1848] Book V, p. 910). In Mill's time it was the small tradesmen of unknown reputation who typically owed money to the dealers who supplied them. There was no worse thought than that the law might permit these small businesses and tradesmen to walk away from their financial responsibilities. Should that happen, "large dealers...would refuse credit [to the small tradesman] as many of them already do" making it impossible for small businessmen, the common people, to engage in enterprise (Mill 1965 [1848] Book V, p. 911).

Mill offered empirical evidence about the principal reasons debtors become insolvent. The rogues and swindlers are the exception, as is the innocent bankrupt. The vast majority of insolvencies occur exactly as J. H. Elliott described in his 1845 book *Credit the Life of Commerce*, which was cited quite extensively and approvingly by Mill (Mill 1965 [1848] Book V, p. 909). Elliott's investigations revealed that "many insolvencies are produced by tradesmen's indolence; they keep no books, or at least imperfect ones, which they never balance; they never take stock; they employ servants...whom they are too indolent to supervise, and then become insolvent. It is not too much to say, that one-half of all the persons engaged in trade, even in London, never take stock at all; they go on year after year without knowing how their affairs stand, and at last, like the child at school, they find to their surprise, but one halfpenny left in their pocket.... I am prepared to say of such tradesmen, from carefully prepared tables, giving every advantage where there has been any doubt as to the causes of their insolvency, that where nine [bankruptcies] happen from extravagance or dishonesty, one 'at most' may be referred to misfortune alone" (cited in Mill 1965 [1848] Book V, p. 910). Thus, Mill concluded that 90% of the bankrupts are in some sense culpable. They should therefore be personally responsible for their insolvency. With more diligence they could have avoided that unfortunate result. Bankruptcy was not something that just happened, it was generally caused by bad business habits and that is why the impecunious need to be punished. Protecting the rights of creditors is what keeps the market process intact.

Mill's *Principles* went through several editions in his lifetime, and the last major edition was published in 1871. Throughout each edition Mill remained an unwavering defender of creditor rights, a position typical of the classical school. On June 4, 1867, Mill participated in the debate before the British Parliament over the bill to "Repeal Enactments Relating to Bankruptcy in England, and to Matters Connected Therewith." *The London Times* carried an account of Mill's contribution to that debate (summarized in Mill 1988:187). Mill complained that the laws of his country had changed from "one bad extreme to another" from the savage treatment of debtors in ancient times, to cases where debtors although not convicted of actual fraud could still "escape with practical impunity" from their creditors (Mill 1988:187). Mill promised to support C. J. Selwyn's proposed amendments to the Bankruptcy Act to allow creditors to attach and claim property acquired by insolvents *after the bankruptcy proceedings*, thereby sharply curtailing the ability of the Court to discharge bankrupts from their debts. Indeed, Mill's pro-creditor ethos was part of the moral culture of nineteenth century England.

According to G. R. Searle, the conventional view in British culture—a culture reflected in and reinforced by the works of the great English novelists—was that a "merchant or trader forfeited his 'manhood' if he became a bankrupt" (Searle 1998:88). In the Victorian novels financial disaster was enough to undermine personal identity and "create confusion in social and sexual roles, leaving in its wake feelings of deep humiliation and disgrace" (see Searle 1998:88).

Mill's ideas about bankruptcy can be readily summarized as follows: bankrupts were inherently suspicious people. Even when innocent of fraudulent bankruptcy, most were guilty of mismanagement and over-optimistic speculation. The idea of allowing a debtor to simply walk away from his debts and enjoy a "fresh start" was anathema to Mill and the other major writers of his day. In sum, the classical economists wanted the law to protect the creditors and hold all tradesmen to the highest ethical standards of behavior, which meant that they should make good on all their business debts. Creditors' rights needed protection and bankruptcy proceedings should have as their principal objective the preservation of the value of the assets possessed by the debtor for the benefit of the creditors (Baird 1996).

In later years the customs and laws would change to allow some creditors to receive additional protections. These practices have become necessary once the corporate form of business organization provided "limited liability" benefits for the owners (Rosenberg and Birdzell 1986:192–200; Miller 1996). Some creditors will refuse to make a loan at an advantageous rate of interest unless they are given additional security against the debtor's subsequent default. If the money borrowed is used to purchase tangible assets, the creditor may demand and be given what is called a "security interest" or mortgage on those specific assets. A document is prepared that is signed by the debtor notifying the public that a specific creditor has a property interest in a business asset that is in the possession of the debtor. A "public record" is made of this fact that certain tangible property in the possession of the debtor is not fully owned by that debtor. Future creditors are therefore put on notice that certain assets will not be available to help pay off any subsequent debts the debtor may incur. The secured creditors enjoy a "priority" in the event the debtor becomes insolvent and his assets are sold to repay the creditors. Their secured claims get paid first, before the other creditors. In a limited liability legal framework, the creation of the secured creditor seems justified since many creditors are far removed from the management of the enterprise without a practical way of checking up on the sobriety and credibility of the managers. They mitigate their distrust by prudently holding a security interest in particular property (assets) (Schwartz 1996:17).

In the case of debtor default, the secured creditor will petition the court to order that the secured property be removed from the enterprise and turned over to the creditor so it can be auctioned off or sold to help recover the creditor's initial investment and unpaid interest. In the case of a bankruptcy petition, the secured asset may not be returned to the secured creditor but instead kept in combination with other enterprise assets and sold as a "collection of assets" along with other enterprise assets such as "good will." The secured creditor will receive the value of his collateral out of the sales proceeds.

But what of the insolvent enterprise? Should not its business interests also be protected by the law? Already, in Mill's time, attitudes toward bankruptcy were becoming more accepting of debtor reorganization. The major catalyst in the debtor rehabilitation movement was the railroad. With the network of railroads that crisscrossed England in the 1840s we have an industry in which high sunk costs make the enterprises subject to frequent financial embarrassment. With overbuilding and competition even the best managed lines can find themselves pricing below average total cost. Losses mount. Under these special circumstances, it may be in the public interest to keep the railroad system from becoming dismembered by individual secured creditors picking off machines, rolling stock, and large sections of laid track. Insolvent debtors might be allowed to remain in possession of the means of production under the supervision of the courts until they work out a court supervised plan to reorganize these businesses. Here creditor rights—that is, the rights of railroad bond holders—must give way to the rights of debtor managers who must be allowed to keep as many assets as possible so as to maintain the railroad assets together and the whole operation in full as a going concern.

## III. The Demise of the Creditor Rights Philosophy

As early as 1867, the English legislature explored statutory systems for the reorganization of the railroads (Finletter 1939:1). These sorts of legislative solutions angered Mill and other economists who refused to concede that "a society built on great enterprises embodying huge amounts of fixed (the British say 'sunk') capital and producing vital goods and services and employing many thousands of workers is a vastly different thing from the unfortunate New England merchant whose bank drafts 'went to protest.'" The turn away from creditor rights all began with the railroads (Martin 1992:375). The railroads were large integrated systems that were easily threatened by the cherry picking of selected assets by unpaid creditors.

What had to be prevented were those myopic creditors coming onto the railroad line and enforcing their legal judgments by picking off bits and pieces of a grand coordinated system and making it all but worthless. Debtor insolvency can and often does lead to a veritable creditors' race. That is a situation where even though all judgment creditors understand that things could be improved if all creditors refrained from exercising their respective court awarded rights, each creditor suspects that if it does not act quickly enough to grab an assets another creditor will act and get that asset first. This bears a definite similarity to the "tragedy of the commons" situation. Bankruptcy systems are used to avoid the tragedy of the commons result—bankruptcy systems prevent a creditor's race (Baird 1996). All bankruptcy systems when triggered put a "stay" on the debt collection activities of creditors acting individually and turn the problem over to a court appointed trustee who marshals and resells the assets for the benefits of the entire group of creditors and with full consideration to their priority status.

And when a collection of business assets is more valuable as a group than if each were picked off and sold separately, then it is in the interests of all creditors that that collection of assets be kept together and the business sold as a "going concern"—this is what Thomas H. Jackson termed the "creditors' bargain" (Jackson 1996). Still other arguments in favor of a bankruptcy system can be raised. A case can be made that a bankrupt firm should be kept intact for the good of the public even though particular creditors are experiencing losses. Such a consideration includes the state's interest in keeping whole communities together and avoiding massive labor displacement and civil unrest. In the United States beginning in the second half of the 19th century, a creative use was made of the oldest of legal forms—the appointment of a "receiver" to achieve some of the objectives of the creditors' bargain (Finletter 1939:1).

The appointment of the receiver on petition from the debtor allowed the courts to stop the creditors from picking off the assets. In addition, the appointed receiver preserved the enterprise, keeping it intact, readjusted the debts of the insolvent debtor, and finally sold the firm to a new group of solvent investors using the sales proceeds to pay his own fees and also as many claims of the unsecured creditors as possible after the secured creditors were paid. The receiver could also initiate a new company "formed for the purpose of carrying on the enterprise" (Finletter 1939:1).

According to some commentators, what receivers try to accomplish is not bankruptcy at all since by their definition bankruptcy procedure is a method of liquidation. Each enterprise is broken into separate pieces and each piece is sold. First the dining room table and then each of the chairs. This, however, is not the view of bankruptcy I adopt here. In my view, the receiver's purpose is not to allow the liquidation whenever the going concern value of the firm is larger than the sum of the separate prices each asset might command when sold separately. Bankruptcy reorganization is the opposite of liquidation. What they both have in common is that the assets are sold and the revenue raised is used to pay off the creditors in accordance with the creditor rights established under the law.

At this point we ask an interesting question. Can the receiver "sell" the firm back to the original owners? This is known as "debtor rehabilitation" and it amounts to a wholesale reorganization of the financial structure of the firm while the original group of owners and managers remain in possession and control of the firm. Suppose there is enough revenue each quarter to cover the variable expenses of production but not enough to cover the recurring fixed costs. This firm is making losses. This firm can be made profitable in a flash of the magic wand by annihilating part of the fixed costs of production. Indeed, the word "reorganization" is a euphemism for the scaling down of debts to the general regret of selected creditors.[6] The bankrupt declares himself bankrupt and asks the court to order a halt or "stay" on all creditor activities to recover assets while the debtor draws up a reorganization plan. The plan is presented to the court or perhaps to both the creditors and the court for approval. Bankruptcy codes vary on the details and rules but the idea behind debtor rehabilitation is simple: the defaulting debtors are left in control of the means of production and given time to reorganize the financial structure of the firm.

Finletter offers us a historic framework for appreciating the historically unprecedented changes in the concepts involved. He divides the logical development of Anglo-American bankruptcy law into four stages of development as follows:

*Stage 1: Debtor Punishment*: The first English Bankruptcy Act was implemented in 1542 during the reign of Henry VIII. Punitive in nature, its main purpose was to seize goods in the possession of absconding debtors, especially when they had put their persons outside the jurisdiction of the local courts. Though these acts exempted many groups from their respective jurisdictions one principle guided the whole of the legislation: "nothing in them should be construed to release the debtor from his obligations or to deprive his creditors of any of their usual common law remedies" (Finletter 1939:21). In short, the purpose of bankruptcy legislation was to strengthen the power of creditors against debtor merchants who run away with another man's goods (Delaney 1992). This pro-creditor feature was radically altered in the 18th and especially in the 19th centuries.

*Stage 2: Debtor Forgiveness*: Something of a humanitarian movement for debtor relief finally did make its way into English law. In 1705, the Statute of Anne provided for the complete discharge of the debtor from his debts. Resentment of this law festered for centuries, with much public sentiment weighing in on the side of Mill's strictures that all debtors be assumed either criminally corrupt or grossly negligent unless and until they prove themselves innocent of these charges. In the United States, an 1841 Act introduced the notion of a "voluntary bankruptcy." In a voluntary bankruptcy the debtor himself can petition the court for debt relief. Of the 33,700 who entered voluntary bankruptcy under the 1841 Act, 32,000 received some amount of discharge from their debts (cited in Delaney 1992:20). According to K. J. Delaney, "under intense pressure from creditors, the act was repealed just one year after passage" (Delaney 1992:20).

The American Bankruptcy Act of 1867 was the first to extend voluntary bankruptcy to business corporations. Now both private individuals and corporations were empowered to petition voluntarily for bankruptcy protection. By the time of the Bankruptcy Act of 1898, "the concept of bankruptcy had fully evolved from an individual action offensive to the community and deserving punishment to an economic state of affairs. . . in which debts outweighed assets" (Delaney 1992:21). As Mill noted in his time, bankruptcy was already losing its punitive character and becoming a mere procedure for liquidating the estate. This series of 19th century statutes granted the bankruptcy court jurisdiction to collect the bankrupt's assets, reduce them to money, and distribute them in accordance with the best interests of the parties involved. The objective was to close-up the bankrupted estates by grouping all the assets collectively rather than handling them individually.

*Stage 3: Debtor Reorganization*: Certain types of corporations could, however, be exempted from bankruptcy liquidation in what we identify as the debtor forgiveness state. A corporation "in whose uninterrupted operation there was felt to be a public interest superior even to the claims of creditors is excluded from the [various] Act [s]" (Finletter 1939:22). Starting with the 1867 statute but consistently carried over in subsequent legislation in the 20th century, there was a non-unanimity provision by which the debtor could recover his right to his property and retain possession of it so long as the majority of the creditors agreed. This represented a milestone in the evolution of debtor relief. In America, it became the basis for incorporating an existing body of law known as "debtor reorganization legislation."

Under these legislative acts, the bankrupt corporation faced with liquidation could instead make an offer to its creditors to pay off some parts of its debt and some creditors in accordance with certain terms and conditions. If a majority of the creditors favored this proposal then the plan went to a Federal judge for final approval. The judge would then decide whether to "confirm" the "composition" or what is now called the "reorganization plan." If the judge confirmed the plan then the promises and obligations contained in the plan became for all intents and purposes an order of the court.[7] The bankrupt was discharged from his debts except those new debts that he had agreed to pay by the terms of the proposal his creditors had approved. According to Finletter, "the composition amendment was a distinct advance [in the direction of debtor relief] in that it introduced for the first time the right of the debtor to retain an interest in his. . . property. By substituting a new estate [in accordance with the reorganization plan] the old estate was ransomed [back]" (Finletter 1939:23).

In America the pioneering pro-debtor legislation of 1867 was repealed in 1878. After 1878, the main purpose of the American bankruptcy system was to protect the value of creditor rights and not rehabilitate insolvent debtors. However, the crisis of 1893 led to a clamor for a new bankruptcy act with debtor rehabilitation provisions, and in 1898 after this twenty year hiatus (1878–1898) new legislation was passed into law. During the hiatus of 1878–1898 something novel happened in the United States. The Federal courts, modifying the old idea of receivership under the equitable jurisdiction of the courts, appointed receivers whose job it was to reorganize the firm for the benefit of the creditors. In most cases these reorganization attempts failed. According to Delaney, the company and the largest creditor (usually the bank) tried to extinguish the claims of the other smaller unsecured creditors (Delaney 1992:22). Many creditors railed against the reorganization plan idea. The dissenting creditors wanted to first be paid off before the debtor and the senior could implement their reorganization plan. All these ideas and early experiments established the precedent for the rehabilitation of debtor relief under a system that would be more sensitive to the interests of the unsecured creditors. Such arrangement required legislation.

*Stage 4: Debtor Rehabilitation*: In this last stage, debtor rehabilitation took on a new shape and culminated in the famous "Chapter 11" provisions under the U.S. Bankruptcy Act of 1978. In America, the 1933 and 1934 Amendments to the bankruptcy law as well as later amendments added by the Chandler Acts of 1838 institutionalized and made more practical the aims and objectives of the receivership idea. Under these laws and amendments, a creditors' committee can reject a debtor's reorganization plan and instead suggest an alternative reorganization plan that does away with the current managers and owners or in other ways restricts their role. This means that creditors do play a meaningful role in deciding by who and how the bankrupt firm's assets will be managed. The process is supervised by a Court-appointed independent trustee. The present managers and owners are invited to offer competing plans. The creditors are divided into classes depending on the priority position of each in the event of liquidation. Each class of creditors votes on the plan. It is possible under the 1978 bankruptcy act for a dissenting class of creditors to be forced by the court to accept the reorganization plan proposed by the others—a so-called "cram-down" provision. With the introduction of the concept of "cram-down" we have come full circle from bankruptcy as a punitive attack on the defaulting and bumbling debtors to something widely recognized as a qualified debtor-rehabilitation statute.

According to Delaney, “this goal of debtor rehabilitation gradually became elevated to stand alongside other norms reflected in bankruptcy, namely, the punishment of debtors and debt collection. As legislators and courts expanded bankruptcy law, it became clear that the law could be used as a political instrument to repair the economy” (Delaney 1992:22).

Bankruptcy law became in the last half of the 20th century a debtor-relief system rather than one strictly established to maintain the value of creditor rights. It does not disregard completely the interests of the creditors who still play a part in the reorganization sequence of events but creditor rights are not its main purpose. On the other hand, the law limits the power of selected secured creditors to claim their collateral or even its full value. Under certain circumstances, Chapter 11 can be used and has been used to annihilate creditor rights. One peculiar use of Chapter 11 is when one group of creditors, acting along with the firm, petitions itself into bankruptcy as a “strategic political device used by large corporations and commercial creditors. . . as another weapon in the corporate arsenal” (Delaney 1992:3).[8]

## IV. Debtor Rehabilitation in the 21st Century

Many countries of the world have already followed the United States and adopted a qualified debtor rehabilitation philosophy. They have looked to legislation and the courts to provide a nurturing “framework within which claimants can bargain about the future of the firm, that is, decide by structure[d] negotiation whether [the firm] should be liquidated or reorganized” (Aghion, Hart, and Moore 1994:220). Aghion, Hart, and Moore explain the basic idea most simply and elegantly as follows:

> The details of Chapter 11 [of the U.S. Bankruptcy Code] are complicated, but the basic idea is the following: claimholders are grouped into classes according to the type of claim they have; committees or trustees are appointed to represent each class; and a judge supervises a process of bargaining among the committees to determine a plan of action for the firm, together with a division of value. During the process, incumbent management usually runs the firm. An important part of the procedure is that a plan can be implemented if it receives approval by a suitable majority of each claimant class: unanimity is not required (Aghion, Hart, and Moore 1994:220–221).

An accompanying note clarifies how unanimity is avoided. According to the authors, “for a plan to be agreed to, it must receive approval by a two-thirds majority in value terms (and a simple majority in number of terms) of each debt class and a two-thirds majority of equity—although under certain circumstances a plan can be forced down on a [dissenting creditor] class [by the Judge]” (Aghion, Hart, and Moore 1994:221).

One of the key features of Chapter 11 bankruptcy is that the incumbent management “can seek protection from creditors unilaterally by filing for reorganization, without creditor consent” (La Porta et al. 1998:1135). This gives management a great deal of power in countries like the United States. In many countries, creditor consent is needed and this prevents management from easily escaping creditor demands (La Porta et al. 1998:1135).

Not only the United States, but even modern Japan, has a Chapter 11 system in place. In the Japanese variant, the Judge appoints the trustee to draft the plan and after a negotiation process it must be ratified by "four-fifths of the secured creditors' approval and two-thirds of unsecured creditors' approval (shareholders cannot veto); if the plan is not ratified, the company is liquidated" (Aghion, Hart, and Moore 1994:221).

Other nations of the world can be loosely grouped as pro-debtor or pro-creditor depending on the ease of difficulty with which they allow management and the pre-bankruptcy owners to remain in possession of the assets both during the negotiation and after the subsequent rehabilitation of the firm. According to Philip R. Wood, a pro-debtor jurisdiction seeks to aggrandize the debtor's estate by restricting secured creditors from (1) collecting their secured property, (2) refusing to enforce an insolvency set-off agreement, and (3) setting aside title finance leases so that the leased asset is treated as "belonging to the lessee on his bankruptcy" and no longer belonging to the creditor (Wood 1997:36). Pro-debtor jurisdictions also demand the return of "all payments and transfers by the insolvent member in long suspect periods [leaving creditors] with a minimum of defenses [and] promote corporate rehabilitation procedures" (Wood 1997:36). A creditor rights jurisdiction uses bankruptcy procedures only to protect the value of creditor rights by avoiding the tragedy of commons where creditors pluck away assets in a relentless effort that produces an outcome that many regret. Once in bankruptcy, a firm might either be liquidated or sold to a fresh new group of investors depending on which choice would result in the most value for the creditors.[9] According to La Porta, it is common law countries that protect investors the most, and French-civil-law countries that protect them the least (La Porta et al. 1998:1135 and 1151). These authors cite several studies that suggest that "countries with better developed financial systems show superior growth in capital-intensive sectors that rely particularly heavily on external finance" (La Porta et al. 1998:1152). This is a view entirely consistent with the claims of orthodox economics such as found in the classical school economists or the modern Austrian writer Ludwig von Mises.

Armed with this distinctive framework, we can follow Wood and speculate about which particular combinations of law and legal practices can be described as "pro-debtor" versus "pro-creditor." It is clear that "the objectives of financial law are to enhance prosperity and to achieve fairness between debtors and creditors" (Wood 1997:89). This suggests a challenge.

Suppose we have a region of the world suffering from radical dis-investment that threatens prosperity and contributes to a decline in living standards. Assume, in addition, that we have hordes of angry creditors railing at the silence now greeting their demands for repayment of their financial investments or at least the return of their collateral. Finally, we accept the fact that the vast majority of the large-sized firms are still state-owned enterprises, in the hands of corrupt politicians, that are for all intents and purposes insolvent and drawing subsidy transfers from the state and a plethora of bribes. Indeed, the workers are paid combinations of wages and paper promises of additional wages. In such an incredible business environment should the modern concept of debtor rehabilitation and Chapter 11 reorganization be introduced? Perhaps the classical endorsement of "creditor rights" is what needs to inform commercial law and legal reform. My view is that instead of debtor rehabilitation, the court system should be used to remove the political control of the old nomenklatura and permit a new groups of solvent owner/managers to be brought in instead. If they fail, then another group, until one is found that serves the most urgent wants of consumers as expressed through the institutions of the market (Mises 1980). This, in my view, is the most practical way of achieving the common goal of creating a competitive market system in modern Russia.

## V. The Case for Creditor Rights in Contemporary Russia

That the modern market system is subject to periodic and unavoidable bouts of depression and recovery—the ebb and flow of the business cycle—was first advanced in the writings of Lord Overstone in the 1840s and was carried over from the radical tradition in economics into the 20th century, notably by Wesley Mitchell, Arthur Burns, Joseph Schumpeter, Simon Kuznets, and most of the 20th century textbook writers.[10] It is reasoned that a modern enlightened bankruptcy code—enlightened by our modern understanding of the business cycle—must make provision for “debtor rehabilitation.” If periodic business downturns are endemic to a modern market system, why should an enterprise be dismantled or sold by a receiver to a new solvent group of owner/managers? Since its difficulties stem from a downturn in business conditions not of its own making and not from fraud, mismanagement, or reckless speculation, it should not be allowed to fail and go out of business. Debtor rehabilitation avoids waste, saves jobs, and promotes social stability. Social responsibility, it is currently thought, requires that the government supervise a reorganization even if it means severely limiting selected creditors’ rights. Once the word is out that these things happen during business cycles, creditors can plan accordingly. Interest rates will be raised, collateralization of loans taken more seriously, and the length of trade credit shortened severely. A modern market system adjusts to these changes in the rules although not without certain costs to efficient production and exchange. According to the proponents of debtor relief, in this way jobs are saved, massive urban blight is avoided, and the distressed firms are kept in business somewhat longer. Indeed, social responsibility to other stakeholders of the modern firm beside the creditors requires no less.

The wholesale transfer to contemporary Russia of these modern pro-debtor welfare state ideas about corporate rehabilitation is an awful mistake. Russia lacks the infrastructure, institutions, traditions, and to a great degree the understandings of a market capitalist system. Current Russian poverty is not the result of a recurring business cycle phenomenon. Russian poverty is part and parcel of a long-term secular stagnation that is underway. In Russia, it is critically important to promote private investment and avoid capital consumption. The “collapsing economy” syndrome can be reversed and the hemorrhaging stopped only if the life-blood of economic prosperity returns in the form of foreign direct investment. Long term investment is keyed to creditor rights, not debtor rehabilitation. The whole point of creditor rights is reassuring those in a position to make the investments that their capital will be returned along with interest. Part of the solution to the collapsing Russian economy must be in the forceful recognition of creditor’s rights.

Indeed, the importance of protecting creditors must be elevated in Russia to something of a social religion if investor confidence is to be restored and the economy is to attract sufficient capital for stabilization and growth. Indeed, the legal reality in modern Russia must change. Investors must believe that if they lend a Russian enterprise, say, a million dollars, they will be repaid. The managers of the Russian enterprise will secure their repayment promise by issuing a security interest in certain property and equipment to the creditor. In the event of default or criminal behavior by the managers, the creditor must be able to rely on a judicial system to reclaim those assets and resell them to recover part of what it is owed. When a Russian firm petitions itself into bankruptcy, the procedure must respect and protect the market value of the creditor's claims.

The current situation in Russia has been described by many commentators and in a variety of ways. Dr. Grigory Yavlinsky, a Russian economist and leader of the Yabloko reformist party, insists that the "present system of economic management, where most large enterprises are run by insiders who disregard the owners' [and creditors'] rights, must be radically reformed . . . the government must encourage responsible management based on a conception of private property that ensures and protects the owner's rights. Bankruptcy laws should be fully enforced to help eliminate incompetent managers, crooks, and Soviet-style directors who are unable to adapt to market realities. Enterprises that hold on to workers and produce nothing but debts should be closed or sold" (Yavlinsky 1998:78).

More precisely, a creditor's rights are better protected in an economy

A. where bankruptcy proceedings are used to avoid a creditors' race and their main purpose is to protect the value of creditor rights;

B. when any creditor is allowed to "set-off" his payments due to the insolvent debtor or his representative, and the debtor is not allowed to "cherry pick" which assets to keep and which to deliver to the creditors in order to satisfy the debt when the creditor disagrees. (In short, the creditor should have his contractually agreed "set-off" rights enforced by the courts);[11]

C. when the creditor is able to reclaim or repossess from the debtor's business establishment a large variety of property (real, tangible, and intangible) in which it has a previous negotiated "security interest." (The creditors' lawful efforts to reclaim the property should not be negated by the bankruptcy law but instead assisted. The insolvent debtor needs to turn them over to the secured creditor because the secured creditor on previous occasion(s) "perfected" that interest in some relatively transparent and cost-effective way.[12] In the case where the asset in question is integral to the going concern value of the business and the firm is petitioned into bankruptcy, the creditor's claim to that asset must be reappraised at current market prices and carefully preserved throughout the bankruptcy proceedings. The bankruptcy proceedings are for the benefit of the creditors and not a debtor-rehabilitation scheme);

D. when the creditor is successful in reclaiming property (such as stocks and bonds) that did not belong to the debtor. (In many situations the debtor has in his possession property that is being held in the debtor's name, but where the debtor was acting as a mere "trustee" or "custodian" for the creditor. This property must be returned to the creditor without delay. It should not become part of the debtor's estate and used to satisfy other creditors' claims against this debtor).[13]

Reflecting on these notions of creditor rights, what can be said about the current state of creditor rights in contemporary Russia? The evidence suggests that creditors' rights are more talked about in theory than protected in practice. Let us consider the evidence.

## VI. The Ominous Demise of Creditor Rights in Russia

In 1997, the esteemed ice cream manufacturer and retailer, Ben & Jerry's, shut down its Russian operations (mostly) in the city of Petrozavodsk (near Finland). That enterprise manufactured and shipped ice cream products to both the Moscow and St. Petersburg areas of Russia. The editors of the *East/West Executive Guide* were curious about the Ben & Jerry corporate retreat and naturally rushed to interview Mr. Bram Kleppner, the former manager of those Russian operations (Kleppner 1997). Mr. Kleppner related financial trouble with Ben & Jerry's joint-venture (Russian) partner. When the parties could not agree and asked the court to intervene, Ben & Jerry's suffered an adverse legal judgment that was rumored to reflect some "influence-buying by the bank" on behalf of one or more estranged Russian partners (Kleppner 1997:26). In the end, Ben & Jerry's took back its trade name but left everything else and simply walked away from the multi-million dollar deal. In addition, they "forgave all of the joint venture's debts to Ben & Jerry's" (Kleppner 1997:26). Ben & Jerry's lost more than its rights as an owner and creditor, it lost its entire investment. The Ben & Jerry's company took down their sign and logo and simply walked away from their substantial fixed investments.

In Mr. Kleppner's interview he offered a relatively benign version about the final days of Ben & Jerry's in Russia, but enough to cause a skeptical investor to read a message between the lines. When asked about the company's experiences as a creditor giving trade credit to the presumably Russian "independent distributors" who worked to get the product from the factory to the consumers in the cities, Kleppner offered some solemn advice. He warned future venturers in Russia "to set very strict credit limits, and if any buyer has an outstanding balance on any previous shipment, not to ship any more product until the buyer has completely paid off the previous shipment" (Kleppner 1997:27). Product distributors in Russian cities are often covers for the racketeers, mafia gangs, and protection racket chiefs (Whitehouse 1998; Ignatius 1995; Ingram 1994; Specter 1994; Bohlen 1993; Simis 1982). Did Kleppner's staff try to enforce a judgment against these distributors only to find themselves and their families threatened with physical harm? Kleppner was not asked about any threats of physical harm or the efficacy of a civil lawsuit resulting in a judgment against the distributor. I advance here only my suspicions about what may have occurred. Such insecurity about life and property is not uncommon in modern Russia.

In another context, litigator Glenn P. Hendrix warns about the unimaginable difficulties presented when using the Russian commercial courts (Hendrix 1997). In 1995, the Russian commercial courts (known as the arbitrazh courts) handed down 237,291 legal decisions, many of which favored the creditors. The difficulties investors face is not so much in obtaining favorable verdicts; the grave difficulty is in trying to collect on those verdicts. According to Hendrix, "the [Russian] Code of [the] Commercial Courts authorizes the seizure and sale of a debtor's property to satisfy a judgment, but does not outline a procedure" to actually obtain possession of the property so that it can be sold to satisfy the judgment (Hendrix 1997:17). Incredibly, Russian bank manager routinely ignore a judge's "writ of execution" to transfer a debtor-owned deposit to a judgment creditor. Incredibly, the bank managers show absolute contempt for the civil court and turn the bank account money to the debtor despite the best efforts of the judgment-creditor to stop this from happening (Hendrix 1997:17). No subsequent follow-up procedure exists to punish the banks for their managers' behavior. Indeed, in a disturbing admission, the First Vice Chair of the

(Russian) State Duma, Mr. Alexander Shokhin, blurted out at a press interview in July 1996 that creditors will find it "much easier to send a group of armed people to collect debts than to appeal to an arbitrazh court and expect its rulings to be carried out promptly" (Hendrix 1997:16). Additional evidence suggests that creditor's rights may have deteriorated even more since Shokhin's 1996 interview.

In March of 1998—only months before the massive financial crisis in Russia in which the Russian government disclosed that it could not meet interest payments on its billions of dollars of outstanding debt ("Investors Face $33bn Losses from Russian Bond Default," 1998)—Russia's new bankruptcy law was announced. This was intended to replace the toothless Insolvency (Bankruptcy) of Enterprises law that the Russian parliament had enacted in 1992. The previous law, a nightmare for creditors, provided that a Russian firm was insolvent if and only if it was unable to satisfy its creditors' demands and at the same time if the total debt it owed was larger than the value of its property or "if the structure of the balance is not satisfied" (Maximov 1998:3). In practice this meant that it was up to a Russian court to declare a firm bankrupt. Before a judge could decide, he or she had to draw up a list and then price the firm's many assets. Such a chore is all but impossible in an economy where an active resale market for already-produced assets simply did not exist and modern accounting practices are still in their infancy. Creditors anxiously waited for a decision while debtors used the time delay to grab, steal, and embezzle what they could for themselves before the curtain falls.

Still, despite the evidentiary difficulties imposed on creditors by the Russian bankruptcy law, "1996 witnessed a total of 2,168 separate bankruptcy or insolvency cases in Russia, versus 1,108 in 1995 and 240 in 1994" (OECD 1997:119). The principal actors in the spurt of bankruptcy adjudications in Russia have been the Federal Insolvency Agency and the State Tax Service. Both agencies—in a desperate effort to raise government revenues (as required by their international lending agencies)—descended on the private firms in organized raids to obtain unpaid taxes in either cash or property. These raids were often costly to the other creditors, including "those who did not receive wages and commercial banks" (OECD 1997:121). Here creditor rights were enforced but most selectively, favoring the tax authorities. Creditor rights must go further than protecting the tax authorities at the expense of other creditors.[14]

In some cases, the logic of the situation bordered on the bizarre. The large gas monopoly Gazprom is one of the most prominent tax debtors in Russia with outstanding debts of well over Rb 15 trillion. Now Gazprom itself is owed over Rb 48 trillion from its customers, who are protected by Russian law from having their electricity turned off for nonpayment of their bills. In practice this means that the households care little about paying their electric bills. The Russian government knows that if the utility company were to shut off power the state would have to pay the electricity bill, and the government would have to subsidize these private expenditures or else risk mass revolt. Thus, the owners of Gazprom are implicitly financing a large part of what would otherwise be debt-financed government subsidies. If the Russian government were to foreclose on Gazprom and Gazprom were to foreclose on its customers, the tax revenues collected by the Russian government would float right out again in the form of private household subsidies.

The 1998 bankruptcy law has now done away with this enigmatic valuation problem faced by the Russian courts. Now to declare a firm "bankrupt" is to declare that the firm has gone three months without making a payment and has a debt more than 500 times the existing officially-designated minimum monthly wage. This condition is much easier for unpaid creditors to satisfy in a court of law. The bankruptcy reform legislation of 1998 will not change much between the Russian government and its state monopolies. However, it may be a bonanza for foreign investors who are afraid of losing their investments once they commit to direct investments in Russia.

Mr. Peter A. Maximov of the Moscow office of the Coudert Brothers law firm (which advises clients about Russian bankruptcy law when they invest in Russia) has declared this new legislation a victory for creditor rights (Maximov 1998:3). Based on a careful reading of Maximov's article, however, there are grounds for skepticism about the future of creditors' rights in Russia.

The 1998 legislation singles out for special treatment a "core-company of a city"(CCC). These are the companies that employ a large number of employers. Many social reformers believe that these CCC must never be allowed to fail—they are the "tent cities" supporting lives and livelihoods in a large geographic area. A CCC is defined as follows: either it employes 5000 employees or its continued existence affects the lives and livelihoods of more than 50% of the people in a defined area. But who defines the "defined area"? So long as the debtor or his agents define the CCC the creditor is not likely to have his rights protected. Russia's new bankruptcy law is similar to the debtor rehabilitation philosophy enshrined in the United States as "Chapter 11" of the 1978 Bankruptcy Code. Russia, most emphatically, is not the United States. Insolvent firms in Russia should not be allowed to reorganize at the expense of creditor rights. The assets of these firms should be transferred in whole or piece by piece to a new group of solvent owners in a manner calculated to raise the most money on behalf of the unpaid creditors (Mises 1980).[15]

It may also be of some interest that on May 29, 1998, President Yeltsin signed a decree that facilitates the seizure of a debtor's property. Additional provisions were made in the Russian Federation criminal code to punish false bankruptcies, that is, those in which debtors feign insolvency to scare outside foreign creditors into agreeing to settle for a buy-out of their interests for a fraction of what those interests are worth. This legislation must be seen as less [of a] victory for creditors than an open admission that the business environment for investors in Russia has reached unprecedented oceanic lows. Further evidence that creditors are routinely defrauded in Russia is the January 1, 1997 addition to the Federation Criminal Code threatening personal sanctions against managers who aggravate or even cause insolvency by grossly negligent behavior (Holland and Rosenberg, April 1997:14).

The 1997 OECD report on the Russian Federation offers an insightful discussion of what ails Russia, and how, absent outside creditors with much power, "insiders" will continue to avoid or postpone reform in order to steal assets for themselves and their small army of collaborators (OECD 1997). According to the OECD report, "the continued dominance of insiders in the majority of Russian firms, given the very weak leverage of creditors in the event of default . . . impedes restructuring and the development of capital markets from several points of view" (OECD 1997:132). For one thing, weak and corrupt management cannot be removed. For another, capital markets have no effective way of punishing managers who fail to mitigate costs and increase revenues. Finally, the local authorities "who control licensing and various other special taxes, are able to engage in informal rent-seeking activities at the expense of enterprise incentives" (OECD 1997:132–134). The privatization efforts from 1992 to 1994 resulted in the privatization of 104,000 state enterprises and a situation where "more than 50 percent of GDP and some 60 percent of employment" was private (Dolan 1998:40). But privatization "favored the rich and powerful [and] it poisoned public opinion against the whole idea of private property" (Dolan 1998:45). Many former public monopolies under the control of the Ministries in Russia are now private monopolies under the control of local mafia. Living standards are assuredly falling at the dawn of the 21st century.

Commentators conclude that something needs to be done to expropriate the crooked beneficiaries of past privatizations. A bankruptcy law designed to protect the value of creditor rights would help to do just that. Unfortunately, Russian bankruptcy law is too undeveloped to cure the problem (Dolan 1998:45). In addition, there is a distinct bias in the law toward debtor rehabilitation that points the entire reform effort of depoliticizing business property in the opposite direction (Boycko, Shleifer, and Vishny 1997). Indeed, it is not much better for foreign investor creditors in the surrounding republics outside Russia. Much evidence points to how difficult it is for creditors to have their business interests protected, especially in the newly formed republics.

The independent Republic of Uzbekistan enacted a new Pledge (Collateral) Law in May of 1998 (Horton and Geller 1998). This law was supposed to empower creditors so that they could claim secured property when a debtor fails to fulfill his financial promises. But the draft of the statute adopted those "weasel words" that make any transparent and calculated protection of a creditor's rights seem highly improbable and remote. Consider, for example, the caveat that the state can substitute a different piece of property for the secured property if it determines that this is in the best interest of a state-owned enterprise's future survival. The Pledge Law points out what everyone conducting business in the region knows well: the state still owns and controls most of the industrial property. So what is it that can be pledged?

A Uzbekistani firm has never owned the factory, the equipment, or other material assets in its possession. What does it own? At best, it might own "the right to economically manage certain assets in the factory." Is this the sort of economic right that can be pledged to secure a debt contract? But when there is no resale market for such an abstract right, how can this right be used to secure a loan agreement? Surely, the land under the factory cannot be pledged, because in Uzbekistan the land is not privately owned. Nor can the machines be pledged—they belong to the State. To actually pledge something the creditor and debtor need to go to the State Committee on Property Management and obtain a special permit to hold a particular security interest (Horton and Geller 1998). The transaction costs of this negotiation threaten to be prohibitive. Bureaucractic machinations and the grease of corruption will most likely slow the deliberations of the State Committee. In the end, the rights of a creditor to enjoy the protection of secured property are of practically no value at all. Attorneys Scott Horton and Tatyana Geller describe the new pledge law with candor:

> As in all nations in transition from a command to a market economy, in Uzbekistan much confusion continues to surround property rights issues. Does an Uzbekistani enterprise actually own its factory, its equipment or other material assets over which it has exercised unchallenged control for decades? These questions must be addressed

> at the outset in the preparation of a pledge agreement. A pledge agreement must describe the obligation with specificity. That obligation, as well as the collateral securing the obligation, must be defined in money terms. . . . The value of assets pledged depends on the nature of the debtors's rights in the property. A debtor may have either ownership rights to its immovable property, or, more frequently, rights of 'economic management' (Horton and Geller, August 1998:33).

The creditor's recourse to securing his loan remains severely limited in Uzbekistan. No one knows what the collateral refered to in the Pledge Law consists of. Horton and Geller pessimistically conclude that "taken collectively, these provisions reflect a distinctly anti-creditor bias on the part of the Uzbekistani legislature, [an apparent] departure from the former relatively pro-credit tenor of the Law" (Horton and Geller, August 1998:35).

Uzbekistan is not Russia. Since 1992 both have been partners in the Commonwealth of Independent States (Goldman 1996:57). The pledge law of Russia could be totally different from the law in Uzbekistan and could operate in a way designed to produce a pro-creditor business environment. This is a possibility, but a remote one. The reality of the situation in Russia can be described as follows.

Many large state-owned firms have been privatized, but in ways reeking of self-dealing, rigged auctions, and insider trading. Now privatized, managers run those organizations for their own personal interest, withdrawing cash, and overpaying consultants. At the helm of insolvent organizations, these managers brazenly continue to function with accelerating negative net worth. Mid-sized businesses, perhaps formed as joint-ventures, survive and in some cases seem to flourish, but losses mount. These losses owe to two causes: first, to over-billing techniques and a variety of subterfuges to under-report profits, avoid taxes, and grab cash second, to the declining productivity we associate with a collapsing economy.

Whatever the "good will" created among the foreign shareholders by announcing a joint venture in Russia, many investors and many other creditors are beating a fast retreat out of Russian and the surrounding Republics.[16] Indeed, on October 21, 1998, at a speech before the Russian Congress of Industrialists and Entrepreneurs, the editors of *Current Digest* reported that the "audience was ecstatic about [then Prime Minister] Primakov's proposal to do away with expedited bankruptcy proceedings." The report went on to say, "The enterprise directors were jubilant—their sins had been forgiven." Yury Luzhkov also delivered a speech. He concluded that Russians should not pay any attention to the market reformers who wanted to assure creditor rights. Luzhkov called for low cost loans to industry because "it's better to help one bankrupt. . . than to ruin the whole country." Luzhkov's campaign-style speech was greeted by "prolonged applause developing into an ovation" ("Primakov Gets Warm Reception. . . " 1998:3).

Several months later, on August 27, 1998, the Bank of Russia ended currency trading on the Moscow Interbank Company Exchange (MICEX) and the ruble collapsed. These events greeted the appointment of Viktor Chernomyrdin as the new head of the Cabinet of Ministers only a few days earlier. The return to the old has been interpreted as a sharp movement away from bankruptcy reorganization as the old oligarchs retain their jobs at the expense of protecting those who might otherwise fund economic development in Russia ("Markets Die as Politics Stalls Policy Response" 1998:7).

I conclude that as of this writing (the Fall of 1999) the future of secured creditors in Russia seems to be ominous indeed. Without direct investment in the plants and factories, productivity falls, real incomes decline, and the economy continues its collapse.

## VII. Conclusion

So what can be learned from the history of economics that might be relevant to the transition economies such as Russia? What can be learned is how much of the success of an extended market system depends on one group of strangers keeping promises to another. The ones who make the promises sometimes use collateral to secure those promises. The recipient of the promises commits resources with the expectation of having them returned with interest or profit. When someone must borrow to invest in materials and other forms of property kept in his possession, a pledge or security system must protect the rights of creditors from the debtor's default. Such a system must assure potential investors that they too will share in the enhanced (value) productivity that the loaned funds make possible. A creditor must be persuaded that his principal will be returned along with the agreed-on interest in the manner and according to the schedule negotiated and entered into by the parties. When enterprises abrogate these promises and creditors descend on the firms to claim their assets by the exercise of their creditor rights, then the need for an orderly bankruptcy procedure arises to avoid a creditors' race. It is in this context that dangerous concepts such as debtor rehabilitation and bankruptcy reorganization rear their ugly heads. In legal systems such as the United States where debtor versus creditor rights are fine-tuned to promote a greater prosperity for all, the mixed rights system has worked and some might say "worked well." It immunizes an otherwise healthy business from a mere "cyclical downturn."

Russia is experiencing much more than a mere "cyclical downturn." Secular decline is what threatens that area, especially at the dawn of the 21st century. In a healthy economy that depends upon capital accumulation, it is critically important that creditors and especially secured creditors be assured that their interests will be placed first and foremost in the event of debtor-insolvency. John Stuart Mill and the classical school thought that the great mass of debtors were the cause of their own misery and deserved to suffer the inevitable consequences of their profligacy at the hands of disgruntled creditors. In our time and especially in the wealthier Western nations, such words seem to be quaint, old fashioned, and even cruel.

The evidence from Russia suggests that the orthodox call for creditor rights is appropriate for Russia. The means of production is in many cases in the hands of many irresponsible and dishonest managers. The solution is to remove the assets from their managerial control when the enterprises they manage become insolvent. In Russia, we would do well to heed the classical school's advice and support all reforms that favor creditors and respect their legal rights and claims. Insolvent debtor firms should be allowed to fail. Arrogant managers should be removed from office, as creditors' committees initiate their own reorganization plans to protect their legitimate business interests. Those firms owned by the political oligarchs should be cut down, dismembered, and the assets they command reshuffled to uses that produce greater value. Bankrupt debtors should not be left in full possession and control of their assets; most certainly these defaulting debtors should not be rehabilitated.

This policy is not vindictive but constructive. The goal is to encourage investors to undertake valuable projects in Russia by ensuring that their business interests as creditors will be well protected. Such security would help to produce a healthier economy; living standards may start to rise as we enter the 21st century. In a region without a rule of law or with a rule of law that protects the reckless and the dishonest, life will rapidly sink into Thomas Hobbes's natural state where life is nasty, brutish, and short.

It is not the financial crisis or "capital flight" that we must fear the most in Russia and the surrounding regions (as difficult as this phenomenon is for assuring investors that they will be able to repatriate the value of their original capital investments). Still, we must address the more serious problem in Russia which is the slow and steady process of disinvestment and capital consumption that heralds imminent social collapse. One small but crucially important step in stopping the capital outflow and the decline of long term investment and net export of the annual production of an increasingly impoverished nation is to adopt the older classical school call for creditor rights.

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**Notes**

1. I have in mind the "tricks of the trade" by which the managers in control of the factories steal cash from the firm. They do so by enlisting other firms to overbill. The manager approving these charges obtains a "kick back" or bribe by receiving cash payments in accounts outside the area. A more sensational episode involves the central bank of Russia and an estimated 855 million dollars of funds that it received from the International Monetary Fund and the World Bank at low interest rates. These monies were used to purchase the Russian central banks' own bonds—the G.K.O.'s that were paying upwards of 200% interest. The G.K.O.'s were later within the same years liquidated and the original 855 million dollars returned to the central bank. The entire transaction involved a secret offshore company known as "Fimaco," located on the Channel Island of Jersey, and owned by the Eurobank. The Eurobank is partially owned by the Russian central bank. What remains unaccounted for is the profits earned on the short-term bonds. Did they leak off into "commissions, risk margins and other profits collected [by insiders] along the way"? The machinations of the Russian central bank and the missing profits have captured the attention of Yeltsin's critics within Russia and the episode is suspected to be another instance of what some critics term the "grabitazation" or, more politely, "nomenklatura privatization" (Bohlen 1999:A8; Boycko, Shleifer, and Vishny 1997:58). According to the *Financial Times* which cited a study of the Russian Academy of Sciences and the Center for the Study of International Economic Relations of the University of Western Ontario, "up to $70 [billion] disappeared between 1992 and 1993 alone. Other specialists argue that total capital flight in 1994–1998 amounted to more than $140 [billion], and currently is running at over $15 [billion] a year" (Jack 1999).
2. The balance of payments must always balance. If we separate capital flows from all other flows and confine all transactions to the "current account," then a deficit on the capital account must correspond precisely to a surplus on the current account. In "hot money" movements where a contagion of pessimism sweeps over the financial markets causing the local currency to cheapen on international foreign exchange markets, short-term capital in the form of bank deposits and selected bonds can decline rapidly while long-term capital flows remain constant or even increase as investors see "bargains" and engage more ferociously in foreign direct investment by; say; purchasing land titles and stocks. Depending on the magnitudes involved, the "current account" of the local balance of payments could remain balanced or even in deficit during a so-called currency panic. In Russia, I contend, we have the "hot money" *plus a decline in foreign direct*

*investment*, although admittedly measurements of the magnitudes involved are difficult to come by. See note 3, however.

3. According to the Russian European Centre for Economic Policy, fixed investment in Russia declined markedly from a peak in the Winter of 1997 to a trough in the Winter of 1999 but did show signs of a revival by June of 1999 (RECEP 1999:9).
4. Kasparov is not afraid to name names. He wrote about the 51% state-owned Aeroflot airline as follows: "[the company] is nominally run by Valeri Okulov, Mr. Yeltsin's son-in-law. But it is universally acknowledged that effective control of the monopoly company rests with financier, media mogul. . . Boris Berezovsky. The non-Berezovsky-owned press has been full of reports detailing how proceeds from Aeroflot tickets are transferred to offshore accounts owned by Mr. Berezovsky and his associates" (Kasparov 1998).
5. Adam Smith uses the word "bankruptcy" at least fourteen times in the *Wealth of Nations*. In Book 5 of the *Wealth of Nations*, Smith anticipates the "creditor-rights" tradition also found in the works of Ludwig von Mises and others, when he attacks debasement of the coinage ("raising the coins" ) as a deceptive substitute for outright public bankruptcy (Smith 1976:929–931). There are other places in Book 5 of the *Wealth of Nations* where Smith discusses bankruptcy. These references include a lengthy discussion of the English East India Company and how in recent times it has staved off bankruptcy by gaining special subsidies from the sovereign (Smith 1976:746, 753, and 819). Book 5 also contains Smith's comparison of tax farming with direct payments to the sovereign. Smith finds tax farming inferior because the tax farmers will squeeze the people until they are ruined without any regard for the broader public interest (Smith 1976:903). In Books 1 and 2 of the *Wealth of Nations*, Smith passes judgment on those adventurers into gold and silver mining or smuggling who systematically overestimate their chances of business success and end up bankrupt because they are not realistic (Smith 1976:127–128, 187, 562). In Book 2, Smith exposes an early version of what might be called today "check kiting" but in the context of bills of exchange. Smith comments about how people totter on the edge of bankruptcy in a desperate effort to obtain credit this way (Smith 1976:308–309). On my reading of the *Wealth of Nations*, those individuals most likely to go bankrupt were those who overestimated their chances of business success and approached business investment as if it were a lottery, counting on their own poverty to eliminate any downside risk. It is clear that individuals may flirt with bankruptcy and sometimes become bankrupt in a desperate effort to keep up the appearances of wealth to those around them when their personal circumstances require greater frugality (Smith 1976:348).
6. Not all creditors lose in reorganization. Some creditors are "more secured" than others and they gain wealth when a reorganization plan cuts the claims of less secured creditors. For example, consider a case where there are 30 unsecured or less secured creditors and only one secured creditor (say, a large bank). In this case, it is conceivable that the secured creditor class will have more power than the larger class of 30 unsecured creditors and will vote to approve only those reorganization plans that protect the full value of its outstanding debt to the reorganizing firm.
7. If the debtors did not keep these promises and obligations, their behavior could be construed as "contempt of court." Contempt for the court is a most serious charge that would subject the managers of the firm to arrest and possible incarceration depending on the circumstances. We have here a sort of voluntary reorganization plan that now subjects the owners to a much more rapid form of legal enforcement presumably by Federal marshals.
8. Delaney explains the strategic implications of Manville Corporation's, a major profitable manufacture of asbestos materials, decision to file for bankruptcy protection in 1982. In the face of swelling damage lawsuits, the company used Chapter 11 to reshuffle the value of creditor claims and finally shifted the risk of loss to a unorganized class of future potential creditors, the future asbestos victims who have yet to be diagnosed with asbestos-related illnesses (Delaney 1992:80). Delaney considers other unorthodox uses of the Chapter 11 debtor-rehabilitation statute in the 1983 case of Continental Airlines and the unions and the 1987 filing of Texaco to avoid paying Penzoil's \$10.53 billion court judgment and to enlist the aid of other unpaid creditors in forcing Penzoil to settle this extraordinary claim (Delaney 1992).
9. Wood makes several additional contributions. First, he reminds us that the American common law system is just one legal system operating among many. In addition to the common law system, Wood distinguishes a mixed common law/ Roman law system now taking root in Japan, South Korea, South Africa, Sri Lanka, and other places; a Germanic and Scandinavian system that can be found in Germany, the Netherlands, Poland, Finland, Norway, Taiwan, and Sweden; a mixed Franco-Latin and Germanic system in Austria, the Czech

and Slovak Republics, Hungary, Italy, Thailand, and Turkey; Islamic law jurisdictions which include Saudia Arabia and Afghanistan; and finally an emerging jurisdictions category where the nations included have not yet given enough evidence of belonging to one grouping or another. Most notably this transition economy group besides China includes Mongolia, Vietnam, Cambodia, the three Baltic Republics, Russia, and the former USSR republics.

10. See for example, "Samuel Jones Loyd (1796–1883)," and "Arthur Frank Burns (1904–1987)" in (Glasner 1997, s.v.).
11. Suppose we have a business entity called "Babbo Enterprises" and an investment bank known as the Metro Bank. The Babbo group borrows $100,000 and promises to pay the bank off in equal installments of $1,000 per month. At the same time, as part of the agreement, the Metro agrees to service letters of credit for Babbo. Babbo opens a business deposit account in the Metro bank. Several months into the contract, Babbo stops paying its monthly installments and Metro seizes the balance in the business deposit account in part payment of the outstanding balance. In a "pro- creditor rights" environment, this practice is supported throughout the insolvency/bankruptcy period even if the consequence of this "set off" is to reduce the amount of net wealth available for distribution among the other unsecured creditors. In some countries such as France "set off" is discouraged or disallowed, and the insolvent debtor or its trustee can "cherry pick" which commitments not to pay and which contract on which to demand payment despite all previous written contractual agreements. The law in Russia on "set offs" is not well developed at this time and will be a leading issue in the 21st century that should be resolved in the way that favors the creditor investment banks.
12. In the Commonwealth of Massachusetts, creditors can perfect their security interests in property in several different ways. One method is to file a "UCC" filing with the Secretary of State and then file a copy of that UCC filing in the town or city hall where the debtor is doing business. The UCC filing describes the property that is to be "secured" to back up the debtor's promises to the creditor and is signed by the debtor. If the debtor were to file for the type of bankruptcy that leads to dissolution, the secured creditor can retrieve the secured property and sell it to cover part of the unpaid balance on the debt. In the United States, a secured creditor is protected against the liquidation of the debtor's business, but is not necessarily well protected against a reorganization bankruptcy where the creditor's efforts to reclaim the secured property will often be defeated in the Bankruptcy Court under Chapter 11.
13. In the common law, jurisdictions property held in a trust is always held for the benefit of the trust's beneficiaries and not for the benefit of the insolvent-debtor's creditors. In Russia it is conceivable that a bank that is selling custodial services and is now custodian of, say, $10,000,000 of stocks and bonds owned by 100 beneficiaries of a mutual fund might be ordered to sell these stocks and bonds for the benefit of this bank's creditors. Common sense would dictate the bank was not the beneficial owner of the stock so why should its creditors benefit in any way from the sale of this stock? Unfortunately, common sense is not what governs creditors including the tax authorities when they are dissolving a bankrupt institution in Russia.
14. In most bankruptcy jurisdictions, unpaid taxes and attorneys fees have "priority" over other creditor rights. This priority bias favoring the tax authorities needs to be modified in Russia in order to attract foreign additional direct investment and reverse the collapse.
15. But what about the tent city phenomenon? By liquidating the anchor industry we are killing off the village and city. How can a city be allowed to fail, shrivel, and die when so many families depend on that unprofitable plant for their jobs and livelihood? This is not an easy problem to remedy. A plant or manufacturing operation that had a purpose prior to 1991 may no longer have any purpose. The town/city that hovered around the plant may be a ghost town but for the artificial subsidies coming in from Moscow. Many anchor plants destroy more value than they produce and they should be allowed to fail and go out of business. Of course, the shock of suddenly dismembering the "iron bread basket" in some small villages may lead to mass deprivation and heart-breaking suffering. There seems to be a case for international help and assistance. Humanitarian efforts are welcomed as the tent city collapses and families move to other areas of Russia. What is not welcomed is an effort to prop up wasteful business operations by continual subsidies and privileges. The reality check of the market is real and important. The tent city areas must find new areas of comparative advantage as the entrepreneurs search for business opportunities. This is a theme throughout central and eastern Europe and the faster the incentives are in place to make that search, the less suffering there very well will be in the long run.
16. The *Financial Times* does report large foreign direct investment ventures coming on line since the mid-August (1998) Russian bond default. In this case, PLM of Sweden has constructed a plant designed to

process 1.75 billion cans a year since "Russia was one of the world's fastest growing markets for canned drinks" ("Canning" 1998:28). PLM owns 52% of the stock and the International Bank for Reconstruction and Development and the International Finance Corporation have much smaller stakes.

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