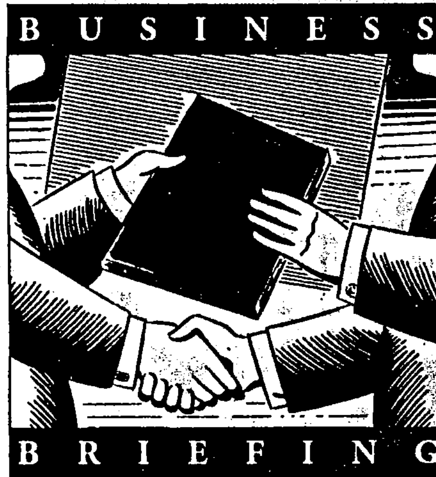
The Moscow Times
NO. 641 WEDNESDAY, FEBRUARY 1, 1995 24 PAGES

When Lenders Come 3rd

By Daniel Rothstein

The recently adopted sections of the Civil Code include provisions that mark a serious setback in the development of a modern bankruptcy law, and are likely to discourage investment in the Russian economy — in particular, foreign investment. The heart of bankruptcy legislation is the prioritizing of various classes of creditors' claims against the bankrupt debtor. The debtor's assets are pooled and liquidated, and claims of the highest priority, as defined by law, are satisfied first. After satisfaction of those claims, any remaining proceeds from the liquidation are used to satisfy claims of the next-highest priority, and so on, until the proceeds are exhausted.



Under the Law on Bankruptcy of November 1992, secured claims — that is, claims on obligations that the debtor has backed up with a pledge to surrender specific property ("collateral") in the event of nonpayment — were in a class above all other claims. The law gave secured creditors the right to take possession of the collateral, if intact, before liquidation of the debtor's assets for the benefit of other creditors. This special treatment of secured creditors is a typical feature of Western bankruptcy legislation, and encourages lending for long-term projects.

Under Section 64 of the new Part I of the Civil Code, in the event of liquidation of an enterprise, secured claims have been subordinated to two other classes of claims: first, claims against the debtor for compensation for personal injury or wrongful death; and second, unpaid wages and severance pay owed the debtor's employees, as well as certain royalty payments.

These new rules, which apply to credit transactions entered since Dec. 8 (the date of official publication of the new Part I), supersede the provisions in the Law on Bankruptcy that put secured creditors first in line.

Secured creditors will now be at risk from new liabilities that the borrower incurs after the loan is made. Lender can require borrower to keep reserve funds to cover wage claims and can take the collateral if reserve requirements are not met. This will make financing costlier. As for claims for personal injury or wrongful death, here the risks are harder to estimate. The lender can have the borrower to take out insurance, but that might be inadequate. Also, bankruptcy proceedings may be delayed while claims are decided in separate court proceedings.

The uncertainty that the new bankruptcy rules introduce will be a deterrent to lenders — banks and financial institutions — who are the main sources of long-term loans to Russian companies. Such loans are almost always given against collateral in the form of the equipment or buildings. The new rules will also impede Russia's integration in international securities markets through inclusion of Russian stockbrokers in European trading and settlement networks. Russian brokers may now be unable to offer these networks adequate collateral (in the form of securities held by the broker and traded through the network) for their borrowings for overdrafts and advances.

The populist appeal of the new bankruptcy provisions is obvious, but the drafters have brought their concerns to the wrong address. Outside lenders can do little to protect wage earners, and even less to prevent personal injuries caused by a borrower's negligence.

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