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**DILEMMAS SURROUNDING THE STATUS OF SECURED CREDITOR
IN BANKRUPTCY PROCEEDINGS IN RUSSIA IN COMPARISON
WITH LAW OF THE UNITED STATES**

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ABSTRACT

One of the biggest risks for secured creditor is bankruptcy of debtor. This paper is going to discuss what guarantees does bankruptcy law provide secured creditors with in contrast with those guarantees that secured creditors benefit from out of bankruptcy proceedings. In more simple words whether creditors can enjoy the same protection under bankruptcy law as well as they enjoy under property or contract law.

Moreover the discussion will be pursued in the comparative prospective. As far as rights of the secured creditors are concerned Russian Bankruptcy Law will be compared with more developed in this aspect United States legal system.

TABLE OF CONTENTS

Introduction	1
1. The Bankruptcy Proceedings under US and Russian Law.....	4
1.1. Policy choices in Bankruptcy Law	4
1.1.1. Why do we need Bankruptcy Laws? – Russian and American approaches in regulating bankruptcy (insolvency)	4
a. American approach	4
b. The opportunity of “fresh start”	5
c. Russian approach.....	5
1.2. Legal instruments in Bankruptcy Law.....	6
1.2.1. United states bankruptcy legislature.....	6
a. General overview	6
b. Title 11 of USC “Bankruptcy Code”	8
i. Structure	8
ii. Scope of application.....	8
iii. Voluntary and involuntary cases	9
1.2.2.Laws on Bankruptcy in Russia 1992, 1998, 2002.....	10
a.Law on Bankruptcy 2002	13
i. Structure	13
ii. Scope of application.....	14
iii. Voluntary and involuntary cases	14
1.3. Bankruptcy proceedings: general overview	15
1.3.1. Rehabilitation mechanisms	16
a. Reorganization of businesses (chapter 11 of US Bankruptcy Code).....	16
b. Rehabilitation procedures under BL 2002	16
i. Supervision	16
ii. Financial rehabilitation	19
iii.External management	21
1.3.2.Liquidation procedures	22
a.Straight liquidation bankruptcy (chapter 7 of Bankruptcy Code)	22
b.Competition proceedings (Chapter VII of BL 2002).....	22
1.3.3.Workouts and Amicable settlement	23

2. The Position of Secured Creditor in Bankruptcy Proceedings.....	26
2.1. Clash of Bankruptcy and contract law provisions: comparative prospective.....	26
2.1.1. Nature of Secured interest.....	28
2.1.2. Nature of the charge	29
2.2. The rights of secured creditor in United States.....	30
2.2.1. Validity of secured right in bankruptcy proceedings	30
a. Exempt property	31
b. Preferential transfer and secured interest	31
c. Fraudulent transfer (conveyance)	32
2.2.2. Automatic stay and secured creditor	33
a. Automatic stay	33
b. Relief from stay for “lack of adequate protection”	33
2.3.2. Cutoff rules	34
2.3. Chargeholder’s rights under Bankruptcy Law of Russia.....	37
2.3.1. Rights of the chargeholder set forth in BL 2002.....	37
a. Secured creditor as a competition creditor.....	37
b. Disposal of collateral in bankruptcy proceedings	42
Conclusion.....	44
Bibliography.....	45

Introduction

The popularity of credit has grown rapidly over the last few years in Russia. In modern Russian society even small children know that it is possible to get almost everything from the shop without paying a ruble on the spot. Different mechanisms have been elaborated by banks (since banks are the main lenders in the credit market in Russia) to lend money to citizens as well as to the businesses. Nevertheless, it is not so easy to get an acceptable credit in a bank for companies. The practice shows that if the lender does not have enough information about the company the latter probably would be refused or offered an inadmissible high interest even if something is given to secure the payment of the debt, for example all property possessed at the moment by debtor. Why is it so? The answer is that lenders do not feel secured if the debtor goes bankrupt. Out of bankruptcy lenders feel more of less confident since the Civil Code of Russian Federation¹ grant lenders with the rights guaranteeing that in case of default the chargeholder² will have a chance to repossess the collateral and sell it. The situation is different in bankruptcy.

In addition, recently there has been a growing interest in determining the secured creditors' rights due to the fact that Supreme Arbitrazh Court³ is expected to issue an interpretation of Federal Law of Russian Federation "On insolvency (bankruptcy)" dated from October 21, 2002⁴ concerning the status of secured creditor in bankruptcy proceedings.

It is widely accepted that the economy of United States of America is based on credit and it has a developed state legislature regulating this sphere of property and contract law. Moreover, the bankruptcy system in the United States is much more developed than in Russia

¹ See, Grazhdanskii Kodeks Rossiiskoi Federatsii (chast pervaya) [Civil Code of Russian Federation (part I)] on 30.11.1994 N 51-Φ3 (updated on 06.12.2007), "Rossiiskaya gazeta", N.238-239, Section III, Subsection I, Chapter 23, para.3

² For the purposes of this paper the term "chargeholder" and "secured creditor" will be treated as synonyms.

³ In Russian legal system Arbitrazh courts are the separate branch of courts dealing with commercial disputes

⁴ See, Federal Law "On bankruptcy" on 26.10.2002 [BL 2002] N 127-Φ3 (updated on 01.12.2007), "Rossiiskaya gazeta", N.209-210

since it has been progressing since 1898 when the first permanent bankruptcy law was adopted. In contrast the first Russian bankruptcy law appeared only in early 1990s right after the Soviet Union collapsed.

Previous research has concentrated on the comparison of general approaches either in the field of bankruptcy law or in the sphere of secured transactions.⁵ No proper consideration has been given to the problem of secured creditors' rights in bankruptcy proceedings in the comparative prospective. Therefore an uncertainty with regard to the status of secured creditors exists.

The purpose of this paper is to analyze the interaction of the law that determines the nature of the rights of secured creditor out of bankruptcy (in the United States it is personal property law; in Russia – contract law) and bankruptcy law itself; and to answer the question “What does happen with the right of the secured creditor towards the collateral once the bankruptcy proceedings are initiated against the debtor under Russian Bankruptcy Law in comparison with the United States Bankruptcy Code?” or “How are the rights of the secured creditors affected by commencement of the bankruptcy case?”.

This paper will show that under Russian law the bankruptcy law provisions do not provide secured creditor with the same legal status as it has under civil law. The relevant amendments should be enacted to solve this problem. Moreover, regardless the fact that there is an enhanced system of the guarantees established in the Article 9 of the UCC for protection of the secured interest the rights of the secured creditor can be also impaired in bankruptcy proceedings commenced under Bankruptcy Code of the United States.

In the first chapter the overview of bankruptcy legislature in Russian Federation and the United States will be made. It will focus on the main types of bankruptcy proceeding in both countries as well.

⁵ *For example see*, Stepanov V.V. Insolvency (bankruptcy) in Russia, USA, France, England, Germany, (Statut 1999); Khimichev, V.A. Creditors' right protection in bankruptcy, (Wolters Kluwers 2005)

The second chapter will provide for brief description of the nature of secured interest under paragraph 3, chapter 23 of the Civil Code of Russian Federation in comparison with Article 9 of the Uniformed Commercial Code of the United States. Furthermore the provisions of Federal Law of Russian Federation “On Insolvency (Bankruptcy)” 2002 and Title 11 of United States Code (Bankruptcy Code) will be analyzed.

1. The Bankruptcy Proceedings under US and Russian Law

1.1. Policy choices in Bankruptcy Law

1.1.1. Why do we need Bankruptcy Laws? – Russian and American approaches in regulating bankruptcy (insolvency) ⁶

In the modern society the general idea of regulating insolvency is to secure the operation and development of the market and to eliminate obstacles in pursuing legal business activity. The introduction of Bankruptcy laws into legal systems is stipulated by multiplicity of reasons such as protection of the debtors against willful creditors, fair distribution of the debtor's assets among the creditors, rehabilitation of the business, preserving the labor places and etc. Each legal system tries to find a balance between rehabilitation and liquidation procedures. Such balance reflects that interests of all participants of bankruptcy proceedings are treated equally and therefore properly secured.

a. American approach

In the American doctrine three goals of United States bankruptcy law were recognized. According to Gerald F. Muntiz⁷ first two pillars are “to promote equality of distribution among similarly situated creditors (*Sampsel v. Imperial Paper & Color Corporation*, 313 U.S. 215, 219 (1941)) and to afford the honest debtor a fresh economic start through the grant of a discharge (*Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934))”. The third one “reflects Congress' intent that the rehabilitation of a business, the preservation of going concern values, employment, commercial relationships, and the appropriate use of economic resources, is preferable to liquidation. As was stated by the court in *In re Ionosphere Clubs* case:

⁶ Nowadays the distinction between “bankruptcy” and “insolvency” is not so crucial, therefore for the purpose of this paper these terms will be treated as synonyms.

⁷ See, Muntiz Gerald F., *The Bankruptcy Power And Structure of the Bankruptcy Code*, Practising Law Institute, Commercial Law and Practice course Handbook series (November 2007) at 36

“The policy of equality . . . may be of significance in liquidating cases under Chapter 7, however, the paramount policy and goal of Chapter 11, to which all other bankruptcy policies are subordinated, is the rehabilitation of the debtor.”⁸

b. The opportunity of “fresh start”

One of the main features of the bankruptcy systems in the United States is existence of the legal mechanisms that provide debtor with the chance to start doing business from the beginning by freeing him from creditors even if in bankruptcy proceedings creditors were not fully satisfied.

As was stated by Grant Gilmore “the federal Bankruptcy Act is presumably based on the theory that it is desirable social policy to allow debt-burden individuals and business enterprises the opportunity to make a fresh start.”⁹ According to Tabb “this fresh start allows hopelessly insolvent individuals to get out from under the weight of their debts and resume productive lives as contributing members of society”.¹⁰

c. Russian approach

The degree of the attention allotted to the debtors and creditors or a business as a whole ongoing concern varies from legal system to legal system.

Several Russian scholars referred Russian Bankruptcy system to the same category of the legal systems as United States¹¹ aimed at both the efficient distribution of the debtor’s assets among the creditors, on one side, and achieving macro-economic functions *i.e.* securing the stability and development of the economy, on the other. The legal mechanisms directed to the protection of the interest of the debtor should correlate with the provisions securing the interest of the creditors, therefore, establishing the balance. The existence of balance in

⁸ See, *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 176 (Bankr. S.D.N.Y 1989)

⁹ See, Grand Gilmore, SECURITY INTEREST IN PERSONAL PROPERTY, VOL II (Little, Brown and Company 1965), at 1281.

¹⁰ See, Charles J. Tabb and Ralph Brubaker, BANKRUPTCY LAW: PRINCIPLES, POLICIES AND PRACTICE (2003) p.58

¹¹ See, Stepanov V.V. INSOLVENCY (BANKRUPTCY) IN RUSSIA, USA, FRANCE, ENGLAND, GERMANY, STATUT (1999), at 23; Karelina S.A. LEGAL REGULATION OF (INSOLVENCY)BANKRUPTCY: TEXTBOOK, WOLTERS KLUWER (2006), available at Legal database “ConslutantPlus”

treatment of debtor and its creditors within bankruptcy proceedings describes the effective mechanism of bankruptcy regulation. In addition, it provides grounds for distinguishing Russian legal system from those legal systems where only one side prevails (England, Germany).

However, in the light of latest Federal Law of Russian Federation “On Insolvency (Bankruptcy)” 2002 (**hereinafter** - *BL 2002*)¹² it can be argued that the rehabilitation mechanisms prevail in the Russian Bankruptcy system. The existence of the different devices that can be introduced by the founders of the enterprise or courts before initiation of the straight bankruptcy proceedings (**competition proceedings**¹³) such as pretrial sanation¹⁴ (*Art.30 of BL 2002*), supervision (*Chapter IV of BL 2002*), financial rehabilitation (*Chapter V of BL 2002*) and external administration (*Chapter VI of BL 2002*) supports this conclusion.

Therefore Russian bankruptcy system fails to establish the balance between rehabilitation and liquidation procedure and should be revised and ordered.

1.2. Legal instruments in Bankruptcy Law

Both in the United States and Russian Federation Bankruptcy is regulated by statutes on the federal level.

1.2.1. United States bankruptcy legislature

a. General overview

According to Article I, Section 8, para.4 congress has the power “to establish a uniform rule of naturalization, and uniform laws on the subject of bankruptcies throughout the United

¹² See, Federal Law “On In solvency (bankruptcy)” on 26.10.2002 [BL 2002] N 127-Φ3 (updated on 01.12.2007), “Rossiiskaya gazeta”, N.209-210

¹³ competition proceedings are defined as “procedure applied to debtor found bankrupt and directed at the proportionate satisfaction of creditors’ claims” (BL 2002, Art.2)

¹⁴ pretrial sanation is defined as measures for rehabilitation of debtor taken by founder of entity, creditors or other persons out of court (BL 2002, Art.2)

States.”¹⁵ The purpose of the Bankruptcy clause in the section 8 “Scope of Legislative Power” of the United States Constitution was explained by James Madison in *The Federalist*:

“The power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where parties or their property may lie or be removed into different states that the expediency of it seems not likely to be drawn into question”¹⁶.

The regulation of bankruptcy by Congress started in 1800 but was fragment and not permanent. The states tried to regulate debtor-creditor relations, bankruptcy and insolvency but faced several important problems. Since there was “constitutional prohibition against the impairment of contracts, states could not constitutionally discharge debts incurred prior to the legislative enactment.”¹⁷ In addition, “states could not pass a law that discharges the debts due to citizen of another state.”¹⁸

The first permanent law was enacted in 1898. This law remained in force for eighty years. In 1978 the Bankruptcy Reform Act was adopted and the Bankruptcy Act of 1898 was replaced by “Bankruptcy Code” contained in the United States Code title 11. It was subsequently amended in 2003 and 2005.

Therefore all kinds of bankruptcy proceedings are supposed to be governed by Bankruptcy Code with only several exceptions. The bankruptcies of special types of entities fall under the regulation of other specialized statutes, for example, insurance or investment companies.

¹⁵ See, U.S. Const. art. I., §8

¹⁶ See, James Madison in No.42 in *Federalist* (quoted by Charles J.Tabb and Ralph Brubaker, *BANKRUPTCY LAW: PRINCIPLES, POLICIES AND PRACTICE*, 2003, p.58)

¹⁷ See, Charles J.Tabb and Ralph Brubaker, *BANKRUPTCY LAW: PRINCIPLES, POLICIES AND PRACTICE*, 2003, p.58

¹⁸ *Id.* at 59

b. Title 11 of U.S.C “Bankruptcy Code”

i. Structure

Bankruptcy Code has nine chapters. Chapter 1, 3 and 5 contain general provisions, rules concerning case administration, provisions framing the status of the debtor, creditors and the estate. The Bankruptcy Code provides for six types of bankruptcy proceedings. Four of them are known as “rehabilitation” chapters¹⁹ since all of them provide for reorganization plan and do not require the debtor to stop its activity. Chapters 9, 12 and 13 are directed to the specific subjects of bankruptcy, in particular, municipality, individuals and farmers.

In this work only reorganization of the corporate bodies will be analyzed, namely Chapter 11. The liquidation case is covered by Chapter 7 of Bankruptcy Code. The last Chapter is dedicated to the transborder bankruptcies.

ii. Scope of application

There are general debtor eligibility requirements set forth in the Chapter 1 of Bankruptcy Code that have to be satisfied regardless what kind of the Bankruptcy proceedings are invoked. According to s.109(a) of Bankruptcy Code “only a **person** (*emphasize added*) that resides or has domicile, **a place of business** (*emphasize added*), or property in the Unites States ... may be debtor under this article.” (U.S.C. Title 11 s.109(a)) As defined by s.101(41) person “includes individual, partnership and corporation...”(U.S.C. Title 11 s.101(41)).

Therefore Bankruptcy Code covers both individuals and organizations. The status of partnerships and corporations are defined in the state laws since the adjustment of corporate relations is in exclusive competence of the states in America. Thus both commercial entities

¹⁹ See, Clarkson. Miller, Jentz and Cross. WEST’S BUSINESS LAW (Thomson, 9th ed., 2003) at 582

and organizations in the form of non-for-profit corporations in given circumstances can be subject to liquidation and reorganization under Bankruptcy Code.

iii. Voluntary and involuntary cases

At the early stage of the bankruptcy legislature it was impossible for the debtor to commence bankruptcy proceeding on his own²⁰ since “bankruptcy law was one intended principally for the relief of creditors of a merchant trader”²¹. In the modern United States bankruptcy system it would contradict one of the main goal of bankruptcy that debtor should be given an opportunity of fresh start if the debtor was not granted the right to commence bankruptcy proceedings on his own. Thus according to Bankruptcy Code bankruptcy proceedings can be initiated both by debtor or its creditors.

Voluntary cases. It is a voluntary case when the debtor is an initiator of the proceedings. In the United States the significant majority of the bankruptcy cases are voluntarily commenced. The debtors, including solvent debtors, are free to file a petition in Bankruptcy courts if the liability towards creditor exists. Such filing automatically constitutes an “order for relief” which has several important consequences. First, all debtor’s rights and interests in property turn into the bankruptcy “estate” that constitute a separate “legal entity”²². Second, once bankruptcy petition is filed “automatic stay” is granted. “Automatic stay” is a “suspension of virtually all actions by creditors against the debtor or the debtor’s property”²³ which does not require any court order. The significance of “automatic stay” will be discussed in the next chapter with regard to the secured creditor right to “relief” from “automatic stay”. The debtor can initiate the proceedings under all Chapters of the Code.

Involuntary cases. In contrast “involuntary cases may be commenced only under chapter 7 or 11” (U.S.C. Title 11 s.303(a)). Moreover, not all debtors are eligible to the involuntary

²⁰ See, Charles J. Tabb and Ralph Brubaker, *supra* note 17, at 87

²¹ Id. at 87

²² Id. at 86

²³ See, Clarkson. Miller, Jentz and Cross, *supra* note 21, at 586

bankruptcy. According to s.303(a) petition by the creditors can not be filed against “farmer, family farmer and a corporation that is not moneyed, business, or commercial corporation.” (U.S.C. Title 11 s.303(a)). Thus all non-for-profit corporations are explicitly excluded from the application of the involuntary bankruptcy.

There are several requirements as to the nature of the claims, status and number of creditors.

If the debtor has more that twelve creditors, three creditors should file a petition in bankruptcy court to initiate bankruptcy proceedings. In case there are less than twelve creditors, one creditor has the right to commence an involuntary case under ether chapter 11 or chapter 7.

In accordance with §303(h) grounds for bankruptcy relief in involuntary cases are: a) the debtor is **generally not paying** its debts as they come due; b) a custodian has been appointed for substantially all of the debtor’s assets within the past 120 days. Contrary to Russian bankruptcy system that would be discussed later American legislature tried to facilitate the commencement of involuntary proceedings for creditors by setting few legal requirements for such initiation.

1.2.2. Laws on Bankruptcy in Russia 1992, 1998, 2002

According to paras. “f” and “g” art.71 of the Constitution of Russian Federation “establishment of the principles of federal policy ... in the sphere of ... economic ... development of the Russian Federation” and “establishment of legal grounds for a single market ...”²⁴ are within the exclusive competence of the federation. Since the bankruptcy system falls within the sphere of the economic development it has never been disputed that Bankruptcy should be regulated by the legislative authorities on the federal level.

²⁴ See, Konstitutsiya Rossiiskoi Federatsii [Constitution of Russian Federation] dated on 12.12.1993 (updated on 25.03.2004, “Rossiiskaya gazeta” N 237, paras. “f” and “g” of Art.71

The new era of the bankruptcy legislature started just twenty seven years ago. In the circumstances of the command economy since 1930 legal relations connected with the bankruptcy of the entities were not regulated at all. The first attempt to adjust the bankruptcy proceedings after collapse of the Soviet Union was Federal Statute of Russian Federation “On Insolvency(Bankruptcy) of enterprises” 1992 (hereinafter – *BL 1992*)²⁵. Regardless inefficiency and imperfection of this legal instrument the significance of BL 1992 is high since it “revived institution of bankruptcy and gave the impulse for further enhancement of existing legal provisions.”²⁶ BL 1992 “created legal basis for involuntary and voluntary liquidation of the insolvent debtor providing for three types of procedure: reorganization (external administration and sanation), liquidation (competition proceedings) and settlement agreement.”²⁷ This law was simple with respect to the fact that it did not cover citizens, i.e. individuals could not be declared insolvent. In addition, the treatment of all types and categories of enterprises such as financial organizations or farmer organizations was unified without due consideration of the specific features of some legal entities.

The second step was made in 1998 when another Federal Law of Russian Federation “On Insolvency (Bankruptcy)” (hereinafter – *BL 1998*)²⁸ was enacted. This phase has been characterized as a reform of the bankruptcy legislature since almost all basic provisions were modified, in particular, insolvency criteria, external indicators of insolvency, procedure for consideration of cases and etc.²⁹

²⁵ See, Federal Law “On Insolvency (bankruptcy) of enterprises” on 19.11.1992 [BL 1992] 3929-1, “*Rossiiskaya gazeta*”, N 279, 30.12.1992

²⁶ See, Khimichev, V.A. CREDITORS’ RIGHT PROTECTION IN BANKRUPTCY, Wolters Kluwers (2005), available at Legal database “ConsultantPlus”

²⁷ See, Borisenkova T.V. *Tri rossiiskih zakona o bankrotstve: balans chastnih i publichnyh interesov* [Three Russian Laws on Bankruptcy: balance of private and public interests], “Arbitrazhnyi i grazhdanskii protsess”, No. 9, 2005, available at Legal database “Consultant plus”

²⁸ See, Federal Law “On Insolvency (bankruptcy)” on 08.01.1998 [BL 1998] N 6-Φ3 (in not in force since BL 2002 was enacted in 2002), “*Rossiiskaya gazeta*”, No 10

²⁹ See, *Scientific commentary to the Federal Law “On Insolvency(Bankruptcy)”*, (ed. Vitryanskii V.V., Statut, 2003), available at Legal database “ConsultantPlus”.

There are mechanisms in the BL 1998 orientated primarily at the rehabilitation of the debtor.³⁰ One of these devices was a newly introduced rehabilitation procedure such as supervision. According to O.U. Skvortsov supervision represents the reflection of pro-debtor tendencies in the bankruptcy system as well.³¹

Nevertheless, as was mentioned by Karelina, BL 1998 was mostly aimed at the protection of the creditors' rights rather than at the preserving of the business. As a result it turned to be a source of the conflicts rather than the instrument of "curing" the economy and lead to the devastation of the many solvent enterprises.³² The main feature of BL 1998 was that it granted "legal" opportunity to utilize bankruptcy proceedings as "an instrument for redistribution of property", and as a consequence, bankruptcy proceedings could be initiated with regard to almost all big industrial enterprises.³³

Having taken into consideration drawbacks of the BL 1998 Russian legislature decided to adopt new bankruptcy statute. Generally the main concept of Russian bankruptcy system was not restructured; instead, the regulation became more detailed and sophisticated in comparison with previous laws.

Changes in the bankruptcy system that was implemented in BL 2002 reflected the intention to solve the problems arisen with regard to the arbitrazh administrators. In particular, the requirements and liability of the arbitrazh administrators enhanced, the level of the supervision over their activity increased. New rehabilitation proceeding was introduced, namely financial rehabilitation, that provided with the opportunity to preserve debtor's business by replacement of the debtor's assets or by third party financing³⁴. The

³⁰ See *Commentary to Federal Law "On insolvency(bankruptcy)"*, (ed. Popondopulo V.F., Statut 2003) at 121.

³¹ Id. at 121

³² See, Karelina S.A *A LEGAL REGULATION OF (INSOLVENCY)BANKRUPTCY: TEXTBOOK*, Wolters Kluwer (2006), available at legal database "ConslutantPlus"

³³ See, Borisenkova T.V., *supra* note 29

³⁴ See, Berkovich N.V., *Reforma zakonodatelstva o bankrotstve: itogi, problemi, resheniya* [Bankruptcy legislature reform: results, problems, solutions], "Bezopasnost Biznesa" N 1, 2005

priority rules were modified as well what lead to the slight changes in the secured creditors' status.

Since the changes were not so radical BL 2002 still reflected pro-debtor attitudes with even more rehabilitation procedures³⁵.

As well as in the United States Law on Bankruptcy has a general application and does not cover special categories of debtors such as credit organizations³⁶ or energy concerns³⁷.

a. Law on Bankruptcy 2002

i. Structure

Federal Law of Russian Federation "On Insolvency (Bankruptcy)" 2002 consists of twelve Chapters. The first, second and the last contain general provisions, rules of bankruptcy case consideration in courts and conclusion provisions accordingly.

As well as in United States Bankruptcy Code special rules for special categories of debtors are included in Chapter XI and X of Russian Law on Insolvency (Bankruptcy). The peculiarities in regulation concern agricultural enterprises, financial organizations, strategic concerns, subjects of natural monopolies and citizens, including individual entrepreneurs and farmers. However in comparison with United States bankruptcy system all these categories of debtors are subject to the liquidation procedure, namely competition proceedings, as well. The special provisions should be applied in conjunction with the provisions contained in the main Chapters of the BL 2002.

As was already mentioned Russian Bankruptcy system differs from other systems by existence of wide spectrum of rehabilitation procedures conducted either involving court or

³⁵ See, Khimichev V.A. *Perspektivnie napravleniya sovershentvovaniya pravovogo regulirovaniya v sphere nesostoyatel'nosti (bankrotstva)* [Future line of development of legal regulation in the sphere of insolvency (bankruptcy)], Vestnik Vyshego Arbitrazhnogo Suda Rossiiskoi Federatsii, N.6, 2005.

³⁶ See, Federal Law "On Insolvency(bankruptcy) of credit organizations" on 25.02.1999 N 40-Φ3, *Rossiiskaya gazeta*, N41-42

³⁷ See, Federal Law "On peculiarities of Insolvency(bankruptcy) of natural monopoly enterprises in the energy sphere" on 24.06.1999 N 122-Φ3, *Rossiiskaya gazeta*, N122-123

not. Chapter II imposes a duty on founders of company to undertake reasonable measures for prevention the bankruptcy of enterprise³⁸. Such proceedings named pretrial sanation would not be covered by this paper since they are not one of the types of bankruptcy proceeding in true sense.

BL 2002 provide for five types of bankruptcy proceedings. Three of them are of rehabilitative nature: supervision, financial rehabilitation and external management (Chapters IV, V, VI). Chapter VII sets rules for conducting straight bankruptcy. Finally BL 2002 grants the opportunity to close bankruptcy procedure by means of amicable settlement at any stage of the proceedings.

ii. Scope of application

Para. 2 Art. 1 of BL 2002 expressly provides that this federal law is applied to all legal entities excluding state enterprises, political parties and religious organizations. According to the next paragraph “relations related to the insolvency of citizens, including individual interpreters, shall be governed by this federal law”³⁹ as well. Nevertheless, individuals can be subject to competition proceedings and amicable settlement.⁴⁰

iii. Voluntary and involuntary cases

According to Art. 7 of BL 2002 “application to the arbitrazh court for recognition of the debtor as bankrupt can be brought by debtor, bankruptcy creditors, authorized agencies.”⁴¹

Debtor has a right to refer to the court in case the debtor foresees the possibility of bankruptcy due to existence of the circumstances evidencing that the debtor will not be able to perform monetary obligation in due time.⁴² In case of companies the law imposes the

³⁸ See, BL 2002, Art.31

³⁹ See, BL 2002, para.3 Art.1

⁴⁰ See, BL 2002, Art.202

⁴¹ See, BL 2002, para.1 Art.7

⁴² See, BL 2002,Art.8

obligation on the manager of the company to file bankruptcy petition in provided by federal law situations⁴³.

Creditors can bring an action to the court once the 30-day period after the submission of the warrant to the bailiff⁴⁴. This provision in law was introduced to eliminate the possibility of abuse from the side of creditors with regard to commencement of unjustified bankruptcy proceedings against the debtor.

1.3. Bankruptcy proceedings: general overview

Every legal system provides for at least two types of bankruptcy proceedings that are of different nature. One of them is directed at the preserving the debtor's business and operates a rehabilitative function, another one aimed primarily at the distribution of debtor's property among the creditors and usually is called liquidation.

United States Bankruptcy system generally contains only two types of proceedings: reorganization and liquidation. Instead, according to Russian bankruptcy legislature, there are numerous rehabilitation proceedings that are usually introduced before straight bankruptcy (competition proceedings). Both legal systems allow courts to replace straight bankruptcy by any of reorganization proceedings in case there is a chance of debtor's recovery. As well as United States system allow to resolve the bankruptcy case without participation of the court by means of workouts, i.e. agreements between the debtor and creditors, Russian law additionally sets out the opportunity for debtor and creditors to settle the problem by concluding amicable agreement as well.

⁴³ See, BL 2002, Para.1 art.9

⁴⁴ See BL 2002, para,2 Art.7

1.3.1. Rehabilitation mechanisms

a. Reorganization of businesses (chapter 11 of US Bankruptcy Code)

According to Black's Law Dictionary "bankruptcy reorganization" under Chapter 11 of US Bankruptcy Code is "A financial restructuring of a corporation, esp. in the repayment of debts, under a plan created by a trustee and approved by a court."⁴⁵

In reorganization cases the debtor's administration such as director or board of directors and management are not replaced by bankruptcy trustee but remain the positions once the bankruptcy case is commenced. According to the Code they obtain a status of "debtor in possession". However, the possibility of appointment of bankruptcy trustee is not excluded. Once it is found that management or directors have committed frauds, gross mismanagement or pursued alike activity bankruptcy court should issue an order to replace "debtor in possession" by trustee. The legal status of "debtor in possession" is the same as of bankruptcy trustee.⁴⁶ The debtor is to be reorganized according to the reorganization plan accepted by each class of creditors. The reorganization plan has to be confirmed by the bankruptcy court as well. The relevance of the reorganization plan will be discussed in the next chapter with regard to the secured creditors concerning their position in acceptance and confirmation of the reorganization plan.

b. Rehabilitation procedures under BL 2002

i. Supervision

⁴⁵ See, Black's Law Dictionary (8th ed. 2004), reorganization

⁴⁶ The status of bankruptcy trustee will be discussed with regard to the liquidation under Chapter 7 of Bankruptcy Code

According to Art. 2 “General definitions used in this Federal law” supervision is defined as “bankruptcy procedure, applied to the debtor in order to insure the safety of the debtor’s assets, to carry out the analysis of the financial analysis of the debtor, to make a list of creditors’ claims and to conduct first creditor’s meeting.”⁴⁷

Supervision proceeding has been introduced by BL 1998 as a measure securing the integrity of the debtor’s property. Nowadays Chapter IV of BL 2002 regulates conduct of supervision.

If the court found that the petition for bankruptcy brought be the creditor or authorized agency is justified it orders the supervision procedure⁴⁸. In case of voluntary case the supervision is introduced automatically once the court has accepted the debtors’ application.

The legal consequences that follow once the supervision is ordered. The management continues to execute its powers⁴⁹. The court has to appoint a **temporary administrator** that has the rights to invalidate null and void claims and is obliged to take any measure for preserving assets of the debtor, assess financial situation of the debtor, register claims, inform creditors about introduction of the supervision and organize the first meeting of creditors. The authority of the management bodies is limited with respect to the decision that can be made, for example, director can not make a decision as to reorganization or liquidation of the legal entity at this stage of the proceedings. Some decisions can be made only upon the consent of the temporary administrator. Once court has issue an order of supervision creditors’ money claims that become due can be raised only in accordance with the procedure provided by BL 2002. Moreover, all enforcement proceedings against the debtor are suspended, setoff is prohibited in case the priority rules are violated and etc.⁵⁰ BL 2002 does not treat these

⁴⁷ See, BL 2002 Art.2

⁴⁸ See, BL 2002, para. 1 of art.62

⁴⁹ See, BL 2002, para.1 of art.64

⁵⁰ See, BL 2002, Art.63

limitations as “moratorium”⁵¹ since according to the law “moratorium” is granted at *external administration* stage and covers limitations with regard to the suspension of default interests and penalty fees as well.

Primary obligation of the temporary administrator is to assess the financial condition of the debtor – to determine the value of the property that belongs to the debtor and finally to determine the possibility of solvency recovery of the debtor. On the basis of financial analysis carried out by temporary administrator creditors meeting has to decide what type of bankruptcy proceedings shall be applied to the debtor. However, the decision of creditors meeting on the type of the proceedings should be approved by the arbitrazh court. Arbitrazh court has an authority to approve or overrule the decision of the creditors meeting and order the next rehabilitation procedures: financial rehabilitation or external administration.

Supervision procedure was a clear evidence of pro-debtor tendencies from the side of the legislature. Due to that fact it was the reason of the debates in the legal literature among scholars. It was suggested by Howman that one should look from the point of view of creditor as well. In this case “if one of the starting pointes is to guarantee the protection of the creditors’ interests, increase the level of repayment, and therefore, decrease the price of credit, then the attitude to the supervision will be changed.”⁵² It was mentioned by Khimichev (2005) “the major disadvantage of the supervision is that it makes impossible to take decisions quickly and smoothly what is of crucial importance in bankruptcy cases since it is directly connected with decrease of the value of the business due to the costs incurred in period of supervision.”⁵³

⁵¹ The term “moratorium” is defined in Art.2 of BL 2002 as suspension of the performance of monetary obligations and making mandatory payments by the debtor. The notion of moratorium for the purpose of this paper can be treated as an equivalent of “automatic stay” with some reservation, in particularly, with regard to the secured creditors’ status.

⁵² See, Howman M. Rol’ rezhima bankrotstva v rinochnoi ekonomike [The role of insolvency regime in market economy], Vestnik Visshego Arbitrazhnogo Suda rossiiskoi Federatsii, special supplement 2001, N 3 at 35

⁵³ See, Khimicev V., *supra* note 28

One more concern about supervision evidenced by the judicial practice as well is connected with the problems that arise in the relationships between the temporary administrator and the management that remains in the position, although under the control of the former.⁵⁴

ii. Financial rehabilitation

Financial rehabilitation is defined in the BL 2002 as bankruptcy procedure aimed at recovery of the debtor's solvency and liquidation of the debts according to repayment schedule.

Arbitrazh court orders financial rehabilitation on the basis of the creditors meeting's decision provided that founders of the debtor or a third party agree to secure the performance of the debtor's obligations. In addition arbitrazh court has discretion to introduce this type of bankruptcy proceedings once bank guarantee is given to secure the performance of the debtors' monetary obligations as well. The BL 2002 allows securing the repayment by any kind of secured transactions that are not in contradiction with current Russian legislature: hypothec, bank guarantee, state or municipality guarantee, suretyship and etc. However, the property owed of the debtor can not be used as collateral.⁵⁵

The main features and consequences of this procedure are the following. There is a repayment schedule that must be fulfilled in due time and in provided order. The same limitations with regard to suspension of the enforcement of claims and etc. as in case of supervision are introduced. During financial rehabilitation management organs continue their operation, but restricted in the disposal of the assets. Once financial rehabilitation is ordered court appoints administrative manager whose functions are to control the implementation of the repayment schedule, coordinate the conclusion of agreements and taking a decisions by

⁵⁴ Id.

⁵⁵ See, BL 2002, Art.79

debtor. Financial rehabilitation shall be introduced for the period of two years maximum.⁵⁶

Not later than one month prior to expiry of the set period of financial rehabilitation the debtor has to submit to the administrative manager a report on the results of financial rehabilitation.⁵⁷ In case court finds that the recovery of the debtor is possible it orders external administration.

Financial rehabilitation is a new type of bankruptcy proceedings that was introduced by BL 2002. It has common features with “amicable settlement (with respect to the possibility of fulfillment the obligation instead of debtor with the help of securing instruments), external administration (with regards to existence of the plan and repayment schedule) and supervision (with respect to the similar roles of the temporary administrator and administrative manager).⁵⁸

The problem raised among the scholar and practitioners concerns the main element of financial rehabilitation - securing mechanism. The person who agreed to secure obligations of the almost insolvent debtor being jointly and severally liable together with the debtor is not protected by the law properly. The issue is that once creditor’s meeting takes a decision to turn to another type of bankruptcy proceedings the law does not provide the guarantee with any priority against other creditors.⁵⁹

According to Berkovich this type of bankruptcy proceedings duplicate external administration since the same task are resolved under the latter.⁶⁰ Moreover in practice of Arbitrazh court of Moscow City financial rehabilitation has never been ordered since a new BL entered in force in 2002.⁶¹

⁵⁶ See, BL 2002, Para. 6 Art. 80

⁵⁷ See, BL 2002, Para. 1 Art. 88

⁵⁸ See, Ermolenko A.S., *O bankrotstve uridicheskikh lits [On the bankruptcy of legal entities]*, “Nalogovii vestnik”, N 1, 2004

⁵⁹ See, *id.*

⁶⁰ See, Berkovich N.V., *supra* note 36

⁶¹ See, Streletskii D.U., Makarova E.S., Ten V.V., Lahtikov V.A., *COMPANY BANKRUPTCY, Educational-methodological center of Ministry of tax and duties of Russian Federation (2005)*, at 56

iii. External management

External management can be introduced by court in three situations. Firstly, once the supervision is completed and the decision is taken either by creditors meeting or arbitrazh court. Secondly, if according to results of the financial rehabilitation external management is justified under BL 2002. Thirdly, it is possible to turn to external management procedure from the liquidation proceedings in case there are sufficient grounds that the debtor will be recovered.

External management (otherwise called judicial sanation) is applied to the debtor to prevent its insolvency. Here the management powers are delegated from the director to the external manager and therefore the executive bodies' power are ceased to exist. External manager has discretion to fire the debtor's director in accordance with labor legislature. Moratorium is introduced at this stage of bankruptcy proceedings.

Creditors are allowed to submit the proof of claims during whole period of external management. Having checked the admissibility of the creditor's claims arbitrazh court includes or rejects to include them in the list of creditors claims.

Not later than one month since appointment of the external manager the latter has to elaborate the plan of the debts repayment.

During external management different measures of economic and organizational character can be taken such as the specialization of business profile can be changed, unprofitable production can be closed, unproductive assets can be sold or disposed otherwise⁶², and business enterprise can be partially sold as well.⁶³

⁶² See, BL 2002, art.109

⁶³ See, BL 2002, art.110

1.3.2. Liquidation procedures

This is the last resort stage for both of bankruptcy systems. In case there is no change to recovery the debtor's solvency the distribution of left debtor's assets follow. Liquidation procedure rules are determined primary at effective satisfaction of creditors' claims. At this stage priority rules play a significant role.

a. **Straight liquidation bankruptcy (chapter 7 of Bankruptcy Code)**

With regard to the liquidation in the United States two immanently connected things should be discussed: the notion of bankruptcy estate and the figure of bankruptcy trustee. Firstly, once liquidation is commenced under Chapter 7 "estate in bankruptcy is created"⁶⁴, which consists of "all the debtor's legal and equitable interests in property currently held, wherever located". Secondly, to preserve an integrity of the bankruptcy estate, to preserve right of the debtor and unsecured creditors, to collect all the pieces of property together and thus to increase its value court appoints trustee in bankruptcy (or bankruptcy trustee). Bankruptcy trustee is given a status of hypothetical lien creditor ("strong-arm" power) and is entitled to possess the debtor's property, avoid any unjustified claim, invalidate secured creditors claims to increase the value of bankruptcy estate and administrate the estate.

b. **Competition proceedings (Chapter VII of BL 2002)**

Under Art. 124 of BL 2002 once court holds that debtor is bankrupt competition proceedings begin and court appoint competition administrator. In Russian bankruptcy system competition administrator appointed by arbitrazh court have the right to invalidate the defect transactions.⁶⁵ But the analysis of judicial practice shows that the status of administrator or manager is different under Russian law from that of Bankruptcy trustee in the United States. Under BL 2002 it is the court who estimates all the claims before including them into the list of creditors' claims. Moreover arbitrazh administrator is not usually

⁶⁴ See, Clarkson, Miller, Jentz and Cross, *supra* note 21, at 586

⁶⁵ See, BL 2002, para. 4 art. 83

interested in the annulment of secured creditors' claims since he is not positioned as a hypothetical lien creditor or a person who steps in the shoes of all unsecured creditors. In Russian bankruptcy system arbitrazh administrator remains neutral.

Once it is determined during liquidation that possibility of debtor's rehabilitation exists bankruptcy law of both countries allow recourse to reorganization (in case of the United States) or financial rehabilitation or external management (with respect to Russia) directly from straight bankruptcy.

1.3.2. Workouts and Amicable settlement

In both legal systems debtors and its creditors can put bankruptcy proceedings to an end by conclusion of agreement at any stage of bankruptcy. This kind of resolution of bankruptcy case is promoted among scholars in both countries⁶⁶ due to the fact that it reduces the cost of bankruptcy proceedings, the assets of debtor are preserved and therefore it increase the possibility that claims of more creditor would be satisfied.⁶⁷ The difference between workouts and amicable settlement is that in case of workout participants decide to settle the case out of bankruptcy proceedings in particular out of bankruptcy court, while amicable settlement is one of the procedures regulated by bankruptcy law and presumes the participation of court since it is the court that should approve amicable settlement before it enters into force.⁶⁸

The effectiveness of rehabilitation procedures provided by the Russian Bankruptcy system is put into question by many scholars. One of the objectives of the bankruptcy in the circumstances of market economy is to facilitate and speed up the resolution of the

⁶⁶ For example in the United States see, Clarkson, Miller, Jentz and Cross, *supra* note 21, at 595; in Russian Federation see, Vitryanskii V.V. *Puti sovershenstvovaniya zakonodatel'stva of bankrotstve* [The ways of enhancing bankruptcy legislation] "Vestnik Visshego Arbitrazhnogo Suda Rossiiskoi Federatsii" N 3, 2001

⁶⁷ See, Popondopulo V.F. *Protседuri bankrotstva v obespechenie interesov creditorov* [Bankruptcy procedures and creditors' interests protection] "Predprinimatel'skoe pravo" N 2, 2006

⁶⁸ See, BL 2002, para.4 Art.150

bankruptcy cases, from one side, and to protect the interests of all participants from the other.⁶⁹ The concept of the rehabilitation procedure which follows one after another “creates serious problems with regard to the proper guarantees that creditors’ claims will be fully satisfied.”⁷⁰

Some authors argue that Russian bankruptcy mechanisms system is too complicated and therefore leaves the field for abuse by all participants of bankruptcy proceedings. Moreover, in practice, supervision, financial rehabilitation and external administration do not achieve its objectives and play the role of device decreasing the value of debtor’s property and delaying its distribution among the creditors. It was suggested by prof. Vitryanskii to eliminate all rehabilitation procedures and leave competition proceedings and amicable settlement as the only bankruptcy law devices⁷¹. Such view seems to be premature and radical. This approach should be implemented carefully with all necessary amendments to the institution of amicable settlement that would provide for additional increased guarantees to impaired categories of creditors and enhanced supervisions of the arbitrazh court to avoid any possibility of abuse or injustice. In addition, amicable settlement should be given an increased legal force, for example with the facilitated opportunity to enforce such agreement in courts. Another option is to follow American approach that is to consolidate three rehabilitation procedures in one, provide for competition procedure and permit debtor and creditors to settle the dispute without intervention of the court.

Bankruptcy system formed in Russian federation presents a variety of mechanisms that are not detailed and developed enough. These mechanisms fail to consider the rights of every participant of the bankruptcy proceedings, for example the right of the secured creditors in

⁶⁹See, Popondopulo V.F., *supra* note 71

⁷⁰See, Howman M., *supra* note 36

⁷¹See, Vitryanskii V.V. *Puti sovershenstvovaniya zakonodatel'stva of bankrotstve* [The ways of enhancing bankruptcy legislation] “*Vestnik Visshego Arbitrazhnogo Suda Rossiiskoi Federatsii*” N 3, 2001

financial rehabilitation since law does not provide the creditors that granted a loan or guaranteed the performance of debtor's obligations by suretyship with any kind of protection. The law is silent on this issue. Arrangements during financial rehabilitation resemble post-petition security arrangements and a possibility of obtaining a new credit under Bankruptcy Code of the United States. It allows creditors "(a) to obtain a "super priority" claim for such loans ahead of all other claims, (b) to obtain collateral for such loans, and (c) to prime existing security interests as long as the existing secured creditors' interests in the collateral remain adequately protected and the debtor establishes that it could not negotiate better financing terms."⁷²

⁷²See, Hon, Robert D. Drain, *Short summary of Chapter 11 of the United States Bankruptcy Code*, 898PLI/Comm 103 (2007) at 116

2. The Position of Secured Creditor in Bankruptcy Proceedings

2.1. Clash of Bankruptcy and contract law provisions: comparative prospective

The interaction between Bankruptcy and property law, in particularly Art. 9 of UCC, that regulates the notion of secured interest, is widely accepted. Firstly, “secured party’s primarily concern is to have protection upon institution of bankruptcy proceedings.”⁷³ It is fairly true since it is bankruptcy proceedings where the issue of claims priority should be resolved among creditors. Moreover, since Bankruptcy law is the combination of provision of private and public nature there is a threat that the right of the secured creditors can be limited or impaired; the value of secured interest can be reduced during bankruptcy proceedings in favor of public concerns.

The peculiarity of the United States system is that property law is regulated on the different from bankruptcy law level, namely it is in the states’ competence to determine the status of the secured creditor, while bankruptcy law is governed on the federal level. It was argued by Phillips that the personal property law, namely the issues concerning security right in the collateral should be regulated at federal level⁷⁴. The relationship between bankruptcy and personal property can be estimated from the point of view of case law. The *Benedict v. Ratner* case⁷⁵ was tried on the basis of New York state property law but was accepted as a leading case throughout the whole jurisdiction of the United States.⁷⁶

Due to the splendid and diverse systems of secured transaction law in the United States, Congress had to consider carefully and properly the rights of the secured creditor in bankruptcy proceedings, without violating the provision of the states property law.

⁷³ See, Tajti Tibor, COMPARATIVE SECURED TRANSACTIONS LAW, Akademiai Kiado (2002) at 200

⁷⁴ See, Phillips M. David, *Secured Credit and bankruptcy: a call for the federalization of personal property*, 50-SPG Law & Contemp. Probs. 53 at 54

⁷⁵ *Benedict v. Ratner*, 268 U.S. 353, 45 S.Ct. 566, 69 L.Ed. 991, U.S.N.Y., May 25, 1925 (NO. 11)

⁷⁶ See, Grand Gilmore, *supra* note 8 at 1321

In Russian legal system the approach to the status of secured creditor in bankruptcy proceeding is ambiguous. On the one side, the principal legal provisions that determine the rights and obligations of the secured creditors are contained in the Civil Code of Russian Federation. This is the primary document being followed once the dispute arises between chargeholder and the debtor in case of debtor's default. Kasso described "charge" as an absolute right to be repaid with the defined sum of money against the owner of the defined property which can be enforced by exclusive seizure of the collateral."⁷⁷ On the other side, there is a bankruptcy legislature that raises only questions not giving proper answers as to the nature of the chargeholders' rights in bankruptcy proceedings. Zhimichev suggested that the secured rights can not be "absolutized" within bankruptcy relations since even Civil Code provisions do not consider them as unconditional due to the fact that priority is given to other categories of creditors against chargeholders in case default of the debtor.⁷⁸ And therefore in accordance with the second view once the security interest is not absolute under Russian contract law it can be eroded by federal bankruptcy legislature. The possibility of the modification exists since contrary to United States system both Bankruptcy law and contract law are regulated on the same level by the same legislative body.

The answer to the question about the status of secured creditors in bankruptcy proceedings lies within the determining the nature of the charge in Russian or secured interest in the United States, in particularly whether security interest and charge fall within the same or different categories, *in rem* or *in personam* rights.⁷⁹

⁷⁷ See, Kasso L.A. THE DEFINITION OF CHARGE IN MODERN LAW, Statut (1999), at 173

⁷⁸ See, Khimichev, V.A., *supra* note 28

⁷⁹ Theoretically, with some stipulations with regard to the peculiarities of different legal systems, all rights are divided into three categories: "proprietary or real (or *in rem*), *ad rem* (more fully: *in personam ad rem*) and purely personal rights. Real right is a right *in* and *over* an identifiable asset or fund of asset; *ad rem* is a merely personal right to have the assets delivered or otherwise transferred to him; purely personal right does not involve the deliver or transfer to the obligee of an identified assets or fund of assets but it is the right to be satisfied by some other way of by the obligor." (Tajti Tibor. COMPARATIVE SECURED TRANSACTIONS LAW, Akademiai kiado (2002) at 49)

2.1.1. Nature of Secured interest

According to Black's Law Dictionary "secured interest is a property interest created by agreement or by operation of the law to secure performance of an obligation (esp. repayment of the debt)."⁸⁰ Secured transactions are considered to be proprietary securities which grant secured creditor *in rem* rights in the collateral. Chattel mortgage, pledge, conditional sale, hire-purchase agreement, account receivables all create security interest against the debtor. In common law countries security interest "give creditors with some additional rights ...: the right of pursuit and the right of preference."⁸¹ *In rem* rights give the owner very strong position with respect to enforcement of such rights in and out of courts. Thus UCC provides for the "self-help repossession" of the collateral once the debtor appeared to be in default.⁸² Secured interest as *in rem* right "includes the retention or recovery of the asset; sale of the assets; foreclosure; and an order vesting legal title in the secured creditor."⁸³

Due to the fact that security interest is the right directed towards the property itself and is not connected with the act of the parties once it is created, it is recognized that such *in rem* rights "survive debtor's bankruptcy whereas personal rights not"⁸⁴ and are not affected by the commencement of bankruptcy proceedings fundamentally. Nevertheless the bankruptcy law intervenes with the right of secured creditors setting additional legal condition or in some cases even restricting this right. The conflict correlation between Art.9 of UCC and Bankruptcy Code has been recognized in case law⁸⁵ and legal doctrine⁸⁶.

⁸⁰ See, Black's Law Dictionary (8th ed. 2004), security interest

⁸¹ See, Tajti Tibor, *supra* note 77 at 83

⁸² UCC s.1-201(34) says: "..."

⁸³ See, Tajti Tibor, *supra* note 77 at 83

⁸⁴ See, *Id.* at 83

⁸⁵ *United States v. Whiting Pools, Inc* 462 U.S. 198 (1983).

⁸⁶ See, Phillips M.David, *supra* note 73 at 53

2.1.2. Nature of the charge

Contrary to the United States security interest which is considered to be a property right against collateral, Russian notion of security interest, *i.e.* charge, does not constitute solely as *in rem* right.

The nature of the charge in Russian legal system has been disputed almost one hundred years. It was intensively discussed by Russian civilists before 1917 year. Some authors argued that charge should be considered as real property right. For instance Em suggested that preemptive right of the chargeholder has *in rem* rights features in cases when goods are provided as collateral.⁸⁷ Dual nature of charge is recognized by many scholars⁸⁸. As was mentioned by Vitryanskii “...to preserve the tradition of Russian law, Code refers charge to the group of personal rights, but its dual nature can not be ignored.”⁸⁹

Different approaches prevailed in different periods of time. In pre-revolution era charge has been considered as *in rem* right. This predetermined legal regime of the property used as collateral⁹⁰. Shershenevich stated that “primary idea of competition process is to satisfy the creditors’ claims in an equal manner... However, contrary to this general rule legal system establishes privileges for certain categories of creditors... Such exceptions are for those creditors that secured claims against the debtor with proprietary right...”⁹¹

During Soviet times the provisions regulating charge relations were included into Art. 35 Chapter 1 “General provisions about obligations” Section III “Contract Law” of BASICS OF

⁸⁷ See, Em V.S., CIVIL LAW (IN 2 VOLUMES). VOL.2 SUBVOL. 1: TEXTBOOK (ed. Suhanov E.A., BEK, 1994) at 118

⁸⁸ See, Shershenevich G.F. TEXTBOOK ON RUSSIAN CIVIL LAW (1907 year edition), SPARK (1995) at 241; Gangalo B.M., TREATISE ON SECURED OBLIGATIONS. QUESTIONS OF THEORY AND PRACTICE, STATUT (2004); Braginskii M.I., Vintryanskii V.V., CONTRACT LAW. GENERAL PROVISIONS, STATUT (2001) at 396; Koraev K.B. *Sootnoshenie veshnih i obyazatelsvennih pravootnoshnii pri bankrotstve* [Correspondence of proprietary and personal legal relations during bankruptcy], “Urist” N 3, 2007

⁸⁹ See, Braginskii M.I., Vintryanskii V.V., CONTRACT LAW. GENERAL PROVISIONS, STATUT (2001) at 400

⁹⁰ See, Koraev K.B. *Sootnoshenie veshnih i obyazatelsvennih pravootnoshnii pri bankrotstve* [Correspondence of proprietary and personal legal relations during bankruptcy], “Urist” N 3, 2007

⁹¹ See, Shershenevich G.F. TRADE LAW COURSE VOL.III, (Bashmakov, 1908) at 449

CIVIL LEGISLATURE of Soviet Union⁹². It meant that *in personam* approach as to the evaluation of charge prevailed. Nowadays charge is regulated in the Contact part of the Civil Code as well. This is the main argument that is used by supporters of the idea of personal nature of security rights. Nevertheless it is obvious that security interest that is established by charge agreement provides chargeholder with additional rights of *in rem* nature, for example, the right of the chargeholder to vindicate the collateral from the possession of the third persons as well as the possession of the debtor itself.⁹³

All deliberations and changes of the concepts inevitably affected the status of the secured creditor in bankruptcy proceedings. If proprietary nature of charge is accepted collateral does not become a part of bankruptcy estate, and secured creditor can enforce its rights out of bankruptcy proceedings. If during debtor's liquidation property used as collateral is not excluded from the bankruptcy estate and any of debtor's property, including those assets that were not pledged, are used for satisfaction of secured creditor's claim then charge is not considered as *in rem* but *in personam* right.⁹⁴

2.2. The rights of secured creditor in United States

2.2.1. Validity of secured right in bankruptcy proceedings

The peculiarity of United States system as has already been mentioned is that federal bankruptcy court will apply state law to resolve the question of existence and validity of security interest. Nevertheless some additional requirements have to be met by security interest to be considered as validly created one. Kalevich stated:

⁹² See, Osnovi Grazhdanskogo zakonodatel'stva Souza SSR I Respublic [The basics of civil legislature of SSSR and Republics] "Vedomosti SND and VS SSSR", 26.06.1991, N 26, st. 733.

⁹³ Civil Code of Russian Federation (part I), Art.347

⁹⁴ Petrov D.A. *Voprosi zashiti prav zalogovogo creditora pri bankrotstve* [Issues of secured creditor protection in bankruptcy cases], Kodeks-info. 2003. N 9-10

“The Bankruptcy Code determines the validity of the security interest in bankruptcy and will not recognize a security interest that does not comply with the UCC s.9-203 rules for creation of a security interest. Moreover, a security interest valid under the UCC will not be recognized in bankruptcy of any of the bankruptcy avoiding powers are applicable.”⁹⁵

Bankruptcy law provides for additional provisions that allow invalidating security interest and therefore the right of secured creditor in bankruptcy proceedings is not unconditional.

a. Exempt property

Despite the fact that “Bankruptcy Code permits a debtor with a right to an exemption of personal property in under 11 U.S.C. s.522(b) ... to avoid nonpossessory and nonpurchase money security interest on certain property”⁹⁶ the analysis of the types of property that are voidable under 11 U.S.C. s.522(f)(1)(b) leads to the conclusion that this provision is mostly irrelevant for the companies and applied only to the individuals who go bankrupt.

b. Preferential transfer and secured interest

Section 547(b) of Bankruptcy Code set the preference rules according to which “trustee may avoid any transfer of an interest of the debtor in property (1)to or for the benefit of creditor; (2)for or on account of an **antecedent debt** (*emphasize added*) owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4)made on or **within 90 days before the date of the filing of the petition** (*emphasize added*); (5)that enables such creditor to receive more than such creditor would receive...”(U.S.C. Title 11 s.547(b)). Once the transaction pursued by debtor and creditor fits these requirements trustee in bankruptcy is empowered by preference law to “require creditors to return preferential transfers of money, property, or liens.”⁹⁷ It is suggested that since it is possible to foresee the commencement of bankruptcy case already within 90 days such transactions allow “creditors

⁹⁵ See, Kalevich Lawrence, *Effect of Bankruptcy Code on secured creditors’ rights*, SECT FL-CLE 11-1(1996) at 4

⁹⁶ See, Id. at 4

⁹⁷ See, Kalevich Lawrence, *supra* note 94 at 6

gain an unfair advantage in the view of preference law.”⁹⁸ Contrary to unfair creditors good faith secured creditors are presumed to have been fulfilled the requirements of Art. 9 of UCC in due time.

With regard to the secured interest problems can appear once secured interest is perfected and therefore validly created within the preference period. Section 547(c) provides for exceptions setting the list of voidable preferences. There are two exceptions that concern the status of secured creditor in sections 547(c)(2)⁹⁹ and 547(c)(5)¹⁰⁰. The first one reflects the situation when debtor grants security interest in collateral to creditor dealing in an ordinary course of business. Another section covers cases when debtor provide creditor with security interests in after-acquired accounts and inventory, i.e. certain floating liens.

c. Fraudulent transfer (conveyance)

Another provision of Bankruptcy Code that potentially can affect the right of secured creditor and lead to invalidity of security interest is fraudulent transfer rules. Under s.548 “when the debtor made a transfer with actual intent to hinder, delay, or defraud creditors” the transaction can be invalidated by bankruptcy trustee. However the possibility that “security interest my face a challenge as a fraudulent conveyance.... is small ... since many of problematic circumstances involving a security interest transfer before bankruptcy are voidable as preferences ...”¹⁰¹ Trustee in bankruptcy will be more willing to raise a

⁹⁸ *Id.* at 6

⁹⁹ s. 547(c)(2) says:

(c) The trustee may not avoid under this section a transfer—

(2) to the extent that such transfer was in payment of a debt incurred by the debtor in the ordinary course of business or financial affairs of the debtor and the transferee, and such transfer was—

(a) made in the ordinary course of business or financial affairs of the debtor and the transferee; or (b) made according to ordinary business terms;

¹⁰⁰ s. 547(c)(5) says:

(c) The trustee may not avoid under this section a transfer (5)that creates a perfected security interest in inventory or a receivable or the proceeds of either...

¹⁰¹ *See, Kalevich Lawrence, supra* note 94 at 11

preference remedy that to recourse to fraudulent law as “the latter may well require proof of actual fraudulent intent”¹⁰² that is fairly difficult.

2.2.2. Automatic stay and secured creditor

a. Automatic stay

As has already been mentioned in Chapter I of the paper filing a petition in bankruptcy automatically suspend the enforcement of any claims raised before such filing or enjoin creditors from enforcing their claims out of bankruptcy proceeding. Art.9 of UCC provides secured creditors with system of devices that can be used by the latter to enforce security interest in case of debtor’s default by recourse to the assistance of the courts or without it. For example, one of distinguishing characteristic of American enforcement system is opportunity of self-help repossession. However, once bankruptcy petition is filed it ““stays”, i.e. restrains creditors from taking action against the debtor or the property of the debtor or the property of the estate to collect their claims or enforce their liens.”¹⁰³ Thus since secured creditor can not raise the guarantees granted to him in personal property law by UCC Art.9 it is now for bankruptcy law to provide secured creditor with something that will ensure the effective enforcement of its right.

b. Relief from stay for “lack of adequate protection”

One of the guarantees provided by Bankruptcy code is the right of the secured creditor to apply to the bankruptcy court for “relief from stay”. It is interesting to mention that these provisions do not provide secured creditor with a special treatment. The wording “party in interest” is used in section 362(d)(1), (2) meaning that not only secured interest is covered by “relief from stay” rules. Therefore, the determinative factor is existence of such interest in

¹⁰² Id. at 11

¹⁰³ See, Epstein G. David, Nickles H. Steve, Smith E. Edwin, *Nine questions: secured debt deals in the 21st century*, Thomson West (2003) at 336

property, in particularly security interest, which is qualified as an *in rem* right. This conclusion lead us the issue of correlation of bankruptcy and property law again since the validity of security interest again is based on proper satisfaction of the requirements of UCC Art.9.

The relief from stay can be granted in case “adequate protection” is not provided by the debtor in relation to the collateral given as a security to creditor. Since “Congress did not issue any standards”¹⁰⁴ with respect to adequate protection and therefore this doctrine provides for the room of wide court discretion in deciding, firstly, what constitutes the inability of debtor to provide a proper protection of the security and, secondly, what kind of protection should be granted.¹⁰⁵ Adequate protection may be granted to the secured creditors in case “the collateral will bring no value to the estate, as for example when the collateral is fully encumbered by the security interest”¹⁰⁶ or “collateral exceeds the amount of debt that it secures.” In addition, “secured creditor may obtain relief from the automatic stay and prevent the debtor from using or retaining its collateral if the creditor can establish that the value of the creditor's interest in the collateral is not adequately protected from diminution in value.”¹⁰⁷ Other forms of adequate protection can be ordered, “including periodic cash payments to the secured lender, payment of post-petition interest or the granting of additional liens to the creditor on previously unencumbered assets.”¹⁰⁸

2.2.3. Cutoff rules

Section 552 “Postpetition effect of security interest” of Bankruptcy Code provides:

“(a) Except as provided in subsection (b) of this section, **property acquired** by the estate or by the debtor after the commencement of the case **is not subject to any lien resulting from**

¹⁰⁴ See, Kalevich Lawrence, *supra* note 99 at 15

¹⁰⁵ See, Ayer D. John, Bernstein Michael, Friedlend Jonathan, *What every secured creditor (and its lawyer) should know about Chapter 11*, 22-NOV Am. Bankr. Inst. J. 22 (2003) at 22

¹⁰⁶ See, Kalevich Lawrence, *supra* note 99 at 16

¹⁰⁷ See, Hon, Robert D, Drain, *supra* note 71 at 115

¹⁰⁸ See, Ayer D. John, Bernstein Michael, Friedlend Jonathan, *supra* note 111 at 22

any security agreement entered into by the debtor before the commencement of the case.

- (b) (1) Except as provided in sections [363](#), [506 \(c\)](#), [522](#), [544](#), [545](#), [547](#), and [548](#) of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such **security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case** to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the **court, after notice and a hearing and based on the equities of the case, orders otherwise.**”

Under UCC Art.9 parties can agree to secure repayment of the debt by providing with collateral in the form of floating lien. What happens with security interest in bankruptcy once debtor has encumbered all its assets in favor of secured creditor? Bankruptcy Law favoring the rehabilitation of debtor ideas limits the effect of floating lien by stating that “property acquired by estate or debtor after commencement of the case is not subject to any lien resulting from any security agreement entered into by debtor before commencement of the case.”(U.S.C. Title 11 s.552(a)). The reason is that debtor should be given a chance to “reorganize its business or financial affairs free of the unhappy prebankruptcy difficulties ... were the debtor bound to its previous commitments, a fresh start or rehabilitation would be impaired.”¹⁰⁹

Nevertheless with respect to “proceeds, offspring and profits” of such collateral the Code establishes the exception trying to find a balance between the rights of secured creditor and debtor. Since bankruptcy law of the United States allows bankruptcy trustee to sell the collateral without obtaining prior consent from the secured creditor “the security interest could be de facto eliminated in a bankruptcy proceeding by the trustee's sale of prepetition collateral ... and the funds obtained from the sale of collateral would be free of the security

¹⁰⁹ See, Kalevich Lawrence, *supra* note 99 at 18

interest that would have validly encumbered the collateral.”¹¹⁰ As was stated in Congress report no. 95–595:

“The exception is to cover the situation where raw materials, for example, are converted into inventory, or inventory into accounts, at some expense to the estate, thus depleting the fund available for general unsecured creditors. The term “proceeds” is not limited to the technical definition of that term in the U.C.C., but covers any property into which property subject to the security interest is converted.”¹¹¹ As far as s.552(b) is concerned two problems are to be discussed.

Firstly, the problems arise in practice as to the definition of the “proceeds”. This question is valid not only within the framework of bankruptcy case, but in connection with the application of UCC Art.9 out of bankruptcy proceedings.

According to s.9-102(a)(64) UCC proceeds are “...whatever is acquired upon the sale, lease, license, exchange, or other disposition of collateral; rights arising out of collateral and etc...”

In cases such as *In re Cafeteria Operators*¹¹² and *In re Skagit Pacific Corp.*¹¹³ courts tried to resolve the issue of whether the benefits can be qualified as proceeds and as a result whether secured creditor acquired security interest in them under s.552(b).

Second “hidden threat”¹¹⁴ for the secured creditors contained in analyzed provision of section 552(b) is that court may eliminate on the basis of the circumstances of the case postpetition effect once it finds that equity requires so.

¹¹⁰ Id. at 19

¹¹¹ See, S. Rep. No. 95-989, 95th Cong., 2d Sess., at 91

¹¹² See, *In re Cafeteria Operators LP*, 299B.R. 400 (Bankr. N.D.Tex.2003)

¹¹³ See, *In re Skagit Pacific Corp.*, 316 B.R. 330,336 (9th Cir BAP 2004)

¹¹⁴ See, White H. Bruce, Medford L. William, *Section 552's hidden threat to secured creditors: there goes your equity cushion*, 25-MAY Am. Bankr. Inst. J.28 (2006) at 28

In *In re Cafeteria Operators* case court stated that “the equities of the case would require the court to limit the extent of the pre-petition security interest's post-petition continuation so as to prevent the secured creditor from receiving a windfall via the debtor's labor.”¹¹⁵

2.3. Chargeholder's rights under Bankruptcy Law of Russia

Analysis of the bankruptcy laws enacted in 1992, 1998 and 2002 shows that treatment of the security interest was different. Under para.4 art. 26 of BL 1992 collateral was not included in the bankruptcy estate. This provision was considered as contradictory to the approach adopted in 1961 Basics of Civil Legislation of Soviet Union that was still in force at that time. The contradiction was further eliminated by BL 1998 according to which property used as collateral was not separated from other assets of the debtor.

The dual nature approach is fully reflected in BL 2002. *In personam* elements of charge are evidenced by the articles of the law that provide for: 1) inclusion of collateral in assets of the debtor composed to satisfy claim of all creditors; 2) different from civil code regime of enforcement of the charge. *In rem* side of charge is characterized by: 1) giving the priority to the secured creditor against other creditor to satisfy its claims from the value of the collateral with the exception against creditors of first and second category¹¹⁶ whose claims appeared before the secured interest has been created; 2) providing secured creditor with the right to control the disposal of collateral during financial rehabilitation and external management¹¹⁷; 3) the charge is left unaffected in case of amicable settlement is reached and secured creditor did not express the consent to the terms of the agreement.¹¹⁸

2.3.1. Rights of the chargeholder set forth in BL 2002

a. Secured creditor as a competition creditor

¹¹⁵ See, *In re Cafeteria Operators*, 299B.R. 400 (Bankr. N.D.Tex.2003)

¹¹⁶ First category of creditors includes creditors whose claims arisen out of personal and life injury; second category consists of claims from labor and license contracts.

¹¹⁷ BL 2002, Para.6 Art.82

¹¹⁸ BL 2002, subpara.2 para.3 Art.156

All creditors within bankruptcy proceedings can be classified as to those who are competition creditors and who are not. According to Art.2 “General definition” of BL 2002 competition creditors are defined as “creditors with monetary claims with exception to authorized agencies, individuals with claims arisen out of personal injury ..., claims arisen out of license agreement ant etc.” Once court finds that creditors’ monetary claim is justified creditor become a competition creditor and as a consequence is included in the list of creditors and therefore loose their right to enforce the claims out of bankruptcy proceedings.

Firstly, contrary to other legal systems as well as United States Russian bankruptcy system sets the requirement for claims that can be raised in bankruptcy case. This requirement is monetary nature of the claim. Usually creditor who is a party to a security agreement is in monetary relation with debtor who goes bankrupt as well. But sometime situation is different and here problems in practice arise. What it the status of the secured creditor in bankruptcy proceedings who entered into an agreement with the third person and debtor in bankruptcy has provided collateral for securing the performance of obligation of third party. One group of courts has an opinion such relations should be considered as non-monetary obligation and repossession of the collateral are to be processed out of bankruptcy proceedings. According to the decision of Arbitrazh court of Krasnoyarsk region “repossession of the collateral that belongs to debtor will not lead to the decrease of value of debtor’s assets due to the fact that debtor acquires the right of creditor towards the third person under Art. 387 of Civil Code of Russian Federation.”¹¹⁹ Therefore it is not necessary to provide such secured creditor with the status of competition creditor. However such position fails to consider the right of the secured creditors that acquire status of competition creditor and therefore have to submit their claims only within bankruptcy case. Moreover

¹¹⁹ The decision was mentioned in the Report on the problems arising in connection with status of secured creditors in bankruptcy prepared for Supreme Arbitrazh Court pf Russian Federation. Available at http://arbitr.ru/_upimg/906274EE5AB6632F23A623437396F0A2_vas_zp_2007-09-13.pdf

once external management starts moratorium is introduced and therefore such creditor would not be able to complete enforcement of its right neither in bankruptcy nor out of it.

Presidium of Supreme Arbitrazh Court held in its decision that “such claims to the debtor can not be considered in bankruptcy case and article 57¹²⁰ is not applied to such claims.”¹²¹

The legal significance of distinguishing competition creditors is that only competition creditors are entitled to initiate bankruptcy proceedings, to vote on the creditors’ meeting and represent interest of creditors at the creditor’s committee.

Another problem connected with qualification of the secured creditor as competition creditor concerns the structure of the monetary obligation. Since claims for penalty fees, fines, interest, damages appeared due to default as well as others property and financial sanctions even if the repayment of them is secured do not provide creditors with the right to vote on the meeting.¹²² To the contrary competition creditor’s status is immanently connected with the right to vote at the creditor’s meeting.

The disadvantage of this differentiated approach is that its acceptance will lead to the formal inequality within the category of the secured creditors. One of them will fall under the regulation of Civil Code of Procedure and will have a chance to enforce the rights out of bankruptcy; others will fall under Bankruptcy law and will be restricted by Bankruptcy framework. Or *visa versa* the creditor that does not fit the formal requirements of the competition creditors set forth in Art. 2 of BL 2002 will be limited in the opportunity to influence the course of bankruptcy proceedings.

¹²⁰ Art. 57 of BL 1998 provides for consequences of commencement of supervision, in particular impossibility to satisfy claims out of bankruptcy

¹²¹ Rechenie Presidiuma Visshego Arbitrazhnogo Suda Rossiiskoi Federatsii No. 2860/02 [Decision of Presidium of Supreme Arbitrazh court of Russian Federation No.2860/02] available at <http://infopravo.by.ru/fed2002/ch03/akt15298.shtm>

¹²² Khimichev V.A., *Problemi primeneniya zakonodatelstva o nesostoyatelnosti (bankrotstve) v praktike arbitrazhnykh sudov* [Problems of application of bankruptcy legislature in practice of commercial courts], “Zakon” (No. 7, 2007)

This analysis demonstrates that status of secured creditor is swallowed up by referring them to the category of competition creditors with inclusion of several provisions in the law that allow to conclude that special treatment is not excluded entirely. This is different from United States bankruptcy system where clear distinction between secured and unsecured creditors exists, where trustee in bankruptcy represents only unsecured creditors and is obliged to invalidate one that are secured. Such treatment is balanced by giving an undisputed priority to the secured creditors. In addition secured creditors are not restricted by time of filing the proof of claim while under Russian law secured creditors being a competition creditors and therefore having equal rights with other creditors is forced to file the petition in due time. If he fails to file in time his claims is not included in the list of creditors and as a consequences this secured creditor will be satisfied last.

As far as priority rules are concerned status of the secured creditors is not clearly defined. Analysis of judicial practice demonstrated that courts in different regions treats secured creditors differently.

For the purpose of resolution of priorities problems it was suggested to classify creditors into two categories: those who falls under priority rule (priority creditors) and those who is not cover by priority system under Art. 134 of BL 2002 (extraordinary creditors). There are three categories of priority creditors. Secured creditors are covered by the third priority order, but special rules contained in Art.138 provide for priority for secured creditors to get repayment of the debt out of proceeds from the sale of collateral before other creditors with the exception to the creditors of first two categories whose claims arose before secured interest has been created.

The controversies in the judicial practice concern the issue whether secured creditors have priority against extraordinary creditors, in particular current payments¹²³, since the provision of Art. 138 of BL 2002 does not clearly determine the limits of the secured creditors' priority.

According to interpretation of Art.138 of BL 2002 by one group of courts held that current payments claim should be satisfied from the value of the collateral prior to the secured creditors claims since secured creditors are considered to be a competition creditors whose claims are satisfied in accordance with priority order. In contrast current payments are extraordinary payments and should be redeemed before turning to the satisfaction of claims that fall under priority rules. Federal Commercial Court of Northern-Caucasian district in its decision court held "secured creditors have a priority only towards creditors that are included in the list of creditors This right can be realized only once all current claims that are not included in the list are satisfied."¹²⁴

Approach accepted by other courts demonstrates pro-secured creditor's trends to avoid abusive overestimation of current payments amount. According to this position secured creditors are the first who get satisfaction once collateral has been sold.¹²⁵ Federal Commercial Court of Povolzhsk district held "...legislator did not provide other exception from priority rules, in particularly current payments ... As a result the lower court's

¹²³ Current payments are defined as "monetary obligations and mandatory payments appeared after bankruptcy petition was filed ..." (Art.5 of BL 2002)

¹²⁴ See, Postanovlenie Federal'nogo arbitrajnogo suda Severo-Kavkazskogo Okruga delo No Ф08-5228/2007[Ruling of Federal Commercial Court of Northern-Caucasian district case No. Ф08-5228/2007].

¹²⁵ For example see, Reshenie Arbitrazhnogo Suda Nizhegorodskoi oblasti delo No.A43-1536/2007-03-25 [Decision of Commercial Court of Nizhegorodskii region case No. A43-1536/2007-03-25]. In this decision court held that "according to para.4 Art.134 of Federal Law "On insolvency (bankruptcy) secured creditors' claims are satisfied from the value of collateral in priority towards other creditors with the exception to the creditors of first and second priority order whose claims arose before secured agreement has been concluded. Under Art. 334 of Civil Code of Russian Federation due to existence of charge secured creditor in case of default from the side of the debtor is entitled to be satisfied from the value of collateral prior to other creditors. Therefore current payments claims are not subject to priority satisfaction out of proceeds from the sale of collateral."

conclusion that secured creditors' claims do not have priority against current payments is not based on law.”¹²⁶

To resolve this issue the amendment to the current legislature is required. One of the solutions is to repay current expenses using the proceeds from the sale of collateral only in case other unencumbered assets are not available for satisfaction of such claims or to set the limits of amount of current payments.

Few articles contain the question concerning the rights of the secured creditors.

b. Disposal of collateral in bankruptcy proceedings

Provisions regulating the disposal of the property used as collateral to secure the performance of debtor's obligation is contained in Chapter V “Financial rehabilitation”, but is considered to be extended to other types of bankruptcy.¹²⁷ Debtor has the right to sell, lease, rent or dispose the collateral otherwise only if secured creditor has consented to it.¹²⁸

The secured creditor is paid off out of the proceeds received after the sale of collateral. Such sale must be conducted in the form of tender only.¹²⁹ Supreme Commercial Court interpreted the provision concerning the sale of collateral in a following way. According to para.16 of Ruling of Plenum Supreme Commercial Court “if collateral has not been realized during financial rehabilitation or external management ... and there is not enough assets to satisfy claims of all creditors secured creditors are paid off in ordinary course provided for all unsecured creditors.” Such interpretation is not clear enough and should be clarified. BL 2002 provides for different solution in competition proceedings. The provisions of BL 2002 with regard to the sale of collateral was interpreted by Commercial Court of Krasnoyarsk region in such a way: “the possibility of sale of collateral during competition proceedings

¹²⁶ See, Postanovlenie Federal'nogo arbitrazhnogo Suda Povolzhskogo okruga Дело N A65-26028/2004-СГ4-26 [Ruling of Federal Commercial Court of Povolzhsk district case No. A65-26028/2004-СГ4-26].

¹²⁷ See, Popondopulo V.F. *supra* note 71

¹²⁸ See, BL 2002, Art. 82

¹²⁹ See, BL 2002, para.6 Art. 82, para.5 Art.101

only with prior consent of secured creditor is not provided by Bankruptcy Law. Therefore, secured creditors' consent is required only at financial rehabilitation and external management procedures.”¹³⁰

¹³⁰ See, Postanovlenie Arbitrazhnogo Suda Krasnoyarskogo kraya delo N A33-2606/04-c4k90 [Ruling of Commercial Court of Krasnoyarsk region case No. A33-2606/04-c4k90]

Conclusion

Analysis of legislature and practice shows that Russian bankruptcy law does not provide creditors with adequate protection. As a result secured creditors are not willing to initiate bankruptcy proceedings to enforce the right. Firstly, it is not clear whether secured creditors have any valuable interest in encumbered property since the nature of such right is ambiguous. Secondly, They are aware that once bankruptcy proceedings are initiated it would be much more difficult to enforce security interest since it is eroded by bankruptcy law in such away that it become difficult to get full satisfaction of the claim from the debtor.

From the first look it can be suggested that the Russian Laws are complicated and therefore developed such as laws in the United States. But that is not the case in reality. Since common law system differs by complexity of the statutory provisions due to the fact that laws are the secondary sources and treated otherwise, namely such provision are more practical, detailed and full of exceptions. Therefore American Bankruptcy system appeared to be more sophisticated, efficient and flexible.

Bankruptcy system formed in Russian federation presents a variety of mechanisms that are not detailed and developed enough. These mechanisms fail to consider the rights of every participant of the bankruptcy proceedings, for example the right of the secured creditors in financial rehabilitation since law does not provide the creditors that granted a loan or guaranteed the performance of debtor's obligations by suretyship with any kind of protection. The law is silent on this issue.

It is exactly the moment to made several modification to bankruptcy legislation in Russia. Firstly, the procedures in which bankruptcy is conducted should be simplified in its forms and by reduced to the types that enforce the idea of bankruptcy system in more efficient and less detriment way. Secondly, more attention should be paid towards the rights of the creditors, especially secured.

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