

**The Introduction of the Concept of the Floating Lien over
Inventory in the Russian Federation: Possible Effects on
Small Business Financing**

By

Denis Khametov

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Supervisors: Andrzej Baniak and Tibor Tajti

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Abstract

This thesis addresses the problem of underfinancing of small business enterprises in the Russian Federation due to imperfections of the legal system of secured transactions and, as a consequence, the imperfection of banking practices. A sample of 44 loans given to small business entities by one of Russian banks has been analyzed to illustrate the problem. To enhance small business crediting changes to the legal system are suggested, in particular, introduction of the concept of the floating lien, which is one of the main features of the American secured transactions system.

The outcome of this thesis is the identification and description of the deficiencies of the current secured transactions system and crediting practices in Russia that inhibit crediting of small businesses, and the estimation of the effects that introduction of the floating lien might bring to the small business financing. This thesis attempts to prove that introduction of the floating lien can enhance crediting activity in Russia and contribute to national economic development.

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List of Abbreviations

ARRA	-	The American Recovery and Reinvestment Act of 2009
CA	-	Credit Agreement
CC	-	The Civil Code of the Russian Federation
EBRD	-	European Bank for Reconstruction and Development
FAQs	-	Frequently Asked Questions
PMSI	-	Purchase Money Security Interest
s.	-	section
SBA	-	The Small Business Administration
SWPC	-	The Smaller War Plants Corporation
RF	-	The Russian Federation
UCC	-	Uniform Commercial Code of the United States of America
U.S.	-	The United States of America

Introduction

According to Fleisig, Safavian and de la Pena (2006) in their research made for the World Bank, credits secured by collateral have benefits over unsecured ones: they make larger amounts of loans available to debtors than unsecured credits, they employ lower interest rates, ensure longer repayment periods and the presence of collateral also plays a significant role in the decision-making process of banks – many borrowers do not receive credits at all due to absence of collateral (p. 1). They also state that in most developing economies secured credit is unavailable or very limited because of inappropriate secured transactions laws (Fleisig et al., 2006, p. 1).

This thesis focuses on problems of crediting small business enterprises in Russia, the priority sector of national economy as proclaimed by the former president (current prime minister) Dmitry Medvedev (Echo Moskv, 2012; Newstube, 2012). Small and medium businesses in Russia in this thesis will be referred together as “small businesses”. Crediting practices in the Russian Federation are far from efficient, they provide insufficient financing for small businesses and need improvement. And that improvement is only possible after enhancement of the legal framework for secured transactions, including most importantly the revamping of and making the floating lien-related law more business friendly (The World Bank and the International Finance Corporation, 2012, p. 9).

Empirical study, which is a part of this thesis, identified that the main type of assets that could be used as collateral in small business crediting are shifting assets, particularly, inventory. In this thesis terms “shifting assets” and “inventory” will be used interchangeably. Due to deficiency of the system of secured transactions in Russia, pledging of inventory by small businesses is either impossible or more complicated than under developed systems of secured transactions.

The improvement suggested by this thesis is the introduction of the concept of the U.S.-type floating lien or its functional elements to Russian secured transactions law. Though the concept of the floating lien cannot be transplanted easily to Russian law due to differences in civil and common law approaches, it might be useful for Russian economy to adopt some functional parts of the concept. As Russia tends to become one of new leaders in the World's economic arena, modernization of the legal system is necessary for successful competition on the global level. The concept of floating lien proves to be the useful concept that can contribute to successful development of Russian secured transactions law.

The method used includes descriptive statistics applied to the sample of 44 loans, and analysis of the respective laws and their practical outcomes.

In the first Chapter we view the position of small business enterprises in the economy of the United States of America and in the economy of the Russian Federation. The objects of the chapter are the definition of "small business" in these countries, statistical data, as well as specific legal framework for small business.

In the second Chapter we study the part of the secured transactions law that regulates floating lien in the U.S. in comparison with the Russian legal framework for secured transactions, particularly specific laws and articles of the Civil Code that regulate pledging shifting assets as collateral. We also detect deficiencies of the developing Russian system.

The third Chapter provides an insight into current Russian banking practice. It contains the analysis of a sample of 44 small business loans given by one of Russian banks. Due to deficiencies of the Russian secured transactions system most of those loans are unsecured. This means that they were not given in amounts requested by clients and imposed higher interest rates on borrowers. The way to cope with these problems would be taking shifting assets, in particular, inventory, as collateral. Floating lien over inventory appears to be the suitable concept for adoption in order to enhance crediting potential of Russian banks. The

case study shows the possible increase in amounts of credits that the adoption of the floating lien would bring to the mentioned 44 clients.

As outcome of the thesis we propose the solutions of the crediting problems that arise due to deficiencies of Russian legal system regarding pledging of shifting assets as collateral. We spell out practical recommendations with respect to changes that would contribute to enhancement of secured crediting and development of financing of small business enterprises in the Russian Federation.

Chapter 1. Importance of small business enterprises for economies of the United States and the Russian Federation

The scope of this chapter is the discussion of the importance of small business for economies of the United States of America and Russian Federation. We also briefly view small business statistics and legislative acts on small business in both countries. We conclude that among the factors that cause underdevelopment of Russian small business sector comparing to American small business are the deficiencies of the legal system for secured transactions and deficiencies in crediting practices of banks caused by the imperfect legal system.

1.1. Importance of small business for the economy of the United States

American officials started to realize the importance of small business for the economy as early as 1942, when “the Smaller War Plants Corporation (SWPC) was established to determine how best small businesses could be used to assist in the production of parts for World War II” (Clark and Saade, 2010, p. 4). The main reason for creation of the SWPC was the fact that the Congress received many claims from small entrepreneurs that big companies have unfair advantage in the competition for the war-time contracting (Clark and Saade, 2010, p. 4). Hereinafter we use the paper prepared by two authors of the Small Business Administration’s office of advocacy – Major L. Clark, III and Radwan N. Saade. The authors give precise overview of the role and importance of small business for the U.S. economy based on official statistical data and applicable legislation.

In 1953 the Small Business Administration (SBA) was created by the Small Business Act to provide assistance to all aspects of small business (Clark and Saade, 2010, p. 7). The Small Business Act viewed the SBA’s function as “to “encourage” and “develop” small business

growth, and to aid minorities and other disadvantaged people in securing loans and learning management techniques” (Clark and Saade, 2010, p. 7). We can see that one of the main reasons for creating the SBA was enhancing small business’s ability to receive loans. Ability to use credit resources was viewed as a precondition for successful national economic development by American legislators.

The SBA generally defines a small business as an independent business having fewer than 500 employees. (U.S. SBA, n.d., FAQs). However, according to the Table of Small Business Size Standards adopted by the SBA, maximum number of employees may be up to 1,500 in such industry as Couriers and Express Delivery Services (U.S. SBA, Table of small business standards, 2012, p. 29) or up to 50 for Heating Oil Dealers (U.S. SBA, Table of small business standards, 2012, p. 27) – these industries represent the marginal cases. A company may be considered a small business on the basis of another approach – if it has average annual receipts (revenue) not higher than \$0.75 million to \$35.5 million depending on industry (U.S. SBA, Table of small business standards, 2012).

Importance of small business enterprises for American economy can be seen from the official statistical data. According to the SBA, in 2009 there were 27.5 million small businesses in the United States; small business firms represented 99.7 percent of all employer firms; 50 percent of private sector employees were employed by small firms; 44 percent of total U.S. private payroll was paid by these firms; small business companies generated more than 50 percent of the nonfarm private GDP; small companies created 65 percent of new jobs in the years 1993-2009 (U.S. SBA, n.d., FAQs). Small businesses are the main source of innovation – “they produce 13 times more patents per employee than large patenting firms” (U.S. SBA, n.d., FAQs). As stressed by Clark and Saade, “small business is an engine of economic growth and job creation [in the United States of America]” (2010, p. 2).

As a means of recovery after the global financial crisis the U.S. Congress passed the American Recovery and Reinvestment Act of 2009 (ARRA) (Clark and Saade, 2010, p. 10). This act among other measures of boosting the U.S. economy provides “\$275 billion available for federal contracts, grants and loans” (Clark and Saade, 2010, p. 11). Clark and Saade note that since 1990s the goal of Federal Government was “awarding 23 percent of its contract to small businesses” (2010, p. 11). They also note that “the dollars awarded to small business under the American Recovery and Reinvestment Act exceeds the 23 percent goal” (Clark and Saade, 2010, p. 11).

Therefore, small business represents in some aspects an equally relevant part of the U.S. economy comparing to big corporations, and in some aspects, such as innovation activity, has superior indicators. American legislation is aimed towards financial stimulating of small business companies: enhancing opportunities to get credit for small business is openly declared as a goal in the Small Business Act, and the recent American Recovery and Reinvestment Act provides help to small business through federal contracts, grants and loans (Clark and Saade, 2010, p. 11). However, the most important support American small businesses receive from the legal system of secured transactions which allows obtaining necessary financing for development, as will be shown in the Chapter 2 of this thesis.

1.2. Importance of small business for the economy of the Russian Federation

Small business in the Russian Federation (hereinafter – RF) has much shorter history than in the U.S. In the Soviet time entrepreneurial activity was prohibited by the state and punishable by the Criminal Code, there were no small businesses in the Soviet Union (Lewinbuk, 2008, p. 853). Private enterprises started to emerge legally only in the time of political and economic reconstruction of Soviet Union: in the end of 1980s – beginning of 1990s (Ojala and Isomaki, 2011, p. 2).

According to Article 4 of the Federal Law “On Development of the Small and Medium Entrepreneurship in the Russian Federation” No. 209-FZ dated 24 July 2007 (hereinafter, Law “On Development of Small Entrepreneurship”), small and medium businesses include consumer cooperatives, commercial organizations and individual entrepreneurs. The Law provides that for a legal entity to qualify as a small or medium enterprise the share of ownership in it of the state or municipalities or of other legal entities, which are not subjects of small or medium entrepreneurship, cannot exceed 25 percent (Law “On Development of Small Entrepreneurship”, 2011, Article 4)¹.

The Law also provides that the number of employees of a medium enterprise has to be in the range between 101 and 250 employees, and for a small enterprise the number of employees cannot exceed 100 employees. Moreover, the Law requires that to qualify as a small or medium enterprise, the revenue from the sale of the products (services) and the balance value of the fixed and intangible assets cannot exceed the certain values stated by the Government of the Russian Federation (Law “On Development of Small Entrepreneurship”, 2011, Article 4). According to the Decree of the Government of the RF “On Marginal Amounts of Revenue from the Sale of Goods (Works, Services) for Each Category of Subjects of Small and Medium Entrepreneurship” No. 556 dated 22 July 2008, for small businesses annual revenue cannot exceed 400 million rubles (12,876,476 U.S. dollars as for 23 May 2012) (Central Bank of the RF, 2012); for medium businesses annual revenue cannot exceed 1 billion rubles (32,191,190 U.S. dollars as for 23 May 2012) (Central Bank of the RF, 2012). The Decree does not contain any restrictions relating to the value of assets.

Therefore, comparing to the U.S. general requirements – number of employees fewer than 500, annual revenue ranging from 0.75 million to 35.5 million U.S. dollars (U.S. SBA, Table of small business standards, 2012), it is possible to say that the American definition of small

¹ Hereinafter all references to legislative acts include the year of last amendment.

business and Russian definition of small and medium business are roughly comparable. For this reason, as mentioned before, small and medium businesses in Russia in this thesis are referred together as “small businesses”.

According to the official statistics, there were 1 618 038 small businesses in the RF at the end of 2009 (Federal Service of the State Statistics, 2010, p. 12). This is a very small number comparing to the U.S.’s 27.5 million of small enterprises. Small businesses in the RF employ 25.9 % of country’s workforce in 2009 (Federal Service of the State Statistics, 2010, p. 12). This is almost two times lower than the U.S. small enterprises’ share of employment (50 %).

The factors that make small business in Russia underdeveloped comparing to the U.S. include historical reasons such as short history of capitalism in Russia and geographical reasons such as severe climate, but they are not limited to them. The most widespread opinion of the factors that inhibit the development of small business in Russia includes difficulty to obtain financing, high interest rates, as well as corruption and administrative barriers (Ivanov, 2009; Volpe and Schenck, 2008).

The Law “On Development of Small Entrepreneurship” aims at creation of “infrastructure of support of subjects of small and medium entrepreneurship” (2011, Article 1). But to solve the problem of underfinancing of small businesses, limited state support is not enough. Reforming of the system that regulates availability of credit resources for small businesses in Russia is needed. In this thesis the reform of the secured transactions system is suggested.

One of the destructive factors that inhibit borrowing activity and, as a consequence, the development of Russian small businesses is the impossibility to use the assets of the company as collateral due to deficiency of the legal system or hostile collateral policy of banks. This situation is discussed at the highest level of national administration: head of Russia’s Central Bank, Sergey Ignat’yev, recently said that “at the present time the average level of annual interest rates charged by banks from private sector companies in Russia is 9-10 percent, but it

depends on the financial stability of a debtor and quality of collateral” (BFM.ru, 2012). He stressed that “if a company cannot provide reliable collateral, credit interest rate may raise up to 12-15 percent” (BFM.ru, 2012).

Banks in Russia traditionally prefer taking real estate as collateral as the most reliable asset that is hard to harm and impossible to sell without registration in the state agency. However, taking real estate as collateral is costly for both parties in terms of both money and time – it is required to pay considerable state registration fees and it takes, practically, at least 14 days to register a security interest over real estate.

Banks in the U.S. have another approach. According to Spanogle (2008), “banks in the Midwest in the U.S. find that cattle make better collateral than farmland” (p. 1). He continues that “cattle can be sold in three to seven days for 95% of their market value; while the bank may wait for months to find a suitable buyer for farmland, and the price will depend on the number of potential buyers” (Spanogle, 2008, p. 1). Spanogle also states that “World Bank studies show that a nation’s capital can be increased by 60% if a commercially effective financing system can be developed which uses movables and intangibles as collateral for loans” (2008, p. 1).

Very few small businesses in Russia can pledge real estate, equipment or means of transport. The type of assets that they can pledge in absolute majority of cases, as will be shown in the empirical case in the Chapter 3, is their inventory: goods for resale, raw materials, or production. This thesis is focused on research of the possibilities of improvement of the Russian legal system and banking practices in relation to pledge of shifting assets (inventory).

Chapter 2. Security interests over inventory in the United States and in the Russian Federation

In this chapter we overview the approaches toward creating security interests over shifting assets (inventory) of the U.S. and Russian legal systems. We also discuss advantages of the U.S. concept of the floating lien and deficiencies of the Russian legal system relating to pledge of shifting assets. We conclude that Russian legal system and, as a consequence, Russian economy would benefit from adoption of the functional elements of the concept of the floating lien.

2.1. Efficient encumbrance of inventory: floating lien in the U.S.

One of the most important and useful techniques proposed by the American secured transactions system is the floating lien. Floating lien is the possibility to encumber all assets of a debtor or all inventory of a debtor. That means that in case of default a creditor can repossess any assets of a debtor or any inventory that is in the possession of the debtor at that time.

The benefits of use of the floating lien include the possibility to get higher amounts of credit because higher value of assets is encumbered, greater freedom for the debtor to conduct his business because he does not have to keep the specific items serving as collateral on a fixed level, and benefits for lenders that include greater control over financing opportunities of a debtor and higher protection in case of default (Mosley, 2011).

The clearest description and explanation of the concept of the floating lien is given by Tibor Tajti (2002, pp. 178-182). Floating lien is the concept not explicitly mentioned in Article 9 of UCC² (Tajti, 2002, p. 178). However, this concept is one of the main distinctive

² Hereinafter the Revised Version of the UCC (effective of 2001) is used.

features of the U.S. system of secured transactions. As Tajti puts it, a floating lien is used to encumber “the whole or the substantial portion of a debtor’s property” (2002, p. 178).

Tajti further provides a classification of essential elements of the floating lien which are contained in the provisions of the UCC Article 9 which refer to (1) the possibility of automatically extending the lien (security interest) onto after-acquired property and (2) the provision on “proceeds”; (3) the possibility to extend the security to future advances without the need to conclude new contracts for each new future advance; (4) the overruling of the *Benedict v. Ratner* ruling, or not requiring by law “policing” of the debtor as a precondition of a floating lien’s validity; (5) and “simple notice filing” (2002, p. 178). The existence of these preconditions makes modern floating lien possible. In other words, these preconditions constitute the “concept” of floating lien.

One of the important features of the floating lien is its ability to “cover” after-acquired property. Tajti underlines that floating lien is especially useful in situations when shifting assets, such as inventory, serve as collateral (2002, p. 178). He admits that according to section 9-108 of UCC Article 9 when filing a financing statement creditor has to describe collateral in ‘reasonable identifying’ terms (Tajti, 2002, p. 179). Subsection (b) of section 9-108 permits identifying the collateral by type of the asset subject to exceptions listed in the subsection (e) – commercial tort claims and consumer transactions (UCC Article 9, 2001).

Tajti stresses that the perfection of the floating lien protects collateral from claims of other creditors but (2002, p. 179). In presence of such system any lender who would like to give a loan to a debtor is in the position to check if any prior security interests have been registered over assets of that debtor. Therefore, a subsequent lender will know that if he grants a loan to a debtor he would be in lower priority position in case of default. In the case of a floating lien, the creditor who has a floating security interest will be in a priority position. A floating lien encourages long-term relationships between a debtor and one principal lender (floating lienee)

(Tajti, 2002, p. 178). Thus, a creditor obtains a certain degree of control over “financing opportunities of a debtor” (Tajti, 2002, p. 179), but not over all business activities of a debtor.

Tajti also points out that the floating lien is a powerful tool in the American secured transactions system, because it is subordinated only to properly perfected purchase money security interests, and win in most of other cases (2002, p. 179). The purchase money security interest (PMSI) is a secured transactions device that indicates the possibility that a seller registers his security interest in the property sold on credit to a buyer and this security interest has a super-priority in relation to all other claims that other creditors have on the assets of the buyer (Tajti, 2002, pp. 167-169).

The concepts of the floating lien and PMSI should be viewed together because they both constitute exceptions from the Article 9’s basic ‘first-in-time’ priority system – floating lien has priority over other claims and PMSI has priority over floating lien (Tajti, 2002, pp. 168-169). PMSI is the solution against the monopoly of a floating lienholder over financing of a debtor and a device that enhances borrowing activity of a debtor – subsequent sellers-lenders can sell on credit and not fear the priority of a floating lien but receive super-priority if they properly register their security interests in the objects sold on credit (Tajti, 2002, p. 180).

According to Tajti, Article 9 gives a debtor the unfettered control over the collateral, and a creditor is protected by the system of filing and “through the provisions on proceeds” (2002, p. 179). System of filing gives a public notice that property was encumbered. It is possible for any interested person to inquire in the public register if any assets of a particular debtor have been encumbered. This is the primary way to reduce uncertainty in the secured lending.

According to section (hereinafter, s.) 9-315 (a) of the UCC Article 9, a security interest continues in collateral even if the collateral has been sold, exchanged or disposed in other way and “a security interest attaches to any identifiable proceeds of the collateral” (UCC Article 9, 2001). According to s. 9-315 (b), proceeds are identifiable even if commingled with other

property if the proceeds are goods or if “the secured party identifies the proceeds by a method of tracing, including application of equitable principles...” (UCC Article 9, 2001). Practically, it means that if raw materials were encumbered, the final produce made from these materials will be encumbered too. Broad approach to the method of tracing and allowance to use equitable principles make the process of identification of proceeds relatively easy.

Presence of the public register for liens (charges) on movable property and adoption of the concept of proceeds allow a creditor to decide whether to “police” a debtor or not. Validity of a floating lien will not be questioned by courts even in absence of “policing” (overruling of *Benedict v. Ratner* rule, which required “policing” of a debtor as a precondition for validity of a security interest) (U.S. Supreme Court, 1925).

Tajti continues that floating lien is a device favorable for long-term relationships between creditors and debtors because Article 9 permits the extension of the security interest on the future advances of credit (2002, p. 181).

Simple notice filing is likely to be the most useful feature of the American concept of the floating lien. Tajti points out that “a properly filled out and filed financing statement will cover after-acquired property and future advances, whether or not mentioned in the financing statement” (2002, p. 181). He also points that it is advisable to be as precise as possible in describing the collateral in the financing statements, for example, “all inventory now owned or hereafter acquired” (Tajti, 2002, p. 181).

His general statement is that the floating lien is the powerful device, subordinate in priority only to the purchase money security interest and “staying afloat come hell or high water” (Tajti, 2002, pp. 181-182). Therefore, the strengths of the floating lien are based of the transparent filing system; they include retention of the security interest in power in relation to the after-acquired property and future advances, covering of the proceeds, and granting the strong priority position. As Spanogle (2008) put it, “the North American Model “security

interest” is a security device which covers all of the assets of a small business” (p. 13). As we can see, this is the functional definition of a floating lien. According to Spanogle, “registered security interest realizes real value to the secured creditor with little cost” (from \$10 to \$30) (2008, p. 13). Moreover, [floating lien] “allows lenders and credit sellers to compete evenly for the business of debtors, and that competition will effectively reduce the costs of credit”, therefore, “debtors are most likely to realize actual value for their collateral when they borrow” (Spanogle, 2008, p. 13).

2.2. System of secured transactions over inventory in the Russian Federation

Russia is a civil law country. As can be seen in Guseva (2007), “similarly to other continental European systems, Russian law is a hierarchical system descending from the constitution of the Russian Federation... to several codes [and] specific statutory acts...” (p. 300). The highest source of law is the Constitution, lower are the Federal Constitutional Laws, Federal Codes, Federal Laws and the lowest level is represented by local legislation of regions and municipalities.

“The main source of private law is the Civil Code of the Russian Federation (hereinafter, CC); Russian civil law governs all transactions, which involve parties of equal status and concern obtaining and exercising of real and personal rights, as well as contractual and non-contractual obligations...” (Guseva, 2007, p. 301). Article 3 of the CC states that the Civil Code is the single prevailing document regulating the private civil law and all other statutes must comply with the CC (CC, 2011).

Secured transactions are covered by Articles 334-358 of the CC; the Federal Law “On Hypothec (Pledge of Immovables)” No. 102-FZ dated 16 July 1998; the Federal Law “On Pledge” No. 2872-1 dated 29 May 1992; the Federal Law “On Insolvency (Bankruptcy)” No.

127-FZ dated 26 October 2002 (EBRD, 2005, p. 1). In case of any contradictions between the mentioned statutes, Russian courts are likely to give priority to the CC (EBRD, 2005, p. 1).

A clear summary of Russian secured transactions system is given by Guseva and Kononov (2009). A review of their summary along with the primary legislative documents is used in the present thesis. Guseva and Kononov (2009) state that Article 5 of the Federal Law “On Hypothec” requires that a hypothec agreement is “consummated only if the object of the transaction is registered in the appropriate public register” (p. 828). But there is no register for charges on movables in Russia (in this thesis we will use the word “charge” analogously to “lien” speaking about Russian Law, because it is a part of the European legal tradition). In practice it means that the only certain way to know if any movable property has been encumbered by any creditor is the disclosure by the debtor. There is one exception – pledges of special machines, such as tractors or loaders have to be registered with the State Technical Inspection. But this is not a registry for charges over all types of movable property. Pledges of special machines are specific and not widespread in Russian banking practice. For these reasons, hereinafter we will say that there is no registry for charges over movables in Russia.

According to Article 18 of the Federal Law “On Pledge”, the pledgor is obliged to keep a book of registration of pledges on its property (Federal Law “On Pledge”, 2011). However, this requirement is often disregarded by pledgors due to low business culture – lack of the embeddedness of law in business people. Moreover, there is no organization that would monitor the keeping of such books. It means that a fraudulent debtor can easily misrepresent his pledge obligations to prospective lenders.

Guseva and Kononov notice that as a rule, pledge is non-possessory in Russian Law (2009, p. 829). Based on Article 339 of the Civil Code, Guseva and Kononov state that along with the written form basic validity requirements for a pledge contract include also “certain material clauses, such as the specification of the object to be pledged (i.e., the collateral), its

value, nature, the term of the obligation collateralized by pledge and the identification of the party in possession of the pledged asset” (2009, p. 829). Furthermore, they provide examples of Russian case law that illustrate that failure to specifically describe assets serving as collateral leads to unenforceability of pledge (collateral) agreements (Guseva and Kononov, 2009, p. 831). To cope with this problem they suggest that “the precise nature of the asset to be encumbered” has to be determined in the collateral agreement (Guseva and Kononov, 2009, p. 834). They conclude that “excessive judicial textualism” and “judicial formalism” are inherent to Russian system of secured transactions (Guseva and Kononov, 2009, pp. 846-847).

Zverev also underlines that in Russian legal system “a subject of charge is to be identified individually rather than within a class of assets”, and “a pledge agreement should quote, among other things, the content and valuation of charged assets” (1998, p. 298). He further admits that “the 1992 Law “On Pledge” introduced a new possibility of creating charges over ‘goods in turnover’, i.e. inventory...” and “the content and natural form of subjects of the charge... are allowed to be changed [in the normal course of business], provided that the total value of the charged inventory does not become less than the one specified in the pledge agreement” (Zverev, 1998, p. 298). Indeed, though to some extent the possibility of floating security interest is recognized by Russian law, in practice it is complicated or costly to use this secured transactions device due to reasons discussed further in this thesis.

Article 357 of the CC regulates the pledge of commodities in circulation, which, in fact, is the identical provision to the mentioned earlier provision of the Law “On Pledge” aimed at creating law for a Russian version of a floating security. According to this article, the pledgor has the right to alter the content and natural form of the pledge (inventory, materials) as long as overall value of the pledged assets “does not become less than that indicated in the contract of pledge” (CC, English Translation, 2003).

Therefore, taking shifting assets as collateral is not prohibited under current Russian secured transactions system. Nevertheless, there is legal and practical uncertainty between the basic cornerstone requirement of specific description of the collateral in a pledge agreement and the opportunity to use shifting assets as collateral, granted by Article 357. According to Article 339 of CC (2011), which lists the general requirements for contracts of pledge, and, more specifically Article 47 of the Law “On Pledge” (2011), “the pledge agreement for inventory must determine the type of the pledged inventory, other identifying features of the inventory, the cumulative value of the collateral, the place where the collateral is stored and types of inventory that might substitute the pledged inventory”. This formulation creates a problem because the type of the pledged inventory has to be determined. If a debtor changes his course of business to deal with another type of inventory then a bank will lose the collateral. Even if the pledge agreement contains the list of types of inventory that might substitute the collateral, a fraudulent debtor can avoid these specific types of inventory. It is not clear what degree of breadth of formulation is possible. Most often in banking practice specific formulation is preferred because it enhances the probability to win in the court due to compliance with the general rule of the specific description, which is stated by the CC. But the specific formulation also enhances the risk that a fraudulent debtor will deprive the bank of collateral. This problem will be further discussed in the Chapter 3 of the present thesis.

Zverev’s summary reflects the problem of a floating security in Russia: “...as a matter of fact the economic essence of the floating charge concept does exist and is recognized now under Russian law. However, this is a very new idea which is legally more of an exception, rather than a separate option of creation of a pledge, and in practice is not widely used” (Zverev, 1998, p. 299).

Priority system in Russian law is regulated primarily by the Civil Code. According to Paragraph 2 of Article 64 of the CC, claims of secured creditors are fulfilled prior to claims of

unsecured creditors out of money received from the sale of the collateral (CC, 2011). Moreover, according to Paragraph 6 of Article 64 of the CC, claims of creditors which have not been fulfilled due to deficiency of assets of a debtor are considered extinguished (CC, 2011). Therefore, in case of presence of a number of secured and unsecured creditors and deficiency of assets banks that gave out unsecured loans are likely to be the last in receiving any reimbursement from a defaulted debtor, bankrupt or not. The same order of payment is stated in Articles 134 and 138 of the Federal Law “On Insolvency (Bankruptcy)” No. 127-FZ dated 26 October 2002. As we can see, Russian law does not provide any special priority for lienees that hold floating security interests over shifting assets, the priority system only distinguishes between (in the descending order of priority): the first priority creditors (for example, tax authorities), secured and unsecured creditors.

Another aspect of deficiency of Russian secured transactions system arises out of the imperfect concept of “fruits”. According to Fleisig, Safavian and de la Pena (2006), “unreformed systems [of secured transactions] often permit a security interest to continue in proceeds only in a very limited way” (p. 33). The same authors underline that many civil codes define proceeds as “fruits and products” of the original collateral, which is a very limited approach because “it includes only first disposition of the collateral and no subsequent dispositions” (Fleisig et al., 2006, p. 33). In Russian law Article 340 of the CC provides that rights of the lienee extend onto “fruits, produce and revenue” if it was stated in the collateral agreement (CC, 2011).

Fleisig et al. (2006) state that “in modern systems a security interest can continue in proceeds for an indefinite period or number of transactions, limited only by the ability to trace those proceeds” (p. 34). This principle is contained in the U.S. law – in the s. 9-315 of the UCC Article 9. By contrast, the concept of proceeds is limited in Russian law (“fruits”); Russian law in this aspect is an example of the unreformed approach described by Fleisig et

al. (2006). This poses a big problem. Fleisig et al. (2006) provide an example that if in an undeveloped system a debtor sells a specific piece of assets serving as collateral and does not substitute it with a new asset, the object of the security interest disappears (p. 33). Under these circumstances in the case of default the creditor will be treated as an unsecured creditor (Fleisig et al., 2006, pp. 33-34). This is true for Russian banking realities: if a specific type of pledged inventory has been sold and not substituted by the same type of assets, the creditor cannot repossess another type of assets, and it is also practically impossible to claim cash proceeds since: (1) it must be expressly stated in the collateral agreement, (2) it has to be proven that the particular money was received undoubtedly from the sale of the type of assets that serves as collateral, (3) a fraudulent debtor is likely to sell pledged assets for cash so no money will go to bank accounts where the money can be stopped by a creditor.

Therefore, the deficiencies of Russian legal system in relation to pledge of the shifting assets (inventory) include: lack or registry system for charges on movables, no special priority for holders of a floating security interest, undeveloped concept of "fruits", and impossibility of general description of collateral. By contrast, all these elements are inherent to the U.S. concept of floating lien. Since American small business statistics show better numbers than Russian small business statistics, for the better development of Russian small business enterprises the introduction of the concept of the floating lien can be suggested.

Chapter 3. Problems of small business crediting in the Russian Federation and their possible solutions

This chapter focuses on practical problems of crediting of small business enterprises in the Russian Federation. We examine the empirical data to show that due to the deficiencies of Russian secured transactions system both banks and borrowers experience considerable inconveniences.

We then show the possible practical effect from change of Russian legal system regarding pledge of inventory. The sample is on a small-scale level (portfolio of a subsidiary of one Bank), however, it reflects the typical situation in current Russian banking practices. We offer the solutions for problems of Russian secured transactions system and suggest improvement of banking practices as preconditions for successful development of small business enterprises in the Russian Federation.

3.1. Description of the Empirical Case of 44 small business loans

Awarding credit to small business in Russia is connected with a number of problems. *First*, small business companies often cannot provide collateral desired by a creditor, primarily – a bank. *Second*, system of legislative acts regulating secured transactions in Russia does not allow small companies to pledge what they can, in particular inventory, and get the desired amount of credit. *Third*, it is cumbersome for both banks and small business owners to collect all the sufficient documents required to identify each particular item of the collateral. Or, in other words, the whole process is too bureaucratic and complicated and the transaction costs are enormous. These circumstances lead to the following outcomes: first, very high interest rates are paid by debtors who are forced to take the more expensive unsecured credits; second, lower amount of credits is given by banks when unsecured

crediting prevails, because the amount of an unsecured credit is limited by most banks to reduce their risks, as a result, debtors receive less money than they need.

Table 1 (Appendix 1) represents a dataset of 44 credits given to small business companies. Information is retrieved from a branch of one of Russian banks (Hereinafter – Bank A). For the purposes of confidentiality and protection of commercial secrecy names of clients are not revealed.

It can be seen from Table 1 that most loans given to small business companies by Bank A are unsecured. Interest rate for an unsecured loan is 16 %; interest rate for a typical secured loan is 13.5 %. The only case where real estate was provided as collateral (Client 34) shows interest rate of 12.5 %. Bank adopted the interest rate policy depending on presence and “quality” of collateral that debtors could offer – real estate was deemed as collateral of the best quality.

For the purposes of this thesis it is, however, highly relevant that most of the clients presented in the table could provide inventory as collateral and yet in most cases it was either impossible under current Russian Law to do so or it would have involved enormous transaction costs (including time and effort). Only this data is a good example of the fact this thesis aims to prove – that the Russian law on floating security is inadequate.

3.2. Deficiencies of the unsecured crediting practices

Unsecured loans are typically more expensive for borrowers than secured ones. Interest rates for unsecured small business credits in Bank A were 2.5 % higher than for credits secured by pledge of movables and 3.5 % higher than for credits secured by hypothec of immovable property.

Unsecured credits are limited in sum by most banks in Russia. In the time period analyzed in Table 1 (summer of 2011) maximum amount of unsecured credit was regulated by the

internal normative documents of Bank A and constituted 1 000 000 rubles, equivalent of 32 971 U.S. Dollars as of 16 May, 2012 (Central Bank of the RF, 2012).

Unsecured crediting also means higher risk for banks. First, unsecured creditors in Russian law have the lowest priority in case of default. Second, obviously, in absence of any collateral the position of the creditor is weak because for a creditor there is no guarantee of the payment except debtor's good faith or personal security devices such as suretyships. Third, high interest rates can make business of a debtor unprofitable and lead to bankruptcy.

Moreover, there is risk that a debtor can take out unsecured loans in different banks simultaneously to fulfill its need for credit resources. There is no credit history database for companies in Russia as yet. The Federal Bureau's of Credit Histories database covers only private persons' loans (including loans of individual entrepreneurs).

If a debtor takes loans from different banks the first bank that might have imposed a floating lien on assets of the debtor but did not do that due to deficiency of laws and banking practices, loses substantial degree of control over financing of a debtor. If the floating lien had been imposed, subsequent creditors would be more reluctant to give loans to the debtor because of facing lower priority. But the first bank could give bigger amounts of credit or credit lines secured by higher value of collateral.

It is possible to conclude that, as opposed to unsecured lending, secured lending helps borrowers receive more money at lower interest rates and helps banks strengthen their position both in control over financing of a debtor and in case of default. Lower interest rates decrease probability of degradation of a debtor's business and, as a consequence, decrease the probability of default.

3.3. Examples of crediting inconveniences due to deficiency of Russian legal system and banking practices

According to Table 1, a number of clients wanted to take out bigger sums of credit. The cumulative amount of credits given constituted 46 799 000 rubles. The cumulative requested volume of loans amounted to 60 099 000 rubles. It should be noted that the requested amount in Table 1 has been corrected in order to not exceed the maximum possible amount of credit calculated according to financial situation of a debtor. Some of the unsecured loans were not given in maximum possible amount for unsecured loans, even though the clients requested bigger sums because of such factors as presence of personal loans of owners of the business, which the bank would calculate together with commercial loans for purposes of risk-taking, or the amount of loan to be awarded could be reduced by the decision of the Credit Committee of the bank.

It should also be noted that all the clients represented in the table have good credit history; credits with bad credit history have not been included in the present analysis. Most of the clients took credits from Bank A before and had a good history of repaying of their previous loans. All of them did not infringe their duties to pay on time their current loans. Maximum delay in payments was not more than 5 days (period allowed by internal normative documents of Bank A to consider the loan “good”). Therefore, the risk that owners would borrow so much that it would harm their businesses is minimized. Clients in Table 1 represent stable small business companies with responsible owners.

Sixteen credits might have been awarded in bigger amounts if Bank A took inventory proposed by these clients as collateral (see Table 1). That would increase the amount of credits awarded by 13 300 000 rubles (28.42 percent). The types of inventory that these clients offered were: clothes, auto parts, computer parts, scotch-tape, leather goods (bags,

purses, gloves, etc.), livestock and meat, cattle and vegetables, drugs and pharmaceuticals, grain and flour, fruit and vegetables, sugar and flour, meat and sausage.

Clothes offered were not accepted as collateral because most of the clothes had been bought abroad in cash – in China and Turkey, they did not have all the documents required by Bank A (accounting, transport and warehousing documents, sale contracts and payment documents). Auto parts bought primarily in Japan and Korea were not taken as collateral for the same reasons. Moreover, rich assortment of clothes and auto parts complicated the problem of documentary identification of purchase of these goods because in case of taking them as collateral the bank needed to verify that a particular Toyota engine, for example, had been purchased and paid in full and, therefore, its seller from abroad does not have any claims on it. Varied goods with low value per unit, such as clothes, shoes, stationery, leather goods, pharmaceuticals, auto parts or computer parts are extremely laborious for banks to take as collateral.

It should be noted that for purposes of analysis of financial position of the debtor internal documents of Bank A allowed considering all inventory of a debtor as his/its assets and putting that inventory into a balance sheet. It was presumed that a seller from abroad is unlikely to come to Russia and claim 10 pairs of jeans. Moreover, common practice of purchasing of clothes from abroad, known to Bank A, presumed that clothes were shipped from abroad only after their payment in full by an entrepreneur or a company (debtor of the bank). However, due to inobservance of formalities such as lack of all documents set by Russian accounting rules for purchase of inventory and impossibility to verify if the inventory offered as collateral had already been encumbered by any creditor, Bank A preferred not to take inventory as collateral in majority of cases. It is worth noticing that Russian accounting and document and the official paperwork rules were designed for use by big companies, they are inflexible and completely ignore specifics of small business.

Another type of inventory that banks in Russia prefer not to take as collateral are food products that have short terms of storage: meat, poultry, fish, etc. The reason is the fear that products might spoil and bank will be in no position to fulfill its claims. Using services of third party warehouses – field warehousing might be a solution, but few clients would agree to pay additional money to third party warehouses if they have their own places to store products. Competition among banks does not allow them to dictate strict rules to clients. However, due to increasing competition in the banking sphere, some banks started to take food products as collateral. The situation is especially characteristic for the seaside regions of Russia, where banks take fish and seafood as collateral because it is the most widespread type of assets.

In the analyzed sample, 6 of the secured credits might have been given in higher requested amounts. For example, Client 9 pledged a car and got 1 300 000 rubles. The company needed an additional 200 000 rubles. As collateral it proposed its own produce – stocks of scotch-tape (duck tape). It used to buy raw materials in China and then process them into scotch-tape. However, due to lack of automated accounting for production, the company could not prove that it processed the paid in full raw materials into the stocks of tape offered as collateral. Therefore, the amount of credit given was limited by value of other collateral (transport). This problem would have not arisen if the system of registration of security interests over movables existed. Indeed, the bank could retrieve from the registry information regarding the existence of the encumbrance of the raw materials by the seller and the existence of the encumbrance of finished produce.

Client 5 offered to pledge tyres. His business was buying and selling tyres for cars and trucks. But due to discrepancies in documents (tyres were enumerated with their individual characteristics in invoices and warehousing statement also contained all the individual characteristics of each tyre, for example, Nokian Hakkapeliitta V 225/55 R16 W27-2). Such

detailization was useful for the client to view the records of sales and order the most saleable items and also for accounting purposes. Due to the fact that his business was small, he did not buy substantial stock of tyres of the same characteristics. High speed of turnover of inventory and time lag between arrival of goods and arrival of documents led to the situation when the specific inventory at the warehouse at the moment of the request for a credit was not accompanied by invoices and payment documents on the very same inventory. It was possible to collect the affirming documents for a part of the inventory at the warehouse but it would take enormous time and effort both from bank's employees and the client. Moreover, the amount of inventory confirmed by documents would not constitute enough collateral to back up the requested amount of credit. Since the client needed credit resources urgently, he consented to take an unsecured credit. If the registry for charges on movables existed, making unnecessary the exhaustive verification of existing of potential claims over every item of a debtor's property, and Russian law allowed encumbrance of "all inventory" of a debtor, the client might have pledged his inventory and might receive a secured credit with a lower interest rate.

The collateral policy adopted by Bank A allowed the collateral to be described generally in the pledge agreement, as a type of assets, for example, "tyres for cars", but to make a pledge agreement the bank demanded that all the documents confirmed buying and payment in full of particular inventory offered as collateral initially. The aim was to exclude claims of other creditors on that value of inventory. So even if individual characteristics of the "tyres for cars" changed in the normal course of business, in case of court proceedings bank would be able to prove that it has claims on particular value of that type of inventory free from all other claims. In absence of registry for charges on movables banks have to exhaustively verify various types of documents. Higher the degree of classification in accounting reports of the client, more time and effort verification of documents takes. Companies that buy and sell

homogeneous products such as flour or sugar have relative advantage other those that sell wide assortment of hardware. It is practically impossible to pledge inventory for companies that trade heterogeneous products.

Client 27 pledged inventory (cows). The company requested and was capable of taking out 1 700 000 rubles but could get only 1 200 000. The reason was the seasonal character of the business: the client would decrease the physical quantity of cows every year in November (credit was taken in October). The absolute minimum quantity of cows that clients would keep throughout the whole year constituted 2 400 000 rubles value. Therefore, the amount of credit was determined as multiplying the value of collateral by coefficient 0.5. Inability to account for proceeds (beef) made it impossible to give out a bigger amount. The client did not store beef; it sold the beef immediately upon slaughter, and current Russian law does not allow claiming of “proceeds of proceeds” (cash received from sale of beef made out of pledged cows). Moreover, the client would buy crops and substantial stock of potatoes and other vegetables in November out of credit resources and accumulated profits, his inventory stocks would substantially increase. Absence of the concept of the floating lien left both the bank and the client at a loss: the client had to go to another bank for an unsecured loan, and the bank lost a substantial degree of control over financing of the client and additional interest it could have charged if the bigger loan secured by “all inventory” (cattle and vegetables) was awarded.

Client 34 pledged real estate and got a credit to buy new milling equipment, but also requested additional 2 000 000 rubles to use in seasonal agricultural works. The business of Client 34 was running a mill. He was buying crops from local farmers to process them into flour. To reduce his costs, he planned to rent a plot of land and start harvesting crops by himself. As a long-term partner of Bank A the owner of Client 34 requested additional amount of credit from Bank A. As collateral he proposed stocks of wheat and rye. This

collateral was not taken by Bank A because most of the crops had been bought in cash from small local farmers without proper documents of payment. Therefore, the client could not develop a new type of business which would have helped him save significant costs, develop his business and eventually become a bigger taxpayer.

The data in Table 1 show that the absolute majority of clients could have taken out credits secured by inventory instead of unsecured credit. The exception is Client 33. This company could not provide enough inventory as collateral due to specifics of its business: a small-scale bakery. The owner would keep raw materials daily stocks on the level not exceeding 100 000 rubles and all produce of the bakery was sold every day, while it was fresh. The process was optimized that way to sell the exact amount of bread and cookies that clients of the bakery (retail stores) required every day. Client 33 represented the only “purely” unsecured loan in the analyzed sample – no inventory to serve as collateral and no possibility to get a lower interest rate. All other clients that requested bigger amounts of credit could pledge their shifting assets – inventory, if Russian legal system and normative documents of Bank A (that entirely base on Russian legal system) allowed method of encumbering of these assets similar to the United States’ floating lien.

3.4. The problem of the requirement for specific description of collateral

When taking inventory as collateral under current Russian legal system, a bank has to properly describe the collateral in the pledge contract (collateral agreement). It is possible to describe collateral in generic terms in the collateral agreement (though, to some extent, for example, in Bank A the wording “chocolate candies” was preferential over just “candies”). However, all items of inventory taken as collateral *initially* have to be paid in full and all individual accounting documents for them must have been presented to the bank before making the pledge agreement (for example, chocolate candies “Kara-Kum”, 100 kilograms,

purchase price 16 000 rubles). Later in normal course of business the debtor could change his assortment of chocolate candies (for example, trade more “Maska” and less “Kara-Kum”) but in case of court proceedings the claim of the bank would be considered as secured only if all the documents were presented to the court confirming payment and warehousing of the assortment of chocolate candies *initially* taken as collateral. Otherwise a court may state that a bank took as collateral the inventory not owned by a debtor and, therefore, the pledge contract may be declared invalid.

As already mentioned in the Chapter 2, according to Article 339 of the Civil Code for a pledge contract to be valid, it is essential that the specific description of the collateral is made in the pledge agreement (CC, 2011). Even in case of taking inventory as collateral banks cannot describe it as “all inventory”. Russian law does not give a precise solution how to describe inventory in pledge contracts and banks have to “balance” between the broad description of collateral (desired by banks) and the general ‘specific description’ requirement of the Civil Code.

According to Paragraph 2 of Article 335 of Russian Civil Code, the pledgor of the object can only be the owner of the object or the entity that has the right of economic management over the object (CC, English Translation, 2003). However, the right of economic management is applicable mainly to state-owned enterprises but not to small business companies, therefore, the main case of interest in this thesis is the right of ownership. Article 218 of Russian Civil Code lists grounds for acquisition of the right of ownership. In most cases in a normal commercial course of action, the right of ownership is acquired “on the grounds of the contract of the purchase and sale” (CC, English Translation, 2003, Article 218).

According to Paragraph 1 of Article 223 of CC, right of ownership “shall arise in the acquirer of the thing from the moment of its transfer, unless otherwise stipulated by the law or by the contract” (CC, English Translation, 2003). However, the contract can stipulate that if

the goods were not paid in full, the seller has the right to demand that the buyer returns the goods (Milakova, 2010). For this reason banks minimize their risks by accepting as collateral only fully paid inventory.

The problem of how to describe the subject of the security interest in the pledge agreement initially for effective repossession in the possible case of default can be illustrated: if the collateral consists of 50 tons of sugar with market value of 1 500 000 rubles and 50 tons of flour with market value of 1 000 000 rubles, it is practically impossible to repossess from the same debtor 90 tons of sunflower oil with value of 2 500 000 rubles in case of default.

Courts use the “pledged or analogous” approach: for example, in the case No. 2-1511/12 from 21 February, 2012, Kalininskiy district court of Saint-Petersburg held that the subject of repossession according to the Contract of pledge of goods in turnover is “bellies of Atlantic salmon in quantity of 50563 kilograms or analogous goods” (Unified Database of Holdings of Courts, 2012). It means that the creditor can only repossess goods or proceeds from the sale of goods that the court will consider analogous to the Atlantic salmon’s bellies. It is unclear what could be considered analogous: could it be herring fillets or only Pacific salmon’s bellies? In absence of the functional approach employed by the U.S. concept of the floating lien (encumbrance of all inventory of a debtor) this question is hard to answer.

Therefore, the problem that arises out of the Civil Code’s requirement of specific description of the collateral as a prerequisite of that contract’s validity is the impossibility of describing collateral as “all inventory”, which is possible under the U.S. system of secured transactions (Tajti, 2002, p. 181). Instead, Russian banks have to describe collateral as a specific type of assets and collect all documents that prove buying and full payment of the exact assets that they take as collateral initially.

3.5. Problems connected with collecting of the documents required by banks

The documents necessary to take inventory as collateral include an accounting statement where all items of inventory are listed with all their individual characteristics; a warehouse document for the very same items (to confirm that they are at the warehouse at the time when the collateral agreement is made); sales contracts with sellers of that inventory to the debtor; documents confirming the buying and full payment of the very same inventory – invoices and payment orders or cash receipts. Therefore, from banks' point of view the right of ownership is confirmed mainly by presence of documents of payment simultaneously with physical presence of inventory, described in those documents, at a warehouse.

It should be noticed that in Russia debtors can pledge goods for resale (trade businesses), raw materials or their finished production (production businesses). Pledging raw materials or goods for resale is easier because to pledge the finished produce in addition to the documents of purchase of raw materials a debtor has to present internal accounting documents for production. As mentioned earlier, small businesses often lack automated accounting for production (technological cards of production, for instance), and the system of accounting for production in Russia was created for big companies, and it can be too costly for small businesses to use the rules suitable for big businesses. For example, many small businesses cannot afford hiring an additional accountant for production or buying specific production software.

The requirements concerning documents pose a number of obstacles. *First*, many small businesses purchase inventory for resale or processing for cash from other small companies which use such taxation system as “unified tax on imputed earnings” (Russian: “ediniy nalog na vmenenniy dohod”). According to Paragraph 1 of Article 346.26 of Russian Tax Code, companies and entrepreneurs who have the right to use this taxation system (it depends on type of their business) may sell goods or services for cash or credit and debit cards without

using cash register machines (Tax Code of the RF, 2012). This means that these sellers have the right not to issue cash receipts for customers, though, they can issue the so-called “inventory receipt” on request of the buyer (Tax Code of the RF, 2012). However, banks view only payments from banks’ accounts or cash receipts as documents that confirm the transaction of purchase. Inventory receipts, also known as “soft cheques” are not accepted by banks as proof of payment of goods due to ease of forgery of these documents.

Buying and selling for cash is typical for the smallest companies. Sellers save their operating costs by not using cash register machines, but buyers do not receive all the necessary documents to use the bought inventory as collateral. Therefore, the smallest companies’ opportunity to grow is limited – the best available financing opportunity for them is expensive unsecured credits. Reasons why cash transactions are preferred by the smallest business entities include saving costs on buying and maintenance of cash register machines and tax optimization. It is impossible for taxation authorities to prove the revenue received if it has not been registered anywhere, not even by cash cheques.

Second, to take inventory as collateral, banks require that a prospective borrower or pledgor had the inventory proposed as collateral at its warehouse (or any other place where bank’s specialists can verify the physical presence of the collateral) at the time of making of the pledge contract, and at the same time had all the documents on the very same inventory. This is problematic for companies with high speed of turnover of inventory. Most companies tend to resell inventory as fast as possible. That has an economic sense: the higher the speed of turnover, the more transactions per month a company can make, and gain higher profits. Moreover, high speed of turnover of goods saves warehousing costs.

Under current Russian banking practices, before making a collateral agreement bank specialists have to visit the warehouse or trading premises (shop) where the future collateral is stored and make sure that is the same collateral as described in accounting documents and

documents of payment. For a number of companies it is complicated and costly to “freeze” all the assets proposed as collateral even for one day in the warehouse. Moreover, if the inventory had been bought from sellers from other cities or regions, it can take considerable time to receive properly signed invoices. Due to peculiarity of small business contracting based in large part on informal long-term relations between buyers and sellers, documents can arrive separately from actual goods. For example, goods are delivered by a transport company and invoices arrive by mail at the end of each month. By the time the invoices arrive, the goods listed in these invoices may have already been sold.

As we noticed before, banking practice shows that to have a chance to win in the court in case of default, a bank would have to prove that at the time of beginning of the collateral agreement the very specific inventory in the warehouse had all the documents affirming its buying and payment and a bank can take as collateral only inventory of that type (if a bank had documents for candies it can take only candies as collateral, not any inventory). Later in the normal course of business, banks accept the right of pledgor to buy and sell inventory freely, given by the Article 357 of the CC, but, residue (stock) of the particular type of inventory determined as collateral (for example, first class flour) has to be irreducible (kept on a certain minimum level) for all the time of validity of the pledge agreement. In practice this means that the pledgor is allowed to change only suppliers of inventory and buy inventory of different trade names or different producers but the type of an asset should remain the same: it would be considered breach of the pledge contract if the debtor-pledgor changed his course of business from buying and selling flour to buying and selling sugar because in this case he would not fulfill the requirements of keeping sufficient residue of flour at his warehouse. Economic realities often require fast change in course of business, especially in the highly-competitive world of small business, but the legal system is inflexible in this respect.

The internal normative documents of Bank A required monthly control of the pledged inventory residue. Each month the pledgor was required by contract to provide the bank with an accounting register of inventory residue. After that a loan officer and a bank's security officer would go to a debtor's warehouse or another place of business to check the physical presence of the collateral personally.

The bank would consider it breach of contract if the residues of each type of collateral identified in the pledge contract declined below quantity and/or value stipulated by the contract at any time the contract is active. For example, Client 42 (see Table 1) was required to keep the residue of the first class flour on the level of not less than 20 tons and 400 000 rubles and the second class flour on the level of not less than 20 tons and 360 000 rubles. That means that if market price for flour decreased, the client would have to increase inventory stocks in natural terms (tons). This created substantial inconvenience for the client's business – he had to keep inventory residue of flour on the contract level even if it was not necessary for the business. He bore the additional costs of warehousing, security, disinfection and rat extermination.

For some businesses, such as food producers, the requirements of “freezing” the assets (inventory – raw materials or production) before pledging them and keeping the irreducible (certain minimum level) residue of each particular type of inventory as stipulated by the pledge contract for all the time of the pledge contract's validity are disastrously useless.

Therefore, the impossibility to describe collateral broadly and impossibility to repossess another type of inventory or another type of assets, which are overcome in the United States by the concept of floating lien, which allows a broad description of collateral, together with the formalistic approach of Russian courts (Guseva and Kononov, 2009, pp. 846-847) make banks demand the excessive amount of documents on each item of inventory to be taken as collateral and impose limitations on borrowers, such as “freezing” of assets before signing the

collateral agreement and keeping the minimum residue of the particular type of inventory for all the time when the collateral agreement is valid. Moreover, difficulty in receiving all the necessary documents at the same time as receiving actual inventory to be pledged limits the amount of credit to be given – amount given cannot be higher than price of the inventory, which is backed by all the documents, multiplied by a corrective coefficient (discount) used by a bank to reduce its credit risks. Corrective coefficients used by Bank A for various types of pledged assets are presented in Table 2 (Appendix 2).

3.6. The problem of absence of registry for charges on movables

Determining of ownership is critical for Russian banks to verify that the client has the right to pledge the assets because he owns them and since he paid them in full, no seller has claims on the assets. But American system suggests another solution: filing a financing statement that would constitute a public notice to subsequent creditors.

As we can see from the description of the cases of Bank A, many clients could receive secured credits if the registry for charges over movable property existed in Russia. There would be no need for the exhaustive verification of the right of ownership. Bank A could check the registry and simply verify if any assets of a particular debtor had been encumbered by any other creditors, such as other banks or sellers on credit.

If a filing system for charges on movables existed, in case of sales of inventory on credit any seller could register his security interest and any bank could see it. Absence of such system imposes negative effect on amounts of credits granted – to reduce credit risk banks often don't take inventory as collateral and give out small unsecured loans – less amounts of credit than needed by clients.

If the floating lien was possible, Bank A might perfect a first-priority security interest over all inventory or all assets of a debtor and thereby give notice to any potential creditors.

But in the current Russian system even if a debtor owns inventory unconditionally and a bank takes it as collateral after a long and laborious procedure of document verification, there is a risk that the debtor would pledge the same inventory in another bank. This is especially hard for a bank to investigate in case of crediting a company because no credit history database exist for companies in Russia. A bank can rely only on a “book of registration of pledges” that a debtor must keep. But as mentioned before, there is no authority that supervises keeping of these books by organizations, and a fraudulent debtor can pledge the same movable assets in different banks simultaneously. Therefore, to solve these problems the creation of the registry for charges over movable property in Russia is necessary.

3.7. The imperfection of the concept of “fruits”

Due to deficiency of the concept of “fruits”, which is used in Russian law instead of American-type concept of “proceeds”, it is problematic for a creditor to claim the proceeds from sale of the collateral. *First*, according to Article 340 of the Civil Code, the possibility to claim “fruits” or revenue from sale of collateral must be stated in a collateral agreement (CC, 2011). It means that careful drafting of contracts is a must. *Second*, Russian law is silent about continuation of proceeds – it is impossible to repossess “proceeds of proceeds”, for example if the collateral is grain and a debtor processed it into flour and sold the flour, the bank cannot claim revenue from sale of the flour. *Third*, it is hard to prove that the cash proceeds were received from sale of the particular inventory which serves as collateral, not from sale of other inventory. Moreover, fraudulent debtors tend to sell inventory for cash and immediately spend the cash received from sale of collateral so their creditors cannot receive any compensation.

A floating lien over all inventory and proceeds as it is constructed by the U.S. secured transactions system is likely to be a solution. “Tracing” of proceeds is likely to become much easier – indeed, if all inventory is encumbered, sale of any item of inventory would constitute

reclaimable proceeds. The unlimited extension of proceeds in time and in number of transactions (Fleisig et al., 2006, p. 34) is an essential improvement needed by Russian legal system.

Therefore, the significant problems for banking practices in Russia are absence of the system of registration of charges on movables and inadequacy of the concept of “fruits”. This can be solved by introduction of the registry for charges on movables and introduction of the U.S.-type concept of “proceeds”, both of which are the essential elements of the concept of the floating lien.

3.8. Transaction costs in Russian banking practices

Already based on the above, one may easily conclude that in Russia too much effort and time is required to collect and check the documents concerning the inventory proposed as collateral. This is a long, costly and exhaustive process for both banks and borrowers.

Borrowers have to collect all the documents required by banks, which is not easy due to requirements of excessive specification, and the fact that many small businesses do not have an automated system of accounting or full-time accountants. Many small businesses are run solely by one person – the owner – and he sometimes physically cannot keep all the routine document work. His main concern is to keep the business going, not to collect papers for every item of inventory.

In Bank A the procedure of taking inventory as collateral consisted of three steps. In the first step a loan officer had to collect all the necessary documents from a prospective pledgor. Typically that process required from two to four working days (pledgor had to make an accounting statement, contact sellers of the purchased inventory and collect the papers from them). After receiving the documents, a loan officer would send them to a bank’s lawyer for verification. A lawyer would check them for one or two working days (depending on his work

load). The process of verification consisted of checking and comparing all the individual characteristics of the inventory in trade documents (invoices), payment documents (payment orders) and accounting and warehousing documents. Every detail of description had to coincide in all these documents. If in some of the documents the lawyer found discrepancies, he would recommend not taking those items of inventory as collateral.

The third step consisted of visiting of a client's warehouse by a loan officer and a bank's security officer to verify the physical presence of the inventory (with all identifying characteristics) stated in the documents. Therefore, the whole process would take ideally from four to seven working days. And for all this time (working days plus weekends) the inventory to be pledged had to stay at a warehouse (cannot be sold). Of all the clients from Table 1 no one received a credit pledging as collateral food products (except products that can be stored for a long time, such as sugar or flour). As mentioned before, Bank A's policy towards taking spoilable food products as collateral was rather hostile due to the fact that if some part of the collateral spoiled, bank could not repossess any other property of the debtor.

According to the crediting rules of Bank A, every month a loan officer and a bank's security officer had to monitor the physical presence of the shifting collateral at a debtor's warehouse. They had to apply for a car at the Bank's department of transport, therefore costs of monitoring included not only extra time and effort of those bank's specialists but also gasoline expenses and wages of drivers. Monitoring might be an efficient method of reduction of credit risk regarding new debtors of the Bank but this requirement was a standard demand for all clients, even for long-term partners of the Bank.

Due to high transaction costs (money, labor and time) in Russia banks and borrowers (who in most cases need credit resources urgently) tend to avoid using shifting inventory as collateral and use unsecured crediting instead. Because of the efficiency of the concept of floating lien, policing of the debtor is less necessary in the U.S. than in Russia, though

policing might be included into the agreement of the parties (Tajti, 2002, p. 179). There are the more efficient techniques: filing of financing statements with the State UCC Office and presence of the developed concept of “proceeds” (Johnson, 2012). Moreover, encumbering of all inventory of a debtor by a floating lien deprives banks of exhaustive verification that assets of a particular type have been bought with all documents. Banks can check the registry for charges on movables to verify if any prior encumbrances exist over the assets proposed as collateral.

3.9. Insurance aspects

Requirements of most banks for unsecured financing include insurance of the life and health of the owner of the business. However, some banks in Russia require insurance of the collateral against risks of spoiling, losing or stealing of the collateral in case of secured loans. Typical tariff for insurance of inventory is 0.5 % (Conference of Lawyer’s Club, 2009) from the “pledged value” of the inventory – determined by discounting “the market value” or “the purchase value” of collateral by a corrective coefficient stated by the bank. Coefficients applied by Bank A for small business credits are presented in the Table 2 (Appendix 2).

Typical tariff for life insurance is 1 % of the initial amount of the loan for each year the loan is active (MDM Bank, 2011). Suppose the loan is 1 000 000 rubles for 1 year. In case of insurance of inventory a debtor will be required to pledge 2 000 000 rubles worth of inventory ($2\,000\,000 * 0.5$ (coefficient) = 1 000 000 – amount of credit secured by inventory). Amount payable for insurance of inventory is $2\,000\,000 * 0.5\% = 10\,000$ rubles. In case of insurance of life debtor will be required to pay $1\,000\,000 * 1\% = 10\,000$ rubles. Therefore, insurance costs would be equal. For this reason, in present analysis insurance aspects are not being accented.

However, if a loan is taken out for more than one year and the ‘limit’ (amount to be given) of the loan is decreasing each year (a common banking practice in case of revolving loans), a debtor may insure the amount of inventory that is enough to cover the remaining debt against the risk of loss and spoiling. In case of life insurance expenses on insurance tend to be the same each year. Therefore, insurance of the collateral against loss or harm might be less expensive for borrowers than life insurance.

3.10. Outcomes of the research and proposed solutions

In the analyzed empirical case 30 out of awarded 44 credits are unsecured. Note that 29 of them could have been secured by a “floating” pledge of inventory if the legal system did not put the restrictions described above on using shifting inventory as collateral. Using shifting assets as security would be beneficial for debtors because they would get higher amounts of credits. As can be seen from Table 1, a possible increase in the amount of credits given would constitute 13 300 000 rubles (28.42 percent increase). These 29 clients could have received lower interest rates, too, if their credits had been secured.

The majority of clients who could not take the requested amount from Bank A took additional unsecured loans in other banks. Some clients did not take more credit resources but postponed their own development and, as a consequence, the development of national economy.

Banks are interested in providing more secured credits because they can earn more profit not from high interest rates but from increasing the sum of principal and decreasing interest rates. Lower interest rates can increase amount of credits in the economy and boost country’s economic growth.

Use of a floating lien with its significant prerequisite – the presence of registry for charges on movables can solve the present problems of Russian banks, make them give more credits

and lead to faster growth of Russian economy due to development of “middle class” – small businessmen. Higher level of employment and higher level of competition would also result out of active development of small business. Banks as floating lienees would gain higher protection in case of default of a borrower. They will be in the position to satisfy their claims out of any assets of the debtor prior to other creditors (with some exceptions, such as first priority creditors according to the Russian law, or holders of purchase money security interests according to the U.S. law, if the two systems will be merged).

The public filing system would show other creditors that a substantial part of assets of a client had been encumbered by a floating lienee. The bank that imposed a floating lien would be in the position to give out a bigger amount of credit to a client with a lower interest rate and at the same time would be protected to some degree from lending of other banks to the same client because they would face lower priority. That would lead to greater control over debtor’s financing and reduce credit risk.

Therefore, the adoption of the essential features of the floating lien is needed by Russian economy: creation of registry for charges on movable property, adoption of a U.S.-type concept of “proceeds”, allowing “reasonably identifying” description of the assets to be encumbered, such as “all inventory now owned or hereafter acquired” (Tajti, 2002, p. 181); and changing the priority system to give the floating security general priority.

Conclusion

Small business enterprises represent relevant parts of economies of both the United States of America and the Russian Federation. One of the factors that preclude the successful development of small businesses in Russia is the imperfection of the national system of secured transactions.

Most small businesses need outside financing. In the Russian Federation most financing is traditionally obtained from banks. However, banking practices for small business financing often include uneconomically high interest rates and providing of lower sums of credit than requested by borrowers. Due to imperfections of the national secured transactions law banks tend to either demand real estate or transport as collateral or to give out unsecured credits, which are expensive for borrowers. The third possibility is not giving credit at all because of impossibility of taking as collateral the assets that small businesses are eager to offer – inventory, or because taking inventory as collateral would be connected with enormous transaction costs.

As a result, credit activity of the real economy declines. Borrowers are more likely to default in case of unsecured crediting because of high interest rates or underfinancing. Banks as unsecured creditors face the lowest priority in case of default. All these circumstances do not allow Russian small businesses to achieve positions that American small businesses occupy in the U.S. economy.

The introduction of the U.S.-type concept of floating lien over inventory with its essential elements is necessary for successful development of Russian small business. The study of the case of 44 small business clients allowed us to identify the major problems inherent to Russian system of inventory-backed lending: exhaustive verification of documents; “freezing” of assets before signing the collateral agreement and keeping the irreducible residue of inventory of the pledged type for all the time the agreement is active; lack of

registry for charges on movables; deficiency of the concept of “fruits”; the requirement for specific identification of collateral in the pledge agreement even in case of inventory.

The proposed solutions include: creation of public registry for charges on movable property to overcome the problem of exhaustive verification of documents and also to show to other potential creditors that a floating lien has been perfected; adoption of the concept of the floating lien that would allow reasonably broad description of encumbered assets and repossession of any assets or any inventory of a debtor in the case of default; adoption of the U.S.-type concept of “proceeds”; and making the floating security a priority in case of default. These measures make it possible to increase amounts of credits given to small business clients (shown in the analysis of the empirical case), reduce interest rates and ultimately will result in higher taxes paid, higher levels of employment and competition in the private sector and boost the whole economy of the Russian Federation.

Appendices

Appendix 1. Table 1. Portfolio of Small Business Loans of Bank A

Client	Credit Agreement (CA) N	Date of CA	Date of CA's end	Amount (thousands of rubles)	Type of collateral	Interest Rate	Requested amount *	Variance	Presence and type of inventory to be encumbered	Possibility to get lower interest rate
Client 1	1	26.01.11	20.01.13	600	unsecured	16,00	900	300	Yes, clothes	Yes
Client 2	2	28.01.11	20.01.12	900	unsecured	16,00	3000	2 100	Yes, clothes	Yes
Client 3	3	31.01.11	20.01.13	800	unsecured	16,00	1000	200	Yes, auto parts	Yes
Client 4	5	08.02.11	07.02.13	1 000	unsecured	16,00	1000	0	Yes, clothes	Yes
Client 5	6	10.02.11	07.02.11	1 000	unsecured	16,00	1000	0	Yes, tyres	Yes
Client 6	8	16.02.11	15.02.12	1 000	unsecured	16,00	1000	0	Yes, cement, plasticine	Yes
Client 7	9	22.02.11	20.02.13	800	unsecured	16,00	800	0	Yes, stationery	Yes
Client 8	16	09.03.11	05.03.12	700	unsecured	16,00	1000	300	Yes, computer parts	Yes
Client 9	18	16.03.11	15.09.12	1 300	transport	13,50	1500	200	Yes, scotch-tape	-
Client 10	19	24.03.11	20.03.13	1 000	unsecured	16,00	1000	0	Yes, clothes	Yes
Client 11	21	30.03.11	20.03.13	800	unsecured	16,00	800	0	Yes, clothes	Yes
Client 12	22	31.03.11	25.03.16	3 345	transport	13,50	3345	0	No	-
Client 13	24	11.04.11	10.04.14	3 360	transport	13,50	3360	0	No	-
Client 14	25	14.04.11	10.04.13	1 000	unsecured	16,00	2000	1 000	Yes, clothes	Yes
Client 15	26	19.04.11	15.10.12	700	unsecured	16,00	700	0	Yes, leather goods	Yes
Client 16	30	20.04.11	20.10.12	700	transport	13,50	700	0	No	-
Client 17	31	22.04.11	10.04.12	900	unsecured	16,00	900	0	Yes, fruit, vegetables	Yes
Client 18	33	27.04.11	20.04.13	840	transport	13,50	840	0	No	-
Client 19	34	28.04.11	20.04.13	1 000	unsecured	16,00	3000	2 000	Yes, clothes	Yes
Client 20	35	28.04.11	20.04.13	1 000	unsecured	16,00	2000	1 000	Yes, clothes	Yes
Client 21	39	13.05.11	10.11.12	1 000	unsecured	16,00	1500	500	Yes, livestock, meat	Yes

Client 22	40	16.05.11	15.11.13	900	transport	13,50	900	0	No	-
Client 23	41	18.05.11	15.05.13	800	unsecured	16,00	800	0	Yes, clothes	Yes
Client 24	42	18.05.11	15.05.13	1 000	unsecured	16,00	2000	1 000	Yes, clothes	Yes
Client 25	45	20.05.11	15.02.12	600	unsecured	16,00	600	0	Yes, clothes, stationery	Yes
Client 26	46	23.05.11	20.05.13	400	unsecured	16,00	400	0	Yes, cement, glue	Yes
Client 27	48	28.10.10	20.04.12	1 200	inventory	13,50	1700	500	Yes, cattle, vegetables	-
Client 28	49	28.10.10	20.04.12	1 000	transport	13,50	1000	0	No	-
Client 29	52	15.11.10	10.11.12	300	unsecured	16,00	600	300	Yes, drugs (pharmacy)	Yes
Client 30	53	24.11.10	20.11.11	590	unsecured	16,00	590	0	Yes, clothes	Yes
Client 31	54	30.11.10	20.11.11	810	unsecured	16,00	810	0	Yes, marble, stone	Yes
Client 32	59	22.12.10	10.12.11	600	unsecured	16,00	600	0	Yes, flour, macaroni	Yes
Client 33	60	28.12.10	20.12.11	400	unsecured	16,00	400	0	No	No
Client 34	74	15.05.08	15.05.13	7 574	real estate	12,50	9574	2 000	Yes, grain, flour	-
Client 35	20	23.06.10	20.12.11	150	unsecured	16,00	150	0	Yes, toys	Yes
Client 36	31	15.09.10	15.09.11	600	unsecured	16,00	600	0	Yes, leather goods	Yes
Client 37	15	10.06.10	10.06.15	630	transport	13,50	630	0	No	-
Client 38	32	15.09.10	15.09.11	500	unsecured	16,00	500	0	Yes, computer parts	Yes
Client 39	28	13.08.10	13.08.11	1 000	unsecured	16,00	1000	0	Yes, clothes	Yes
Client 40	33	27.09.10	27.09.15	1 400	transport	13,50	1400	0	No	-
Client 41	55	24.06.11	20.06.14	400	transport	13,50	1500	1 100	Yes, fruit, vegetables	-
Client 42	56	24.06.11	20.06.13	700	inventory	13,50	1000	300	Yes, sugar, flour	-
Client 43	57	04.07.11	02.04.12	500	transport	13,50	1000	500	Yes, meat, sausage	-
Client 44	27	13.08.10	13.08.11	1 000	unsecured	16,00	1000	0	Yes, shoes	Yes
Cumulative amount	-	-	-	46 799	-	-	60 099	13 300		

* Requested amount has been adjusted with consideration of the financial situation of a client. This amount might have been given out if a client provided additional collateral.

Appendix 2. Table 2. Marginal Corrective Coefficients for Types of Collateral for Small Business Loans of Bank A

Type of collateral	Marginal coefficient
Means of transport	Not exceeding 0.6
Equipment	Not exceeding 0.6
Goods and materials of value, including stock of finished produce, raw materials, inventory in turnover	Not exceeding 0.5
Objects of real estate	Not exceeding 0.6
Securities	Depending on type of a security and rating of an issuer

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