

**Why doesn't the bankruptcy system in Ukraine work?  
Some aspects of institutional development.**

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by

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*ABSTRACT*

**Why doesn't the bankruptcy system in Ukraine work?**

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One of the reasons for slow development of the Ukrainian economy is inappropriate governmental regulation of the micro-economic activity. The vision of the scale of such regulation varies among different economic schools. One of the issues on which various economists agree is the need for the state enforcement of private contracts. Bankruptcy Code plays an important role in it. On the one hand, bankruptcy is a way of exit from the market and along with free entry is a basic assumption of the competitive market model. The more efficient is a bankruptcy procedure, the more we can rely on the results of the modeling, *ceteris paribus*. On the other hand, the efficient bankruptcy procedure is one of the institutions, which are necessary for the economic development since it vetoes unsuccessful activities and prevents (deters) the inefficient behavior.

Ukrainian Parliament adopted the Bankruptcy Law in 1992 and since then lawmakers added to the 'bankruptcy law package' over 20 amendments and instructions to regulate the process. However, inability of the existing procedures to provide adequate measures has been the main reason for the small number of bankruptcy cases and the development of the arrears' crisis.

This research is intended to disclose the problems of bankruptcy system in Ukraine. It opens the features, which should be covered by the bankruptcy law to make the procedure of exit more efficient.

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## SECTION 1. INTRODUCTION

*(The virtue of bankruptcy).*

The goal of the enterprise in the market economy is to earn profit for its owners. Some enterprises earn more profit than others do, since they use factors of production more efficiently. If the enterprise in the competitive market conditions temporarily functions less efficiently than others it earns less profit; if this happens on the continuing basis, it suffers loss. In this case the owners have to change the management of the enterprise, because if they do not, the market value declines and the enterprise changes owners. Profit <sup>1</sup> indicates that the enterprise adds value and uses the resources efficiently. A permanent negative profit (loss) reveals that the enterprise subtracts value. In this case the enterprise as a business entity should be liquidated to let the resources go where they earn more.

The only way the value subtracting enterprise can continue its functioning is to ‘guzzle away’ its capital or use the resources of others. These could be the owners of equity as well as the other bodies – banks, suppliers, state budget, etc. In the latter case, it takes the form of unperformed obligations. Value-subtracting performance of the borrower or consumer freezes the resources of its creditor or supplier. Since all economic agents in the economy are related, this process might end up in the full or partial immobilization of the resources in the economy. Therefore, the functioning of the majority of economic subjects depends on the fulfillment of the contracts. The issue of the ability and willingness of enterprise to fulfill its obligations gives concern not only to the enterprise’s partners, creditors or investors, but also to the makers of laws which regulate the entrepreneurial activity.

Moreover, no limits on entry/exit the market is one of the fundamentals of the perfect competition model. <sup>2</sup> This guarantees that a sufficient number of firms remains in the market and

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<sup>1</sup> Economic theory suggests that in the long run the enterprise in the competitive market make zero economic profit. This means that the capital invested in a particular venture earns the same rate of return as if it were put elsewhere. Here I mean accounting profit, which is calculated as Revenues minus Costs (including depreciation, etc.)

<sup>2</sup> I believe that this somewhat ambiguous statement is suitable for this sentence. I understand that usually it is not possible to apply the term ‘free market’ to the ‘real’ economy as we used to do under the theoretical framework. The other assumptions of the perfect competition are: large number of small producers, homogeneous product, perfect knowledge, mobile resources.

produce efficiently to satisfy the market demand at the competitive price. [Hashi, 1995, p.3]. One of the ways to exit the market is bankruptcy procedure.<sup>3</sup>

Irrespective of the reasons which brought the enterprise to the bankruptcy, the bankruptcy procedure should be efficient, not to slow down, but to enhance the functioning of the economy by:

- preventing the immobilization of the resources by the inefficient businesses;
- speeding up the transition from the low to the high (normal) return activities;
- reducing the costs of this transition;

The efficient bankruptcy system should provide fairness and uniformity, be accessible, easy to use, cost efficient and not result in undue delay.

According to the information provided by the Ukrainian Government (Cabinet of Ministers and Derzhkomstat), despite the fact that the share of bad debt in the arrears continues to grow (over 70% increase for 1997 and 84% for 1998), the dynamics of the bankruptcy cases in Ukraine reveals the weakness in the Ukrainian bankruptcy system (only 47% increase in 1997 and 27% in 1998).

I suggest that the shortfalls of the bankruptcy system in Ukraine deepen the deterioration of the economic fundamentals. I do also suggest that the issue crucially depends on the establishment of an efficient bankruptcy procedure, but suspect that there exist more fundamental problems which prevent not only the establishment of a better procedure, but also the whole process of the implementation of the market reforms in Ukraine. I understand that any positive change in the Ukrainian bankruptcy system will adversely effect those economic agents who act inefficiently. These agents, under certain circumstances, may start the process of backward changes in the system. Therefore, I suggest that such changes be made in the context of general economic reform.

The mission of this research is to:

1. Study the issues, which are related to the system of bankruptcy in Ukraine.

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<sup>3</sup> The term 'bankruptcy' in the North American legislation is used to describe personal inability to repay debts. The lawyers in these countries use the term 'insolvency' to refer to the enterprises in distress. However, in the legislation of the European countries and NIS, the term 'bankruptcy' usually means the insolvency of the enterprise. This paper refers to the bankruptcy of enterprises only and I will use both of the terms interchangeably.

2. Evaluate current arrangements with respect to the efficiency of problem solving.
3. Provide recommendations for the appropriate legislative and administrative actions.

In the paper I will present criterion, which define the effectiveness of the bankruptcy law (section 2). Then, I will consider the current Ukrainian bankruptcy procedure and its influence on the bankruptcy run and show why the existent procedure can not help to deal with the problem of 'bad' arrears (section 3). At the very end I will try to suggest improvements of the Ukrainian bankruptcy system and the ways of their implementations (section 4).

## SECTION 2. ECONOMIC AND LEGAL ENVIRONMENT OF THE BANKRUPTCY.

*(What is bankruptcy and how the procedure works).*

### ***Theoretical aspects.***

The main goals with which the economists were concerned from the beginning of the profession and which, most probably, will remain the central issues of the professional discussions for a long time, are economic growth and efficiency. The first is related to the wish to produce the higher quantity and the better quality of goods and services - or, simply, to provide the higher living standard. The second is concerned with maximization of output with minimal efforts under scarce factors of production. [McConnel, 1993, p.23]. It is obvious that the achievement of the former goal depends on the success with the latter.

Modern economics states that to find the roots of long run economic growth one needs to approach the issue of economic efficiency in different terms than does standard economic theory that examines the resource allocation at an instant time. "The key to sustained economic growth is adaptive rather than allocative efficiency" [North, p.1].

Allocative efficiency comes from a perfect competition model. In the economy of perfect competition, the 'for-profit' producers act in the way that maximizes the satisfaction of the consumers. The equality of price and minimum of the average costs in the long run shows that competitive firms will use the most efficient of the known technologies and set the lowest price within their costs of production. The equality of price and marginal cost shows that the resources are allocated according to the tastes of consumers. The competitive price system redistributes the resources and technology assuring the efficiency of their allocation in the long run. Later, economists argued that the model of perfect competition might not end up with the most efficient allocation of resources since:

- There is no way the competitive market system can guarantee the optimal allocation of incomes;
- There exist externalities and public goods;
- Competitive market system does not facilitate fast technological progress, because enterprises earn no economic profit and can not devote much resources to the research activities; and
- It does not provide the variety of goods and services and the conditions for its production, because differentiation of goods would require additional spending, that can not be allowed if no economic profit is made.

Nevertheless, the concept of perfect competition provides a useful benchmark for evaluating the efficiency of policy advice.

The concept of adaptive efficiency is concerned with the willingness of a society to acquire knowledge and learning, to induce innovation, to undertake risk and creative activity of all sorts, as well as to resolve problems and bottlenecks of society through time [North, p.1]. Adaptive efficiency is a concept of positive economics and is closer to the real world since it recognizes the existence of imperfect knowledge and uncertainty and states that "improvements in policy results could emerge only from changes in the structure of decision making. ... attention of economists must be shifted from choices among alternative policy options within given sets of rules to choices among alternative sets of rules" [Wicksel, 1896]. North [North, p.1] has shown that "the organizational failure may not only be probabilistic, but systematic, due to preferences with respect to ideologies which may give people, on the basis of imperfect knowledge, preferences for the kind of solutions that are not oriented to such a policy."

Adaptive efficiency shows the importance of institutional development to economic growth. Olson [Olson, 1982] also has shown that the way institutions evolve shapes long run economic performance.

Since "institutions define the incentive structure of a society" [North, p.1], rules that regulate entry, governance structures and the flexibility of organizations, determine the kinds of economic activity that is profitable. However, it is important not only to have rules that reward creative and, adapting successive experience, entrepreneurial talents, but also ones that "eliminate the maladapted parts of the organizational structure" [North, p.2].

The bankruptcy law, as an institution (rule) of the latter type, plays a crucial role in economic development. This rule is called to prevent the inefficient activity and, therefore, allow the efficient allocation of resources, both human and physical. In a world of positive transaction costs, the importance of efficient bankruptcy procedure can be derived from the concept of adaptive efficiency that suggests to eliminate failed economic organizations, as well as allocative efficiency that requires the possibility of free exit from the unprofitable activity (industry).

The absence of a functioning bankruptcy procedure may lead organizations to behave inefficiently. In such a situation the economic units devote efforts not to the minimization of costs, but to finding external financing to cover their costs.



According to Kornai [Kornai, 1995, p. 219] this might take the form of "soft subsidy, soft taxation, soft credit and soft administrative prices." Under soft budget constraints (SBC), neither allocative, nor adaptive efficiency can be achieved. The obstacle for allocative efficiency is an absence of need to adjust input-output to the price signals. The adaptive efficiency is limited, since there is no need to adjust to unfavorable external circumstances. Under SBC, the Shumpeter's "constructive destruction" - elimination of old products, technologies and organizations is made unnecessary and no innovation and growth occurs.

Besides, while competing for external financing one misapplies the efforts and resources, which could be used elsewhere and, thus, is unproductive.

Stiglitz [Stiglitz, p.134] defining the gains and failures of the economic science over the years, stressed that there has been "... relatively little formal modeling ... [and] ... no evaluation of the efficiency with which ... [Bankruptcy law and competition policy] works, and upon what that depends."

Despite the limitations of the existing studies and the need for further development, the role of bankruptcy law as of an institution that facilitates economic growth can not be over-appraised. This is especially true relatively to the transitional economies. Gros [Gros, 1995, p. 289] has shown that "in general, where bankruptcy laws are deficient... financial restructuring of enterprises has lagged behind, and foreign and domestic investments have often been hesitant to come forward."

### ***Terms and definitions.***

According to the glossary of "Definitions of Insolvency and Bankruptcy Terms and Expression," "insolvency is the state of not being able to pay one's debts as they fall due or having an excess of liabilities over assets." As mentioned above, the standard economic theory suggests that the enterprise that can not cover the variable costs in the short run or average costs in the long run, should terminate its activity in the cost-inefficient business. In practice, there are several ways for the enterprise to do this. The first and the most efficient way is if the management of the enterprise understands the problem before losses actually occur and shifts the activity to the more attractive sector. In this case it can use the funds flowing from the new activity to cover the debt collected by the previous one. In the second way, the management can approach the creditors <sup>4</sup> and ask to postpone or restructure its obligations in a peaceful way. This is the usual way to settle claims (or to set the new ones) if

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<sup>4</sup> For the purpose of this paper I use the term 'creditors' to mention all bodies, corporate as well as physical which have the claims for debtor's assets. The creditors could be, but not limited to banking institutions, suppliers (including utility companies), workers, tax authorities, and shareholders.

the creditors trust the management and view the company as viable. The third way arises when the management does not shift from the unprofitable activity, does not apply to creditors and takes no actions to repay its debts. The creditors, then, can petition the court to resolve the problem. In the fourth way the management can file for the bankruptcy itself in court if the company has no means to meet its debt obligations.

Once the court is involved there are two alternatives to a bankrupt enterprise - *reorganization* and *liquidation*. In the majority of countries the laws provide a possibility for both of them, but facilitate one or other to the different degree. Some authors argue that laws of most European countries 'prefer' liquidation, while the U.S. and Canadian laws favor reorganization. [Martel, 1994a, p.19]. While some opportunities for maneuvering exist <sup>5</sup>, in general, the court procedure is well defined by the bankruptcy law.

### ***Procedure.***

When the court takes the petition of the creditors or the bankrupt enterprise into consideration, the procedure goes as follows.<sup>6</sup> The court notifies all of the creditors about the beginning of bankruptcy procedure and requests them to present all unsatisfied claims to the debtor including those due to at future dates. This information is processed and presented to the creditors' meeting. During the meeting the creditors decide upon the future 'fate' of the debtor. As was mentioned, the debtor enterprise may be liquidated or reorganized. Liquidation means the sale of all assets. Reorganization means postponing the debt repayment and giving the chance to debtor to continue its activity. In both cases the *administrator* of the assets is appointed. The appointment of the administrator usually means the dismissal of the enterprise's management. In some cases the management can continue to perform its duties under the auspice of the administrator if the last views it as helpful in maximizing of the liquidation value. The administrator reviews the recent activity of the enterprise and may, with the court approval, annul the contracts, which it takes as fraudulent or illegal.

In the case of liquidation the administrator evaluates the assets and develops the liquidation plan. Later, the assets are sold and the creditors are paid according to their

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<sup>5</sup> Here I mean that in the most countries, the bankruptcy law allows for peaceful settlement between the debtor and the creditors at any stage of the court procedure. Russian new bankruptcy code and the existing Ukrainian law on bankruptcy do not allow for peaceful resolution after the beginning of court procedure.

<sup>6</sup> The described below procedure gives the main features of bankruptcy laws used in the majority of the developed countries.

priority<sup>7</sup>. When no assets are left, the administrator reports to the court and the latter stops the procedure. All debts are cancelled and the notification of the liquidation of the debtor is put in the national register of the businesses.

If the creditors view the current value of firm to be higher than the liquidation value, they restructure its obligations and let the enterprise continue its activity under the control of the administrator or without it. At this stage the problem usually arises, since some creditors do not agree for reorganization, especially if they are confident in the full settlement of their claims during liquidation. To resolve it the other creditors sometimes prefer to settle such claims immediately from their own funds. Then, the detailed plan of the reorganization is set. The enterprise continues business and satisfies the claims of the creditors according to the plan. The court procedure is finished when all creditors agree to it.

### ***Factors which determine the efficiency of bankruptcy procedure.***

The efficiency of the bankruptcy law is defined by its ability to reduce costs incurred in the bankruptcy [Fisher, 1996]. These costs can be directly related to the bankruptcy procedure (e.g. costs for payment of different duties and remuneration to the administrator of the estate) and indirectly (opportunity costs of seizing operations, time wasted, etc.). The latter type of costs cannot be always well defined and measured. However, logic suggests that both types of costs rise as the time spent on bankruptcy procedure increases. Therefore, the time provision is one of the law's efficiency indicators. Costs depend on the actions of the estate administrator, the motives of the debtor's management and the willingness of creditors to negotiate. The first factor above is a motivation of the estate administrator (as a body that controls the procedure) to speed up or slow down the process. To fulfill its mission the administrator usually should take a neutral or adversarial attitude towards the debtor. Martel [Martel, 1994a, 1994b] suggests that the administrator should not be in any kind of relations (family or business) to the debtor enterprise. The second factor influences the decision the debtor's management makes, when it recognizes that the enterprise faces the financial problems, to file for bankruptcy timely or to risk trying to overcome the difficulties alone. The third factor influencing the length of the bankruptcy procedure is the ability of debtor's management to negotiate with creditors and avoid the court proceedings [Hashi, 1995]. This ability is not directly regulated by the legal framework, but largely depends on it.

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<sup>7</sup> The bankruptcy law provides the **Absolute Priority Rule** (APR), according to which the claims of the creditors are settled. Usually, the order is like following: the claims of the senior creditors (which own any kind of collateral assets), the workers, the tax authorities, the unsecured creditors, and the share holders and owners. The claims of the successive class of the creditors (also called - junior creditors) can be settled only when the claims of the precedent class (senior creditors) were settled in full.

The studies of bankruptcy laws from different countries made by Martel and Fisher [Fisher, 1996] and Hashi [Hashi, 1995] have shown that the following issues should be carefully discussed while making the bankruptcy law, because they might greatly affect the efficiency of its application.

1. Availability and duration of the term when the debtor may not respond to creditors' claims after the filing for bankruptcy – the so-called 'Automatic Stay Provision'. Such suspension allows the viable enterprise to continue business operations and meet the payments in full when money becomes available. In the case of a nonviable firm, management will, most probably, use the delay to use available funds for the other than claims settlement objectives, thus, reducing the value of the company.

2. Ability of an enterprise to raise money after the beginning of bankruptcy proceedings. It is quite obvious that new creditors will demand additional guarantees on their claims settlement in the case the enterprise goes bankrupt. To provide these guarantees, the law should envisage the priority for the settlement of such claims.

3. Possibility of the exchange of existing liabilities for new ones.

4. Roles of the debtor's management and creditors in the appointment of estate administrator and specification of reorganization plan. No one, but the management of the enterprise is informed better about the financial state of this enterprise. Thus, only managers know how to maximize enterprise value in the given moment in the best way. The management, being aware of the potential of the enterprise, knows how to go out of business (namely, through reorganization or liquidation). At the same time, the management has a specific motivation in its action.

5. Availability of incentives to the creditors which could professionally evaluate the company' financial potential and via their actions 'signal' the other creditors. This step would help to speed up the negotiation and voting procedures. For example, the company could issue the new debt obligations or propose to exchange existing liabilities for new ones. Then, the credit institutions and the stock market would professionally evaluate the company's chances to discharge the new debts and the price of its shares, so that the other creditors could faster make their decisions on the bankrupt enterprise.

6. Existence of time limits for bankruptcy procedure.

7. Number of creditors. Procedure of bankruptcy goes faster if the number of creditors the debtors have to negotiate with is not very large.

*McCain's essence of the bankruptcy law.*

The other theoretical framework that touches the bankruptcy issue is game theory. This point is well defined by Roger A. McCain [McCain, 1999].

Using the modified Clark's model of business enterprise, McCain shows that the existence of "no credible commitments" principle is crucial to the debt contract renegotiations. He argues that if the law prevented the renegotiations of the debt contract by honoring the interests of only one party, no restructuring would take place. According to McCain, "the essence of the bankruptcy is a renegotiations of the loan contract between a lender and a group of workers and, laws exempting the creditor from the full amount of the debt, in appropriate circumstances, are laws for the protection of the creditors, not debtors." I will use this conclusion while considering the bargaining power of different creditors in the bankruptcy process typical for Ukrainian economy.

I have shown that both classical and modern economic schools consider efficient bankruptcy procedure among the key issues related to the achievement of general efficiency and continuing economic growth. The former one stresses that the availability of free exit from the market is important for the efficient allocation of the resources within the economic system. The later one indicates the need of bankruptcy as an institution that eliminates the 'unsuccessful' behavior and structure and makes it possible for the society to adapt the most successful and, thus, most efficient experience necessary for the sustainable economic growth. The threat of bankruptcy should prevent the inefficient behavior of economic agents. The previous studies suggest that bankruptcy law should provide the cost-efficient procedure. The game theory suggests that this law should not give an exclusive power to any of the creditors.

### SECTION 3. THE DEVELOPMENT OF THE BANKRUPTCY SYSTEM IN UKRAINE.

#### *About Ukraine.*

Ukraine is situated in the southeastern part of Central Europe and has its own territory and government. It borders on Russia, Belorussia, Moldavia, Slovakia, Romania, Hungary and Poland on land and Russia, Georgia, Bulgaria and Turkey on sea.

Due to favorable climatic conditions, Ukraine is traditionally an agricultural area. It grows wheat, maize, buckwheat, red and green vegetables, all kinds of fruit, melons and berries. The country is rich in natural resources, such as iron ore, coal, color metal, oil, gas, mineral salts, clay and potential power. It has developed a varied industry, concentrated mostly in and around big cities, such as Kyiv, Zaporizhia, Dnipropetrovs's, Odessa, Kharkiv, L'viv and others. It produces planes, ships, lorries, locomotives, computers and electronic equipment.

The gross domestic product decreased in 1998 by 1.7 percentage points comparing to 1997 and reached 103869 mn. UAH<sup>8</sup>. The number of loss-making enterprises in 1998 reached 53% of all enterprises. The majority of loss-making enterprises are in procurement and sales (61%), semi-manufacturing (56%), transportation and communication (55%) and industry (53%).

For the 9 months of 1998 the receivables increased by 1.2 times and payables by 1.1 times. Overdue receivable payments between Ukrainian entities achieve 92.7% of all receivables, the domestic share of overdue payables concludes 95.9% of all payables. The majority of overdue receivables are generated in the industry 47.1% of total arrears, in transportation and communication – 11.6%, and in trade – 10.7%. The negative feature of due payments between Ukrainian enterprises is the dominance of the arrears; in receivables the share of arrears reaches 70.2% and in payables – 75.6%. In the majority of cases the arrears are generated in trade operations: 82.5% of the receivables arrears and 62.1% of the payables arrears. Envisaging the possibility of late or non-payments, the enterprises have either to increase the risk premium in the price or closely monitor their partners. Such an activity negatively influences the efficiency of their main businesses. Many managers complain about the impossibility of returning the debts caused by the procedural limitations.

#### *The legislative developments.*

Verkhovna Rada (the Parliament of Ukraine) adopted the current bankruptcy law in May 1992. At daybreak of the Ukrainian independence and the pro-market transformation of

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<sup>8</sup> The data in this subsection is taken from Derzhkomstat express-releases for 1998.

the economy, the law was enacted rather for demonstration than working purposes. The general fear of bankruptcy from the side of the lawmakers, owing to the misunderstanding of the role of this process in the economy, resulted in serious drawbacks in it. Since then, their understanding has been slightly improved. Several attempts to change the law undertaken in the parliament have resulted only in the minor amendments to it. On July 8, 1998 the President issued the decree “On the additional measures to enhance the bankruptcy procedure” that significantly simplified the run of bankruptcy, but the parliament vetoed this order, arguing that the proposed procedure could allow privatization of some state owned enterprises (SOEs) not permitted by the legislation.<sup>9</sup>

### ***The current procedure.***

In general, the procedure that regulates bankruptcy in Ukraine does not differ a lot from the procedure used in other countries. The current Ukrainian bankruptcy procedure was mentioned in the previous section and is given in the supplement to this paper. The general problem of the bankruptcy law in Ukraine is similar to the problems of other Ukrainian laws - the norms are not clear and consistent to provide straightforward guidance to the participants of the process. For example, the definition of Bankruptcy<sup>10</sup> is misleading, since what is called bankruptcy is in fact insolvency and bankruptcy arises when the debtor is taken to the court. According to this definition, practically every Ukrainian enterprise could be treated as a bankrupt, since almost all enterprises have arrears and are not able in a timely fashion to settle the claims of the creditors. Table 1 shows that the law does not provide clear powers, rights and duties for the participants of the process.

### ***Absolute Priority Rule.***

Absolute Priority Rule (APR) refers to the order of priority for distribution of the proceeds of liquidation. According to APR, senior creditors are fully compensated before junior creditors receive anything, and junior creditors are fully compensated before shareholders receive anything. According to the Ukrainian bankruptcy law this order is as follows: before all, the money from the asset sold are paid as the fees to the administrator and to the creditors whose claims are secured (collateralized). Next, the claims of workers on wages are settled. In next turn, the claims of tax authorities on budgetary arrears and, in the next, the claims of the junior (unsecured) creditors are settled. The owners are paid the rest, if anything is left. [Law on Bankruptcy, article 21]

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<sup>9</sup> According to the national privatization program, a significant number of large- and medium-scale enterprises, which are regarded as strategically important to the national security, should remain in the state ownership.

<sup>10</sup> Bankruptcy is the inability of the enterprise to timely settle the claims of the creditors caused by the insufficiency of assets in the liquid form [Law on Bankruptcy, article 1]

**Table 1. Factors, which define the efficiency of Bankruptcy procedure. (Their availability in the Ukrainian law on bankruptcy).**

#	Recommended by Martel, Hashi.	Availability in Ukrainian Bankruptcy law.
1.	Motivation of the administrator of the assets (trustee).	Trustee is liable for a failure to properly perform his functions [Bankruptcy Law, article 9]. The remuneration of the trustee is limited and uncertain, so it is likely that he will manage the process (either liquidation or reorganization) to his own benefit.
2.	Management's liability for not timely filing to the court (informing creditors)	Not Available (NA). Besides, "... the requirement of the audit is a significant disincentive to a debtor filing, both for the costs (which the debtor can ill afford) and for the subjection to scrutiny. It may also delay the initiation of a bankruptcy proceeding significantly, causing further losses for creditors." [Coates, p.6,1996]
3.	Automatic Stay Provision.	NA.
4.	Additional guarantees to the new creditors.	NA.
5.	Exchange of the existent debt for the new one.	Not clearly defined.
6.	Incentives to the professional creditors.	NA.

Source: Martel, Hashi, and Law on bankruptcy.

### ***'Kartoteka #2'.***

After the court has adopted the liquidation plan and the assets are sold out, the money, which come to the creditor's account may be transferred according to the rule called 'Kartoteka #2'.

Once the enterprise runs the budgetary arrears, it is subject to 'Kartoteka #2' rule. This rule is a sequence of money transfers from the enterprise account. This regulation in its current form was imposed, starting October 1, 1998, at the demand of tax authorities as an effort towards increasing tax receipts from the enterprises, which have budgetary arrears.<sup>11</sup> Before October 1, 1998 there used to be the similar procedure, according to which, anybody who had a payment claim on an enterprise could withdraw the money from the account without any permission of this enterprise. However, due to frequent fraudulent withdrawals before October 1, 1998 the newer form of 'Kartoteka #2' was introduced. In this regulation the exclusive right to withdraw money from the account was given to the tax authorities and

<sup>11</sup> Under budgetary arrears it is meant the tax and other obligations to the state or local budgets which were not timely performed for any reason.



other state services (fire fighter, health and other inspections – in total, the regulation provides twenty-one case when the exclusive withdrawal can be made).

According to this rule, the money that comes to the account are distributed in the following way: 10% is transferred to pay the arrears on obligatory pension insurance; 15% goes to pay current wage and tax arrears; 5% goes to cover inter-enterprise arrears; 50% of the rest is used to repay overdue wages and 50% - to repay overdue taxes. As can be seen from the schedule, approximately 52.5% are taken by the state and local authorities, 42.5% - are paid to the workers, and 5% of the account turnover should cover the day-to-day business operations. It should be noted that "Kartoteka #2" is applied to any enterprise that has budgetary arrears. The debtor's as well as its creditor's accounts might be managed according to this rule. Let us turn now to the bankruptcy case. Suppose, an enterprise was declared bankrupt and is subject to liquidation. Money obtained from the selling of its assets is paid to the creditors, particularly, to other enterprises. Suppose now that this creditor in turn has budgetary arrears and is subjected to the 'Kartoteka #2.' This means that this creditor would be able to use only 5% of the received amount to cover its liabilities before its own creditors - other enterprises. It is natural to suggest that the enterprise would not be willing to use its banking account to conduct business operations if it is prevented from managing it. More precisely, each enterprise uses its banking account to the extent it can not conduct business transactions off the account (in the other words, unofficially). The bankruptcy procedure is a legal process that is official by definition, so it limits the possibility to receive the proceeds from liquidation unofficially, since the money is transferred via banking account. Considering all mentioned above, I would suggest that 'Kartoteka #2' restricts the incentives of the enterprises to initiate the bankruptcy procedure.

In other words, enterprises, which are at 'Kartoteka #2', have no incentives to start the bankruptcy procedure against its debtor.

***Problems of the initiation (incentives to start) of bankruptcy procedure.***

According to the Ukrainian law "On bankruptcy", when the enterprise does not fulfill its obligations before creditors due one month or more, they can apply to the court and start the bankruptcy procedure [Law on bankruptcy, article 5, part 2]. Any of the creditors or the management of the debtor itself can initiate the procedure. As was already mentioned, to the creditors of the enterprise can belong:

1. Workers, which have not received the payment for their labor;

2. Public sector (tax authorities) which has not received the payment for provided public goods;
3. Another enterprise that has not been paid for provided goods and services;

Let us look what incentives to initiate the court procedure against the bankrupt enterprise have each of them.

### Workers.

One type of creditor, which can initiate the bankruptcy procedure, is employees. Their unpaid labor is one of the external resources needed for the value-subtracting enterprise to stay alive. The only possible case when the workers might want to initiate the bankruptcy procedure of their company is when the latter does not pay their wages. I suggest that, the low 'legal literacy' and bad organization of workers can explain the fact that this type of creditor only rarely applies to the court. Smart workers foreseeing the possibility of bankruptcy and wage arrears leave their job and look for the other employment opportunities before such events. Those who stay, most probably, can not find a job at another company and have no other choice, but to expect the payments of their wages. The start of the court procedure by the workers might be classified as a 'free-rider' problem. The initiation requires the devotion of some efforts (costs) from the worker that begins the procedure, but the wages paid (public good) are given to all workers of the bankrupt enterprise.

Based on the mentioned above, I suggest that workers do not start the bankruptcy procedure either because they are not informed about such a possibility, or they do not expect to be better off after it.

I have conducted a survey among the students of the EERC master program in Economics aimed to find out the attitude of the worker to the initiation of the bankruptcy procedure. In the questionnaire the students were asked about their attitude to the possibility to start bankruptcy procedure if they were the average workers at an average Ukrainian enterprise that does not pay wages. Two questions were asked:

1. Will you file your company for bankruptcy?
2. If you do, would you expect to find a job before or after you get the money as a result of bankruptcy workout?

The students were welcomed to provide their comments on the issue.

The aim of the first question was to reveal the opinion relative to the bankruptcy initiation. The second question, nominally, was aimed on finding out whether the appeal to

cost-benefit analysis contributed to their decision. The idea behind the latter question was rather to stimulate respondent's thinking of the bankruptcy and providing additional comments, than to answer the question.

The questionnaire was distributed via electronic mail to all EERC students (80) and 24 of them responded. Though the sample did not represent the population (workers) it gave me some new ideas about the worker's reasoning. The majority (16) of those responded indicated that they would not start the procedure. The answers of the rest (those who would start), have shown that the other factors than the outcome of cost-benefit analysis influenced their decision. The survey, in general, confirmed the hypothesis that the employee is reluctant to start the bankruptcy. The additional comments have shown that the possibility to file the company for bankruptcy by the employee was not known to the respondents before. Taking into account that the respondents were more 'educated' than an average worker, one can conclude that the initiation of bankruptcy is unlikely due to the fact that most of the workers are low legally educated. I have intentionally biased the sample towards the better literate members since it would strengthen my hypothesis of the 'low literacy' issue. Contrary to the expectations that not filing for bankruptcy is a result of 'free-rider' outcome, some of the respondents stated that they are not likely to file because they would feel moral obligations to the colleagues fired. The others indicated that they would file irrespective of the perspectives to get a job in the future. Such responses indicate the existence of a variety of the views on the bankruptcy issue and, thus, the need for further work in this direction.

Taking into consideration the insufficient understanding of the bankruptcy role by this type of creditor, I suggest that the law should envisage the possibility of informational provision and organization of workers to reveal their incentives to initiate bankruptcy.

Besides, it is known that defining property rights or state intervention (regulation) can solve a 'free-rider' problem. In the case of bankruptcy initiation, providing compensation (giving clear incentive) to the person that starts the procedure and devotes the resources to this can accomplish the task. Taking into account that the workers are the first to be compensated in the case of bankruptcy, employees are better off even if another creditor starts the procedure. However, this solution remains effective relative to the other creditors in the other cases.

State (State tax authorities).

The increase of the budget arrears is another way for the value-subtracting enterprise to get external funding. The problem is twofold. On the one hand, the enterprises should be

able to pay to the state for the provision of public goods as well as to the other suppliers. If it is not, it should not continue its activity. On the other hand, if the taxes are higher or the quantity of the public good is lower than optimal or both <sup>12</sup>, the enterprise may refuse to pay such a price – to fulfill its tax obligations, as it may do with a contract of any other ‘unfair’ supplier. The emergence of budgetary arrears, in this context, is a result of the lack of state coercive power or excessively high level of taxation in the economy, or both.

Under first reason I mean that there exist a possibility not to pay taxes. This refers to the evasion of taxation. Under the second, I mean the circumstances in which the payment of all taxes in full amount drives its profitability below a market rate of return. The decision of the management of a particular enterprise not to pay taxes is made taking into account, among other things, the ‘tax-oriented’ behavior of other enterprises. Since, in general, the enterprise monitors its competitors before others, I assume that the level of tax conformity should be approximately equal across all enterprises in the certain branch of the economy. The third reason is the understanding by the majority of tax officials that the state requires too high price for the good it provides and, as a result, the tax authority connive at late (or non-) payment of taxes. I suggest that the budget arrears should be equally growing if the state impose high taxes uniformly across all sectors of the economy. If it does not, by violating its devotion to the uniformity of taxation, <sup>13</sup> the state creates an objectionable reaction from the highly taxed enterprises. The increase of budget arrears from the side of these enterprises is a natural way of reduction of such tax inequalities. Putting it differently, one can conclude that the state supports some branches by taxing them less.

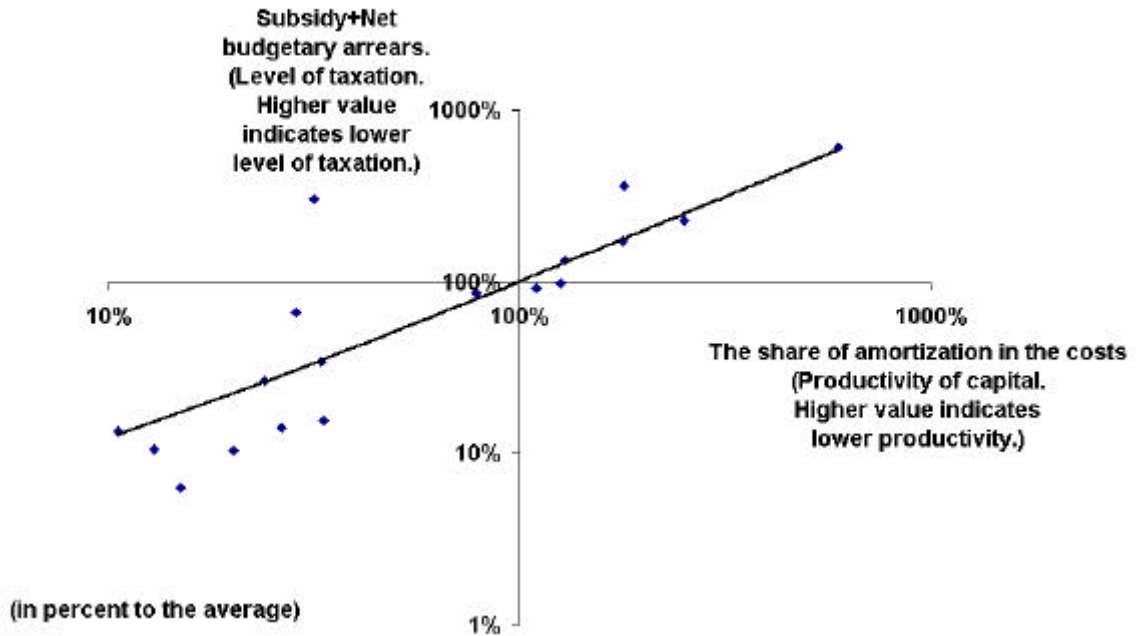
As can be seen from the figure 1, the state supports (taxes less) those branches of industry, which have low efficiency. Therefore, the policy towards reduction of the budgetary arrears (produced by the inefficient enterprises) by bringing the debtors to the court and starting the bankruptcy procedure would be basically inconsistent. In other words, the state will not initiate the bankruptcy procedure against those, which it supports (inefficient enterprises).

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<sup>12</sup> The optimal parameters (level and price) of the provision of the public good can be implicitly or explicitly estimated by the enterprise. The problem is that it has the incentives to understate it when asked. The state uses its coercive power to get this payment. The provider of the public good has the same incentives to overestimate the parameters of the provision as the consumer to underestimate.

<sup>13</sup> Ukrainian Law on the system of taxation [article 3] declares that taxation in Ukraine is based on the principle of uniform (equal and non-discriminatory) taxation.

**Figure 1. The relationship between the levels of taxation and efficiency of enterprises by branches of Ukrainian economy.**



Source: Derzhkomstat. Idea of Volodymyr Dubrowsky.

However, the state has to finance its budget and collect the tax arrears. In Ukraine, the state tries to parry the lack of tax receipts by having established the special regime of account's servicing, known as 'Kartoteka #2'. The fact that it is much more easier for the state to withdraw money from the account of the debtor via this regulation than via costly and time-consuming bankruptcy procedure helps to understand why the state would be unwilling to apply to the court.

As was shown, the state has almost exclusive right to get the unpaid taxes in the case of bankruptcy (it goes second in the Absolute Priority Rule). This 'undeserved' bargaining power along with 'Kartoteka #2' halts the incentives of the other creditors, namely, those, which go after the state in the APR – unsecured creditors, to participate in the bankruptcy process. Recall that according to McCain, granting the exclusive right to recover the debt to one creditor prevents the renegotiation of the contract and, thus, no restructuring takes place.

#### Other enterprises.

Enterprises, which do not get payments for provided goods and services, are the other external source of resources for the value-subtracting enterprise. This type of creditor can be both value-subtracting enterprises and value-adding ones. The desire to get the unpaid

money is equal for both of them. However, a value-subtracting enterprise might not require its money back in order not to make a precedent of the bankruptcy that might later hurt it. At the early stage of using bankruptcy in the economy where the inefficient (value-subtracting) enterprises prevail, this might add to the problem of bankruptcy initiation. In fact, in Ukraine, loss-making enterprises include more than the half of all enterprises and their share has grown from 43% in 1996 to 53% in 1997 [Statistical yearbook, 1997, p. 51]. During this time the budgetary arrears increased by 26.9% (the overdue budgetary arrears increased by 25.9%) [Derzhkomstat, own calculations]. One way or other, the majority of Ukrainian enterprises ends up at 'Kartoteka #2' regulation.

The value-adding enterprise has a fundamental wish not to lose its money. This wish is consistent with and is derived from its profit maximizing strategy. It may seem that value-adding enterprise as well as a value subtracting one does not want to initiate the bankruptcy of its debtor in order not to make a precedent for itself. In fact, the management of value-adding enterprise is not afraid of bankruptcy, because the chances to remain employed after the bankruptcy is higher for the management of value-adding enterprise, than for the value-subtracting one. The reason is that value-adding enterprise has a better chance to undergo restructuring. If the value-adding enterprise does not apply to the court to get its money back, it would mean that the costs of using the bankruptcy procedure to return money is higher than the benefits. Indeed, the legal rules around bankruptcy issues provide a clear disincentive to an enterprise to fight against bad debts.

One of the explanations of this is the regulation of 'Kartoteka #2'. Value-adding as well as value-subtracting enterprises may get under control of 'Kartoteka #2'. This rule suggests that the enterprise will get in its disposal only 5% of the debt received from the liquidated enterprise. Moreover, it takes time to obtain these 5% of the debt. There is some costs associated with the filing the debtor to the court. Therefore, there is a great chance for the creditor (value-adders and value-subtractors) that the costs of returning the debts will exceed the benefits.

**Table 2. The order of creditor’s claims settlement in the Ukraine and the structure of the arrears in the economy.**

#	Absolute Priority Rule	The structure of the arrears. Payables/Receivables	Kartoteka #2 (simultaneously, mind the shares)
0	Administrator and the creditors which claims are secured by assets	NA	Undefined.
1	Workers (the claims on wages)	6.4% / -	Aprox. 42.5%
2	Tax authorities and other budgetary institutions (claims on taxes)	22.5% / 5 %	Aprox. 52.5%
3	Unsecured creditors (enterprises, claims on payments for goods and services).	71.1% / 75%	5 %
4	Owners	-	What is left

Source: Bankruptcy law, Derzhcomstat, own calculations.

Suppose now that the value-adding creditor has no budgetary arrears and, thus, is not at ‘Kartoteka #2’. According to the APR, it receives its money only after trustee, workers and the state receive theirs. So, it substantially decreases the chance that the money will be paid in full.

This can be demonstrated graphically (See Figure 2). Several assumptions should be made to build the graph.

1. Since it would be difficult to collect information about the payables to workers, state and other enterprises from every entity, I assume that the share of payables at every enterprise is proportional to the share of such payables in the economy. (See Table 2, column 3).
2. The trustee gets 5% as remuneration for the liquidation services (this is the maximum amount allowed for such a job in Ukraine). In the other words, the trustee takes 5% of the market value of the bankrupt enterprise (or its assets).

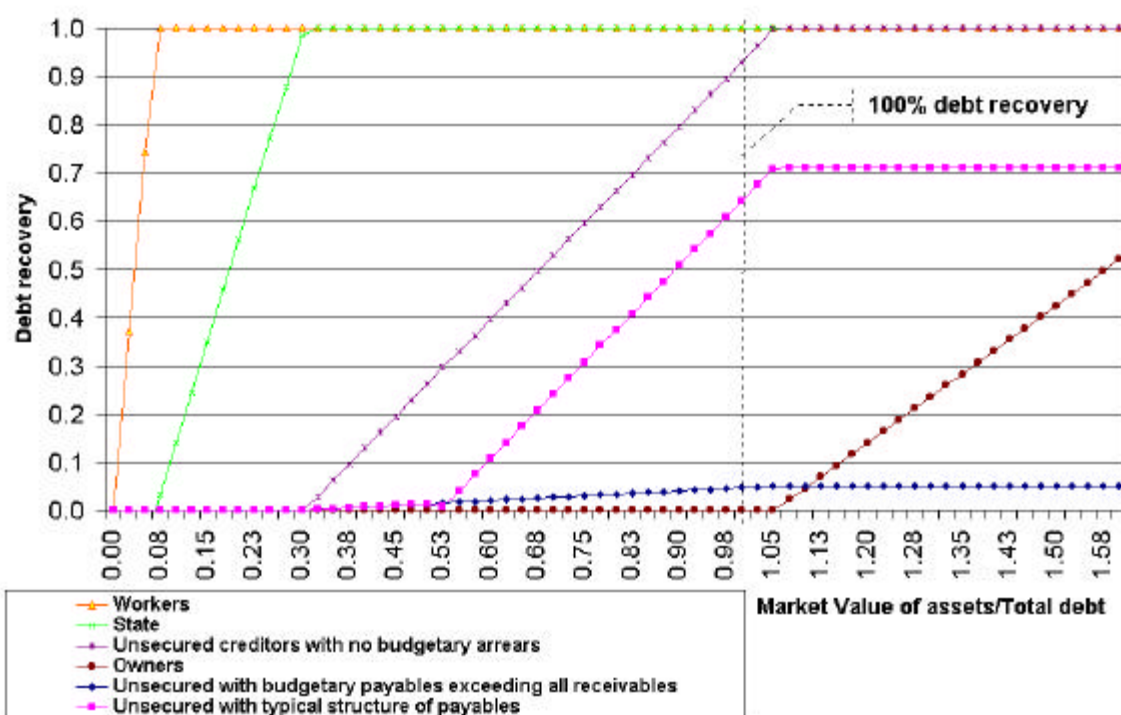
The curves are built according to the formula given in the Appendix B. The curve for the owners shows whether owners receive something (at ‘zero’ on the vertical axis the owners receive nothing, above ‘zero’ - they receive the amount left after all creditors have been paid in full).

The graph shows that the enterprises (as creditors) would receive anything only after the ‘Market value / Debt’ percentage is bigger than 30% and receive all amounts if this ratio exceeds 105%. However, it is unlikely that an enterprise that has  $MV/D=105\%$  will be liquidated. Normally, when the debtor is liquidated, this index is much lower.

Recall that if the enterprise (creditor) is at ‘Kartoteka #2’ it receives approximately 5% of that shown in the graph.

The graph below shows how the share of the debt recovered by the different creditor in the liquidation procedure is related to the ratio of the assets' market value to the total debt of the enterprise. The curves reflect the ex-ante probability of debt recovery by a particular type of creditor and, therefore, its willingness to apply to the court.

**Figure 2. The relationship between the debt recovered and the indebtedness of**



Source: Derzhkomstat, own calculations. (See also Appendix B).

The low ex-ante probability of debt recovery coupled with non-zero costs for the participation in the legal procedure provides a clear disincentive to the enterprise to initiate the bankruptcy. The surveys show that enterprises as creditors rarely apply to the court – 76% of the respondents have never done this; 17% - have applied several times; 7% - usually initiate the hearings while trying to collect their debts. [Ilchuk, 1999, p. 25]. The above confirms that the ‘far from perfect’ bankruptcy law and confiscative money transfer system are among the main reasons for the break in the bankruptcy process.

### Management of the debtor.

The director is not interested in the bankruptcy of its enterprise if he/she is using his/her position to his/her benefit. In the case of non-profitable enterprise, this might take place as illegal selling out of the assets. If the enterprise is profitable, this might occur as a legal or illegal use of an agent to sell the output. This agent (subsidiary) usually has an exclusive dealing agreement and makes profit by buying output at the low price. The price is set at (or below) the costs level to reduce or eliminate accounting profit and avoid taxes paid



by parent (core) company. The agent stops its activity after one accounting period. Then, the new agent is set up. If the parent company is a value-adding enterprise, this scheme might help the company to continue operations in the environment of the excessive taxation. In any case, if the parent company continues to make investments taking funds from 'other than profit' sources, this issue remains the problem to the tax authorities and will most probably forfeit its importance when the state policy towards lower taxes becomes credible.

If the parent company is a value-subtracting enterprise, then I can not find any other explanation for such an activity, except when its management extracts profit for itself. This issue is known as an agency problem and the director is a person who cares about keeping everything as it is.

It should be noted that some of the directors envisage the fatal end of their enterprises and pursue the activity that minimizes their expected loss (opportunity costs in terms of present value of the expected salaries) from the bankruptcy. In this situation, the directors appropriate the assets themselves by using barter and other forms of trade which do not require the use of a banking account (to prevent the confiscation of the money by the tax authorities). The assets are sold at the lowered price and something else is bought at the higher price, so that the balance value of the assets is unchanged. The assets sold in this way are usually the most liquid or most productive part of the enterprise. Such a practice is not very harming in the sense that the new buyer uses these resources more efficiently than does their former owner. On the other hand, this lowers the market value of the enterprise and, correspondingly, the amount the creditors get after the liquidation procedure.

The director of the potentially bankrupt enterprise is not interested in the selling out of its venture because he will lose the job along with the source of income. This income might come to the enterprise itself as a subsidy from the state because, as was mentioned above, there is a potential for large social tensions. On the other hand, the management has a stable income if the enterprise continues functioning through increasing its indebtedness. The increase of the arrears is no longer possible at the expense of the normally functioning companies. These entities do not want to raise the volume of debtor arrears if the particular partner is considered to be untrustworthy. Therefore, I conclude that the bad debts, under normal conditions, can not be increasing because the companies do not correctly evaluate their partners.<sup>14</sup>

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<sup>14</sup> Normal conditions describe here the economic situation that is opposite to the one described as a 'virtual economy'. This term was introduced by Gaddy and Ickes in their article 'Realities of the Russian virtual economy', published in 'Foreign affairs' in September/October 1998.

Owners.

The private owners of the enterprise, in general, are unwilling to support a value-subtractor. Nor do they wish to allow the management to support other enterprises at their (enterprise's) expense. As was already mentioned, the owners of the enterprise in the arrears will try to change the management before filing the enterprise for the bankruptcy.

The state as an owner might have specific reasons to monitor the activity of the State owned enterprises (SOEs). For example, it might allow SOE to earn a loss because it produces socially desirable public good.<sup>15</sup> It seems that the provision of public goods in Ukraine is a question of politics, not of economics, taking into consideration hot battles around privatization issues at the Verkhovna Rada. Despite the reasons which guide the minds of Ukrainian policy makers towards privatization, I suggest that their decisions to support loss-making SOEs might give the wrong incentives to the management of these value-subtracting enterprises. Kornai treated this case as an imposition of the Soft Budget Constraints (SBC) and has shown that under SBC an enterprise tends to act inefficiently [Kornai, 1995]. I suggest that the permanent increase in the bad debts is related to the state support of the inefficient enterprises.

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<sup>15</sup> The theory of public finance argues that when making costs-benefits analysis of the public projects one should use the social interest rate instead of the private one. This one is argued to be lower than the market one, because the society tends to underestimate the value of public good. Thus, when implemented, public projects which interact with the 'private benefit driven' businesses might generate losses, but still be justified from the public point of view.

*How it works.*

**Table 3. The dynamics of the bankruptcy cases in Ukraine.**

	1996	1997	1998, first half ( % annualized)
Change of bad debts in the arrears, %	NA.	Approx. + 72 %	+ 84%
Petitions to the arbitrage courts	9478	12306	8040
Change to the previous year, %		30	31
Started cases	6552	9645	6135
Change to the previous year, %		47	27
Finished cases with announcement of bankruptcy	1691	4107	1797
Change to the previous year, %		143	88
Finished cases with the approved liquidation balance	855	2320	1091
Change to the previous year, %		171	94

Source: Kabinet of Ministers, Derzhkomstat.

The share of the bad debt in the economy was increasing from year to year. For 1997 it increased by 72% compared to 1996 and in 1998 it grew by 84% compared to 1997. This dynamics could approximate the change in the share of value-subtracting enterprises in the economy. As it was noted already, if the enterprise subtracts value, it earns negative profit (loses). If it does this for a long period, it is probably taking the resources from the external sources. Under normal circumstances this should be reflected in the growth of the number of the petitions to the court and started bankruptcy cases and, with some approximation, the change in announcements of bankruptcy.

However, the real situation does not show such a relationship. The yearly increase in the number of petitions to the arbitrage court was 30% in 1997 and 31% in 1998. Also, the yearly growth of the started cases amounted to 47% and 27% in 1997 and 1998 respectively. From the above facts I can conclude that bankruptcy institutions does not work in Ukraine, at least at the stage of launching the procedure. And this is not very surprising taking into account the discussion in the previous sections.

On the other hand, the finished cases with announcement of bankruptcy increased by 143% in 1997 and 88% in 1998 compared to the previous year. Finished cases with approved liquidation balance<sup>16</sup> grew by 171 % and 94 % in 1997 and 1998 respectively. This decline in the court activity could be explained by the increased complexity of the cases. Nevertheless, these fairly large numbers (comparing to the growth of the bad debts) reveal the positive fact that unhealthy pressure to the court officials does not exist and once the

<sup>16</sup> Approved liquidation balance means that liquidation committee has sold out the assets and the arbitrage court closed the case.

bankruptcy case is started, the court considers it fair. Unfortunately, lack of data limits me from drawing more clear conclusions on this issue.

The run of the bankruptcy procedures in the Ukraine is somewhat specific comparing to the other countries. Ukrainian politicians as well as economists argue that the reason for the pre-bankruptcy position of the majority of Ukrainian enterprises is not their activity, but the state of the economy. The restrictive monetary policy, liberalization of the foreign trade, and low internal demand brought financial difficulties, for which most of the firms should not be punished. Such firms would be able to cope with their problems if they had access to financial markets and found new markets for their products. While agreeing that the downward trend of the country's economic conditions during the so called 'transition process' bolstered the financial failure or induced insolvency of the many firms, I suggest that this downturn just revealed the weak fundamentals and the lack of institutional development in the economy.

As was shown, the inadequate number of bankruptcy cases in Ukraine reveals the weakness of the institution of bankruptcy in the country. Despite the fact that the existing bankruptcy procedure in Ukraine is similar to the procedures of better developed countries, Ukrainian bankruptcy law does not contain provisions, which are crucial for the efficiency and does not provide the clear guidance to the participants of the bankruptcy process. The state regulation of the economy is reflected, also, in the intervention into management of day-to-day business transactions. On the one hand, the possibility to get privileges from the state diverts some enterprises from the efficient behavior and allows them not to perform contracts. On the other hand, the exclusive power of the state (as a creditor) and, often-inconsistent state policy towards the performance of some of the debtors depresses the incentives of the other creditors to limit this inefficient behavior. "Kartoreka #2" designed to help the state to collect its debts, allows it to avoid using the bankruptcy procedure that ensures performance of business contracts and recovery of inter-enterprise debts.

#### SECTION 4. CONCLUSIONS AND POLICY RECOMMENDATIONS.

The importance of efficient bankruptcy procedure can be derived from the concept of adaptive efficiency that suggests to eliminate failed economic organizations, as well as allocative efficiency that requires the possibility of free exit from the unprofitable activity (industry). Furthermore, the absence of a functioning bankruptcy procedure may lead organizations to behave inefficiently. In such a situation economic units devote efforts not to the minimization of costs, but to finding external financing to cover their increasing costs (the situation is known as Soft Budget Constraints).

Despite the fact that the existing bankruptcy procedure in Ukraine is similar to the procedures of other countries, Ukrainian bankruptcy law does not contain provisions, which are crucial for the efficiency and does not provide the clear guidance to the participants of the bankruptcy process.

Furthermore, state intervention into the business activity continues to take place. State supports some enterprises in the economy by taxing them less, while this support can not be justified from the economic point of view. The supported enterprises do not provide public goods and, on average, are less productive.

The lack of tax receipts forced state to take the responsibilities over the regulation of the banking account of the enterprises, which have budgetary arrears. The action has driven the state from the use of bankruptcy system, stimulated enterprises not to use their accounts and resulted in the slow down of economic activity.

Further, the excessive power of the state over money transactions coupled with its selective support to some enterprises depressed the incentives of other creditors (mainly enterprises) to use bankruptcy system to collect their debts. In addition the low 'legal literacy' and bad organization of workers prevent this type of creditor from appealing to the court.

The research has confirmed the hypothesis that the absence of the efficient bankruptcy procedure in Ukraine is a reason for the increase of the arrears and low efficiency of economic units. In particular, the Ukrainian economy lacks the institution of bankruptcy. And it is a state that has power and ability to make changes in this field.

The policy towards reduction of ‘bad’ arrears should be aimed at the elimination of the incentives to create them. The issue depends on the efficiency of the bankruptcy regulation and the credibility of its application. Adoption of the more progressive bankruptcy law, cancellation of the state regulations of enterprise’s accounts (Kartoteka #2) and uniform policy towards inefficiently working enterprises (elimination of soft budget constraints) should be the first steps in this direction.

As it was shown, in the current setup no creditors have enough incentives to initiate and participate in the bankruptcy process. Some of them do not initiate bankruptcy by the nature of their status (managers of the debtor enterprise and the tax authority (in case of the bankruptcy of the SOEs). The others do not initiate bankruptcy because of the institutional framework they work in (or the distortion of incentives this framework generates).

The policy makers should consider the following issues if they want to improve the situation.

- I. The bankruptcy law should be a clear guide to the participants of the bankruptcy process. It should reflect the issues, which are found to increase efficiency of bankruptcy laws in the better-developed countries as well as the specifics of the current economic situation in Ukraine.

To the earlier belongs: a) increasing the motivation of the administrator of the assets (trustee); b) defining management’s liability for not timely filing to the court (informing creditors); c) Automatic Stay Provision; d) additional guarantees to the new creditors; e) possibility to exchange of the existing debt for the new one; and f) the provision of incentives to the professional creditors.

The latter includes the increasing ‘legal education’ of the workers and making the incentives to the first creditor that initiates the procedure along with reduction of the state interventions in the business administration. This can be accomplished either by changes to the Absolute Priority Rule (APR) or cancellation of ‘Kartoteka #2’ regulation.

- II. APR does not allow the main interested party – enterprises (who accounts for the majority of the debts) to initiate the process. As long as this party will be prevented from realizing its interests, bankruptcy will not perform its main task – preventing bad debts and inefficiency in the economy. Once debtor feels it may remain unpunished for the not-performed obligations, it loses the incentives to perform them. The other party, in its turn loses the incentives to

continue business. Since the functioning of the economy depends to the great extent on the obligations made and fulfilled in the business sphere, the incentives to the leading (by the majority of transactions) creditor should not be destroyed.

By the strength of the motivation to initiate bankruptcy /liquidation/ process the creditors can be ranked as:

1. Enterprises – always want their money back;
2. State – wants payments of taxes from private enterprises, but supports SOEs.
3. Workers – least interested in the initiation.
4. Owners and managers have specific interests and usually are not interested in bankruptcy.

The APR is a major component of the Bankruptcy law, in sense, that it defines the incentives of the creditors to start bankruptcy.

Those who are the first, probably, have little incentives, since they are always sure. Those who are the last, probably, have little incentives since they are very unsure. Therefore, those in the middle have enough incentives, because they are not sure enough.

In the case of Ukraine, to work, the APR should be designed to make use of the incentives. Workers, who have low incentives, should stay at the first place. Enterprises should be at the second place in order not to lose incentives when they are at the third. State should go third as it has not still defined with its attitude to bankruptcy.

In the best for the State case, it should be given the same priority as the enterprises as it in fact does not differ from them, but does not crucially depend on the recovered money in every particular case.

- III. The ‘Kartoteka #2’ as a regulation that gives the extraordinary power to the state to collect its debts and simultaneously lowers its incentives to initiate the bankruptcy procedure, should be cancelled.

*Suggestions for further research.*

It was found that workers might have specific interests relative to the initiation of the bankruptcy procedure. I have suggested that the general reluctance of the workers to call for their unpaid wages can be explained by their low legal literacy. However, besides the educational factor, there is some evidence that in Ukrainian workers are not willing to leave their job or start the bankruptcy if they are unpaid. The reason is that they substitute the income they do not get from the wages by the income they get from appropriating the assets of the enterprises or so. I suggest that the further study of worker's behavior might give the insight into the bankruptcy problem.

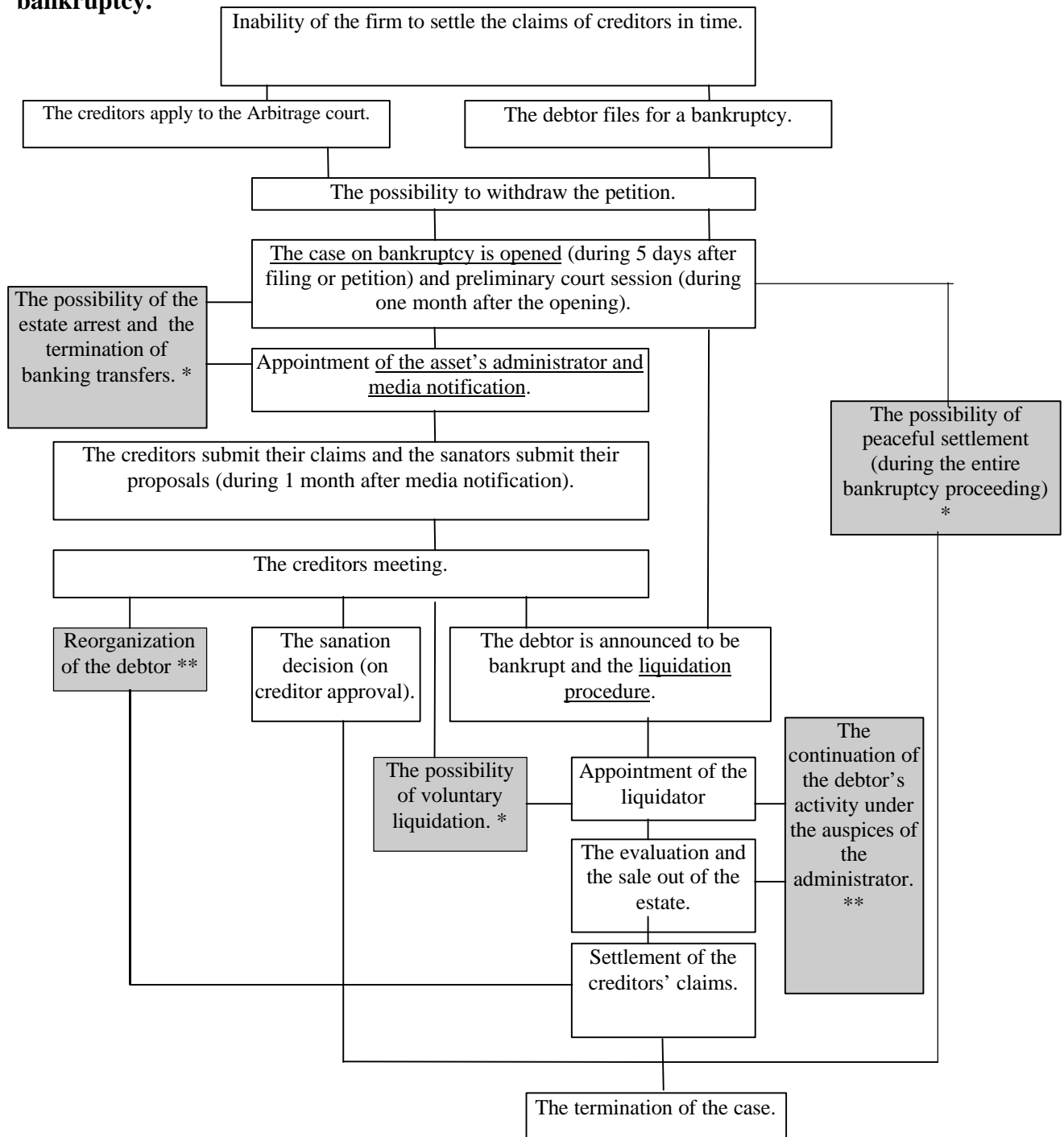
The conclusions would be more powerful if the suggestions, which come from the 'healthy logic', were supported by data that were not available at the time they were presented in the paper.





APPENDIX A.

**Figure 3. The comparison of the bankruptcy procedure according to the existing Bankruptcy Law of Ukraine, to the draft of new Bankruptcy Law and to the international standards of bankruptcy.**

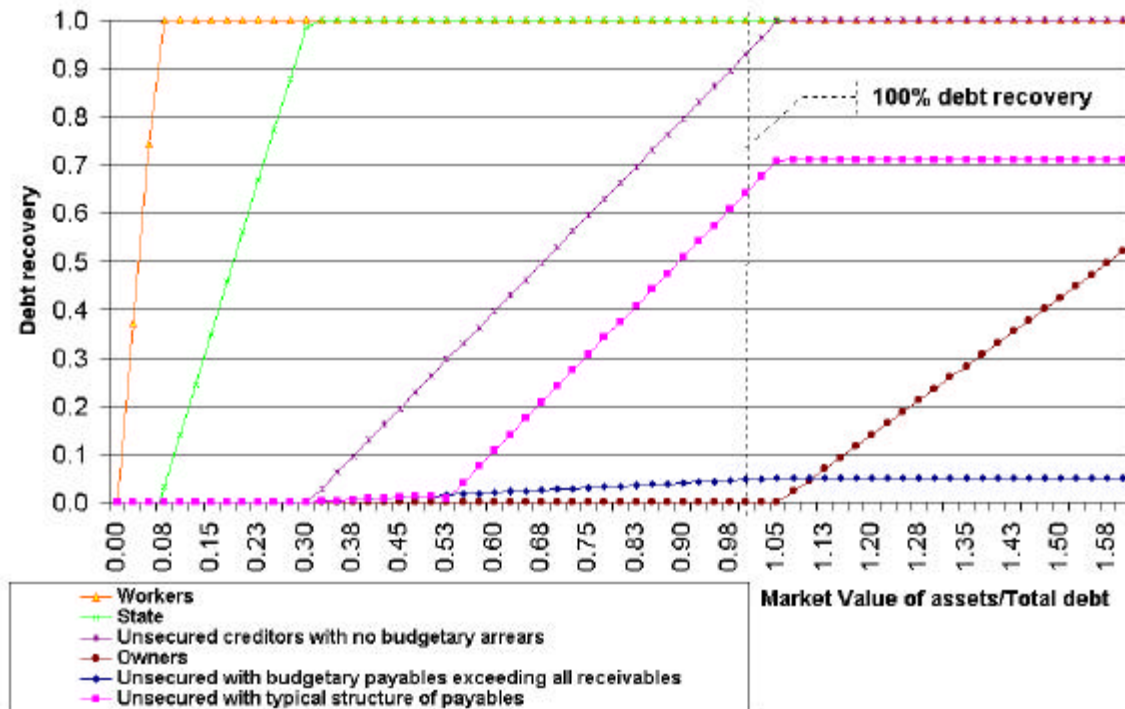


The procedure according to the existing law.

\* The amendments to the procedure according to the draft of the new Law on Bankruptcy.

\*\* The procedure according to the international standards of bankruptcy.

## APPENDIX B.



The graph presents the results of the simulation of the liquidation workout in the bankruptcy procedure.

The following assumptions have been made to conduct the simulation:

1. The structure of receivable arrears of an average enterprise is analogous to the one of the Ukrainian economy. (To construct a more realistic model one would need to consider and aggregate the arrears of all enterprises in the economy.)
2. Once the procedure is started, the debts are covered according to the Absolute Priority Rule (administrator, workers, state, enterprises and owners). The debts of the successive claimant can be covered only after the debts of the previous claimant have been covered in full.
3. The enterprises are divided according to the volume of budgetary arrears they have. There are three types of the enterprises:
  - Those, which have no budgetary arrears.
  - Those, which have average volumes of budgetary arrears.
  - Those, which have excessive budgetary arrears (the volume of their payables to the state is higher than the total volume of their receivables.)
4. The money that comes from the liquidation of the debtor to the creditor's account is transferred according to 'Kartoteka #2' rule if a creditor (enterprise) has budgetary arrears as long as it has the budgetary arrears.

The simulation was aimed on the revealing the distribution of money from the liquidation.

On the horizontal axis I show the level to which the total payables of the debtor can be covered with its assets when the latter are sold out – (Market value/Total debt).

The vertical axis (Market value/Debt to the specific creditor) reflects the level to which the debt of a particular creditor (worker, state, and enterprise) can be covered. This ratio reflects the ex-ante probability of debt recovery by a particular creditor before the procedure begins.

The curves have been constructed according to the formula:

$$\begin{aligned} \text{Debt recovery} = & \\ & (\text{Market Value} - \text{All previous payments})/\text{Specific debt} \\ & \quad \text{if Market Value} - \text{All previous payments} < 0 \text{ or } > 1 \\ 0 & \quad \text{if Market Value} - \text{All previous payments} < 0 \\ 1 & \quad \text{if } (\text{Market Value} - \text{All previous payments})/\text{Specific debt} > 1 \end{aligned}$$

The vertical dashed line indicates the situation when the value of enterprise's assets is just enough to cover all its debts. In such a situation all claims would be settled if the enterprise was sold without the bankruptcy procedure.

Let us consider this situation in more details, because it is typical for the enterprise on the edge of bankruptcy.

Since the bankruptcy procedure requires the work of the assets administrator, the last creditor (enterprise) can not cover its debt in full. In fact, the successful (with no budgetary arrears) enterprise can recover 95% of its debt. As can be seen, the average (with typical budgetary arrears) enterprise will be able to use 60% of the money received for its business activity. The enterprise with excessive budgetary arrears will be able to manage itself only 5% of the received amount.

The management of the enterprise, being aware of the budgetary arrears of its enterprise, and evaluating the market value of its debtor, decides upon the fate of the debtor – to file or not to file it for a bankruptcy. Even in the absence of the transaction costs (except administrator's fee), the expected value of the debt recovery may be low enough to deter the initiation of the proceedings.