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**State Policy and Legislation in the Sphere of Insolvency Regulation:**

- Situation analysis
- Recommendations on improvement

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**However, this does not exclude that the state as a representative of society should be enforced to take decision to introduce the special regime of overcoming the insolvency of the particular enterprise. But the property form is not of decisive importance for decision to be taken. This means that the form of state property is not a reason for establishing the bankruptcy immunity for enterprises neither from legal nor from political point of view. ....44**

**The extent of importance of the enterprise activity for the interests of the country may be a ground for introducing a special regime of overcoming its insolvency. All developed countries shall determine kinds of enterprises where material changes are being controlled by governments proceeding from the strategic interests of the country. ....44**

**The most wide-used forms of the country's participation in prevention of companies' bankruptcy are as follows: ....44**

**Many examples of the state interference in the process of bankruptcy prevention appeared in the period of the current global crisis. All governments were impelled to develop anti-crisis programs, the main objective of which was to take special measures against the bankruptcy of large banks and companies that present the real sector of economy. 44**

**The most large-scale anti-crisis program was implemented in USA in 2008-2009. The American Government has made unprecedented by the extent financing of banks and three car giants. Financing was handled based on the principles referred to above. In 2009 the American banks completed the repayment of state assistance as they were interested in the restoration of their independence and ownership rights. ....44**

## **Russia 44**

**Restrictions and injunctions for the state-owned enterprises bankruptcy is a phenomenon specific to the group of former post-socialist countries, which were late in reconstructing their national economies. But its practical implementation has various forms. ....44**

**Russian legislation on insolvency (bankruptcy) stipulates differentiation of regulatory systems for state-owned enterprises. But unlike Ukraine, the policy of Russia in the sphere of insolvency does not set the goal to create the additional protection against bankruptcy. Differentiation is introduced in order: ....44**

**Firstly, to take into consideration the procedures' specifics determined by other laws, in particular: ....44**

**Secondly, to take into account the enterprises influence on national interests. The following specifics are envisaged for strategic enterprises and defense industry organizations regardless of their form of property: 45**

**Subject to the findings of the world practice analysis, the following conclusions regarding liquidation of restrictions and injunctions for the bankruptcy of state-owned enterprises in Ukraine have been made: ....45**

**Recommendations for Ukraine .....45**

**Based on the analysis of the Law “On Restoration of Debtor’s Solvency or Recognition of Debtor’s Bankruptcy” and the state policy in the sphere of insolvency regulation, the following purposes of the introduction of restrictions and injunctions for the bankruptcy of state-owned enterprises may be determined:.....45**

**Unlike other post-socialistic countries, Ukraine uses the method of total protection against bankruptcy based on the state ownership that, firstly, inevitably brings to the material reduction of incentives to the development of the public sector, which covers the significant part of the Ukrainian economy; and secondly, creates considerable “thrombi” for the circulation of funds on a national level. Actually, doing so, the state has declaimed responsibility for resolving the insolvency problem for state-owned enterprises. ....46**

**Due to this, the liquidation of restrictions and injunctions for bankruptcy of state-owned enterprises is one of obligatory directions of upgrading the regulatory insolvency system in Ukraine. ....46**

**This process is rather complicated and bears serious potential risks. It is necessary to perfectly study conditions, under which these risks may be minimized in case of liquidation of restrictions and injunctions. See below our considerations thereon: .....46**

**1)The system of insolvency regulation should not differentiate business entities in the market by their forms of property. Some specifics may be acceptable only within their compliance with legal rules that regulate the process of state-owned enterprises management. ....46**

**2)The policy of total protection against bankruptcy should be replaced by the system policy of preventing insolvency of state-owned enterprises, which activity affect significant interests of society. ....46**

**3)The first and quite safe step is to narrow down the area of application of restrictions for bankruptcy. Pursuant to the Ukrainian legislation, the state-owned enterprises include public enterprises (with 100% public**

ownership) and economic companies, where the State's share in the equity capital exceeds 50%. This list covers all strategic enterprises. The bankruptcy of enterprises where the State's share in the equity capital is less than 50% does not affect the interests important for the country. .... 46

4) In case of cancellation of a court injunction and restrictions, the risks may be neutralized by using state policy means. In case of strategic need in the protection of the important enterprise against bankruptcy, the State should assume the guarantees for the fulfillment of obligations to the creditors. But such actions should not artificially retain inactive business entities in the market or create ungrounded market advantages for separate enterprises. .... 46

Creation of the eligible institutional management system for state ownership objects is a key condition for the full cancellation of restrictions and injunctions for bankruptcy of state-owned enterprises.  
46

Authors of report see real opportunities for the creation in Ukraine of the efficient system for performing by the State the functions of owners of the enterprises-debtors. In our opinion, the State Property Fund of Ukraine (SPFU) may become such body. Table 6.1 contains cases for such choice. .... 46

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## Summary

1. Like in other countries with transition economy the system of state regulation in Ukraine was created through adopting the world experience. The first law "On Bankruptcy" (1992) and the second currently effective law "On Restoring the Debtor's Solvency or Declaring it a Bankrupt" (1999) were developed with regard of the standards applied by the bankruptcy legislation of the developed countries.

However, ten years of application of the second law shows its low regulatory efficiency. Ukraine is almost in the end of the list in the international ratings of the bankruptcy procedure efficiency. The reason lies in considerable procedural constraints of the current legislation. The main thing, though, is that the Law design does not meet the realities of the modern Ukrainian

economy in many ways. One may state that the main direction of further improvement of insolvency legislation should be in consideration of the specifics of business processes in Ukraine.

2. Business management in Ukraine is complicated by such historically specified parameters as lack of government levers, anti-capitalistic stereotypes and corruption traditions. This caused essential deviations from the liberal-democratic model of organization and functioning of the society, state and economy:

- a) Perception of corruption in the society as an admissible sin and, as a consequence, corruption damaging all institutions of the society, state and economy including:
  - Corruption deformation of legislative system;
  - Shadowization of economic relations.
- b) Delayed and inappropriate reformation of the economy institutions and, as a consequence, underdeveloped market, which objectively increases:
  - Risks of insolvency and bankruptcy;
  - Negative social and economic consequences of certain businesses leaving the market.
- c) Disrespect in the society, including economic entities, to legislation, distrust to the institutions of state and court, tendency to resolve problems in the informal way.
- d) Stereotype of the state ownership priority and, as a consequence, excessive state sector of the economy.
- e) Disrespect in the society to the private property rights and, as a consequence, 'pro-debtor' orientation in the 'creditor-borrower' conflict, especially if the debtor is the state and the creditor is a private person.
- f) Inappropriately reformed state with limited capacity and poor fulfillment of the state functions regarding the property rights protection, including the state property, and the function for enforcement of the agreements implementation.

3. The report considers the opportunities for creation of the effective system of direct counteraction to the above negative phenomena within the Ukrainian legal framework. With this in view, the report presents analysis of relevant legal relations in the developed capitalist countries and in Russia. The findings of this analysis underlay formulation of the requirements to the Ukrainian legislation on insolvency regarding the Ukrainian realities by five main directions:

a. *Creditor and debtor interests balance.* Regarding 'pro-debtor' traditions to provide consistent observance of the principle of irreversible, quick and full debt repayment. To exclude deviations from these principles for the state-owned objects and special objects attracting the subjects benefiting from specially established procedures and restrictions to the debt recovery.

b. *Selection of the options for addressing the enterprise insolvency problems.* To preserve business (not an owner) as a priority, including the bankruptcy procedure. To strictly observe the priority of selling the business before the whole property complex to be liquidated. To expand a possibility to use non-judicial ways of the enterprise's solvency restoration as a method of debt recovery.

c. *Removal of restrictions on the state-owned enterprises bankruptcy.* To implement mandatory procedures for active involvement of the state as the owner at all possible stages of addressing the insolvency problem, such as debt recovery, privatization with preliminary debt recovery, participation in rehabilitation, restructuring and bankruptcy procedures.

d. *Creation of a system for prevention of misconduct and fictitious bankruptcy.* To implement ongoing control and automaticity of the bankruptcy procedures. In order to prevent shadow privatization through fictitious bankruptcy to recover debts exclusively in the monetary forms and to sell property only on the basis of competitive bidding.

With the above in view, it is necessary to implement and approve a system regulating the right of arbitration managers regarding the conflict of interests inherent in their activities. It is important to combine three controls – state, professional and public. It is also appropriate to strengthen the requirements to the admission (personal requirements, training, licensing, appointment to the position) and responsibility for the consequence of the activities (membership in the self-regulation organization, insurance of material responsibility for professional risks, strengthening of criminal responsibility).

e. *Involvement of the state.* To create a powerful specialized institutional system for insolvency regulation in Ukraine. In view of legal gaps, weak public administration system and shadow economy on a large scale this institutional system is expected to incorporate more functions than similar systems in the developed countries. For prevention of the conflict of interests it is necessary to institutionally separate functions of the law and the state policy making, support of the regulation and prevention of the law violation as well as functions of the owners.

## **Background**

Ukraine entered into the third stage of the economy law transformation in the sphere of the economic entities insolvency regulation. The first law “On Bankruptcy” was adopted in 1992 and the second law “On Renovation of Debtor’s Creditworthiness or Declaration of Bankruptcy” became effective on January 1, 2000 and is still applicable.

Imperfection of the current Law was determined long ago, but acute political instability after 2004 and the global financial and economic crises of 2007-2009 postponed solution of this problem. It is only in 2010 when draft changes to the Law have been initiated. One may trace two approaches in the law-making activities. The majority of experts and representatives of relevant state authorities again propose variants of the procedural improvement of the Law. On the other hand, there are supporters of cardinal revision of the concept of the state policy and legislation in this sphere itself regarding the specific conditions of the Ukrainian economy development.

The authors of this analytical research as economists do not touch the problem of procedural norms and their improvement. Such analysis requires special professional approach and is rather the subject of interests for lawyers. The subject of this research consists in the analysis of the effective law from the standpoint of its compliance with the real economic conditions under which the legal regulation of the business insolvency takes place.

The above determines a perspective in which we consider the problem. First, for us it was important to identify if it is really critical for Ukraine as a country in transition to properly reflect specific economic conditions in the concept of the Law. Second, if it is really critical, by which methods it is advisable to combine the world liberal standards with specific economic conditions directly in the Ukrainian legislation. Third, it is necessary to identify to what extent it is admissible to apply national specialization of the legal norms for regulation of the business entities insolvency.

Ten-year application of the effective Law “On Restoring the Debtor’s Solvency or Declaring it a Bankrupt” has dramatically demonstrated that it is the discordance of the law with the real economic conditions of Ukraine that specifies ineffectiveness of the system of state regulation in the sphere of insolvency. Specifics of Ukraine that were not considered in the legal norms resulted in the situation when a formal system of the state regulation (legislation) was partially replaced by informal (shadow) system with its mass cases of inequitable conduct of the business entities.

Analysis of the application of the first and the second laws on bankruptcy has allowed distinguishing those particular factors inherent in Ukrainian economy, which need to be considered under drafting new law.

Analysis of these factors underlies formulation of conceptual approaches (requirements) to the following problems arising in the course of choosing a model of state regulation of prevention and control of persistent insolvency of business entities:

- a) Balance of interests of the creditors and the debtors.
- b) Selection of the methods for solution the business entities insolvency problems.
- c) Removal of restrictions on bankruptcy of the state-owned enterprises.

- d) Creation of a system of prevention of inequitable conduct and fictitious bankruptcy.
- e) Application of specific approaches to conduct bankruptcy procedures of certain types of enterprises. Permissible differentiation in the bankruptcy regimes.
- f) Involvement of the state.

The authors of the research hope that approaches formulated on the basis of the analysis of the world experience and specifics of the development of the Ukrainian economy will be practically helpful for the law-makers in drafting the new law on insolvency and bankruptcy.

## **1. General Ideology for Creation of the System for State Regulation of the Business Entity Insolvency**

Formation of the ideology for creation of the system for state regulation of the business entity insolvency lasted relatively long in the world historical perspective. Its modern variant was completed in about 70-80s of the previous century when the countries with developed market economy experienced a series of reforms of the available systems for bankruptcy regulation.

This ideology was based on the rational world experience accumulated during long historical practice. Therefore, the proposals on improvement of the Ukrainian legislation in the sphere of insolvency should be developed on the basis of this ideological scheme.

### **1.1. Targets, functions, objectives and principles for the system creation**

Market and a system of the state regulation for its support are the main elements of the modern model of the effective economy.

Functioning of the market economy is the example of the live self-regulatory system. Free competition and bankruptcy are the main mechanisms for the self-regulation. Competition carries out automatic selection of the owners and enterprises dividing them into effective and ineffective. The bankruptcy mechanisms are designed to remove from the market owners and enterprises that prove to be ineffective in the course of the competition.

Energy of the market as well as other types of energies like nuclear energy is not positive or negative phenomenon per se. The market incorporates a powerful incentive – profit generation providing progressive advance of the economy by selecting the most effective owners and enterprises. However, the market energy just like nuclear energy may have destructive consequences. A system of the state regulations acts as an adjusting and guiding mechanism of the market domain. It is designed for removal of critical risks, sustainable functioning of the economy and protection of the interests significant for the state.

Persistent insolvency of the business entities is one of the critical threats, which may interfere normal functioning of the market economy. This creates dangerous ‘clots’ in circulation of finances and assets. That is why there is no market economy country, which does not have in place special institutional systems in this or other version (legislation and administration bodies) for prevention and control for persistent insolvency of the business entities.

We will briefly specify the general requirements formed by the world practice to the system of state regulation of the business entities insolvency.

The most concentrated feature of any economic system is definition of the target for its functioning. Objectively, the aim of any state intervention into the activities of the business entities is to provide sustained growth of the effective market economy and to create reliable protection of the interests important for the state.

However, the objective aim is the deep essence of the state regulatory policy. For various spheres of business it acquires a specific form that is then incorporated in the relevant legislation and the state policy. *For insolvency a specific target of the state intervention into the activities of the business entities may be formulated as follows: to provide irreversibility of the debt recovery*

*by the methods that facilitate growth of the sustainable and effective economy without damaging the interests significant for the country.*

The system of state regulation of the business entities insolvency should be designed so that the ‘sanitary’ function of the bankruptcy be implemented rationally, i.e. without extra losses, and be safe for the effective business, population and the country at large.

The system of state regulation of the business entities insolvency should be based on the general principles including the following:

Supremacy of the property rights, irreversibility of the agreement implementation (values inherent to the market economy);

Equality of all business entities before the requirement of the debt recovery irreversibility (protection of the market competition);

Publicity and transparency of decision making procedures (public control fundamental).

Tasks of the state in the sphere of regulation of the business entities insolvency may be conditionally divided into three main groups:

Support of effective enterprises;

Liquidation of ineffective owners and/or enterprises;

Prevention of misconduct and false bankruptcy.

The process of the state in the sphere of regulation of the business entities insolvency includes four components:

Recognition of the insolvency status;

Establishment of methods for renewal of creditworthiness;

Regulation of procedures;

Identification of the participants of the process and their functions.

## **1.2. National specifics**

The above mentioned set of targets, tasks and principles should be viewed as an ideological backbone to support creation of any national legislation aimed at prevention and control for persistent insolvency of the business entities under conditions of market economy.

Figuratively speaking, ‘muscles’ of the legislation, that are specific procedural norms building up on the ideological backbone, are noticeably different in different countries.

The format of the national legislation on regulation of the business entities insolvency is affected by the following factors:

Specifics of the economy development;

Concrete targets of the economic development for the given period;

Combination with the current system of the state regulation;

Developed traditions (common practices) of business management;

General administration culture (practice).

Reflection of the country specifics in the nature of the regulatory system is a native process. The system of state regulation in the sphere of insolvency is imbedded into the current

environment that specifies selection of specific forms and mechanisms for implementation of its targets, objectives and functions. If the system fails to be naturally adopted by the environment, this may have a negative impact on the effectiveness and in some cases may provoke accumulation of various distortions, some being even of criminal nature.

International experts with good reason consider that the nature of the insolvency regulation laws requires permanent transformations following the changes in the economy and economic policy. In some countries the said legislation is reviewed every 2-3 years.

*However, there are certain limits for reflection of the national specifics in the legislation. On the one hand, these specifics should not in any way deform a general ideology recognized in the world and reflecting liberal approaches. On the other, such reflection is required to the extent that allows the efficiency of the state regulatory policy to be strengthened.*

## **2. Specifics of Ukraine that have impact on development of the system of state regulation in the sphere of insolvency**

The first law “On Bankruptcy” and the second law “On Restoring the Debtor’s Solvency or Declaring it a Bankrupt” were drafted in the period when Ukraine was in search of the models for the national economy and public administration. The capital and business were at the stage of their creation. Therefore, the national law in the sphere of insolvency was designed mostly on the basis of the international experience.

Import of the international experience is rather common for the countries in transition. For them practice of the developed countries is an unbeatable proof of successful development. Additionally, due to the lack of own experience in these countries such adoption of the developed countries experience considerably reduced the time necessary for development of the legislation for the unknown market economy models.

During 19 years after collapse of the Soviet Union Ukraine has been formed as a state with its sustained system of economy and public administration. In 2005 the European Union recognized Ukraine as a country with the market economy. The economy of Ukraine incorporated a considerable layer of business entities.

During its short but rapid development Ukraine acquired stable specifics, which now have a noticeable impact on its further development. Therefore, under drafting new bankruptcy legislation the priority should be given to the task of using the recognized world liberal standards for creation of the system for state regulation of insolvency so that it would be consistent with the nature of the national economy and the public administration.

This is a complicated and new task for Ukrainian lawmakers. Success of this effort largely depends on the right selection of specifics to be considered while developing the regulatory system and the mechanisms for incorporation of these specifics into the regulatory norms.

### **2.1 Specifics of Ukraine formed under its post-socialist transformation**

Unlike the developed countries with their rather long history in development of the system of state regulation of the business insolvency by way of gradual and natural selection, Ukraine along with other former socialist countries began to form its regulatory system in the radical conditions of the start of the post-socialist transformation process.

The former socialist countries of the Eastern Europe and countries emerged from the former Baltic republic of the USSR at the very beginning set a task of integrating into the European Union. Population of these countries managed to preserve to a great extent the former values of the society before the socialistic period with their economies incorporating a noticeable share of private sector.

This group of states implemented post-socialist transformation of their economies by the liberal principles. Their legislation and practice in the sphere of regulation of the economy including regulation of the business entities insolvency were formed under the guidance and scrutiny of the European Union. By the end of the 90s these countries mainly completed their post-socialist reconstruction with formation of democratic political systems and market economies. In 2004-2005 they accessed the EU as new members.

Ukraine belongs to the group of former socialist countries, which passed this way with deep deformations because of unfavorable starting conditions.

Transformational deviations in Ukraine occurred due to the unfavorable starting conditions, particularly:

1) Lack of internal motive forces that would be interested in implementation of the market reforms. Decision on implementation of the market reforms was made under the influence of the international organizations and governments of the developed countries.

2) Deep structural crises and weak statehood as the consequence of destructive way of withdrawal of Ukraine from the USSR. The state proved incapable to manage objects of the state sector. Renovation of the Ukrainian economy after crises was historically related with large private capital that passed the stage of primary accumulation with all negative features inherent in this process.

3) Under preservation of the monopoly for the state property and weak control from the state the right to dispose of the state property and the resources passed to certain officials which were not controlled by the state.

4) Population for the period of the Soviet power lost the experience of business management and treated private property with bias. Renovation of the business skills coincided with active primary accumulation taking place under weak state control and mass employment of shadow practices.

Under the pressure of international organizations and governments of the developed countries Ukraine right after withdrawal from the USSR had to initiate the market reforms. However, when external pressure weakened, the reformation activities in the country rapidly faded.

History of the further development of Ukraine clearly demonstrated that in the next years there were only separate episodes in renovation of the market reforms. All these episodes were related to periodical pressure from the international organizations and government of the developed countries on Ukrainian power. They were concerned with retardation and accumulation of deformations in this region of the world. However, every time when pressure was weakened, the reforms in Ukraine without active internal support again came to a stop.

As a consequence unlike countries of the first post-socialist group Ukraine failed to complete the process of post-socialist transformations. At the end of the 90s the Soviet type economy was replaced by a distorted economic system representing a specific mixture of the elements of market economy, remains of the socialist economy and new elements of the so-

called ‘oligarchy’ economy (merge of power with large national capital, mass corruption and shadow activities). Half- authoritarian political system was established in Ukraine.

Therefore, as a result of the first stage of post-socialist transformations Ukraine created a political and economic system, which had essential deviations from the liberal-democratic model.

After secession Ukraine inherited from the Soviet Union an incapable part of the Soviet state administration, which should be reconstructed for conditions of the newly created independent state and new type of market economy. However, the national system of public administration began its renovation following the old pattern with minimum adjustments to regulation of the market economy. The administration reform in Ukraine has never been completed. ‘Privatization’ by the state officials of their functions has become a common practice – they transformed into the source of private incomes for the state officials.

Tension within the Ukrainian society that was displeased with the results of the economy and political system transformation was constantly growing and in 2004 resulted in the ‘orange’ revolution. Five years of political struggle and then decline of output and paralysis of the banking system during the global crises led to a complete standstill of the market reforms. During last five years a gap between the liberal model and the Ukrainian format of the economic system became even greater.

A state system of economy management was essentially affected. Administrative wars destroyed the administration vertical, some functions and branches of the public administration disappeared. Action of the market mechanisms was blocked by administrative methods.

New team that came after the presidential elections directed its efforts to restore the stability of the public administration system in Ukraine. However, its activities were not aimed at changing its nature. On the contrary, the activities of the team resulted in strengthening of administrative methods of the economy control.

After 2004 Ukraine began losing important elements of its economic freedom. According to the data of the American Research Institute of Heritage Foundation, the index of economic freedom of Ukraine in the 2010 rating fell from 55.8 down to 46.4 points as compared to the rating 2005<sup>1</sup>. Ukraine during these years lost 74 positions moving from 88<sup>th</sup> to 162<sup>nd</sup> place (among 173 countries). Ukraine again appeared in the group of depressive countries of the world.

*Therefore, deviation of the Ukrainian economic system from the liberal economic system and weakness of the public administration system have become special institutional signs of modern Ukraine. These signs determine the Ukrainian specifics that have direct impact on the processes of the business entities insolvency and on selection of the design of the state regulation system in this sphere.*

## **2.2 Specifics of Ukraine to be considered while drafting new legislation on bankruptcy**

In this section an attempt is made to group specifics of Ukraine into two categories: a) deviation of the Ukrainian economic system from the liberal model and b) manifestations of weaknesses of the public administration system including economy management.

### **Deviation of the Ukrainian economic system from the liberal model**

<sup>1</sup> <http://www.heritage.org/index/>

The Ukrainian economic system deviated from the liberal model as a result of incomplete and distorted market reformation process and stereotypes of the population formed during the Soviet period and even earlier.

Specifics from this group include the following parameters inherent in Ukrainian economy.

### 1) Underdeveloped market

*The underdeveloped market strengthens the insolvency risks for the business entities.* Additional risks for businesses are also created by a high level of monopolization; inequality of the economic entities on the market strengthened by the administrative interventions (pricing, access to the resources, exemptions, export quotas etc.); critical export-import dependence (export of Ukrainian products to the foreign markets, import of fuels).

In addition, Ukraine has sectors where insolvency may arise artificially because prices are regulated not by the market but by the administration methods. Housing and utilities infrastructure is the example of such sector. Administration restraint of prices for housing and public utilities services with considerable cost increase of fuel and energy sources led to total insolvency of business entities in this sector. It is only national reform of the price (tariff) system that can essentially improve the situation.

*Underdeveloped market reduces opportunities for business entities to manage their insolvency independently.* Poor stock and credit markets and market of insurance services limit opportunities for business to accumulate external financial resources when the first critical signs appear.

Consequently, a relatively high level of business loss ratio is typical for Ukrainian economy. In 2009 when Ukrainian economy overcame the modern global crisis, a share of unprofitable enterprises made up 39.9%, and in January-May 2010 it grew up to 47.1%.

In the recent years a total value of indebtedness intensively increases including rapid growth of outstanding debts. As against January 1, 2007 (before the crises) the value of liabilities of the enterprises as of April 1, 2010 grew from 946.6 to 1620.5 billion UAH or 1.7 times. For this period the amount of outstanding debts under credit grew from 4.5 to 69.9 billion UAH or 15.5 times.

### 2) Excessive state sector in the paradigm of its advantages

Small privatization in Ukraine was completed in 1996 and mass privatization in 1998. For relatively short historical period (6-8 years) small firms passed the period of the primary accumulation and transformed into powerful business groups. All this provided rapid transformation in the property structure. According to the experts, if in 1992 the integral index of the public sector share achieved 77.0%, then in 1998 the strategic positions were occupied by the private sector, the integral index of its share being 63.3%.<sup>2</sup>

However, further privatization began losing its growth rates and after 2004 it was paralyzed. Political opponents employed privatization as a tool in the political struggle. A political opponent once in the opposition blocked all attempts of the power team to renew privatization since it may provide to the power enormous financial resources at the cost of selling strategic enterprises.

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<sup>2</sup> [http://www.library.ukma.kiev.ua/e-lib/NZ/NZV44\\_2005\\_economy/04\\_goncharova\\_ng.pdf](http://www.library.ukma.kiev.ua/e-lib/NZ/NZV44_2005_economy/04_goncharova_ng.pdf)

As a result, after 18 years of privatization a proportion of the state sector (without budget organizations and banks) still occupies a noticeable share in the production factors: 15.6% of the full-time employees; 14,2% of residual value of fixed and intangible assets<sup>3</sup>. It is noteworthy that communal property objects are not taken here into consideration. Therefore, in contrast to the developed countries *the Ukrainian state has to perform a lot of unusual functions – functions of the owner of business entities.*

Moreover, the majority of the state assets were concentrated in the strategic sectors and natural monopolies: military-industrial and fuel and energy complexes, science, railways, post, telecommunication, housing and public utilities infrastructure etc. State security and meeting the basic demands of the population largely depend on functioning of these sectors. *Along with stereotypes inherited from the socialist past this supports the paradigm of advantage of the public property over private ownership.*

### **3) Shadow economy and mass corruption**

Since 1991 the economy of Ukraine was gradually drawn into deep structural crises. Cessation of Ukraine after collapse of the USSR led to destructive consequences for the economy: sustainable corporative and technological links were at once broken, a huge market was lost, state enterprises that composed the basis of the country economy began to shut down. In contrast to other socialist countries Ukraine was not attractive to foreign investments. State proved incapable to prevent economic collapse.

In such crises conditions and without actual control from the state the national private business was initiated. Primary accumulation was mainly based on exploitation of the state enterprises and resources. In conditions of weak state control the right to provide the private capital an access to the state resources and enterprises appeared in the hands of the state officials. This provoked emergence of large-scale shadow economy and mass corruption in Ukraine.

In spite of the state weakness Ukraine owing to the energy of the new capital managed to overcome the first structural crises of the 90s and demonstrated high rates of economic development. Ukrainian economy appeared capable to overcome the years of acute political instability after the ‘orange’ revolution and to surmount deep global crises of 2007-2009. It is noteworthy that in both cases Ukrainian economy was renovated without real assistance from the state and foreign capital. Phenomenal capability of the Ukrainian business for survival contributed into this result. The Ukrainian business in order to survive traditionally employs shadow economy and corruption. One can clearly trace an algorithm in development of the Ukrainian economy – improvement of conditions for business functioning is automatically accompanied by the reduction of the shadow economy scales.

Omnipresent shadow economy and mass corruption created an informal (personal arrangements) system for regulation of relations between business entities and the business entities and the state parallel to formal (legislation) system of the market regulation.

Existence of formal and informal regulation systems is inherent in regulation of the business activities of any country. In the developed countries the informal system (personal arrangements) in the general sense does not conflict with the formal system (law) and is based on positive business practices, traditions of the administrative culture, ethical norms observed in the society. Shadow personal arrangements are also available, however they are not welcomed and state together with society actively struggle with them.

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<sup>3</sup> [http://www.me.gov.ua/control/uk/publish/article?art\\_id=149793&cat\\_id=36252](http://www.me.gov.ua/control/uk/publish/article?art_id=149793&cat_id=36252)

*Appearance of a huge informal system – a system of informal arrangements of the shadow nature is the Ukrainian phenomenon. The informal system was created under the direct impact of the merge of business and power, propagation of shadow business practices and mass corruption. The formal system in a sense services the needs of the informal system.*

The Ukrainian society accepts the shadow system of personal arrangements as traditional and is tolerant to its manifestations.

#### **4) Stereotypes specifying conduct patterns of business entities**

*Stereotypes may in many respects explain inclination to these or other ways of insolvency problem solution by different business entities involved in this process.* These stereotypes were developed on the basis of socialist past and long period in history when Ukraine did not have its statehood.

The most important stereotypes inherent in the Ukrainian society are as follows.

a. ‘Pro-debtor’ stereotype. It is based on the paternalism typical for the social economy. Until present paternalism of the power manifested itself in relation to the state-owned enterprises. Paternalism in the private sector emerged as a result of the bond of power with business when availability of the patron from the state administration became a decisive condition for successful business.

b. Disrespect to property rights. Disrespect to private property is also inherited from the socialist stereotypes inoculated in the Ukrainian society by terror and brainwashing. On the rebound, this created disrespect to the state property viewed as belonging to no one. Recent Ukrainian history has not fostered positive stereotypes towards private property rights. The primary accumulation process with all its negative moments adds to hostile attitude of the population to ‘oligarchs’. Poorly managed state property is widely used for shadow privatization of incomes by directors and managers.

c. Disrespect to laws. In the history of the socialist Ukraine and in the recent history administrative management mechanisms always prevail over legal regulation. This stereotype is currently supported by the imperfect legislation with its large gaps bridged by ‘manual’ control and corruption mechanisms of decision-making. In fact, laws are servicing a system of informal personal arrangements.

d. Tendency to informal settlement of conflicts, disrespect to state and court. The recent history of Ukraine led to emergence of a powerful informal (personal arrangements) system for regulation of relations within the business and business with the state. This system complies with the shadow economy, which occupies powerful position in Ukraine. Disrespect to state and court is fostered by open merge of the power with large capital and by mass corruption. Moreover, state authorities and courts are ineffective institutions. Official procedures for solving problems are log, costly and uncertain.

#### **Weakness of the state administration system**

As it was already mentioned along with independence after collapse of the USSR Ukraine received a poor system of the economy management. Ukraine had to create statehood and a system for appropriate regulation of business at the same time. Due to lack of appropriate experience, weak national reformatory forces, necessity to stand against forthcoming crises and simply because of time pressure *Ukraine created a system of public administration that proved incapable to effectively perform its functions in the economy.*

a. The state failed to provide a necessary normative and legal framework for regulation of the market economy, in the first place regulation of business activities. There are numerous gaps or poor legal rules that are replaced by ‘manual’ control allowing the state officials to create barriers for business and channels for corruption.

b. There is no special system for management of the state property objects. i.e. effective institutional framework for implementation by the state of its owner’s functions. Ukraine does not yet have a unified state policy for control and development of the state sector. The state is incapable to maintain creditworthiness of its enterprises. The state assets are not protected against shadow privatization through fictitious bankruptcy.

c. The available specialized state authority on bankruptcy provides regulation of business entities insolvency within its functions, responsibilities and established administration system, which is not enough at present. Functions of law and policy formulation as well as system control of the state in this sphere are being lost.

d. Insufficient professional level of state administration staff, crises of positive traditions in the state administration, mass corruption.

### **3. Evaluation of regulatory capacity of Ukrainian legislation on bankruptcy**

Ukraine began to form a system of state regulation of the business entities insolvency along with the process of post-socialist transformation of its economy. The institute of bankruptcy was renovated in Ukraine in 1992 when the first law of Ukraine “On Bankruptcy” was adopted.

The next step in the development of the system of state regulation of the business entities insolvency became the adoption of the Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” (1999). This law is still effective.

Ten years is a too long period to exist without changes in the system of insolvency regulation. The current law was designed for economic conditions of Ukraine in the 90s. Since that time the Ukrainian economy changed enormously together with business entities. Moreover, years of practical application revealed weaknesses in the legal norms and methods of the law enforcement in conditions of Ukraine.

In order to determine ways of further improvement of the regulatory system in the sphere of insolvency it is necessary to make a detailed analysis of the regulatory capacity of the effective law. In contrast to lawyers who focus their attention on the analysis of the procedural efficiency of the law and its application practice, this research aims at analyzing the law efficiency and application mechanisms from the standpoint of the Ukrainian specifics, which cause negative tendencies in the sphere of insolvency, and their adequate reflection in the law.

#### **3.1 The first stage: the Law “On Bankruptcy” (1992)**

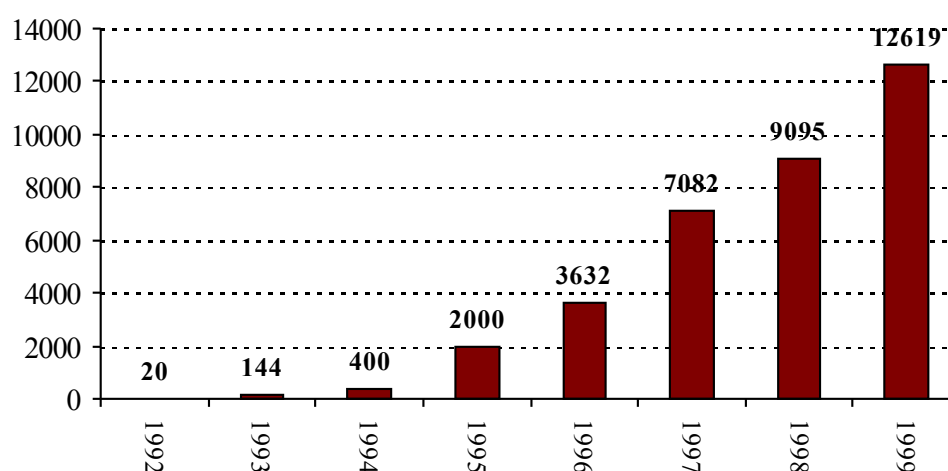
The first law “On Bankruptcy” was developed under the strong influence of the global process of post-socialist transformation of the countries that previously had been the members of the socialist system, and of the particular situation developed in Ukraine after secession. The first moment identified orientation of Ukraine to the standards of the developed countries, the second – to addressing specific problems of the structural crises spreading to the Ukrainian economy.

Particular situation developed in Ukraine in the early 90s specified the following approaches for organization of a system of insolvency regulation:

- Tough ‘pro-credit’ tendency. The crisis was accompanied by a rapid production decline and it was important to confront the growing default crisis. Since state-owned enterprises formed the backbone of the economy, the state by adopting this law made a decision for all debtors. There was not place in the law left for the interests of a specific enterprise in debts.
- Bankruptcy as the priority way of addressing the insolvency problem. The state did not have capacity to support creditworthiness of its enterprises since it had neither financial nor organizational resources. The only way to prevent the threat of economical collapse in this period was to change the ownership category for the state-owned enterprises through privatization and bankruptcy.
- Lack of specialized institutional system. The law does not specify a special state authority and even the main figure of the competition process – the arbitration manager. The reason is in the lack of time and experience in practical regulation under conditions of the market economy, which requires specialized institutional support.

The first law was composed of 22 short articles, which only outline the system of state regulation in the sphere of insolvency. The first three years after adoption of the law the system was not operational because of low procedural capacity and lack of the specialized institutional support. Under conditions of mass insolvency of the state enterprises the official bankruptcy procedure was only applied to small enterprises appeared outside the state sector (Figure 3.1).

**Figure 3.1. The number of the filed cases on bankruptcy in 1992-1999<sup>4</sup>**



As it is seen from Fig. 3.1, burst of activities in filing bankruptcy cases was observed since 1995 and it happened because the bankruptcy was used by different groups of entities for achieving their interests: by state authorities – for achieving their departmental interests, and by the private capital – for implementation of their shadow interest in establishing control for production assets.

Interests of the state tax services. The tax bodies began to widely apply the bankruptcy threat as a tool for pressure on the enterprises indebted to the state budget. For example in 1998-1999 the state tax bodies initiated 70% of all bankruptcy cases<sup>5</sup>.

<sup>4</sup> V.V.Dzhun. Insolvency Institute: the world experience in development and specifics of its establishment in Ukraine. Kyiv: Yuridicheskaya Praktika Publishers', 2006, p.87

<sup>5</sup> B.V.Dzhun. Insolvency Institute: the world experience in development and specifics of its establishment in Ukraine. Kyiv: Yuridicheskaya Praktika Publishers', 2006, p.89

Interests of the private capital. The private capital has found a new way in Ukraine for achieving interests, which is fictitious bankruptcy. The fictitious bankruptcy was used by the private capital as a way of shadow privatization, which provided fast, cheap and noncompetitive method for laying hands on the state-owned property.

Explicit weakness of the Ukrainian regulatory system forced the power to search for the ways of its strengthening. The efforts were made towards solution of insolvency problems of the state enterprises, which were still occupying leading positions in the Ukrainian economy.

In 1996 the Agency on Bankruptcy with a high status of the central body of executive power was established<sup>6</sup>. Its main functions were formation of the state policy and legislation, control for observance of legislation, control for the process of prevention and overcoming insolvency of the state enterprises.

The President of Ukraine and the Government of Ukraine initiated by their decisions creation of conditions for propagation of the methods for turning around the enterprises<sup>7</sup>.

However, segmentary changes failed to produce the desired effect for improvement of the regulation system and in 1994 it was decided to draft new law on bankruptcy.

### **3.2. The second stage: the Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” (1999)**

A period of drafting of new law was considerable extended in time. The law “On Renovation of Debtor’s Creditworthiness or Declaration of Bankruptcy” became effective from January 1, 2000.

The second effective law undoubtedly has advantages over the first law on bankruptcy. It provides a wider procedural framework for implementation of procedures. The law comprises 53 lengthy articles incorporating a large number of legal rules. An attempt was even made for the first time to incorporate specifics of business activities in Ukraine into the design of the system for state regulation of the business entities insolvency.

However, ten years of the second law application clearly demonstrated its low efficiency. It is confirmed in the opinions of the international legal experts. The low efficiency of the bankruptcy procedures was also marked by the annual international ratings. According to the last WB rating “Doing Business 2010”, Ukraine considerably yield to not only developed countries (OECP), but also to the Eastern Europe and Middle Asia (EEMA) countries as to duration and cost of the bankruptcy procedure including also steps in recovering the debt amounts to the benefit of the creditors.

Table 3.1

#### **Comparison of indices that characterize procedural efficiency of bankruptcy**

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<sup>6</sup> Decree of the President of Ukraine of June 17, 1996, No 435/96 “On Creation of the Agency on Prevention of Bankruptcy of Enterprises and Organizations”

<sup>7</sup> Decree of the President of Ukraine of July 8, 1998 No 753/98 “on Additional Measures for Strengthening Efficiency of Applying the Bankruptcy Procedures”, Resolution of the Cabinet of Ministers of Ukraine of August 22, 1996 No 990 “On Agency on Prevention of Bankruptcy of Enterprises and Organizations”

	<b>Time index (years)</b>	<b>Index of expenditure (related to business costs, %)</b>	<b>Index of collection (related to amount of debt, %)</b>
<b>Ukraine</b>	2,9	42	9
<b>OECD</b>	2,9	8	69
<b>EEMA</b>	1,7	13	31

The law has significant procedural gaps but most important is that the actual system of the state regulation of business entities insolvency cannot through this Law either achieve its objectives or perform the tasks it is supposed to solve.

1) *Balance of interests that benefit the debtor*

The legal experts believe that the second law on bankruptcy is ‘pro-creditor’ although if its norms and procedures are scrutinized from perspective of economic interests the bottom line is quite opposite. It is evident that in this Law the traditional for Ukraine ‘pro-debtor’ stereotypes received the upper hand once again:

- The debtor has procedural capacity of procrastinating and even stonewalling insolvency proceedings. It is proved by the fact that court decisions on reorganization or bankruptcy of debtor entities take years and years to result in real action;
- The priority position of the debtor is traditionally displayed by insolvent enterprises in which the state holds more than 25% of all authorized capital (limitations and ban on bankruptcy procedures);
- Debtor enterprises that are considered central for urban economy especially those producing hazardous or strategic products enjoy special perks (state guarantees, possibility of protracting reorganization procedures to 10 years etc).

In other words, the state fails to accomplish one of its major functions: exerting pressure of business so as to coerce it into dutiful exercise of its contract obligations. Advantages granted to debtors by this Law infringe on the key principle of the insolvency regulation area, i.e., ensure that the process of debt collection is imminent, fast and complete.

At the same time if the insolvency issues are brought for their settlement out of court, i.e., without interference of the state the scale of ‘debtors-creditors’ relations tips toward the latter.

2) *Dominating role of liquidation relative to sanitation or selling property before selling the business*

Opposite to the first Law on bankruptcy the second Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” provides the entire spectrum of leverages that can address the insolvency issues faced by business.

The new legislation makes an emphasis primarily on methods of reorganizing potentially viable enterprises by way of their sanitation or restructuring: both through the court proceedings and out of courts deals concluded to solve the debt issues. The Law endows the founders (owners ) and the competent central and local government agencies with the responsibility to timely intervene and take measures to prevent business from bankruptcy. It is expected that all costs

associated with the out-of-court reorganization or restructuring of state owned enterprises will be shouldered by the state budgets.

The Law considers Bankruptcy as an extreme measure that can be taken only if the enterprise is found nonviable and subject to liquidation.

Since early 1990-s Ukraine started developing a normative basis for the timely detection of insolvency cases and helping businesses to restore their solvency<sup>8</sup>. The assistance was to be provided primarily to the public sector enterprises.

Unfortunately, all endeavors of building up the system of keeping ailing businesses afloat and implementing best practices of reorganizing the potentially healthy debtor enterprises went downhill. Even in the public sector, where the state was the principal owner, there is no system that would detect potential bankruptcy at the early stage and help out the debtor enterprises in overcoming their economic hardships.

As to court procedures, the main technique of addressing insolvency problems for businesses remains the bankruptcy. According to the State Department on Bankruptcy Issues, in July 2010, 601 court proceedings regarding bankruptcy were terminated, including 19 through restoration of solvency and 469 (78%) through the bankruptcy (liquidation). This is the typical picture for the last decade.

The limited court practice of implementing solvency restoration tools for potentially healthy businesses can be explained by a number of factors:

First, the court solvency restoration proceeding is unattractive to businesses. It is expensive (corruption “tax”), lengthy and obscure in terms of final results. If the debtor who gets entangled into the court mechanism is the Ukrainian private enterprise more often than not it is doomed. This is true for both liquidation and for any solvency restoration methods. Under liquidation, the property of the debtor is distributed among creditors and under reorganization or restructuring they distribute among themselves the most liquid part of this property.

Second, the private creditors prefer to address indebtedness issues out of court, which is faster, provides better chances of collecting the debt and the possibility of getting control over the debtor’s property in non-competitive ways.

Third, the prevalent use of bankruptcy as a way of addressing the insolvency problem is explained by the commonly adopted practice of getting advantage of court proceedings as a means to achieve murky corporate and private interests:

- The state tax agency keeps to massively implement the danger of imminent bankruptcy as the tool to pressure enterprises indebted to the state budget;
- Due to the imperfections of the standard bankruptcy procedure the state agencies use bankruptcy to liquidate the non-operating enterprises;
- The private businesses recur to the fake bankruptcy as a tool of illegally privatizing the public property; seize the businesses in a raider fashion; eliminate their rivals on the market; evade contract obligations.

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<sup>8</sup> Resolution of the Cabinet of Ministers No 990 dated 22.08.1996 that charged the Bankruptcy Agency with the task of boosting up the training of specialists on issues of financial sanitation of insolvent enterprises; Decree of the Ukrainian President No753 dated 08.07.1998 “On additional measures to improve efficiency of bankruptcy procedures” where the emphasis was made on finding methods of restoring solvency of enterprises; Executive Order of the Ministry of Economy of Ukraine No10 dated 17.01.2001 “On approval of methodic recommendations regarding identification of insolvency and attributes of actions to conceal bankruptcy, faking bankruptcy or driving businesses to bankruptcy”; Executive Order of the Ministry of Economy of Ukraine No14 dated 19.01.2006 that enforced amendments and addenda made to Methodical recommendations.

Fourth, the state as an owner is incapable to perform its functions of preventing and eliminating insolvencies of public sector enterprises. Over the last five years, even the State Property Fund of Ukraine (SPFU) that by virtue of its statute is a specialized agency whose objective is to privatize and manage the public property has *de facto* resigned on its functions of reorganizing public enterprises out of court. These days, 9 large public entities are in the middle of reorganization although these court proceedings date 6 to 8 years and are far from being over.

Predominant use of bankruptcy as the only means to address insolvency of businesses is associated with considerable negative implications for the national economic development:

- Bankruptcy is the most destabilizing factor of addressing insolvency problem. It is rather risky to implement it on a large scale.
- There is a large risk of ousting from the market potentially healthy businesses that could be economically restored.
- The fraudulent and coercive bankruptcy undermines ownership rights, the principal institution of the market economy.

### 3) *Limitations on bankruptcy of public sector enterprises*

Keeping in place the bulky public sector pushes the state into assuming functions of the business owner, which are alien to its nature. As a quasi-owner, the state performs its functions through a specialized system of state administration.

However, up till now no system of managing public sector enterprises was created in Ukraine. In fact, management of these enterprises is performed by numerous state administration agencies, to which these functions are not essential. The 2006 Law “On Administration of Public Sector Enterprises” does not specify for the state agencies any managerial norms and regulations, including the functions of addressing insolvency issues faced by public sector enterprises. More to the point, this legislation does not provide any clear-cut budgeting sources to cover the costs associated with these objectives, nor real financial monitoring procedures nor ways of preventing and overcoming insolvency of public sector enterprises.

These functions, to a certain extent, are performed only by SPFU, which however acts only on a comparatively small section of the public sector. SPFU manages mostly small and medium enterprises that constitute an impressive 81.9% of all public sector enterprises but only 14.8% in terms of their corporate rights. Other state-owned enterprises, including huge stockholder and holding companies are under the jurisdiction of the Cabinet of Ministers and a score of different ministries and departments (18.1% in terms of their number and 85.2% in terms of value). On the other hand, over the last five years SPFU has considerably reduced the scope of its functions related to public sector property administration mostly due to political turmoil and the global economic crisis.

The weakness of the institutional public property administration system makes the public sector overly vulnerable to bankruptcy. To balk this untoward trend, Ukraine started installing barriers to bankruptcies in the public sector. This was all the more simple to do since the society is still lulled by the stereotypes of public property purported advantages. Ukrainian public is too prone to condone any additional protection provided to public enterprises against bankruptcies, especially considering its less than benevolent attitude toward the “oligarchs”, which was strengthened in the political fighting of last few years.

The Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” excluded state enterprises banned to privatization from the category of those who can undergo the

bankruptcy procedures. Besides, the Law instituted a one-year moratorium since the commencement of privatization on any court bankruptcy proceedings against mining enterprises. In November 2001, the special law was passed to prohibit the coercive privatization of property in businesses declared bankrupt if the share of their authorized capital held by the state exceeds 25%<sup>9</sup>.

#### 4) *Large manifestation of misconduct and fictitious bankruptcy*

The Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” does not impose effective barriers to misconduct and fictitious bankruptcy<sup>10</sup>.

The Law provides for four methods of countering the possible influence of informal (shadow) system of interests produced by the private capital:

- Traditional method: introduce administrative limitations and bans on bankruptcy of the public sector enterprises;
- Implement competitive methods of selling property through privatization auctions or tenders;
- Apply such form of reorganization as restitution with regard to contracts or deals that have been entered by debtors with one of the creditors or with another person within six months that preceded the court decision on reorganization and extending them preferential right to collect the debt or to receive their due in property of debtor who leaves the business;
- Set up selective expert evaluation (at the request of the court) of the businesses financial status as apart of the bankruptcy case and prepare findings about any attributes of concealed, fake bankruptcy or driving to bankruptcy with regard to enterprises where the state holds more than 25% of their authorized capital.

However, these norms and regulations produced scarce if any effect on the possibility of preventing shadow processes that encompass the insolvency issues:

First, the Law did not eliminate loopholes in the legislative base that allow alienating some and even all property instead of financial compensation (non-competitive direct sale of property during reorganization; participation of investor in reorganization etc). It leaves the possibility of illegally get hold of the public property through fake bankruptcies and illegally redistribute property of private owners.

Second, the Law restricted jurisdiction of the special state bankruptcy agency in the field of control and fake bankruptcy detection by cases initiated at requests of the court and by enterprises where the state holds more than 25% of the authorized capital. According to statistics of the State Department on Bankruptcy Issues, as of 01.08.2010 their share does not reach even 4% in the total number of enterprises that are subject to bankruptcy procedures.

Third, the administrative and criminal justice system is virtually absent in this area: any damage inflicted on interests of those engaged in insolvency litigations in this area goes unpunished. Special state agency on bankruptcy issues, public prosecutor's office and court do not control and track insolvency issues on a systematic basis. The cases of initiating court proceedings on these grounds are extremely rare.

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<sup>9</sup> Law of Ukraine No 2864-III dated 29.11.2001 “On introduction of moratorium on coercive privatization of property”

<sup>10</sup> <http://www.zahvat.net/pravozaschitniki/1098/1099/>

Besides, the Law has introduced a new player into the process of settling insolvency issues among businesses: the arbitration manager. The structure of the Law and real practice creates for him potential possibilities of transforming into the active participant of shadowy insolvency settlements.

On one hand, the very status of the arbitration managers is associated with the conflict of interests. This is an entrepreneur, i.e. a person who does business in order to obtain profit. This is also a person who receives broad functions and powers in the competitive process as the representative of somebody else's property interest.

On the other hand, the fees this person is entitled to pushes him or her into the search for additional (illegal) income sources. The Law sets up a low level of monthly: not higher than the monthly average for the last 12 months (that is under conditions of crisis). The level of salaries paid to arbitration managers is determined by the creditors' committee (in real life, the "black" salary funds are created). Arbitration manager plays a key role in deciding how to dispose of the debtor's property.

This law and real practice have created a far too lenient accessibility and responsibility system for arbitration managers. As a matter of fact, anybody with a higher legal or economic education can be considered as having necessary qualification to become an arbitration manager. The job requirements do not take into account the nature of arbitration manager work that is to substitute the debtor's managerial bodies and perform financial and economical reorganization of debtor's ailing business. As to occupational limitations they are minimal: the candidate should not have any vested interests in debtor and creditors (which is easy to conceal) and should be admitted to hold this or any other managerial position.

Special training is a formality and does not ensure the sufficient professional qualification for the job. Today, 14 colleges are certified for to perform this training. Professional training is usually performed as 5-day introduction courses: basics and concept of anti-crisis management; legal basics of anti-crisis management; economic basics of anti-crisis management; business planning, building up competitive advantages and financial sanitation; anti-crisis management.

The organization of the training system does not ensure that the newly acquired knowledge will be independently and fairly assessed. The candidates pay the fee for training courses out of their own pocket; there are no official requirements to those who sit in the examination committees.

The conditions of issuing licenses to this critical type of activity are formal and overly simplified. To be granted the license the candidate has to submit a copy of his/her diploma of the higher legal or economic education and the certificate of the training courses. The cost of the license is that of one minimum wage. The easiness with which a candidate can pass this procedure proves that the choice of this occupation cannot be serious. Today, the register of the State Department on Bankruptcy Issues, which is a licensing agency, includes 2,684 arbitration managers.

Table 3.2

**Summarized information about arbitration manager licenses<sup>11</sup>**

<b>Index</b>	<b>2008</b>	<b>2009</b>
Applications considered	366	697

<sup>11</sup> <http://www.sdb.gov.ua/>

Licenses issued	340	673
Licenses re-issued	23	22
Copies issues	3	2
Total licenses by end year	2,264	2,684

The organization of arbitration managers' professional activities does not include control mechanisms nor does it impose responsibility for results:

- There is no state agency that would systematically supervise the arbitration managers' professional activities;
- The insurance of risks borne by arbitration managers that is introduced by this Law has not as yet been implemented, meaning that the latter are not held liable for any damages they may inflict on the involved parties: debtor and creditors;
- The control system does not foresee the mechanism of professional supervision by the self-regulatory organization similar to the lawyer organization;
- No transparency requirements are set forth to arbitration managers.

*Therefore, it can be concluded that the Ukrainian legislation include provisions that in practice not only generate for arbitration managers stimuli to seek illegal income sources but also provide them with possibilities of illegally obtain such income. The access to professional activities is comparatively low efficient. This is confirmed by a rather numerous examples of poor management.*

#### 5) *Low efficiency of the state in performing its functions*

In the area of insolvency, the state in Ukraine ought to perform several functions: a) to devise state policies and legislation; b) to support implementation of state policies; c) to perform systematic control; d) to be the owner of the debtor's enterprise.

Let's scrutinize the above functions that are envisaged by current laws:

The Ministry of Economy of Ukraine formulates state policies and legislation;

The State Department on Bankruptcy Issues, the subdivision of the Ministry of Economy of Ukraine, performs functions of a special state administration agency on bankruptcy issues. Its job is to support implementation of state policies; perform functions of the licensing body; execute some supervisory functions with regard to businesses where the share of the state in authorized capital exceeds 25% (issue findings at court's requests) and arbitration managers (verify their professional activities). The public prosecutor's office and court perform selective control and initiate court proceedings;

SPFU and the executive agencies are the bodies that are charged with responsibility of administering the public sector enterprises.

According to the Ukrainian Constitution, the Ministry of Economy has to develop economic policies on the whole and in particular areas. However, this function is traditionally performed by line ministries and committees, in their respective jurisdictions. For example, SPFU acts in the area of privatization and administration of the public sector enterprises, Ministry of Fuel and Energy in its jurisdiction etc. The State Department on Bankruptcy Issues revealed its incapacity of successfully performing all these functions and as a result lost them to other players.

The functions that the State Department on Bankruptcy Issues is supposed to accomplish conceal an inherent conflict of interests: the Department plays the role of a state regulator in the area of insolvency; it performs several functions of a state as the owner of businesses and, at the same time, the functions of the Ministry of Economy of Ukraine as the state administration body that is empowered with administration of appropriate public sector enterprises.

As it was mentioned above the existing institutional system of public property administration cannot exercise its functions in area of insolvency. In this sense SPFU has only a small advantage.

The existing Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” does not compensate for the absence of legal norms that must regulate the functions of the state as the owner of insolvent enterprises. It incorporates only two fragmentary positions:

- Among the debtor owners, it outlines the agencies that are responsible for administration of the public property;
- It establishes the mandatory procedure of coordinating the reorganization and restructuring of enterprises where the state holds more than 50% of the authorized capital with agencies responsible for administration the public property.

Public prosecutor’s office and court are not engaged in systematic supervision of main process players: debtors, creditors and arbitration managers to track down their bad faith behavior. If they do, these are one-off episodes that do not create an efficient system to oppose the fake and deliberated bankruptcy.

Table 3.3

**Functions and powers of the state agencies on bankruptcy issues that have been historically established in Ukraine**

<b>Functions and powers of the state agency on bankruptcy</b>	<b>executive agencies</b>	<b>self-sustained organizations</b>	<b>one of Ministry of Economy departments</b>
<b>1. State policies in area of restoring insolvency and bankruptcy</b>			
Summarize good practices; develop suggestions on how to improve legislation			
Compliance control			
Develop state policies (program) on bankruptcy prevention			
Implement the state policies (program) on bankruptcy prevention			
Prepare proposals on the state investment policies			
Create organizational, economic and other conditions for implementing insolvency restoration or bankruptcy procedures			
Methodological support of bankruptcy issues			

Prepare drafts of standardized documents for the Ministry of Economy			
Have the right to represent the Cabinet of Ministers at its request in international organizations and to enter into international treaties			
Have the right to receive free of charge information, data and documents			
Have the right to hold liable the heads of the Agency territorial branches, chiefs of enterprises			
Decisions of the Agency within its jurisdiction are mandatory for executive agencies, local governments and businesses of any ownership type			
<b>2. Regarding enterprises</b>			
To compile and maintain the register of bankrupt businesses			
<i>With regard to enterprises the state holds more than 25% of all authorized capital:</i>			
To analyze the financial status; identify insolvent enterprises			
Enter these enterprises to the insolvency register			
Evaluate the financial status of enterprises following the decision of court			
If requested, prepare findings about any available attributes of the concealed, fake bankruptcy or driving to bankruptcy			
Develop proposals on out-of-court reorganization; coordinate between investors and creditors on their respective participation in reorganization			
Prepare proposals regarding the sell of some property as part of reorganization or all property as part of liquidation			
Manage works on attracting investors to finance restructuring and reorganization measures			
Ensure functioning of the Stabilization Fund			
Ensure implementation of the antimonopoly policies			
Hold tenders to attract investors			
Prepare findings for the Ministry of Economy on financing measures under the out-of-court reorganization plan, from the state funds			
Develop proposals on creation of new employments, social protection and upgrading of employees that loose their jobs following restructuring and			

reorganization			
Monitor the procedure compliance			
<i>Regarding enterprises that are entered into insolvency registers:</i>			
Maintain the register			
Manage the property			
Approve and control implementation of business plans on restructuring and reorganization			
Perform restructuring and reorganization			
Enter and terminate labor contracts with managers			
Prepare privatization proposals			
Control due diligence in using funds appropriated for restructuring and reorganization			
<b>3. Regarding procedures</b>			
Ensure conditions of compliance regardless of ownership types			
Ensure compliance by an absent debtor			
Play the role of a player in arbitration proceedings regarding bankruptcy and delegate employees to the liquidation committee			
Suggest to the court candidates for position of arbitration managers (property managers, reorganization administrators and liquidators) for enterprises where the state holds more than 25% of all authorized capital			
Manage the Ministry of Economy committees on preparation of suggestions to the court regarding candidates for position of arbitration managers (for enterprises where the state holds more than 25% of all authorized capital)			
Develop draft version of standardized documents			
Issue bankruptcy certificates			
<b>4. Regarding arbitration managers</b>			
Organize professional training			
Build educational and methodological basis for professional training			
License the specialists			
Monitor payments made to the arbitration managers supervisors to eliminate their salary backlogs			
At the request of the Ministry of Economy prepare			

findings regarding the arbitration managers' compliance in area of bankruptcy legislation			
<b>5. Administration of property belonging to enterprises that are under Ministry of Economy jurisdiction</b>			

*The above analysis showed that the Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” and the practice of its implementation fall short of ensuring the efficient institutional support of all state functions in the area of insolvency.*

### **Conclusions**

Conclusion: the analysis of the Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” and the practice of its implementation taking into account the Ukrainian specifics has shown that the state regulatory system fails to create efficient mechanisms that would counter negative manifestations of these specifics and fails to perform additional functions that emerge due to these specifics, through required tools.

Table 3.4

### **Comparison between objectives and tasks that should be and are accomplished by the Ukrainian insolvency regulator system**

<b>Theoretical</b>	<b>Real</b>
<b>Objectives</b>	
Ensure stability and growth of production efficiency	Achieve internal objectives of state agencies and promote shadowy interests of the private business
Imminence of debt collection	‘Pro-debtor’ policies do not ensure imminence of debt collection
<b>Tasks</b>	
Support of efficient businesses	The scope of tools used to restore efficiency of viable businesses is extremely restricted
Liquidate inefficient owners and productions	Legislation and practice provide debtors with immunity, which complicates liquidation of inefficient owners and productions
Preempt misconduct and fictitious bankruptcy	There are no efficient barriers against influence that shadowy interests produce of decision making process

As a result, notwithstanding the deep revamping of procedural norms the current Law does not meet the objective of the state regulation system in the area of business insolvency: the imminence of debt collection through means that would contribute to steady economic growth and efficiency and would not affect critical national interests. The Table 3.4 includes summarized conclusions that the report authors have drawn on the basis of their analysis.

The following sections contain recommendations on the ways that can be used to improve legislation and practices of the national regulatory policies in the area of insolvency. Keeping in mind the analysis results the ways of reforming regulatory system were chosen that would directly correlate with specifics of entrepreneurship in Ukraine. These recommendations outline general approaches that must underpin the appropriate legislation norms on insolvency and bankruptcy.

#### **4. Recommendations: optimal balance of creditor and debtor interests**

One of the principal reasons why the Ukrainian Law “On Restoring the Debtor’s Solvency or Declaring it a Bankruptcy” is inefficient is that it is pro-debtor by its nature. By the end of the day it resulted in the “pro-debtor” nature of the actual insolvency regulatory system that has evolved in Ukraine as this Law was implemented.

The ‘pro-debtor’ regime has sharply undermined the efficiency of the regulatory system, since the priority given to debtors has transmuted in a sort of “arterial thrombus” that blocks the cash and asset flow in the Ukrainian economy.

During the analysis of experience collected in countries from all over the world the main emphasis was made on the following issues:

- identify factors that in different countries determined the choice of one or another debtor vs. creditor balance of interests (‘pro-creditor’ or ‘pro-debtor’ regulatory regime);
- determine the impact that the regulatory regime produced on the national development (economic and social protection);
- identify methods of achieving the optimum balance of creditors and debtors interests (from perspective of its possible application in Ukraine).

#### **World experience**

The experience of different countries shows that the options of finding the balance between creditor and debtor interests are numerous. According to some analysts, there are at least 5 regimes of building up the regulatory system<sup>12</sup>:

- mostly “pro-creditor”;
- mostly “pro-debtor”;
- moderately “pro-creditor”;
- moderately “pro-debtor”;
- neutral

The extreme regimes aim at the totally opposed targets: the pro-debtor” regime prioritize the social targets (cushioning the bankruptcy for debtors and general public, sometimes at the expense of creditors), the “pro-creditor” seeks imminence of debt collection (by totally eliminating debtors from the insolvency processes and playing in hands of creditors).

Different countries may choose combinations of the objectives that they pursue in order to solve the debtors’ insolvency problems, and correspondingly embrace one of the above regimes.

#### *“Pro-debtor” regime*

<sup>12</sup> V.V.Dzhun. Insolvency Institute: the world experience in development and specifics of its establishment in Ukraine. Kyiv: Yuridicheskaya Praktika Publishers’, 2006, p.25

France where the socialists are rationally quite strong adopted the clear-cut “pro-debtor” insolvency solving regime. The prevailing practice in this country is to reorganize debtor businesses at any cost. Since society in France considers the social stability as its highest priority the bankruptcy, which is inevitably accompanied by the business liquidation and imminent mass layoffs is not welcome.

Contrary to France, in USA the priority is to observe personal responsibility in everything: from private life to business, and nonetheless this country also implements “pro-debtor” regime when solving insolvency issues. However, in this case it is driven by other objectives than in France. In its economic policies, the centerpiece place is attributed to creating conditions of sustainable economic development. That is why the unquestionable priority in solving business insolvency is given to maintaining the debtor (business) economic vitality, sometimes at the expense of infringing the interests of creditors. In the United States, the mandatory initial procedure is to reorganize the debtor business. Bankruptcy is viewed as an extreme measure.

#### *Rigid “pro-creditor” regime*

Among developed countries the most rigid “pro-credit” regime in the insolvency area is adopted in Germany. Here, the legislation is very tough to debtors. All court proceedings start from reorganization and reorganization has no advantages as opposed to bankruptcy. In Germany, the bankruptcy is supposed to perform its “sanitary” role, i.e., clean the market of all inefficient owners and businesses. Possibly this is the consequence of the historical background: reunion of the FRD and the former socialist GDR, whose economy was comparatively inefficient and had to be immediately reformed.

#### *The well-balanced regime*

In Great Britain the regime of addressing insolvency relies on a more balanced ratio of debtor and creditor interests. The stability of economy is achieved without implementing any radical methods, mostly by satisfying the interests of all businesses concerned. This is why the British legislation protects the debtors, on one hand and preserves the creditors’ interests, on the other hand. To achieve this, the bankruptcy cases are resolved through a special method where priority is given to sell entire property (business) not in piece meal fashion.

#### *Adjustment regime and efficiency of economy*

The analysts have revealed the consequential relation between the following determinant factors: “quality of national insolvency legislation – competitiveness level of national operators on transnational markets – macroeconomic indices of the national production”<sup>13</sup>.

In other words, there is a well-defined dependence between the efficiency of the national bankruptcy regime and dynamic/ progressive restructuring of the national economic systems. “Pro-debtor” regime that prioritizes debtors restricts participation of creditors and, inevitably, leads to increased price of credit. Without pressure of imminent bankruptcy, the capital loses motivation and the national economy forfeits its economic impetus.

In most cases the “pro-debtor” regime is implemented in countries that are characterized by robust social priorities. However, practical application of this regime in France runs into strong criticism. Socialization of economic policies is considered to be the main reason of the French economy weaknesses.

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<sup>13</sup> V.V.Dzhun. Insolvency Institute: the world experience in development and specifics of its establishment in Ukraine. Kyiv: Yuridicheskaya Praktika Publishers’, 2006, p.26

The unprecedented example in the world practices is the use of “pro-debtor” regime in the USA, whose economy still displays forceful dynamism. This however can be explained by the fact that the “pro-debtor” regime here has historically evolved not to achieve social targets, as was the case of other countries, but to exercise the functions of the state to achieve the sustainable and dynamic growth of the national economy. Support that business receives from the state when facing a financial predicament helps to reduce the timeframe it needs to get reorganized and even to forestall production interruptions. What is more important, superiority of the ownership rights, imminence of debt collection and free competition ensure that promotion of debtor rights does not interfere with the national economic growth.

Opposite to the “pro-debtor” regime the “pro-creditor” insolvency regime exercises powerful pressure on debtors through the debt collection mechanism that may include liquidation. This can be considered as an impediment to economic development since the business always faces the danger of being squeezed out of the market through bankruptcy.

### ***Conclusions***

The analysis of the global experience leads to the following conclusions that can be used for striking a balance between debtor and creditor interests in the Ukrainian regulatory system:

- the insolvency regulatory system is one of the important factors that impacts the efficiency of the national economy;
- “pro-creditor” regulatory system creates pressure on debtors and undermines economic growth stimuli;
- “pro-debtor” regime is associated with risks of disrupting economic growth but is the important element of preserving economic and social stability in the country;
- the real balance of creditors and debtor interests must reflect the cognizant choice of social targets among the entire set of national priorities.

### **Recommendations for Ukraine**

Over the last few years, the national priorities that must be taken into consideration when building up the insolvency regulatory system in Ukraine have been affected by the lingering political instability and global crises accompanied by the abrupt downfall of production and considerable financial losses for the public. The economic policy today necessitates two strategic goals: search for reserves of restoring the economic growth and ensure stability of business and society.

Along with the above factors it should be borne in mind that the Ukrainian society is still strongly influenced by traditional stereotypes: biased attitude to creditors, sympathy with debtors and condoning perquisites for some categories of debtors, which are difficult to abolish.

Therefore, improvements of the insolvency regulatory system in Ukraine must be implemented through achievement of the following mutually exclusive objectives:

- ensure stimuli of economic development by taking into account as much as possible the creditors’ interests;
- not to provoke instability in the economy and social life by safeguarding the debtors’ interests.

*Based on the global experience and taking into account the specifics of doing business in Ukraine it appears that the balance between debtor and creditor’s interests can be best achieved by implementing the following approaches.*

- 1) The objective of safeguarding creditors' interests must be reflected in all legislative norms and in real practice: the principle of imminent debt collection in due time and to fullest extent possible must be rigorously observed.
- 2) The existing legislation must be as much as possible be purged of debtors' prerequisites that run counter to the above principle of imminent debt collection.
- 3) The purge of prerequisites for indebted public sector enterprises must be synchronized with the process of creating the efficient public sector regulatory system. Otherwise, it can lead to negative trends, in particular, surge of the shadow privatization.
- 4) If it is necessary to preserve special bankruptcy procedures for some enterprises or to implement other special regimes such procedures and regimes will not interfere with the overall process nor impact the amount of debt collection nor infringe on the general principle of its imminence. In these cases the liability toward creditors will rest on persons who benefit of such special regimes and procedures.

The above however does not imply that the legislation should be totally free of immunities for the debtor's rights and interests. We believe that the current law should be amended to strengthen the positions of the debtor, strike the balance between the creditor and debtor interests and, by the end of the day, make the rational choice of the ways to address the insolvency problem. Today, the creditors push the debtors into bankruptcy and in case of reorganization or restructuring into selling their property.

We would like once again emphasize that imminence, timeliness and completeness of debt collection are the "sacred" principles, which must underpin the entire structure of the new insolvency and bankruptcy legislation.

## **5. Recommendations: how to select methods of addressing insolvency problems**

Over their historical development different countries embraced different methods of addressing the insolvency problem. These include voluntary settlement, restoration (or if the accepted terms to be used: reorganization) of business capabilities in from of sanitation or restructuring, and the bankruptcy (liquidation).

All of these methods are applied in two major ways: out of court and through court proceedings. In developed countries the state regulatory system comprises not only court proceedings but also out-of-court settlements.

In the Ukrainian legal practices the methods that are applied remain rather scarce: this is usually the bankruptcy meaning liquidation of the debtor's enterprise. The measures of supporting potentially viable businesses are used rarely. The out-of-court settlements are typical for self-regulating regime, i.e., for businesses who address this issue between themselves, more often than not though murky and criminally tainted deals.

The analysis of the global experience must focus predominantly the aspects that if accounted for will help identification for Ukraine of the ways to support potentially viable businesses and to democratize the solvency restoration regime (out of court), in particular:

- The ratio between solvency restoration methods that has historically emerged in developed countries and in Russia;
- The insolvency regulatory systems that are not broadly used in Ukraine: identification, prevention and sanitation of debtor enterprises;

- The out-of-court settlement practices.

### **The global experience**

Historically, the insolvency regulation systems in developed countries have evolved as a means of punishment. Over years the regulations system has dramatically changed. Along with ensuring the imminence of debt collection its objectives now include sustainability and dynamism of economic development. The ways of solving conflicts between debtors and creditors also became more subtle.

These days, the debtor's actions are based predominantly of voluntary acknowledgement of his/her insolvency and the ways of solving this problem are selected by finding a balance of debtor and creditor interests. The entire system of the legal regulation, state administration and business traditions creates the situation where debtor is better off by volunteering into procedure of financial recovery or bankruptcy.

This change in business relations raised the popularity of solving insolvency problems out of court. That is why in developed countries the out-of court settlement of insolvency developed into a quite specific system. In terms of its impacts on debtor and creditor it is completely identical to the court procedure.

If the insolvency cases are brought to the court it usually leads to the following: a) the business insolvency status becomes legal; b) the conflict between creditor and debtor is solved, c) any criminal misdoings in bankruptcy procedures are legally persecuted. In the countries of Western Europe about 75% of all cases involving the potentially insolvent enterprises end up bankruptcy issue solved out of court and only 15% of such cases go to court.

In the last few years, the early detection of insolvency became a predominant method in the developed countries. The out-of-court settlement includes a number of special out-of-court warning procedures<sup>14</sup>. These procedures can be initiated by debtors, creditors and by state agencies that are responsible for registration and monitoring of legal entities. In many countries, these procedures can be launched even without legal identification of insolvency. All it takes for all concerned parties is to feel anxious about economic and financial status of the business in question.

The practice of developed countries includes different options of informing interested parties of any problems in enterprises that are potential bankrupts. But in all countries this is an obligation of the enterprise/ business manager who can be otherwise held liable in administrative or in some cases in criminal court.

In the system of the state insolvency regulation the advantage is given to out-of-court warning and insolvency recovery methods. Such countries as Australia, Austria, Great Britain, Ireland, Spain, Singapore and Japan implement rather lenient, voluntary forms of the out-of-court reorganization or liquidation. Canada, Italy, France, New Zealand and the USA lean toward more forceful, coercive out-of-court insolvency regulation methods.

### Great Britain

Great Britain is characterized by a broad application of the out-of-court insolvency settlement procedures, which are voluntary to all parties concerned. In general, the voluntary acknowledgement of insolvency is typical for countries with common (precedent) law system, such as Great Britain. In these countries, about 60% of all bankruptcies are implemented by

<sup>14</sup> [http://revolution.allbest.ru/bank/00031561\\_0.html](http://revolution.allbest.ru/bank/00031561_0.html)

creditors reaching a decision about liquidation of the debtor enterprise according to its articles of association.

In Great Britain, the out-of-court settlement procedures regarding organization of debtor businesses are called the “rescue culture”. This term denotes the general tonality of measures that are applied for these purposes. Although these measures can widely vary they all fit within the scope of the common civil and corporate legislation and have an objective of relieving in the shortest terms possible the bankruptcy risk from a business and keep it afloat.

According to the British law the voluntary liquidation of enterprises by decisions reached by creditors can occur in a case if it was positively voted by the majority of stockholders (at least 75%) and this decision was supported by the findings of the court. Although this norm allows the owner of the debtor enterprise to participate in the process of selecting the ways of addressing insolvency it does not limit the interests of creditors. Any creditor who disagrees with the stockholders’ decision can file suite and insist on accepting additional reasons for the coercive liquidation of the debtor. Such reasons may include, among others, the suspicion that the audit of the debtor was carried out improperly.

It should be noted that the out-of-court acknowledgment of insolvency and coercive liquidation by the court decision are identical by their structure and protect the creditors’ rights to the same extent.

Remarkably, in Great Britain, banks can perform some functions of the bankruptcy agency concerning court proceedings. Any British bank that concludes on insolvency of its client can appoint for the debtor an administrator or auditor whose fee will be paid by the debtor. The auditor will issue to the bank a report not only on the debtor’s financial status but also on the competence of its management. The bank cannot liquidate the debtor business but can initiate its restructuring under agreement with its stockholders.

### France

France has specific bankruptcy prevention legislation and well-developed pretrial precautions.

Legislative enactments stipulate various pretrial precautions intended to timely reveal difficulties at the enterprises and to prevent the deterioration of situation with the following measures to be taken for this purpose:

- 1) To improve accounting and financial reporting that is of certain importance (particularly evaluation data) for legal entities.
- 2) To increase shareholders’ control of chief officers by developing written questions.
- 3) To expand authority.
- 4) To create groups for taking preventive measures.

The groups shall be approved by a regional state representative. They may have different legal entity forms and are usually composed of accounting organizations, Chamber of Commerce or professional organizations. Individuals may not be members of the groups. The main task of the groups is to analyze accounting and financial information on a confidential basis.

- 5) To introduce alerting procedures to be carried out by:

- the auditor if he in the process of work has detected factors that may have an adverse effect on the continuation of the enterprise’s activities. The specific procedure is stipulated by

the Law on Incorporated Enterprises (4 stages).

- the companies' shareholders who may put written questions to the Chairman of the Board of Directors (the latter should give the answer within one month and to provide the auditor with the copies of questions and answers); or by the members of limited liability companies who may put their questions only to the Managing Director.
- organizations represented by employees.
- the Chairman of the Commercial Court authorized to make investigation.

6) To grant the special mandate. The Chairman of the Commercial Court may appoint a special agent for providing assistance to the Director of the distressed enterprise.

7) To employ the conciliation procedure. The procedure allows the debtor to negotiate with his creditors under supervision of the agent appointed by the Chairman of the Court. This procedure is not binding and may be optionally confidential.

In specific cases (when the enterprise is under reorganization) the decision to issue the additional stocks may be taken. Such plan of restoring the enterprise's health may be accepted if there is a chance for it to continue its activity. This is the way to achieve the introduction of the supplementary capital by the company's members or outside investors in order to cover losses and restore or even increase the net equity.

The court competence (jurisdiction) is to take decision on introducing amendments to the company's articles of association required for continuation of its activities at the expense of supplementary issue of stocks. Subject to the court decision, the competitive manager shall be permitted to convene general shareholders' meeting for the purpose of introducing amendments to the articles of association.

This method is considered by specialists as one of the most efficient and quick ways of accumulating financial resources for restoring health of the insolvent enterprise.

### Germany

Germany has no specific legislation and official pretrial precautions for the insolvency (bankruptcy) prevention. The only comparable institute is the insolvency courts and the powers of the previous competitive managers in the period between submitting the declaration of insolvency and the official initiation of the bankruptcy procedure. In Germany the executive authorities shall not participate in pretrial precautions.

However, Germany has a large set of rules related to the civil and corporate legislation, which implement various preventive measures. These measures are intended to reveal insolvency problems at the early stage and to prevent their progress.

These preventive measures are embodied in:

- the harsh accounting legislation that introduces the obligatory procedure for regular audit of balance sheets for large legal entities;
- special notification system. If the enterprise loses up to 50% of his equity capital, then the Managing Director or the Board should notify the company's members (shareholders) thereof and shall bear personal liability therefore. Along with this, the Managing Director or the Board shall be obliged to submit the declaration of insolvency to the court if the excess indebtedness or incapability to effect payments appears.

Mostly, the extrajudicial measures are used by banks. The two-week delay in the loan repayment affords grounds for breaching the loan agreement and imposing penalties on the client. To resolve the insolvency problem, the banks use all opportunities provided by the terms and conditions of the loan agreement, i.e. seizure of the client's accounts, securities and valuables deposited with bank; sale of goods acting as a loan security. Nevertheless, all claims for the debtor's real property may be allowed by the bank only under court decision.

The banks assess financial standing of the enterprise-debtor. If the enterprise's insolvency affects the interests of several banks, then, to solve the debtor's problem, the banks' pool (Creditors' Committee) shall be created. The Creditors' Committee shall take a complex of prompt steps aimed at the increase of the enterprise liquidity.

#### Italy<sup>15</sup> \_

The insolvency legislation of Italy notably limits the possibility of applying the extrajudicial measures to resolve the problem of the enterprise insolvency.

The insolvency status is considered as an objective condition for declaring the debtor a bankrupt. The Law stipulates that the bankrupt status should be assigned by the eligible court when the debtor insolvency in the market becomes apparent.

The Italic legislation does not contain the requirement regarding the obligatory recognition by the court of accounts payable when initiating the bankruptcy procedure. The insolvency status has to be confirmed by the non-performance of contractual obligations or any other externalities, which evidence that the debtor is unable to repay the loan or to fulfill his obligations.

The insolvency status has to be apparent. The legislation identifies the following as the bankruptcy evidence: the company dissolution, material decrease in the company's assets, the entrepreneur's suicide as well as the fraud against the company and the sale of the company's property. However, if the banks and the creditors do not see any threat to the entrepreneur's financial position, such insolvency evidence shall not be taken into consideration.

In case if insolvency occurs due to the material and unlawful decrease in the entrepreneur's assets, the public prosecutor should appeal to the eligible court with the submission on declaring by the latter the entrepreneur's bankruptcy. As for the debtor's initiative, the law stipulates that the entrepreneur may file petition to the court to declare him a bankrupt.

Failure to collect debts by the creditors by means of the ordinary procedure for the execution of the court judgment is not a prerequisite for the initiation of the bankruptcy court procedure. The right of initiative belongs to the creditors, the debtor and the public prosecutor as well as to the court in the process of reviewing the commercial claim.

In a certain sense, the cases when the debtor enters into the special agreement with the creditors to prevent bankruptcy may be considered as an example of the extrajudicial procedure for resolving the insolvency problem. Pursuant to this agreement, the creditors shall express their intentions to reduce the debtors' obligations or the amount of his debt.

Such special agreement should be brought to the court. Only the court is authorized to take the final decision whether to declare the debtor a bankrupt or not.

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<sup>15</sup> [http://www.securities.org.ua/securities\\_paper/review.php?id=524&pub=3666](http://www.securities.org.ua/securities_paper/review.php?id=524&pub=3666)

## Russia

The applicable Law “On Insolvency (Bankruptcy)” contains the special Chapter II “Prevention of Bankruptcy”. It describes the rules that regulate actions of those who are obliged to take bankruptcy prevention measures (founders or owners) and those who may assist therein (creditors, outside investors).

The preventive measures include:

- 1) Extrajudicial caution – if the bankruptcy evidence occurs, the chief officer of the debtor is obliged to notify the founders (owners) thereof.
- 2) Pretrial recovery – is a financial support in the amount enough to repay monetary obligations and compulsory payments and to restore the debtor’s solvency.

Financial assistance shall be rendered in various forms, i.e. as:

- loans;
- a surety or a bank guarantee;
- deferred payments;
- waiver or assignment of debt; and
- through selling a part of assets.

In Russia there is established the Government Commission on the Bankruptcy of Strategic Enterprises and Organizations and Defense Industry Organizations. This is a permanent body set up to coordinate the efforts of federal bodies of executive authority in preventing the bankruptcy of the enterprises listed above.

The Commission has the following main responsibilities regarding strategic enterprises and defense industry organizations: a) to take decisions that the claims for the repayment of debts and petitions for the declaration of the insolvent enterprises bankrupts should be presented to the arbitration court; b) to elaborate and agree measures to prevent the bankruptcy of distressed enterprises.

As assessed by analytics, the system of preventing bankruptcy in Russia is legally incapable. Provisions of the Law on Insolvency (Bankruptcy) only specify the lines of actions. Other regulatory laws, in particular, the Law on Accounting and the Corporate Law, do not reflect the required rules as well. But the main reason of incompetence of the bankruptcy prevention policy is the absence of the specific system of responsibility for failure to take preventive measures stipulated by the law.

The bankruptcy still remains a dominant way of resolving the insolvency problem in Russia. One of the reasons thereof is the use of bankruptcy as a lower-cost method of taking over the corporate control. The bankruptcy acts as an alternative for buying up the stocks in the secondary market and is a no-lose way of property redistribution for an aggressor.

The structure of the Russian Law “On Insolvency (Bankruptcy)”, as emphasized by Russian analytics, is developed in a way to “kill” a business entity. It presents a procedure for the enterprise liquidation and redistribution of the debtor’s property among creditors.

## ***Conclusions***

The following conclusions from the world experience analysis are of special importance for choosing the lines of optimizing different ways of resolving insolvency problems in Ukraine:

- the Ukrainian and Russian systems in the sphere of insolvency regulation are very much alike but cardinally differ from the regulatory systems applied in the developed countries. Therefore, it is necessary to be quite careful with the “mechanical” importing the experience from the developed countries, to follow the principle of conformity with real conditions and, at the same time, to orient to the global liberal standards;
- the world practice expressly shows the historical tendency in the regulatory systems development: a) from punishing systems aimed against the debtor to the systems for saving business on conditions set forth by the debtor and creditors; b) from the practice of resolving the problem of a particular debtor to the creation of national systems for supporting the business entities solvency within the economic system of the country;
- in the developed countries all punishing functions as to enterprises-debtors are minimized, and the enterprises liquidation is an exceptional measure usually used in case of criminal violations;
- in many of the countries the bankruptcy is applied in the context of restoring the solvency. The enterprises-debtors improve their financial standing by using special regime of repayment under obligations with business and owners being retained.
- the function of early insolvency detection based on the debtor’s voluntary consent and prevailing application of extrajudicial procedures is dominant within the regulatory system of developed countries;
- legal proceedings are mostly connected with such moments as the necessity of the insolvency legalization, settlement of disputes between a debtor and creditors, and criminal violations.

### **Recommendations for Ukraine**

Likeness of Ukrainian and Russian regulatory systems in the field of business entities insolvency as well as their cardinal difference from the models used in the developed countries raised the natural question regarding the objective reasons thereof.

The difference between regulatory systems of the emerging and developed countries is in full conformity with objective differences between the development level of market economy and general system of state regulation in these countries as well as with the distinction between their civilization levels.

But the deepness of these differences gives an indirect evidence of being late with the reformation. So, the main task of the next stage of the reformation of the insolvency regulation system in Ukraine is to reorganize it in the context of historical transformation of regulatory systems observed during last decades. Undoubtedly, it is necessary to identify, which stage of transformation would be optimal for the Ukrainian regulatory system.

Key directions of improving the ways of resolving the insolvency problem for business entities in Ukraine include the following:

a) The legislation should provide a legal basis for the creation of the national solvency support system for business entities. And only within this system it would be reasonable to determine the lines of improving some ways of resolving the insolvency problem.

b) It would be logical to create a separate regulatory sub-system of preventive and extrajudicial procedures for restoring the state-owned enterprises' health. The sub-system may be established on the basis of the institutional management system for state ownership objects and perform the following functions, i.e. it may:

- continuously monitor the enterprises financial and economic state with the purpose of early detection of insolvency;
- implement preventive procedures that include a real system of chief officers' responsibility for violation thereof;
- carry out pretrial recovery and restructuring procedures and timely transfer the enterprises threatened by insolvency prior to their privatization.

To make such system real, it is necessary to determine financial sources required for carrying out the all abovementioned procedures.

c) The system of preventive and extrajudicial procedures for restoring the private enterprises' health requires detailed development with allowance for the following evidence:

- it is a huge complex of enterprises different in size and significance for society. Along with the system of a full-scale control over the business entities activity, it would be necessary to introduce the simplified procedures for resolving insolvency problem for a certain group of enterprises;
- there should be professionally discussed the issue on choosing authorities to be entrusted with the functions of preliminary tracing and sounding the alarm with regard to the enterprises threatened by insolvency in the private sector (these may be state tax authorities, banks, etc.);
- special state power authority on bankruptcy should ensure methodological and consultative support for all procedures connected with the detection of insolvency risks, pretrial recovery and restructuring the enterprises of the private sector;

d) The preventive system may be constructed by introducing preventive procedures to the corporate and tax legislation, and implementing rigid accounting requirements. To ensure legal capacity of preventive procedures, it is necessary to introduce the responsibility for their violation for chief executives of enterprises;

e) To ensure vital business, it is necessary to create political and legal advantages. The decision on bankruptcy should be obligatory preceded by the attempts to restore the health of the enterprise-debtor. In case of liquidation of the enterprise-debtor, the advantage should be given to the sale of business rather than of property (retention of business in case of changing the inactive owner).

f) It is essential that regulation of the out-of-court settlement of the insolvency problem for business entities be implemented. Now the informal regulatory system (shadow personal agreements) for the "debtor-creditors" relationship predominates. This step may become a mechanism that will not only reduce the default risks (risks of non-return loan) but also will create certain mechanisms for transforming shadow processes to a legal practice.

g) According to the conclusions of international experts, the wide use of extrajudicial procedures for resolving the insolvency problem for enterprises is in compliance with the specific conditions of entrepreneurial activity in the emerging market countries. In their opinion, in the countries, where the lack of knowledge and experience in the field of commercial court trials is observed, it would be reasonable to involve the courts in the settlement of insolvency problems only in extremis.

h) Relying on the results of analysis of case initiators, it is necessary to find out the ways of reducing “unreal (unjustifiable) bankruptcy” (departmental and shadow interests). The potential ways of resolving this problem include the following:

- liquidation of “thrombi”, which force separate state power authorities to use bankruptcy as a way of achieving departmental interests (inefficient liquidation procedure for non-operating enterprises; bringing pressure on the debtors to the state budget, etc.);
- revival of the large-scale privatization and affording equal access thereto for all investors as an alternative to the shadow privatization;
- creation of efficient barriers against using bankruptcy for shadow purposes, including the establishment of a special state supervision system and the employment of various kinds of criminal responsibility;
- use of various incentives for voluntary participation in the bankruptcy prevention procedures and reestablishment of the enterprises-debtors’ solvency (restructuring of the budget indebtedness, obtaining the right to the national assistance, government guarantees for bank loans, etc.);
- formation of a new social stereotype of an honest entrepreneur within the trend of “socially responsible business” that started spreading throughout Ukraine from 2005.

## **6. Recommendations: removal of restrictions and injunctions for the bankruptcy of state-owned enterprises**

Removal of restrictions and injunctions for the bankruptcy of state-owned enterprise is a quite acute problem for Ukraine. Everybody understands that this step is indispensable, but the ways of putting this idea into practice with no adverse effect are still being discussed.

The analysis of world experience should give answers to the following three questions:

- in what way the developed countries reach balance of interests with no special approach to different kinds of objects being applied;
- which of the approaches may be acceptable for Ukraine;
- how special approaches to the state-owned enterprises bankruptcy are implemented in the legislation of Russia as of one of post-socialist countries.

### **Practice of developed countries**

Practice of developed countries has no legal restrictions with regard to the enterprises bankruptcy, including state-owned enterprises. One of indisputable postulates of the state regulation policy in these countries is ensuring equal conditions in the market for all business entities.

However, this does not exclude that the state as a representative of society should be enforced to take decision to introduce the special regime of overcoming the insolvency of the particular enterprise. But the property form is not of decisive importance for decision to be taken. This means that the form of state property is not a reason for establishing the bankruptcy immunity for enterprises neither from legal nor from political point of view.

The extent of importance of the enterprise activity for the interests of the country may be a ground for introducing a special regime of overcoming its insolvency. All developed countries shall determine kinds of enterprises where material changes are being controlled by governments proceeding from the strategic interests of the country.

The most wide-used forms of the country's participation in prevention of companies' bankruptcy are as follows:

- the state assumes responsibility on enterprise's obligations to the creditors;
- financial assistance is usually rendered on a reverse basis;
- financial assistance is rendered on conditions of limiting the company's independence (the administration competence or ownership rights, i.e. the partial nationalization is being applied).

Many examples of the state interference in the process of bankruptcy prevention appeared in the period of the current global crisis. All governments were impelled to develop anti-crisis programs, the main objective of which was to take special measures against the bankruptcy of large banks and companies that present the real sector of economy.

The most large-scale anti-crisis program was implemented in USA in 2008-2009. The American Government has made unprecedented by the extent financing of banks and three car giants. Financing was handled based on the principles referred to above. In 2009 the American banks completed the repayment of state assistance as they were interested in the restoration of their independence and ownership rights.

### **Russia**

Restrictions and injunctions for the state-owned enterprises bankruptcy is a phenomenon specific to the group of former post-socialist countries, which were late in reconstructing their national economies. But its practical implementation has various forms.

Russian legislation on insolvency (bankruptcy) stipulates differentiation of regulatory systems for state-owned enterprises. But unlike Ukraine, the policy of Russia in the sphere of insolvency does not set the goal to create the additional protection against bankruptcy. Differentiation is introduced in order:

Firstly, to take into consideration the procedures' specifics determined by other laws, in particular:

- for unitary and economic companies, where the state-owned share in the equity capital exceeds 25% - in the property evaluation procedures;
- for socially significant objects of cultural heritage – when specifying the ways of sale via tender.

Secondly, to take into account the enterprises influence on national interests. The following specifics are envisaged for strategic enterprises and defense industry organizations regardless of their form of property:

- the insolvency threshold was raised as they pertain to large enterprises;
- there was stipulated the pretrial restructuring as a special system of insolvency prevention;
- the participants of court proceedings were added by the representative of the federal authority responsible for the appropriate sector of the state policy;
- the additional requirements to the appointment of the arbitration manager (insolvency official), bankruptcy administration, sales conditions for the specialized property of the enterprise performing the government order were established;
- the State was granted the priority right to buy out such enterprises in tenders.

### ***Conclusions***

Subject to the findings of the world practice analysis, the following conclusions regarding liquidation of restrictions and injunctions for the bankruptcy of state-owned enterprises in Ukraine have been made:

- legislation on the regulation of enterprises insolvency should not include the rules, which application would create the additional protection against bankruptcy of separate business entities, including because of the state form of property;
- special approaches to the separate kinds of enterprises are acceptable in cases when there appears the need in the coordination of the process of resolving the insolvency problem with the legislation that regulates activities of such enterprises, including the state-owned ones;
- regulatory policy in the sphere of insolvency may include the rules, which would facilitate the creation of conditions for preventing the insolvency of enterprises important for society. So, the insolvency legislation may lay emphasis on the obligatory performance by the state of this function with respect to the enterprise of such type.

### **Recommendations for Ukraine**

Based on the analysis of the Law “On Restoration of Debtor’s Solvency or Recognition of Debtor’s Bankruptcy” and the state policy in the sphere of insolvency regulation, the following purposes of the introduction of restrictions and injunctions for the bankruptcy of state-owned enterprises may be determined:

- neutralization of risks for important national interests (strategic enterprises) and performance by the State of its functions in case of unsupervised change of form of property (cancellation of production);
- support of a steady operation of so called “planned loss-making” enterprises in such kinds of activities where the prices (tariffs) for services are regulated on a administrative basis (coalmines, public utilities enterprises, etc.);

- decrease in the pressure of market competition on the state-owned enterprises to a safe level under the conditions of their disadvantage to the private analogues in the market

Unlike other post-socialistic countries, Ukraine uses the method of total protection against bankruptcy based on the state ownership that, firstly, inevitably brings to the material reduction of incentives to the development of the public sector, which covers the significant part of the Ukrainian economy; and secondly, creates considerable “thrombi” for the circulation of funds on a national level. Actually, doing so, the state has declaimed responsibility for resolving the insolvency problem for state-owned enterprises.

Due to this, the liquidation of restrictions and injunctions for bankruptcy of state-owned enterprises is one of obligatory directions of upgrading the regulatory insolvency system in Ukraine.

This process is rather complicated and bears serious potential risks. It is necessary to perfectly study conditions, under which these risks may be minimized in case of liquidation of restrictions and injunctions. See below our considerations thereon:

1) The system of insolvency regulation should not differentiate business entities in the market by their forms of property. Some specifics may be acceptable only within their compliance with legal rules that regulate the process of state-owned enterprises management.

2) The policy of total protection against bankruptcy should be replaced by the system policy of preventing insolvency of state-owned enterprises, which activity affect significant interests of society.

**3)** The first and quite safe step is to narrow down the area of application of restrictions for bankruptcy. Pursuant to the Ukrainian legislation, the state-owned enterprises include public enterprises (with 100% public ownership) and economic companies, where the State’s share in the equity capital exceeds 50%. This list covers all strategic enterprises. The bankruptcy of enterprises where the State’s share in the equity capital is less than 50% does not affect the interests important for the country.

4) In case of cancellation of a court injunction and restrictions, the risks may be neutralized by using state policy means. In case of strategic need in the protection of the important enterprise against bankruptcy, the State should assume the guarantees for the fulfillment of obligations to the creditors. But such actions should not artificially retain inactive business entities in the market or create ungrounded market advantages for separate enterprises.

Creation of the eligible institutional management system for state ownership objects is a key condition for the full cancellation of restrictions and injunctions for bankruptcy of state-owned enterprises.

Authors of report see real opportunities for the creation in Ukraine of the efficient system for performing by the State the functions of owners of the enterprises-debtors. In our opinion, the State Property Fund of Ukraine (SPFU) may become such body. Table 6.1 contains cases for such choice.

SPFU has represented the State in the court proceeding as an owner of the enterprise-debtor for a long time. SPFU performs functions of monitoring, recovery (restructuring) of enterprises, appointment (dismissal) and evaluation of chief executive officers.

Table 6.1

**Main characteristics of SPFU as a state power authority**

	<b>Indicator</b>	<b>Characteristics</b>
1	Status	State power authority entrusted with special powers
2	Functions	Privatization and management of objects of state ownership
3	Functions of state-owned enterprises management	<ul style="list-style-type: none"> <li>• Maintenance of the Unified Register of objects of state ownership</li> <li>• Monitoring of financial status</li> <li>• Control over the use of resources and assets</li> <li>• Recovery and restructuring</li> <li>• Representation of bankruptcy cases before the courts</li> <li>• Appointment and dismissal of CEOs, regular evaluation of their activity</li> <li>• Participation in the Supervisory Boards activity</li> </ul>
4	Potential for the performance of the State's functions in the sphere of insolvency regulation	There are special structures and a legal base for arranging the sale of objects and some property according to the procedures applied in privatization.
5	Structure	<p>The Central Administrative Office and 27 regional offices (all oblasts, the cities of Kyiv and Sevastopol).</p> <p>Departments on Management of Objects of State Ownership included in the Central Administrative Office:</p> <ul style="list-style-type: none"> <li>• on corporate relations and restoration of solvency;</li> <li>• on strategy of corporate management;</li> <li>• on management of state property and lease relationship;</li> <li>• on property disposal.</li> </ul>
6	Human resources	The Central Administrative Office - 780 persons, regional offices – 2,312 persons.
7	Financial resources	Revenues from privatization and management of objects of state ownership. In 2009 the privatization resulted in UAH 814.7 million with UAH 431.2 million in the form of dividends.
8	The perspective pursuant to the Program of Reforms of	Due to the completion of privatization in 2014, 2013 total objects of state ownership will be transferred for management to SPFU.

	the President of Ukraine	
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As a result of political destabilization and the crisis, the State Property Fund of Ukraine has lost these functions. So, it would be necessary to renew them. But this task fully fits into the process of its transformation from the privatization body to the authority of state ownership objects management connected with the completion of privatization in Ukraine till 2014.

## **7. Recommendations: establishment of the system for prevention of misconduct and fictitious bankruptcy**

Absence of the efficient system of state regulation, deformation of the process of post-socialistic reorganization of economy and the loss by population of positive entrepreneurial traditions have caused the increase in the criminalization of the entrepreneurial sphere in Ukraine. The unfair behavior of arbitration managers (insolvency officials) and deliberate bringing the enterprises to bankruptcy have become the most wide-spread forms of criminal behavior in the economic sphere.

### **7.1. Prevention of fictitious/fake bankruptcy**

To choose the model for the system of preventing fictitious bankruptcy in Ukraine based on the analysis of world practice, it is necessary to reveal the following:

- typical mercenary purposes of fictitious bankruptcy;
- structural principles of fictitious bankruptcy detection and prevention system;
- use of the mechanism of responsibility for deliberate mercenary actions.

### **World experience**

Last time, first of all as a result of global financial crisis, the number of cases of using fictitious bankruptcy has increased. In such a way some entrepreneurs attempt to evade the fulfillment of their obligations to the creditors.

In the world practice the fictitious bankruptcy is mostly not regulated by the bankruptcy legislation. This refers to the competence of Criminal Law.

The Criminal Law differentiates separate criminal actions, which may infringe the creditors' interests (concealment of the property, documents, etc.), and deliberate criminal use by a debtor of fictitious bankruptcy methods (for the purpose of evading the fulfillment of obligations to the creditors). The criminal actions may take place both before beginning the bankruptcy procedure and thereafter.

The system of punishment for criminal actions in this sphere includes both administrative (dismissal, injunction for certain kinds of activity, etc.) and criminal responsibility (penalties and imprisonment).

The system of fictitious bankruptcy detection and the system of criminal responsibility of business entities for its application with mercenary purposes shall be built depending on the extent of risk of this negative phenomenon for the country's economy.

At the same time, the world experience provides convincing examples showing that in practice it is rather difficult to identify formal elements of fictitious bankruptcy as deliberate

actions, especially in the emerging market countries where it is difficult to distinguish between actions of criminal nature and actions, which look as adverse effect of non-professional work of chief executive officials or as such that were provoked by the undeveloped market and a high level of its monopolization.

More efficient practice of preventing fictitious and deliberate bankruptcy in developed countries is based on many factors that create unfavorable environment for such kind of actions. It engages all mechanisms: legal, economic, organizational, business traditions, society position.

The system of fictitious bankruptcy detection and prevention usually includes many structural units, i.e.:

- special procedures of pretrial supervision;
- procedural leverages: precise regulation of procedures, steady observance of the right to appeal, irreversibility of punishment, etc.;
- specialized state control;
- publicity and transparency of procedures and decisions.

### France

In 1983 the French bankruptcy legislation undertook material changes. The traditional Criminal Code's provision of on bankruptcy was supplemented with a new rule on the arrangement of fictitious insolvency. It was fixed a penalty for the debtor's criminal actions made to "avoid monetary and proprietary collections imposed by the criminal court in the investigation of criminal cases or in the process of civil proceedings on delicts (torts), quasi-delicts and alimony".

Four ways of committing a crime, i.e. concealment of assets, fraud, increase in liabilities, falsification and concealment of documents and accounting reports, and non-maintenance of financial reporting are recognized to be deliberate actions.

The legislation of France does not stipulate that it is necessary to establish the debtor's insolvency in civil proceedings in case of bringing the action on fictitious bankruptcy before the court.

The Criminal Code of France establishes responsibility for the organization of fictitious insolvency in the form of 3 years imprisonment or the large monetary fine.

### USA

In USA the measures on criminal and legal regulation of bankruptcy are included in the Model Penal Code. The Code recognizes the deliberate bankruptcy as a crime and envisages different kinds of criminal responsibility.

Criminal actions include the following: destruction, concealment, withdrawal, encumbrance by commitments and transfer of the pledged property; falsification and concealment of documents or records; distortion of notices or the refusal to notify the authorized person of the property to be provided by the debtor.

The Code stipulates relatively mild punishment (from 1 year imprisonment) for all bankruptcy-related crimes. Only separate states established more sever penalty.

The system of resolving insolvency problems in USA is decisively characterized by experts as a “life save” for enterprises. Thus, the debtors prefer to voluntarily enter into the official procedure for the solvency restoration. The fair and honest behavior of the enterprise-debtor is one of the conditions permitting thereto to get advantages in conditions of restoration of its health.

According to court statistics, 80-85% of all bankruptcy cases are finalized with the enterprise reorganization, 15-20% - with liquidation, and only 1.1% of enterprises guilty in deliberate bankruptcy are brought to responsibility. The reasons for bringing to responsibility are distributed as follows: 2% - for negligence, 1.5% - for malpractice, 0.9% - for accidents, 93.1% - for professional incompetence and 2,5%<sup>16</sup> - others.

### Germany

The criminal legislation of Germany establishes highly severe punishment for bankruptcy caused by negligent or criminal actions. The criminal legislation defines three kinds of bankruptcy that are subject to punishment, i.e. simple, fraudulent and especially grave bankruptcy.

Simple bankruptcy takes place if a person does not know about the coming insolvency of the enterprise due to his negligence as well as he causes it by his light-minded actions. The guilty shall be punished by 2 years imprisonment or by a fine.

The bankruptcy is qualified as fraudulent if a person (under conditions of the enterprise's over-indebtedness or in case of threat and occurrence of insolvency) divests, conceals or makes unusable the property components, which in case of sales would be disposed in favor of creditors; gambles the property away; and sells goods or securities on credit on conditions disadvantageous for the enterprise. In the same way there is defined the suppression of rights of other persons or recognition of their rights as fictitious, incorrect maintenance of trade books, their concealment, destruction or damaging as well as preparation of fictitious balance sheets. All the abovementioned actions shall be punished by the 5 years imprisonment and a fine.

The especially grave bankruptcy implies mercenary actions of the guilty person made in his interests, which cause the threat of ruin for many persons, and the loss of entrusted to him valuables. The legislation stipulates the 10 years imprisonment for such a crime.

The Law on Bankruptcy establishes that, if the debtor is aware of his incapability to repay debts, he should notify the court thereof within 3 weeks. If such a declaration was not submitted, the court prosecution may be applied to the debtor.

The objective prerequisites of the court prosecution include: ceasing payments, initiation of bankruptcy proceeding or submission of petition for the initiation of bankruptcy proceeding.

### Great Britain

The English Law defines the bankruptcy of a legal entity by the term “insolvency”. The legislation establishes responsibility for deliberate actions of directors and employees of the company prior to and after the initiation of bankruptcy proceeding. Serious malpractice is punished by the 7 years imprisonment. Less serious violations are punished by fines to different amounts.

Minor violations include concealment of information on carrying out the external management (bankruptcy administration) by the company in the business correspondence, non-

<sup>16</sup> <http://www.e-vid.ru/index-m-192-p-63-article-3057-print-1.html>

registration of acts and facts significant for the company management and bankruptcy administration, untrue declarations, non-fulfillment of requirements to the reports to be kept in the process of bankruptcy administration, violation of the restricted legal competence, etc.

Unlike Germany, the English Law does not use the term “crisis” in the definition of bankruptcy. To make clear whether the malpractice in the sphere of bankruptcy is subject to punishment, there are applied civil procedural acts, i.e. the judgment of the court on the company liquidation and decision on voluntary liquidation.

The 7 years imprisonment is stipulated for the persons who performed their managerial functions during 12 months prior to the date of taking decision on the company liquidation in case if the person concealed a part of the company’s property or the debt, appropriated a part of the company’s property in a dishonest way, falsified any reports or documents referred to the company’s business or property or pledged a part of the company’s property acquired on credit.

### Russia

As concluded by experts, the fictitious bankruptcy has become wide-spread among Russian business entities<sup>17</sup>. Deliberate (fictitious) insolvency enables the enterprise-debtor to initiate the bankruptcy procedure that would give it the opportunity to materially reduce its debts repayment. Bringing to bankruptcy is also used for seizing control over the other enterprise.

The rule that determines the insolvency status allows comparatively easy to reach the external symptoms of insolvency at the expense of manipulations with the property (withdrawal of the company’s assets and transfer them to a loyal firm) and the artificial growth of indebtedness.

The Law on Bankruptcy (Insolvency) stipulates that the verification for presence of elements of fictitious and deliberate bankruptcy should be made:

- obligatory by arbitrary managers with respect to all enterprises, regarding which the bankruptcy court proceeding was initiated;
- in the form of the examination appointed by the court by the petition of the bankruptcy entities.

Subject to the Law, this function is recognized as an integral part of the professional activity of the arbitrary manager. In such situation there appears the possibility of total verification for the presence of elements of fictitious and deliberate bankruptcy with respect to all enterprises, regarding which the bankruptcy court proceeding was initiated. Such verification shall be made in compliance with the Rules approved by the Federal Government<sup>18</sup>.

These Rules are a kind of algorithm intended to neutralize the factor of the arbitrary manager’s personality and thereby to enhance the objectivity of conclusions.

But notwithstanding such total control, the system of irreversible punishment of business entities in Russia is not still created. They continue to use bankruptcy for criminal purposes. The judgments of conviction are still rare. Only 5% of the initiated criminal actions are finalized

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<sup>17</sup> <http://nalog.yuga.ru/obyazannosti/bankrot/krasnodar-bankrot/?id=3008&print=1>

<sup>18</sup> RF Government Decree dated 27.12.2004 №855 «Provisional Rules on Approval of Arbitrary Manager’s Verification for the Presence of Elements of False and Deliberate Bankruptcy».

with the judgment of conviction<sup>19</sup>. Russian experts consider the following to be the reasons thereof:

- **firstly**, it is quite difficult to transform formal features into the legal status of a crime as it is hard to prove the cause-effect relation between definite actions (omission of actions) and their consequences;
- **secondly**, the procedural part is not supported by the expertise, based on which the court may take decision. The Criminal Expertise Center at the Ministry of Internal Affairs and the *Federal Center* for Judicial *Expert* Studies at the Russian *Ministry of Justice* have no special sub-divisions, and the practice of non-governmental expertise centers is not recognized;
- **thirdly**, the powerful resistance (counteraction) is observed: corruption, pressure of shadow interests, administrative and political pressure.

### **Conclusions**

The following conclusions made in the process of the world experience analysis are important for the construction in Ukraine of the efficient system for fictitious bankruptcy detection and prevention:

- the choice of mechanisms of fictitious bankruptcy prevention has to be based on the specification of selfish purposes, to achieve which the fictitious bankruptcy method is used;
- the mechanisms of fictitious bankruptcy detection act as procedural “filters” where the test for the presence of formal elements of malpractice is handled;
- the extent of criminal responsibility for these violations shall be determined by the degree of impact these negative phenomena have on economy;
- it is impossible to effectively oppose these crimes by separate uncoordinated measures, it is required a complex approach, which would create unfavorable environment for these crimes.

### **Recommendations for Ukraine**

The following specifics should be taken into account when choosing mechanisms of fictitious bankruptcy prevention in Ukraine.

**Firstly**, the structure of mercenary interests satisfied by means of fictitious bankruptcy cardinally differs from the practice of developed countries. Typical mercenary interests of using fictitious bankruptcy in Ukraine include:

- seizure of state property (shadow privatization);
- property redistribution (raiding);
- removal of competitors;
- avoidance of fulfilling obligations to creditors.

**Secondly**, presence of powerful motivations for using fictitious bankruptcy:

- to receive higher income (by using the lower-cost way of receiving ownership rights to assets and by expanding the market niche, etc.);

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<sup>19</sup> <http://sud-expertiza.ru/expertizi.php?=52&m=2377>

- to compensate the impossibility of achieving goals by legal methods due to unavailability of government assets caused by the privatization paralysis; absence of free circulation of stocks on stock exchanges where the redistribution of ownership rights is being made; the highest in the world business tax burden, etc.

**Thirdly**, the abovementioned methods are available for use. The country has no system for the detection of bankruptcy elements and monitoring of insolvency. The criminal responsibility system is actually inoperative. The attitude of society to such criminal actions is quite loyal.

**Fourthly**, there are available instruments for the realization of fictitious bankruptcy, in particular, the shadow economy and total corruption.

The list of these specifics decisively demonstrates the increased need of Ukraine in the creation of the environment, which, on the one hand, would make the use of fictitious bankruptcy, as a business method, unnecessary, and, on the other hand, would make the use of this method for business purposes dangerous for its participants. The following may be referred to the main measures developed in this sphere:

1) Legal norms should establish the bankruptcy procedure characterized by maximum clear requirements; certainty of the applicable criteria; and automatism in taking decisions. The corruption field may be materially narrowed by limiting situations when an official and a judge have to take one or another decision. Freedom of choice in taking decisions (such as regarding their reasonable expedience, fair price, etc.) traditional for developed countries, is being inevitably transformed into a corruption channel in Ukraine.

2) It is necessary to make responsibility for fictitious bankruptcy and bringing to bankruptcy irreversible. The Criminal Code of Ukraine stipulates special measures of punishment for fictitious bankruptcy or bringing to bankruptcy (fines and imprisonment). But the system of responsibility is not still in operation. The legislation does not provide the list of deliberate actions that would become the basis for referring them to the category of crimes. No centers for “beating alarm” that would initiate the cases on fictitious bankruptcy before the court.

3) It is required to define the approach to the creation of the system for detecting fictitious bankruptcy elements: a) monitoring techniques; b) dislocation of the functions performance; and c) the verification procedure. Currently, the functions of detecting bankruptcy elements are carried out by the State Department on Bankruptcy but only on the court’s request and regarding the enterprises where the state-owned share in the equity capital exceeds 25%. Their share in the total number of enterprises, regarding which the bankruptcy actions were initiated, does not reach even 4%.

4) When choosing the means of fictitious bankruptcy prevention, it is necessary to proceed from the specific character of mercenary interests:

- a) To neutralize attempts of shadow privatization through fictitious bankruptcy, it is required to act in two directions:
  - in the process of bankruptcy – to fully eliminate the possibility of using property for the repayment of debts as well as of taking advantage of noncompetitive ways of transferring the property, property complexes and corporate rights;
  - in the process of management of state ownership objects – the occurrence of insolvency of state-owned enterprises should automatically cause the pretrial rehabilitation and, if it is unreasonable, the transfer them for privatization.

- b) To neutralize the use of fictitious bankruptcy for raiding enterprises, it is necessary to upgrade the Corporate Law and court proceedings on such cases (for example, the location of such proceedings).
- c) It is necessary to find out the ways of responding to a new kind of crime in Ukraine connected with the use of artificial insolvency and fictitious bankruptcy to avoid the fulfillment of obligations to the creditors, including to the State as a creditor. In such a case the long-term world experience will be of great use. In various countries there is accumulated the rich practical experience of the effective opposition to such kinds of economic crimes.

5) As evidenced by the world experience, the effectiveness of fight against such economic crimes to a large extent depends on the presence of positive motives for fair behavior of business entities. The developed countries have been elaborating the mechanisms of business self-regulation in the forms available for society for a few decades. Last years the policy of socially responsible business has widely spread. But in Ukraine this movement is supported only by separate companies-initiators. The State so far stands aside.

6) It is necessary to strengthen public control by increasing transparency and publicity of bankruptcy procedures with allowance for the confidentiality requirements. In the developed countries the non-governmental initiatives exert considerable pressure by exercising additional control.

## **7.2. Prevention of misconduct of the arbitration manager**

For the first time in Ukraine, the applicable Law “On Restoration of the Debtor’s Creditworthiness or Declaration of Bankruptcy” recognized the arbitration manager as a subject of the competition process that is in compliance with the world practice.

However, the ten years operation of the Law showed that the Ukrainian version of the institute of competitive managers (arbitrary managers) appeared to be “incapable”. Its structure does not ensure the professional level of the debtor’s property management and even allows the arbitrary manager to use the bankruptcy procedures for the achievement of shadow purposes of participants and the formation of their own revenues.

Improvement of the institute of arbitrary managers is of urgent need not only for the construction of the efficient system for fictitious bankruptcy prevention but also for upgrading the system of insolvency regulation in Ukraine in whole. Thus, in the analysis of the world experience, the particular attention was devoted to the determination of requirements for key elements of the institute of competitive managers:

- status of a competitive manager;
- access and activity control systems; and
- systems of responsibility for the activity’s results.

### **World experience**

One of the main roles in ensuring the efficiency of the competition process is played by the competitive manager. The competitive manager is usually appointed by the court and should implement the competition process within legislation.

#### USA

Pursuant to the USA legislation, the insolvency procedures on particular cases shall be implemented by private competitive managers.

USA has no institute for managers' certification but the selection of candidacies for appointment, supervision of their activity as well as their appointment in some cases is carried out exclusively by the federal institution – the Executive Office for United States Trustees, which is subordinated to the Ministry of Justice and has an extensive structure throughout the country. The acquisition of status of a private competitive manager means his public recognition as a specialist on bankruptcy.

The payment for competitive managers' labor is effected from the fund formed by various centralized payments to the Executive Office for United States Trustees made in the course of court proceedings.

The state control over the activity of competitive managers shall be exercised by federal managers. The Institute of federal managers was founded in 1983. Federal managers are the members of a special executive power authority – the Executive Office for Federal Managers and perform the following functions, i.e. they shall:

- supervise liquidation, reorganization and other procedures;
- appoint temporary competitive managers;
- supervise activity of the temporary competitive manager after his appointment by the creditors;
- ensure the compliance with the bankruptcy legislation and take measures for stopping fraud and malpractice;
- submit the cases to investigating and prosecuting authorities, if necessary;
- ensure timely and professional management of the competitive property and control that the fees of private competitive managers be reasonable;
- appoint the Creditors' Committees and convene their meetings in the process of enterprises reorganization.

Federal managers are the employees of the Federal Government; they shall be appointed and dismissed by the General Prosecutor of USA. The Program of federal managers is implemented in 21 regions of the country, which cover all Counties but for Alabama and North Carolina. In these two States the Institute of Bankruptcy Administrators performs similar tasks.

Professional control over the activity is exercised by professional associations of private competitive managers. The federal manager should create the association of private competitive managers, ensure their activity and supervise their work within his region. The supervision shall also cover all functions of private competitive managers, including the management and sale of the debtor's assets (property).

The supervision of the federal manager's activity shall be carried out by the Office of Federal Managers and the General Prosecutor of USA.

The General Prosecutor shall also inspect the work of private competitive managers.

France<sup>20</sup>

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<sup>20</sup> <http://www.duma.gov.ru/sobstven/analysis/bankruptcy/130404france.htm>

In France the following names are used for different kinds of competitive managers, i.e. the court administrator (“administrateur judiciaire”) and the mandated (authorized) liquidator (“mandataires-liquidateurs”).

The supervision of competitive managers’ activity shall be carried out by the prosecutor (that is within the jurisdiction of the prosecutor’s office) and by the judge appointed by the Ministry of Justice who may at any time to make inspection.

In France there is a system for licensing the activity of court administrators, mandated liquidators and experts on evaluation of current situation at the enterprise.

*Court Administrator.* Court Administrator should be registered with the national list composed by the National Commission. The Commission is composed of 11 members and 11 replacement members who are appointed for 3 years period. The activity of the court administrator is not limited by territory. This profession may not be combined with any other one, except for a lawyer. The appointment of the court administrator shall be obligatory made according to the standard procedure and, only if the court considers it to be necessary, according to the simplified procedure on a discretion basis.

*Mandated (authorized) liquidator.* The liquidator should be selected from the list of liquidators prepared by the National Commission. The Commission is composed of 9 members and is subordinated to the Court of Appeal, within which jurisdiction the liquidator’s activity falls. The liquidator’s activity is territorially restricted by the jurisdiction of the Court of Appeal that has the registration list of liquidators. The right to enter into the list is a full monopoly of the National Commission, so the liquidator may be appointed only once. Profession of a liquidator may not be combined with any other one.

*General requirements for a court administrator and a mandated liquidator.* To be registered in the national lists, the contenders should meet the following requirements, i.e. they should:

- a) be residents of France;
- b) have sufficient guarantees of their moral behavior;
- c) have special degrees and diplomas of:
  - the Master of Law;
  - the Master of Economics or Business Management;
  - diploma recognized by the Ministry of Education and the institution of higher educational in the field of business and management;
  - other equivalent degrees and diplomas;
  - the document confirming that the contender has passed examination and is able to perform functions of the auditor (“commissaire aux comptes”);
  - diploma of higher accounting and financial courses;
  - DEA degree (diploma of advanced study) in the field of law or business management;
  - DESS degree (diploma of higher specialized education) in the field of law or business management;
- d) have work experience in their professional activity;
- e) pass professional competence examination;
- f) be younger than 65.

The examination commission that takes the professional competence examination shall be composed of the representative appointed by order of the Chairman of the Court, the representative of the Clearing House (“Cour des comptes”), the member of the commercial court of primary jurisdictions (of first instance), a Professor or a teacher of law, economic sciences or business management and three court administrators, one of whose should work in the field of civil law.

*Responsibility insurance.* The contenders should pay two entrance fees: to the system of professional insurance and to the Guarantee Fund. The administrative manager and the mandated liquidator registered in the national lists have to insure their professional civil responsibility as well as to be insured against negligence or a mistake that may take place in the process of their activity.

The insurance premium shall be paid through the agent – the Guarantee Fund (‘Caisse de garantie’), which executes the insurance policy against all risks arisen from the applicable legislation. The Guarantee Fund is a legal entity managed by its members that deals merely with the cash disbursements, payment of invoices or valuables owned or managed by each court administrator or mandated liquidator. The State is represented in the Guarantee Fund by the officer of the Prosecutor’s Office. The participation in this Fund is binding for all kinds of competitive managers.

The Fund’s costs are accumulated at the expense of annual contributions of its members. Contribution amounts should be sufficient to cover all expenses connected with the operation, legal commitments and specifics of the Fund (including compulsory insurance of the Fund and its separate members).

*Mechanism of bringing to responsibility.* Control shall be exercised and disciplinary measures shall be taken by that state power authority, to the competence of which a court administrator or a mandated liquidator falls. Each office shall be subject to the obligatory control inspection once every four years. The limitation period for disciplinary sanctions constitutes 10 years. The Court of Appeal in Paris has an exclusive jurisdiction to examine appeals regarding these issues.

A court administrator or a mandated liquidator may be brought to civil responsibility for any losses caused by his undue actions and inflicted to the creditors or the debtor.

*Professional control.* Liquidators and managers have their own professional associations. The National Council (‘Conseil’) is a general representative body of professional associations. The Council is composed of 16 members, 8 of whom shall be selected on behalf of each professional association (administrators and liquidators) for the 4 years period. Professional associations and the National Council have a status of social organizations.

The National Council is responsible for the protection of collective interests of managers and liquidators. It arranges their professional education and exercises supervision over their activity.

### Italy

The establishment of the institute of competitive managers in Italy was to a large extent influenced by the general concept of the system for state regulation of insolvency as one of the reasons of failure to perform commercial agreements.

Italy has no special requirements for and licensing of competitive managers' activity<sup>21</sup>. Competitive managers are selected from the representatives of the local Bar Association or the local Association of Auditor and Accountants. The Italian legislation contains special requirements for these professional groups. In exceptional cases, the persons of other professions may be appointed. However, such choice should be duly substantiated.

The Law does not stipulate the compulsory insurance of a competitive manager's responsibility. Representatives of various professions in Italy are not obliged to acquire the insurance policy; this is their private matter. Accordingly, if the manager does not acquire the insurance policy, he will himself bear responsibility for the losses caused by his activity.

The Law on Bankruptcy of Italy contains some cases when a certain person may not be recognized as a manager in the process of the bankruptcy procedure, in particular, if he:

- is declared a bankrupt;
- is convicted to get penalty;
- is the affiliated person of the bankrupt or his relative to the fourth level of relationship;
- is the bankrupt's creditor;
- carried out professional activity in the interests of the company-bankrupt;
- was connected with the activity of the company-bankrupt for two years prior to the bankruptcy declaration.

The competitive manager may be brought to the criminal responsibility for the violation of his obligations on keeping the Registry of all economic transactions or entering into agreements that stipulate transfer of costs received in the process of the bankruptcy procedure. The debtor and other interested persons are entitled to file a suit regarding the actions of the competitive manager (his responsibility is regulated by general provisions of the Civil Code on responsibility under agreements).

The competitive manager's activity may also become the subject of investigation in the court if it resulted in the losses for third persons.

In Italy the self-governing organizations that include competitive managers do not exist. Also, there is no there a special list of bodies authorized to regulate or administer the sphere of the competitive managers' activity. Legal requirements related to the competitive manager coincide with the requirements for the lawyers-members of the local Bar Association or for the auditors-members of the local Association of Auditors and Accountants. In Italy accountants are subordinated to the Unified Professional Organization of Accountants that employs the uniform control procedure.

### Great Britain

In Great Britain the functions of the bankruptcy assets management are performed by:

- a) the administrative manager (administrative receiver), who is appointed by the holders of any company's debentures secured by the pledge.
- b) official bankruptcy assets manager (official receiver), who is a judicial official and a public servant working in the Trade and Industry Department and heading the regional office.

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<sup>21</sup> [http://www.securities.org.ua/securities\\_paper/review.php?id=524&pub=3666](http://www.securities.org.ua/securities_paper/review.php?id=524&pub=3666)

- c) the liquidator appointed by the court for disposal of the company's assets and obligations after the decision on its liquidation (voluntary liquidation) has been taken or the order on its liquidation (enforced liquidation) has been issued. The executive powers shall be granted to the official liquidator from the Government Department on the Debtors' Property Management.

In Great Britain, as in other countries where the external management of the debtor is used, the individual who bears personal responsibility shall be appointed as a competitive manager.

The state's control over the activity of the bankruptcy assets manager shall be exercised by the State Secretary on trade and industry.

The State Secretary performs functions of the authorized state body on licensing the competitive managers' activity. He may assign the right for licensing to the authorized legal unions, institutes and associations of chartered accountants, and associations of insolvency specialists. Such practice is considered to be unsuccessful and did not become popular in other countries.

### Germany

Legislation of Germany does not stipulate participation of executive authorities in the bankruptcy procedure, and thus they have no powers to exercise control over competitive managers. Instead, the control shall be exercised by the court, which has a right to demand the report on the situation at any time.

In case if the competitive manager does not fulfill his duties, the court, after giving the notice, may impose the fine thereon.

In Germany the licensing of the activity and special requirements for the competitive managers are not envisaged. The competitive manager's title is not included in the list of professions. The Law on Bankruptcy specifies only general requirements for the person who may be appointed to this position, i.e. this person should:

- be an individual;
- have a due qualification, in particular, the entrepreneurial experience and
- be independent of the debtor and the creditors.

On practice, the most of the appointed competitive managers are the lawyers. The court shall prepare the list of lawyers recognized thereby as competent and eligible for the implementation of bankruptcy procedures.

Legislative requirements for the insurance of professional risks of competitive managers are also unavailable. But in the appropriate laws such requirements are specified for legal and accounting activity as well as for the activity of tax advisers.

Application of disciplinary sanctions is within the court competence – it shall take decision to relieve the competitive manager of his duties. In case of deliberate violations or negligence, the competitive manager shall bear financial responsibility. The fines shall be imposed by the court that appointed the competitive manager. If the criminal law is not followed, the criminal responsibility occurs.

In Germany the self-governing organizations of competitive managers do not exist. At the same time, the professional organizations are established. For example: the Chamber of Lawyers, the Chamber of Chartered Accountants, the Chamber of Tax Advisors, which members

should be lawyers, accountants and advisors. These Chambers represent persons belonging to a certain professional group. They protect their interests, assist support, exercise control and punish for violations.

### Canada<sup>22</sup>

In compliance with the legislation of Canada, in addition to judges, the trustees, the official liquidator and the Superintendent shall participate in the bankruptcy procedure.

*Trustees.* Trustees are the key executors of the bankruptcy procedure. They are the specialists who have a license for private practice. Their activity shall be regulated and controlled by the Federal Government represented by the Superintendent. The trustees are usually chartered accounts who shall take special exams to become a competitive manager. They are obliged to prevent conflict of interests and adhere to ethical norms established by Superintendents.

The System of control over the trustees' activity should include a) public control due to the established condition of public reporting; b) control by the competent state authorities; c) control on the part of creditors through the inspectors appointed thereby who constitute something like the "board of directors". All contradictions shall be settled in the court.

The trustee shall be responsible for compiling the register of creditors, control the enterprise-debtor's activity as well as specify the way of resolving insolvency problems by the creditors' consent.

The trustee's functions of an administrator, a creditors' representative and a debtor's advisor imply conflict of interest. So, in Canada the great attention is focused on the compliance with all instructions. In particular, the Superintendent shall give directives, which have the effect of subordinate acts, and establish requirements that should be strictly followed by trustees.

*Bankruptcy Superintendent.* The bankruptcy Superintendent is a public servant of a federal level. As an officer of the Ministry of Industry, he is subordinated to the Minister or the Deputy Minister. But this does not refer to the confidential elements of the bankruptcy procedure itself.

Superintendents shall control the process of management of all property and settlement of all issues within the Law on Bankruptcy. The performance of these duties include: a) the approval of all rules for the trustees certification; b) granting by the latter of personal guarantees of diligent performance of their duties; c) the issuance of directives (including ethical code) and information letters; d) the interference in judicial or administrative issues; e) the maintenance and publication of the appropriate documents.

The Superintendent's expenses are partially compensated at the expense of costs to be paid by the trustees to the creditors.

*Official liquidators.* Official liquidators are discussed in the legislation that regulates general rules of rendering support to commercial agreements. They are appointed in situations when the debentures (debt obligations) acting as a guarantee for creditors are not reimbursed. The pledged property is transferred to the official liquidators for management, and they shall take decision whether to introduce the trust management of the property or to liquidate it in favor of pledge holders. Liquidators may be practitioners hired by the creditors for the disposal of the

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<sup>22</sup> Institute of bankruptcy: formation, problems, reformation trends. – M.:IEPP, 2005, p.319-322

pledged property. In most cases the liquidators receive the status of a trustee in the bankruptcy procedure.

### Russia<sup>23</sup>

The institute of arbitration managers in Russia has passed several stages of formation. The effective Law “On Insolvency (Bankruptcy)” has provided the most complete legal description thereof. The structure of the institute of arbitration managers comes maximal close to the format that has historically formed in the developed countries.

To be the arbitration manager, the person should:

- be a citizen of the Russian Federation;
- be registered as an individual entrepreneur;
- have a higher education;
- have managerial experience at least of 2 years;
- pass at least 6 months training as the assistant to the arbitration manager;
- have no criminal record;
- be a member of self-governing organizations;
- not be the interested person in regard to the creditors and the debtor;
- have the insurance agreement on professional responsibility for the term of no less than 1 year with the insurance amount of 2 million Rubles per year.

The figure of the administrative manager is used in the procedure of financial rehabilitation of the enterprise-debtor. He is entitled to:

- demand from the debtor’s administration the information on the enterprise’s standing;
- take part in the property inventory;
- agree the contracts and the debtor’s decisions and, in case of discrepancies, to demand their defiance by the Arbitration Court;
- appeal to the court with the demand to suspend the administration of the enterprise-debtor;

The duties of the administrative manager include:

- maintenance of the creditors register;
- calling of the creditors’ meeting;
- control of the implementation of the rehabilitation plan and the repayment schedule.

The legislation stipulates the powerful system of professional and public control of the arbitration managers’ activity.

For the first time in Russia, the Law has implemented the institute of self-governing organizations and entrusted it with the following functions:

- to control the observance of the legislation with members of the organization;
- to protect the rights and the lawful interests of its members;

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<sup>23</sup> Institute of bankruptcy: formation, problems, reformation trends. – M.:IEPP, 2005, p. 180-198

- to ensure the information availability with regard to its members and the bankruptcy procedures;
- to facilitate the professional training of the organization's members;
- to keep the register of arbitration managers;
- to render assistance to the Compensation Fund for the financial support of its members' professional responsibility.

The structure of the institute of arbitration managers provides powerful channels of influence of self-governing organizations on their activity. There exists the multistage system of access to the activity. The arbitration manager should a) be a member and entered to the register of self-governing organizations; b) have the insurance agreement on professional responsibility, which is the obligatory attribute of a self-governing organization; c) be appointed by the court for the particular enterprise according to the list of candidacies provided by the self-governing organization.

The Law rather extensively specifies the conditions of professional responsibility insurance for arbitration managers. The Compensation Fund or the property for the reciprocal insurance shall be formed from the contributions of self-governing organizations. It should constitute no less than 50 thousand Rubles per year as calculated per one member of the organization.

The State's control in the sphere of arbitration managers' activity shall be exercised by the Federal Service of state registration, cadastre and cartography. Control shall be exercised in two directions: on the one part, over activity of self-governing organizations, and, on the other part, over activity of arbitration managers.

The Federal Service shall maintain the Register of self-governing organizations and be entitled to take decision on the inclusion of the self-governing organization in or out of this Register. The Federal Service is entitled to initiate in the court the administrative cases on violations made by arbitration managers.

### ***Conclusions***

Analysis of the developed countries experience with their long history of position of the bankruptcy manager, and the Russian Federation, where the arbitraon manager is an innovation, permits identifying the primary parameters of the bankruptcy manager institute:

- in consideration of its position and role in the process of resolution of an enterprise insolvency problem, the bankruptcy manager possesses the status, which contains the conflict of interests in itself – on the one hand, it is an entity, which performs independent professional activity, and on the other hand, it is a party to the bankruptcy proceedings as the representative of another person's interests;
- accordingly, the system of governing the bankruptcy manager activity employs two mechanisms: one of an entity, which conducts an independent professional activity (the professional control), and one of a participant in bankruptcy proceedings (the systemic government control in various forms);
- in connection with this, governing of the bankruptcy managers activity in all countries includes the following components:
  - a. free admission to the said business;
  - b. the systemic control on the part of government;

- c. the systemic professional control;
- d. administrative and criminal responsibility;
- e. personal financial responsibility for the professional risks;
- the status of the Russian arbitration manager incorporates even more deepened conflict of interests – on the one hand, it acts as an individual business entity, which all enterprise is directed towards increase of own profit, on the other hand, it is a party to the bankruptcy proceedings so it shall observe the balance of interests.

### **Recommendations for Ukraine**

The day-to-day practice proves that system of governing the activity of arbitration managers in Ukraine is ineffective. The reason for such situation is that there are no sufficient legislative provisions in place and that the provisions of the Law, which have already been established, are not used in practice.

The current Ukrainian legislation:

- embeds into the status of the arbitration manager the profound conflict of interests – it conducts its professional activity as an individual business entity - private person;
- the system of its business remuneration disrupts the balance of interests for the benefit of creditors;
- conditions of admission to business are formal and do not implement the function of effective "filters" for selection of adequate applicants;
- there are no provisions for existence of the self-regulating organizations, which should exercise professional control over such business;
- the government does not systematically control the situation in this sphere<sup>24</sup>.

Let us make an attempt to formulate the primary directions for improvement of the arbitration managers' institution on the basis of comparison of world experience with the established Ukrainian practice. The predominant purpose of the present recommendations is to substantiate approaches, which will facilitate increase in the professional level and establish effective countermeasures to prevent potential misconduct on the part of arbitration managers:

1) In order to diminish the gravity of conflict, which is embedded into the status of the arbitration manager, it is necessary to consider the issue of changing the business legal structure of conducting its enterprise. In our opinion, the more relevant structure as compared with the individual business entity - private person - shall be the «independent professional entity», which is granted to the lawyers, auditors, etc.

2) The system of governing the arbitration managers' activity shall be established in consideration of the status of independent professional entity, which is provided in Ukraine, for example, for the notaries. Such structuring of the above entities' business supervision more adequately meets the world requirements. This being the case, the primary attention within the system establishment process shall be drawn towards formation of the effective mechanisms for prevention of the negative aspects, which were evidenced in the business of arbitration managers particularly in Ukraine.

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<sup>24</sup> In accordance with the State bankruptcy department information, as of 01.08.2010, it administered 80 inspections of observation by the arbitration managers of their licensing provisions, which accounts for nearly 3 % of total amount of inspections.

3) It is necessary to increase efficiency of the "filters", which shall ensure admission to the said business of highly professional specialists that possess high moral and ethical qualities:

- requirements for the candidate shall be amended by adding the request for proofing the relevant experience in entrepreneurship and executive activity by the applicants;
- it is advisable that the applicant is entitled to obtain the license only after undertaking the training on the job or do an internship as the assistant to the arbitration manager;
- the training program needs to be viewed, it is necessary to establish system of an unprejudiced evaluation of the candidate's academic and practical skills;
- the applicant shall be a member of the self-regulating organization that is to be associated with and supported by the organization, which shall assume additional responsibility for the arbitration manager's actions;
- the applicant shall be entitled to independently bear responsibility for risks of his or her professional activity, that is their professional responsibility shall be insured.

4) The world practice testifies to the effect that the monitoring system of arbitration managers activity needs to be established as a "multi-channel" system:

- The primary system is the government control of individual arbitration managers' activity and their self-regulating organizations. The control shall be exercised by the specialized government agencies in the sphere of insolvency (special agency in the bankruptcy affairs, arbitration tribunal body, special-purpose public prosecutor's legality supervision, etc.).
- Additional system shall exercise a professional control through the framework of the self-regulating organizations. The self-regulating organizations will gain their legal capacity no sooner than the current legislation clearly specifies their role and functions in the bankruptcy proceedings. For example, membership in the self-regulating organization as an admission condition to the business of arbitration manager, selection of the candidates for the position of arbitration managers, which are to be appointed by the court, from the list of the candidates recommended by such organization, etc.
- Along with the world practice, the special government agency in the bankruptcy affairs shall be commissioned with the following functions: formation, assistance in development, and the control over activity of the self-regulating organizations that associate arbitration managers.
- The public control – it is necessary to introduce elements of publicity within the framework of confidentiality requirements for the arbitration managers' business. As of now, the insolvency sphere is closed for the public control.

5) Special attention needs to drawn towards preserving the balance of dual interests, which are inherent in the status of arbitration manager. Practitioners in the developed countries prefer independent sources of remuneration for the bankruptcy manager services. It is necessary to eliminate excessive dependence in terms of remuneration for the arbitration managers' services upon the committee of creditors In Ukraine.

6) It is necessary to establish effective system of the arbitration managers responsibility for results of their activity:

- a) administrative and criminal responsibility in accordance with the results of the monitoring from the government;
- b) responsibility to the self-regulating organization (possibility of loss of membership);
- c) personal financial responsibility for the professional risks (insurance).

## **8. Recommendations: approaches to establishment of the institutional system for governing the sphere of business entities insolvency**

The system of the government regulation in the sphere of insolvency of enterprises as a special direction for the government regulatory policies requires a specialized institutional system. Such system is established in many developed countries.

Ukraine has made several attempts to reconsider the institutional system of supporting the government regulatory functions in the sphere of insolvency. Still, up until now it remains weak and does not provide a necessary basis for effective accomplishment of the regulatory functions by the government.

There is a variety of models in the world for establishment of institutional system that enables the government to exercise its regulatory functions in the society. Each country establishes the model in consideration of the particular situation developed in the area of realizing its regulatory functions, existing system of the government, and administrative traditions.

The analysis of world practice is very helpful for determination of general principles of establishing such specialized institutional systems, in particular:

- dependency of the institutional systems establishment upon the determined objectives;
- other factors, which influence the establishment of the institutional system;
- the list of functions, which are to be exercised by the specialized executive bodies;
- optimal allocation of the specialized functions.

### **World experience<sup>25</sup>**

While generalizing practice of the developed countries, it is possible to put together the list of most widespread functions, which are performed by the government bodies in the sphere of the enterprises' insolvency. Those functions may be conditionally divided into four primary groups (Table 8.1):

1) The government policy: analysis of practice and development of the proposals with regard to the government policy and legislation improvement; methodical and consulting support.

2) Concerning the insolvent enterprises: maintaining the register of the bankrupt enterprises; establishment of the legally binding requirements with regard to accomplishment of the auditor inspections and property valuation; prevention of unfair actions; revealing of

<sup>25</sup> <http://www.birzhaplus.ru/fin/?44916>;  
[http://www.securities.org.ua/securities\\_paper/review.php?id=524&pub=3666](http://www.securities.org.ua/securities_paper/review.php?id=524&pub=3666)

fictitious bankruptcy; revealing of the wrongful acts by the enterprises' top management alongside with submission to the court of petition for their disqualification.

3) Concerning procedures: the right for declaration about admitting the debtor to be insolvent; examination of the activities; provisions for implementation of insolvency proceedings in the event of the enterprise's resources insufficiency to pay the procedural costs; protection of interests of the large groups of small creditors; provisions for payments of a salary and severance pay in the event of insufficiency of the bankruptcy assets.

4) Concerning specialists: organization of training for specialists; establishing the licensing procedure; monitoring of their activity; developing and monitoring the observance of a scale and rules for compensation of the arbitration and bankruptcy managers' work.

Functioning of the special government executive agencies in the developed countries with regard to insolvency of the enterprises is maintained on the similar principals, still their establishment, scope of authority, and particular structure of functions have their own specificity in various countries. Some countries develop an autonomous specialized system that intends to serve the government functions in the sphere of insolvency of the enterprises. Other countries do not observe such specialization - the government functions in the sphere of insolvency are disbursed among the relevant government agencies and exercised alongside with other vested functions.

In most cases, such differentiation in models of the institutional system establishment is a consequence of choosing the particular concept – or the countries consider problems of the enterprises insolvency only as one of vast majority of cases, which may be governed by the general commercial, administrative, and criminal legislation, or treat a problem of resolution of the enterprises insolvency as one of the important factors that make provisions for steadiness of the national economy development.

The most prominent examples of establishing the system of government regulation in the sphere of the enterprises insolvency *in the absence of specialized institutional system* are those that are practiced in Italy and France.

**Functions and authorities of the government agencies on bankruptcy affairs  
in the different countries<sup>26</sup>**

<b>Functions and authorities of the government agency concerning bankruptcy</b>	<b>Great Britain</b>	<b>USA</b>	<b>Sweden</b>	<b>Russian Federation</b>
<b>1. A government policy</b>				
The government control over legislation administration	+	+	+	+
Development of the legislation and power to initiate legislation		+	+	
Development of recommendations by the government with regard to the government policy	+	+	+	
Rendering of the explanations with respect to the legislation application	+		+	+
The analysis and provision to the government of the statistical information with regard to insolvency affairs	+		+	
Collection and analysis of results of the concrete resolutions accomplishment in the bankruptcy cases and development of the government recommendations to the courts and specialists in bankruptcy affairs	+	+	+	
Consultation of the government officials, judges, lawyers, and specialists in bankruptcy issues	+	+	+	

<sup>26</sup> <http://www.birzhaplus.ru/fin/?44916>

<b>2. Concerning insolvent enterprises</b>				
Obtaining information about the financially unsuccessful enterprises, including with the power of free access to the territory of such enterprises	+			+
Organization of carrying out expert evaluation of financial standing of the enterprises where the government possesses share in the authorized capital that exceeds 25 %				
Imposition of the legally binding requirements with regard to conducting financial audit of the debtor, including carrying out valuation of its assets value	+		+	+
Maintaining the register of the legal entities, which shall be registered in accordance with the legislation about bankruptcy	+	+	+	+
Prevention of the wrongful acts in the event of bankruptcy, revealing attributes of the intended and fictitious bankruptcy	+	+	+	+
Revealing of the deliberate actions of the top management (officials) of the operational enterprises	+	+	+	
Preparation of the conclusions about presence of attributes of the hidden, fictitious bankruptcy or making the enterprises bankrupt where the government possesses share in the authorized capital that exceeds 25 %				
Raising a demand on the debtor's manager for elimination of the detected violations of the current legislation on bankruptcy	+	+	+	+
Submission to the court of the petition for disqualification of the debtor's manager	+	+	+	+
<b>3. Concerning procedures</b>				

Reference to the court with the claim for declaring the debtor as insolvent (bankrupt) in the cases as provided by the current legislation	+	+		+
Expert inspection of the cases about bankruptcy (insolvency)	+	+	+	+
Provision for exercise of the bankruptcy proceedings at the enterprises, which do not have sufficient funds for accomplishment of the liquidating procedures (of the absent debtor)	+		+	+
Protection of interests of the large groups of small creditors in the course of accomplishment of the bankruptcy proceedings	+	+	+	
Ensuring the payment of indebtedness with regard to the salary and the severance payment to workers in the event of insolvency and a lack of bankruptcy assets			+	
<b>4. Concerning specialists</b>				
The organization of education system for the specialists on bankruptcy	+			+
Approval of the requirements to the persons who perform professional activity in the sphere of crisis management	+	+	+	+
The organization of monitoring the arbitration and bankruptcy managers' activity	+	+	+	
Licensing of activity of the bankruptcy specialists in the person of arbitration managers	+		+	+
The monitoring of observance of professional and ethical standards of activity by the bankruptcy specialists	+	+	+	
Development and monitoring of observance of a scale and rules of compensation for the arbitration and bankruptcy managers	+	+	+	

## Italy

General character of the government regulation system in sphere of the enterprises insolvency is stipulated in Italy by the special legislation about bankruptcy. Absence of specially designated executive authorities, which would commission certain functions in this sphere, originates from the principles, which constitute the basis for legal regulation of the business entities activity in this country.

Firstly, historically cases about insolvency of the enterprises in Italy is one form of the business cases about failure to discharge own contractual commitments. Therefore, the government regulation system in this sphere of subjects of the entrepreneurial activity discharges its inherent functions primarily by employing the general commercial (contractual) and administrative legislation as well as general provisions with regard to administration of the court proceedings.

Secondly, Italy as well as the majority of other developed countries of the world practices resolution of the insolvency problems primarily on a voluntary basis without bringing the case for consideration to the court. Only in cases where it is necessary to apply enforcement measures or upon non-reaching consent by the contractual parties cases about insolvency of the enterprises shall be brought for consideration to the court.

This situation determines a specific role of the government in administration of the cases about insolvency of the enterprises. As a rule, the city council acts in the capacity of the government prosecutor in such cases in this country. Government executive agencies are not directly or indirectly involved in the activities of this entity.

The government executive agencies are involved in the procedures of resolving the enterprises insolvency problems just in the capacity of:

- subjects if they are representatives of the government as one of the creditors (for example, in the issues associated with indebtedness with regard to tax payments);
- members of the creditors' committee if they act in the capacity of the advisory body;
- coordination body in cases when the arbitration manager intends to declare continuation of commercial activity of the insolvent debtor.

## France

France administers the procedure of the companies' insolvency without participation of the specially designated government body. Executive authorities engage in the problems of the enterprises only from the point of view of prevention of insolvency approach. Participation of the government and local executive authorities is exerted in the form of the financial or tax assistance.

Office of the Public Prosecutor possesses certain authority in the bankruptcy process. However, it is not a specially designated executive authority, which deals with the bankruptcy

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cases. The public prosecutor may submit the case about insolvency of the debtor with the appropriate justification for consideration to the court. It has the power to obtain information about all insolvency proceedings.

The Public prosecutor is entitled to set up the period of supervision, which it may administer in the following ways:

- request for the term continuation;
- request for replacement of the general procedure with the special simplified procedure, which is normally applied to the small-size enterprises;
- request for changing the functions of manager;
- exclusive conclusion or terminations of the contract on leasing, management, or operational rent.

The Public prosecutor has the power to submit the requests concerning appointment of the special bankruptcy manager, replacement of a number of persons, which participate in the insolvency proceedings (the bankruptcy manager, experts, representative of creditors, representative with regard to implementation of the plan, liquidator).

The Public prosecutor has certain powers with regard to the procedures as well: submission of requests with regard to termination of activity of the legal entities or liquidation of the enterprise by the court resolution, cancellation of the re-structuring plan.

It holds the power to administer the appeal procedures, to interfere with the processes of the sanctions application and bringing the criminal or administrative actions against persons, conduct supervision and demand compensation for the damages inflicted.

The public prosecutor possesses considerable powers with regard to bringing the case to the court concerning top managers of the enterprises; it may request the indebtedness repayment as well as performance of the re-structuring, initiation of the bankruptcy procedure or other actions against entities. It may also bring cases for consideration before the criminal court.

Still, the majority of the developed countries prefers to establish *creation of the special institutional system for resolution of the issues associated with insolvency of the business enterprises*. These executive authorities, as a rule, possess high enough status, which allows them to genuinely influence all the associated procedures and their participants.

### The Great Britain

In the Great Britain, the role of the bankruptcy authority is administered by the Insolvency Service, which is part of organizational structure of the Department of Trade and Industry. It is quite sizeable structure. Its permanent staff includes 1800 employees.

Functions of the Insolvency Service include:

- Licensing of specialists, monitoring of their activity;
- administration of functions of a bankruptcy manager in the cases of insufficient assets of the bankrupt enterprises for payment of services of the bankruptcy manager from among the independent specialists;
- identification of the possible reasons for bankruptcy of the debtor and its accrued losses;

- identification of the reasons for not notifications about bankruptcy by directors of the debtor enterprise as soon as it became clear to them that business continuation is impossible;
- audit of the documentation of the companies in cases of obtaining the complaints from clients, partners, or the public;
- instruction of the unsuccessful companies to pass the auditors' check and appointment of the corresponding auditors at the expense of the company;
- insisting on liquidation of the enterprises in case the Insolvency Service has come to conclusion that it is meets the interests of society (such cases constitute approximately 1 % of all bankruptcy cases in the country);
- commence the legal proceedings in the court against the debtor.

### USA<sup>27</sup>

Since 1934, [US Securities and Exchange Commission](#) (SEC USA) within the structure of the government of USA has served as a government agency on that deals with insolvency issues. The American Bankruptcy law as revised in 1978 establishes three groups of the main functions for SEC as follows:

[appear before the court](#) and to be heard on all the issues concerning affairs about bankruptcy, in particular, with respect to appointment of the bankruptcy manager, appointment of the commissions of creditors and shareholders, level of payment for bankruptcy manager services, property utilization, sale, and lease;

supervise and provide for adequacy of the statements by the debtor enterprises about their financial position and availability of the assets;

appeal against the approval by the court of the reorganization plan on the basis of abusing on the part of the debtor.

In some cases SEC will appeal against terms of sale of the operational insolvent enterprises, insisting on and securing other conditions.

In 1983, the Institute of Federal Managers was established in addition to the SEC. As it was already mentioned in the previous section, its members belong to the special executive authority – Executive bureau of federal managers. The bureau is a part of the US Ministry of Justice.

The bureau acts in the capacity of "supervisor" over the insolvency proceedings and is established to ensure the complete federal system of bankruptcy on the part of General public prosecutor of USA.

The major purpose of the federal managers is the control over activity and payment for services of the private bankruptcy managers as well as prevention of the fraud, dishonesty, and violation of the law in the course of insolvency proceedings administration.

Once again, we restate the functions of federal managers:

- the primary function – administration of supervision of the process of liquidation, reorganization, and other procedures;

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<sup>27</sup> <http://www.duma.gov.ru/sobstven/analysis/bankruptcy/120404usa.htm>

- responsibility for appointments and exertion of supervision over activity of the private managers of bankruptcy assets (private employees who manage bankruptcy assets of the debtor);
- compliance with law provision about bankruptcy, prevention of misconduct and abuse;
- bringing the cases before the investigation agencies and criminal court;
- ensuring the timeliness and professionalism of administration of the bankrupt's assets and consideration of reasonableness of the professional fees;
- appointment of the creditors' committees and convocation of their meetings in the course of reorganizing the enterprises.

### Canada

There is a specialized government agency in Canada that deals with the issues associated with bankruptcy, which reports to the country government – “Institute of superintendants on insolvency”. This agency scope of competence involves the following functions:

- legislative initiative concerning the issues associated with insolvency;
- generalization of the experience and practice of bankruptcies in the country;
- development and monitoring of observance of the uniform professional standards by the arbitration and bankruptcy managers;
- licensing, monitoring of the activity and revoking license of the specialists on bankruptcy;
- bringing the cases about bankruptcy before the courts.

### Sweden

The government agency that deals with bankruptcy issues in Sweden is a part of the unified system with tax service and law-enforcement agencies and is in dual general subordination to the Ministry of Finance and Ministry of Justice. This agency has departments in all parts of the country. It administers the control and governance of exercise of insolvency procedures. Its powers involve:

- development and monitoring of implementation of the government policy in the field of bankruptcy;
- consultation of the courts, which are engaged in the insolvency procedures;
- education, licensing, and consultation of the bankruptcy managers;
- administration of the functions of bankruptcy managers in case of bankruptcy of the small enterprises;
- consultation of creditors in the course of administration of the insolvency proceedings;
- assessment of the level of payment for services of bankruptcy managers, payment of balance for services of these specialists in case of lack of resources with the debtor's enterprise;
- monitoring of observance of the secured creditors' interests;
- ensuring publication of information about declaring the enterprise a bankrupt.

## Russia

Practice of Russia includes the initial stage when in order to strengthen the system of government regulation in the sphere of insolvency of subjects of entrepreneurial activity the special government agency was established, which has been reorganized several times. Since September 1993, Federal department on the insolvency (bankruptcy) affairs has become functional in the Russian Federation as part of the State property fund of the Russian Federation. In March 1997, Federal service of Russia in the affairs of insolvency and financial improvement replaced the previous department, which in June 1999 was transformed into the Federal Agency of Russia on financial improvement and bankruptcy.

Search for the optimum alternative of development of the special agency lengthened out, so further on Russia took some other way. In March 1999, the Federal Agency of Russia on financial improvement and bankruptcy was liquidated.

Further on, the institutional system of government regulation in the sphere of insolvency functioned in a following way:

Firstly, entering in action of the new Law «On insolvency (bankruptcy)», which described in details all the procedures, powers, functions, and authority of all the subjects – participants of the process;

Secondly, allocation of functions of the special body among the corresponding government agencies, which status and resources provide for their more effective administration;

Thirdly, improvement of institute of arbitration managers with higher degree of governing their conduct, responsibility for results of their actions, and thorough control on the part of the government.

Special powers of regulation authority in sphere of insolvency and financial improvement of infections are vested in the Department of corporate governance, which is a structural subsection of the Ministry of economic development of the Russian Federation. Its primary powers include the organization of work in the area of: development of government policy and exerting the regulatory support, including the rules and way of activity of the self-regulating organizations; professional training and activity of arbitration managers; carrying out of the financial analysis, inspection of the hidden or fictitious bankruptcy; maintaining the register of the bankrupt enterprises, etc.

The department performs similar functions with regard to the spheres of valuation business, government cadastral valuation of the land, land ownership relations, and the government statistical business.

Since 2005, the Federal Agency of the government registration, cadastre, and cartography has administered the powers of the supervision body. The service revises activity of the self-regulating organizations of arbitration managers. It is entitled to commence the administrative proceedings in the court concerning breaching the law by arbitration managers.

## ***Conclusions***

Since research was accomplished on the basis of express-analysis, the authors were forced to use only publicly available information, which does not cover a complete picture of establishment of the special institutional system in the different countries. Still, even these fragments provide opportunity to specify approaches, which need to be employed by Ukraine:

- The choice between establishment of the special control agency with considerable authority and refusal of establishing the special control system for insolvency sphere

depends on the selected concept by the country of organization of the governance system in the sphere of insolvency and establishment of the nation-wide regulatory system.

- The powerful specialized agency is created in those countries where the society intends to strengthen influence of the government upon governing of the insolvency sphere. In addition, specialization always serves as the additional factor for quality assurance of administration by the government of its regulatory functions.
- The government functions in the sphere of insolvency comprise three primary groups:
  - a) formation of the government policy and legislation;
  - b) implementation of the government policy (support of the processes is required);
  - c) administration of the systemic control.

In order to prevent the conflict of interests, these groups of functions, as a rule, shall be separated in the institutional way.

- The concrete allocation of such functions has considerable differences in various countries. For example, all of them may concentrate in the special agencies that deal with the bankruptcy issues. Still, they may be allocated among the special agency and special-purpose government departments. In certain countries, the specialized agency is absent at all and its functions are allocated just among the special-purpose departments. The choice of model is influenced by the tasks of establishing necessary institutional conditions for effective administration by the government of its regulatory functions.

### **Recommendations for Ukraine**

The law «On restoration of insolvency of the debtor or recognition it as bankrupt» has specified the type of institutional system for supporting the regulatory functions in the sphere of insolvency. The status and the scope of competence of the special government bankruptcy is designed to establish the economic and organizational preconditions for implementation of a government policy towards prevention and overcoming of bankruptcy.

Since 2006, the State bankruptcy department under the Ministry of Economics of Ukraine has administered the function of special government agency in the sphere of bankruptcy.

Practice of the latest years has shown that the existing institutional system does not render necessary support for administration of the regulatory government functions in the sphere of insolvency. It does not provide for the systemic and complete way of administration of the function, which constitute the matter of government regulatory policy.

**Change of the status and functions of a government agency on bankruptcy in Ukraine**

The agency title	Period of existence	Status	Participation in administration of the functions in sphere of recovery of insolvency and bankruptcy
<b>Agency on bankruptcy affairs</b>	17.06.1996 15.12.1999	Central executive authority	<p><i>Government policy:</i> formulation of the government policy and monitoring of compliance with legislation.</p> <p><i>Concerning the enterprises:</i> maintaining the register of the bankrupt enterprises; regarding the state owned insolvent enterprises: monitoring, register maintaining, property administration, sanitation and re-structuring administration.</p> <p><i>Concerning procedures:</i> participation in the absence of the debtor.</p> <p><i>Concerning specialists:</i> organization of the training.</p>
<b>Agency on bankruptcy affairs</b>	15.12.1999 24.09.2005	Self-sustained government agency under the Ministry of Economics of Ukraine	<p><i>Government policy:</i> function of the Ministry of Economics.</p> <p><i>Concerning the enterprises:</i> maintaining the register of the bankrupt enterprises; regarding the enterprises, in which the government share in the authorized capital constitutes more than 25 %: administration of audit of their financial standing, preparation of proposals and conclusions concerning presence of attributes of fictitious bankruptcy, carrying out of <a href="#">pre-judicial restructuring</a> and property sale.</p> <p><i>Concerning procedures:</i> the expanded participation.</p> <p><i>Concerning specialists:</i> organization of training and assessment of conformity of their activity to the current legislation provisions.</p>
<b>Government bankruptcy</b>	25.03.2006	Governmental body of the	<p><i>Government policy:</i> function of the Ministry of Economics.</p> <p><i>Concerning the enterprises:</i> maintaining the register of the bankrupt enterprises; regarding the enterprises, in which the government share in the authorized capital constitutes more than</p>

<b>department</b>		state administration as a part of the Ministry of Economics of Ukraine	<p>25 %: administration of audit of their financial standing, preparation of proposals and conclusions concerning presence of attributes of fictitious bankruptcy only upon request of the court.</p> <p><i>Concerning procedures:</i> participation in the absence of debtor.</p> <p><i>Concerning specialists:</i> organization of training and assessment of conformity of their activity to the current legislation provisions..</p>
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Judging by the results of the analysis of world practice, we will specify approaches to development of the institutional support of the government functions in the sphere of insolvency, which take account of the concrete situation in Ukraine:

1) Given the general weakness of the government, non-developed legislation and mass insolvency of subjects of entrepreneurial activity, establishment of the special institutional system is a necessary precondition for Ukraine for ensuring efficiency of administration by the government of the regulatory functions in the sphere of insolvency. The special institutional system in the Ukrainian situation increases opportunities for achievement of the systemic and complete way of administration of the function, which constitute the matter of government regulatory policy.

2) The selection of institutional system format shall not create the conflict of interests. Practice of Ukraine provides evidence that in the event of vesting the conflicting functions into one body they cannot be supervised, and illegitimate interests (of departmental, political, corruption, and other nature, etc.) prevail in such agency's activity. The specialized functions shall be separated in the institutional way: government policy formulation – government policy implementation – control functions.

3) It is inappropriate to create analogues of the previous autonomous agencies as the history of Ukraine proves that they are impractical bodies and not only in the sphere of bankruptcy. The primary reason for liquidation of the majority of them is their low status and lack of resources (financial and administrative), which they may dispose of. Much more rational approach is to optimally use the potential, which is inherent in the existing institutional scheme «the Ministry of Economics of Ukraine – State bankruptcy department».

The «central executive authority – structure subordinate to it, which exercises a role of specialized government agency on bankruptcy» scheme is the typical one for the majority of developed countries. This scheme, on the one hand, provides for separation of the inherently conflicting functions (formulation and implementation of the government policy), on the other hand, it lays the foundation for achievement of unity of a government policy and practice of its implementation.

There is a hope that unlike the previous stages of history of Ukraine, there is a possibility to optimally employ the administrative scheme «Ministry of Economics – State bankruptcy department» in the current situation. [Certain optimism is also buoyed by the fact](#) of achievements by a new ruling authorities in restoration of an administrative vertical and strengthening of administrative discipline after five years of political destabilization and administrative wars.

4) It is necessary to review a scope of functions of the State bankruptcy department, which performs a role of special agency in this sphere, in particular:

- liberate it from all functions, which are not inherent in it (for example, management of the enterprises, which are subordinate to the Ministry of Economics);

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- remove restrictions on administration of separate functions concerning the sphere of enterprises, where the government share in the authorized capital exceeds 25 % (for example, detection of attributes of fictitious bankruptcy, check of the arbitration managers' actions, etc.);
- provide for increasing of the methodological support and consultation with regard to carrying out of procedures aimed towards detecting the attributes of insolvency and facilitation of the pre-judicial improvement of insolvent enterprises of a private sector;
- increase a role in formulation of the government policy and revision of current legislation (on the basis of generalizing the previous experience).

5) A problem, which requires careful additional research, is selection of a format of institutional support of the government's specific functions – detection (investigation), prevention, and forcible discontinuation of misconduct, fictitious bankruptcy (bringing to bankruptcy). These types of violations are quite popular in the sphere of subjects of entrepreneurial activity insolvency in Ukraine.

These functions are administered in the administrative practice of Ukraine in accordance with five schemes, so it is necessary to select a format for administration of functions in the sphere of insolvency among those schemes:

- target functions of the Office of Public Prosecutor and State Security Service;
- target judicial supervision;
- within the structure of the tax authorities, which are the most active inspectors and initiators of collecting of tax liabilities with employment of the courts;
- Quasi-investigatory and quasi-judicial functions, which are administered by the government bodies with special status (analogue – Antimonopoly committee of Ukraine);
- within the framework of the general control functions of government bodies (analogue – the State Committee of Ukraine for regulatory policy and entrepreneurship).

As in other countries, these functions may be administered on a systemic basis by several government agencies. They may allocate in accordance with two major directions: control of activity of the arbitration managers and prevention of fictitious bankruptcy.

## **9. The new legislation: types of examination**

As of today, there is no recognized standard in Ukraine for carrying out of examination of the draft laws. Verkhovna Rada and the Ministry of Justice of Ukraine implement the practice of carrying out of obligatory legal examination of all draft laws<sup>28</sup>. In 2009, the Cabinet of Ministers of Ukraine approved the Methodology of carrying out of anticorruption examination of the drafts regulatory legal acts<sup>29</sup>, which now is an obligatory procedure. In the course of examination, the majority of ministries employ the methodical recommendations, which they independently approved for the scope of own competence.

<sup>28</sup> Executive office of Verkhovna Rada of Ukraine. The rules for drawing the draft laws and the primary requirements for the legislative technique (methodological recommendations). Kyiv, 2007; methodological recommendations with regard to conducting the legal examination of draft regulatory legal acts as approved by the resolution of collegiums of the Ministry of Justice of Ukraine dated 21.11.2000 No. 41.

<sup>29</sup> Methodology of administration of anticorruption examination of the draft regulatory legal acts as approved by the Resolution of the Cabinet of Ministers of Ukraine dated 8 December 2009 No. 1346.

Beginning from the middle of 1990s, both the President and Verkhovna Rada of Ukraine several times assigned the task of development of a methodology for carrying out the criminological examination, which covers also the economic draft laws. It is associated with the mass expansion of corruption and economic crimes. Yet, the final decision is not adopted, this issue is still in the stage of consideration by various interested parties.

Discussions about necessity of establishing the general rules of drafting the laws and among them – standards of draft laws examination are under way in Ukraine for quite a long time. The most complete and, from our point of view, the most reasonable approach is formulated in the Methodical recommendations about preparation and registrations of the draft laws (a law development rule) prepared by the Legal Policy Institute<sup>30</sup>.

The draft of Methodical recommendations offers the standard of obligatory examination with regard to preparation and registration of the draft laws, which includes 7 types of examination. Among them, 5 types may be applied towards examination of the draft Law on insolvency and bankruptcy, in particular:

legal examination ;

scientific examination;

anticorruption examination;

criminological examination – for the draft laws in sphere of regulation of economy, financial and banking and insurance activity, criminal and civil legislation as well as with regard to other issues, which legal regulation may affect the society criminalization;

public evaluation.

The abovementioned draft law does not require mandatory carrying out of the financial and economic examination (draft laws, which implementation shall require certain financial and other material expenses allocation) as well as examination for a gender equality.

Below are the approaches for accomplishment of certain types of examinations as explained in details:

for the legal, scientific, and public examinations – on the basis of the Methodical recommendations about preparation and formalization of the draft laws (a law development rule) as prepared by the Legal Policy Institute;

for anticorruption examination – on the basis of Methodology of carrying out the anticorruption examination of the regulatory legal acts' drafts as adopted by the Cabinet of Ministers of Ukraine;

for criminological examination – on the basis of the drafts of corresponding laws, which have been submitted for consideration to Verkhovna Rada of Ukraine.

As the listed documents stipulate just general approaches and, basically, in the context of law, authors of the current report took the liberty to make some amendments to the above concepts. By their nature, these amendments shall become the requirements, which, from our point of view, shall be introduced to the draft law that is intended for regulating the sphere of insolvency.

Ukraine now is on a threshold of new wave of market reforms. And in consideration of this, the imperative mission in this period shall become examination of the economic draft laws for conformity with the market reforms requirements, that is for liberal standards, which are

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<sup>30</sup> Methodological recommendations with regard to preparation and formalization of the draft laws (law development rules).

recognized in the world, and the mission of reorganizing the Ukrainian economy towards this objective.

### **Legal examination**

This type of examination is the basic one for any draft law. The draft law shall be subject to obligatory legal examination irrespective of its type, subject of the legal regulation, terms of preparation, etc. Practice of legal examination has attained the most extensive development in Ukraine.

Legal examination is an assessment by the specialists-lawyers of the draft law for its conformity with the Constitution and current legislation of Ukraine, competence of the law drafting authority (official), estimation of financing of the drafted legal provisions, which are to be implemented, support of their accomplishment by the organizational measures, sanctions, encouragements, as well as observance of the law drafting rules.

The major purpose of the examination is assurance of the draft law conformity with the Constitution of Ukraine, coordination with other acts of the legislation, conformity with the international obligations of Ukraine and provisions of the legislation of the European Union, and prevention of origination of conflicts of jurisdiction (elimination of gaps).

In order to carry out legal examination for conformity of the draft law positions with the primary legal framework of EU, practitioners need to:

- study the situation with regard to governing by the legislation of EU provisions, which are contained in the draft law, and procedure resolving the issues that lay within the scope of legal regulation of the draft law;
- determine the degree of conformity of the draft law provisions with the primary legal framework of EU.

While conducting the legal examination of the Draft law on insolvency and bankruptcy for conformity with the primary legal framing of EU, we suggest drawing special attention to assessment of presence of factors, which are indicative of non-observance of the primary liberal approaches (discordance with the tasks of reforming):

- harm the regulation purposes – unavailability of a debt repayment;
- violate guarantees of the ownership title;
- lead to inequality of subjects of the entrepreneurial activity in the market (distort market competition);
- do not observe balance of interests;
- establish additional barriers to an entrepreneurial activity.

### **Scientific examination**

Ukraine is the country with transformational economy, that is, it is characterized by the process of stage-by-stage reorganization of economy towards a market direction. In consideration of Ukrainian features, it is possible to conclude that this process in a sense is an innovation not only for Ukraine but also for a world history of implementing the liberal reforms.

Transformational nature of the economy poses specific requirements to the regulatory legal acts, which determines a format of government regulation system – it shall be adequate to the stage, on which the real economic transformations are implemented. The previous experience

has shown that the inadequate regulatory legal base leads to the considerable negative consequences in development of the Ukrainian economy – to growth of the shadow economy and mass corruption scale.

So, the test for adequacy to a concrete stage of reforming of the Ukrainian economy is an obligatory type of examination of any economic draft law. Such examination may not be exercised within the frameworks of legal examination. It may be accomplished only within the scope of scientific examination.

Scientific examination is an activity of relevant bodies, organizations, specialized expert organizations, individual experts and expert commissions, which involves research and assessment of the scientific level and legal characteristics of the draft law, conformity of its concept with the principles of domestic and foreign policy as determined by Verkhovna Rada of Ukraine, with nation-wide programs and specially established requirements (economic, financial, criminological, national safety, ecological, etc.).

Scientific examination of the draft law shall be conducted by the research, expert, and other special organizations and institutions, independent scientists, and specialists, which possess the required qualification and special knowledge in the corresponding area of the law. Foreign organizations and enterprises, international organizations, and individual scientists and specialists from other countries may also be involved in performance of examination.

In the course of examination, specialists assess conformity of the draft law provisions with the international standards in sphere of guaranteeing human rights, coordination with the main principles of domestic and foreign policy of the country, nation-wide programs, study observance of the requirements concerning ensuring of the national, economic, financial or ecological safety of the county as well as appropriateness and reasonableness of adopting the act, etc.

Regarding the Draft law on insolvency and bankruptcy, we suggest to conduct additional examination of its provisions, within the framework of scientific examination, for conformity with:

- objectives of the government regulation in the sphere of insolvency – provision of unavailability and completeness of a debt repayment to the creditors in the established period (for example, in the course of choosing methods of guaranteeing the national, economic, or ecological safety in case of bankruptcy of certain types of enterprises);
- real situation, in which the regulatory policy of the government shall be implemented, that may lead to an inaccuracy of the purposes and tasks intended in the draft law as well as to strengthening of negative tendencies in development of the Ukrainian economy (for example, with a weak institutional control system over the state owned enterprises).

### **Public examination**

One of important directions in the post-socialist transformation of Ukraine is transformation of a totalitarian political regime, which was in place during the Soviet period, into a democratic society. An inseparable element of a democratic society is establishment of conditions for active participation of the public in adopting the important decisions for society. This goal is perfectly served by the mechanism of public hearings. Public examination shall be performed for the purpose of studying the public opinion and obtaining of consultations from

citizens with respect to subject of the legal regulation, proposed ways of resolving the mentioned problem and choosing an optimum alternative of settlement of issues touched upon in the draft law.

As of now, Ukraine established the certain mechanism of public hearings. Public hearings are normally organized for draft laws, which regulate an issue that is of important political or social and economic importance for development of region or separate area of economy or a government field of activity, as well as in cases when the draft law contains provisions, which influence the rights and freedoms of person and citizen and vital interests of the variety of people and entities.

The coordinating committee shall be established for administration of the organizational matters and facilitation of coordination of the work associated with assuring the registration and processing of remarks and proposals, which arrive in the course of the public hearings, and their further inclusion in the draft law.

The period for conducting public hearings of the draft law shall not be less than one month and more than three months.

The draft law shall be published in the mass media, placed in Internet and brought to the notice of wide spectrum of population in other ways.

The remark and proposal are subject to the obligatory consideration by developers of the draft law. The analysis of the received proposals takes place in the mass media, in Internet and other sources, which were used for bringing the corresponding draft law to the notice of wide spectrum of population.

### **Anticorruption examination**

Presence of mass corruption in Ukraine results in deformation of the regulatory policy and real practice. The Ukrainian experience provides many examples when the passed laws during their application and the declared market reforms during their implementation bring in the opposite result.

Attempts of introduction of the draft laws anticorruption examination are accomplished in Ukraine for quite a long time. Mandatory performance of the anticorruption examination of draft laws officially took effect only in 2009<sup>31</sup>.

Table 9.1 below summarizes the corruption factors and their attributes, which shall be considered in the course of anticorruption examination of draft laws in accordance with the official Methodology.

Table 9.1

### **Corruption factors and their attributes**

Expansion of the discretionary powers	Indeterminacy of the term for making decision, absence of conditions and grounds for their adoption, duplication of functions of the various government agencies.
Abusing own authority	Absence of powers of a government agency with respect to

<sup>31</sup> Methodology of administration of anticorruption examination of the draft regulatory legal acts as approved by the Resolution of the Cabinet of Ministers of Ukraine dated 8 December 2009 No. 1346.

	adoption of the legal act or establishment of standards of conduct under the condition of absence of the act of prevailing legal force on this subject.
Establishment of the over-inflated requirements for the private persons and legal entities	Unlimited list of documents, which are requested from the private persons and legal entities, or absence of grounds for refusal in exercising by such persons of their powers.
Usage of the rights of private persons and legal entities depending on the interests of official or officer of a government agency	Absence of the clear procedure of exercising by the private persons and legal entities of their rights in the presence of different methods or terms of administering any deeds within the framework of the established administrative procedure.
Selective change of scope of the private persons and legal entities' powers	Establishment of exceptions from a general standard of conduct for the private persons and legal entities, which depends on a choice by the official or officer of a government agency.
Excessive freedom of by-law making	Establishment of the blanket <sup>32</sup> rules in case of absence of key standards of conduct as established by the act of the prevailing legal force.
Not clear language formulations	Notions and terms, which are interpreted ambiguously, categories of estimating nature, which render opportunities for expansion of the discretionary powers of government agency.
Presence of the gaps in legal regulation, conflict of laws, and declarative provisions	Lack of the provisions, which regulate certain public relations or procedures that permit the executor to eliminate such legal gap in the process of law enforcement at own discretion.
Absence or incompleteness of administrative and competitive (tender) procedures	Lack of established procedure for carrying out by government agencies, their officials and officers of certain actions, as well as absence of certain elements of such procedure.
Absence of prohibitions and restrictions in the course of making decisions by the government agencies, their officials and officers	Absence of preventive provisions, which determine the status and authority of the government agencies officials and officers.
The erroneous purposes and priorities	Objective unreasonableness of adopting the legal act, excessive complexity of the mechanism that regulates the public relation, and non-conformity of the act provisions with its declared purposes.
Presence of actions, which may permit or provoke committing the corruption offences	Presence of the corruption provision, which permits committing the corruption offences.
Violation of balance of interests	Establishment of privileges for one group of parties to a

<sup>32</sup> Legal provision, which entitles government officials to independently establish standards of behavior or refers to other regulatory legal acts.

	legal relationship, which narrows or limits the rights of other persons and may testify to wrongful interest during preparation and implementation of the legal act.
Evasion from the established procedure	Use of opportunities concerning establishment of distinctions for the purpose of evasion from performance of the general procedure as specified for the relevant public relations.

Analysis of the abovementioned factors illustrates that the primary attention is drawn towards examination of separate provisions for possibility of corruption actions of an official (employee).

Still, development of the regulatory process itself and direct procedures for making decisions are very important for prevention of corruption. Anticorruption development of the regulatory system and separate procedures in accordance with world practice implies presence of the following elements in them:

- publicity;
- openness;
- transparency;
- open access to information.

In connection with this, we suggest introduction of examination of the above mentioned parameters as an obligatory component in the anticorruption examination.

### **Criminological examination**

It is a widespread opinion among criminologists that any repeatedly published law is a direct or indirect source of the new violations. Its qualitative criminologic examination is capable to detect all criminologically meaningful factors or at least minimize the criminogenic consequences of its adoption and implementation.

In Ukraine, criminal offences in the economic sphere is quite common. In particular, specific criminal offences are commonly committed in the sphere of insolvency, which are associated with misconduct that results in inflicting damage to the debtor or creditors, as well as implementation of fictitious bankruptcy (bringing to bankruptcy) for the purpose of pursuing the sordid motives. As practice has shown, the current Law «On [reestablishing the debtor solvency](#) or declaration it a bankrupt» does not establish barriers to the spreading of such types of offences (for example, lack of the procedures of their detection and "the alarm" centers).

In connection with this, criminological examination needs to be considered as an obligatory type of examination for regulatory legal acts, which regulate sphere of insolvency of subjects of entrepreneurial activity.

Criminologic examination<sup>33</sup> means revision and examination of the draft regulatory legal acts accomplished on the basis of scientifically reasonable technique with use of criminologic knowledge for the purpose of detection and prevention of statutory recognition of the provisions, which implementation may lead to strengthening the effects of reasons and conditions that result

<sup>33</sup> The formulation that is normally used in the draft laws on the criminological examination.

in commitment of crimes, or weaken the social resources (measures) directed towards elimination of such reasons and conditions.

The primary purposes of the criminological examination are as follows:

objective and complete assessment of the draft law, upon request, as submitted for criminological examination, for conformity with modern level of the scientific criminological knowledge with regard to crime prevention;

sufficient usage in the course of realization of expert examination of the draft law of information about criminal and anti-criminal factors, which have effect in the sphere of its regulation;

forecasting and estimation of the possible negative consequences of implementation of the draft law provisions, in case of its adoption, with regard to strengthening criminal and weakening anti-criminal factors.