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*Elena A. Podkolzin*a

THE INSTITUTION OF BANKRUPTCY: RULES AND BEHAVIOR STRATEGIES RUSSIAN EVIDENCE

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The main function of the institution of bankruptcy is to resolve problems arising from insolvency. The main goal of this paper is to study the possible approaches to resolving the insolvency problem. We define the structure of the institution of bankruptcy, which we consider to consist not only of legislation and its enforcement, but to also include informal out-of-court mechanisms and the possibility of different economic agents interpreting the same fact differently. This helps us understand the differences in how agents behave in the framework of this institution. The focus in this paper is on the mechanisms that could be used outside formal proceedings, all of which are illustrated by examples from Russian evidence. We also discuss the development of the institution of bankruptcy in Russia.

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Основная функция института банкротства — это решение проблем, связанных с различными аспектами ситуации неплатежеспособности экономических агентов. Главная цель данной работы — анализ различных вариантов разрешения проблем несостоятельности. На основе анализа различных стратегий компаний определяется структура института банкротства. Мы включаем в понятие института банкротства не только законодательство и соответствующие механизмы принуждения к исполнению, но и неформальные внесудебные правила разрешения проблемы, а также рассматриваем влияние различных интерпретаций одних и тех же фактов разными экономическими агентами на варианты использования института банкротства. Особое внимание в работе уделяется внесудебным неформальным механизмам. Для каждого механизма приводится пример из российской практики, также в работе обсуждаются пути развития института банкротства в России.

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State University — Higher School of Economics, Moscow:
Laboratory for Institutional Analysis of Economic Reforms
Department of Institutional Economics
E-mails: e_podk@mail.ru, epodk@hse.ru

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Introduction

The institution of bankruptcy is an important element in the functioning of modern market economies. Bankruptcy legislation codifies the rights of creditors and debtors and thus provides incentives for economic activity. Bankruptcy enhances competition in the markets by excluding inefficient structures. A high level of competition and the threat of going bankrupt increase managers' incentives for conscientious governance of their companies; strong protection of creditors' rights reduces the cost of credit. An institution of bankruptcy that functions well reduces the risks for creditors, raises the level of investment activity, secures property rights and increases trade. As a result, the institution of bankruptcy improves the business climate in the country.

Russia has had bankruptcy legislation since November 1992. A new law was introduced in March 1998. Before 1998, bankruptcy cases were extremely rare; however, a sharp increase in the number of bankruptcies was observed after the adoption of the 1998 law. Though experts state that the 1998 bankruptcy law was written well, in reality Russian bankruptcy law led neither to a restructuring nor to a hardening of the budget constraint of managers. The legal system in Russia was faulted by the widespread corruption of regional arbitrage courts. A new version of the bankruptcy law was adopted at the end of 2002.

This paper deals with the insolvency (bankruptcy) legislation of Russia, or more precisely with the institution of bankruptcy in Russia. There are several approaches to studying bankruptcy. Traditionally, it was lawyers who have analyzed bankruptcy law, and standard legal theory focuses its analysis on the aspects of fairness and equity in bankruptcy. Over the last two decades, many studies on the economics of bankruptcy proceedings have been published. Economists analyze bankruptcy law as a legal instrument to achieve the best possible outcome, which implies the minimization of social losses. From the perspective of law and economics, the efficiency of bankruptcy procedures is at the core of the analysis. We analyze bankruptcy as one of the essential institutions in the economy, and we argue that the institution of bankruptcy should not be reduced to the legislation of bankruptcy.

The main goal of this paper is to identify a set of possible rules that economic agents actually use to solve the problem of insolvency. We argue that these rules form the institution of bankruptcy, and in doing so we thus extend the concept of institution further than economists usually do. We analyze the relationship between the behavioral strategies of companies and a set of rules that underlie the institution of bankruptcy. This helps us to understand the differences in how agents behave in the framework of this institution. We focused on the mechanisms that could be used before formal proceedings ensue. Our discussion is based on a number of studies that analyzed Russian experience.

Insolvency problems

Our starting point is to define the essence of the insolvency problem. We look at the possible causes of insolvency problems and the available means to overcome them.

The main parties are a debtor and a creditor. The starting point of their relations is the signing of a contract. In accordance with this contract, the creditor gives the debtor the assets necessary for the completion of a specific project, and the debtor is obligated to repay the creditor by a certain date. The ability of the debtor to pay off the debt depends on the success of the project, and this is determined by the debtor's efforts and the manager's capabilities as well as by external conditions. If insolvency problems arise, the parties can come to an agreement as to how the debt will be discharged either via official procedures and court hearings, or via out-of-court procedures.

Let us consider this situation in detail. We outline the insolvency problems in order of their appearance, and split this process into four stages:

- **First stage:** pre-contract relations, working up and signing a contract (occurrence of obligations).
- **Second stage:** the debtor faces insolvency.
- **Third stage:** bargaining, renegotiation and bankruptcy.
- **Fourth stage:** new contract or payments through liquidation.

The first stage. In considering the insolvency problem it is important to start with *ex ante* incentives for the agents. Potential creditors must have incentives to lend money and a potential debtor must have incentives to use the received money for the agreed-upon purposes, and to return the money to the creditor at the appointed time. These incentives are highly correlated with the level of contract enforcement and the set of strategies available to the firms (see the *"Bankruptcy rules"* section).

Analysis of bankruptcy is usually based on contract theory. Relations between the participants in a potential insolvency problem are characterized by asymmetric information and the associated difficulties. Thus, bankruptcy legislation can be treated as a way to signal the "quality" of parties: "The presence of standard bankruptcy contracts reduces the information burden imposed on them..."[1].

The second stage. We can enumerate the following general ways in which the relationship of the parties may evolve after the signing of the contract:

- No financial problems preventing the repayment of the debt arise[2], and all contractual obligations are fully met.

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[1] [Stiglitz, 2002, p. 609].

[2] We assume non-opportunistic behavior of a debtor: if he is able to, he will pay off his debt. However, there are cases when parties use bankruptcy to reallocate property rights, and here the main object is to make a profit, not to repay the debt. This problem was considered by [Akerlof, Romer, 1993]; [Lambert-Mogiliansky, Sonin, Zhuravskaya, 2000]; [Radygin, Simachev, 2005].

- Structural shifts[3] have taken place in the economy. The debtor's project failed, and he has to overcome these shifts but has no funds to repay the debt.
- The debtor company's management is inefficient.
- Temporary insolvency is caused by fluctuations in business activity. Generally, this situation is easily overcome by the company.

We outline three possible causes for the emergence of an insolvency problem. Information about structural shifts in the economy is not information known to the private debtor. For this reason, we assume that the creditor is able to recognize this situation. The appearance of two other factors (management inefficiency and temporary insolvency) is information usually known to the private debtor, and the creditor cannot be sure about the cause of insolvency. However, it is essential for the creditor to determine the root of the insolvency problem in order to make further decisions. Looking ahead, the scenario develops as follows: first the debtor recognizes the appearance of difficulties and decides whether or not to disclose them to the creditor[4]. If the debtor decides not to cover up this information, he asks the creditor to revise the terms of acquittance.

The third stage. If the debtor decides to hide his financial difficulties from the creditor, the latter learns about the former's insolvency only when the debtor is unable to pay off the debt.

After becoming aware of the difficulties of the debtor, the creditor needs to decide upon his following course of action: whether or not to agree to the debtor's offer. On one hand, the debtor may be able to resolve all difficulties if he is given additional time. On the other hand, the effect of a soft budget constraint may arise. If the creditor agrees to revise the terms, the parties sign a new agreement. If the creditor refuses to reconsider the terms, one of the following scenarios takes place.

- The first possibility is the liquidation of the company without the initiation of bankruptcy proceedings. This is an appropriate way to solve the problem only if the assets of the company are sufficient to satisfy all creditors, and to repay the whole debt.
- The second possibility is the use of alternative mechanisms[5]. On one hand, these mechanisms could help the parties come to an agreement on the restructuring of the debt; on the other hand, the parties could fail to agree upon the terms and they will have to look for alternative solutions.

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[3] For example, because of product innovation (the debtor's competitors developed a substitute), and the debtor's product became noncompetitive.

[4] The debtor may hope to overcome problems in the nearest future, and prefers not to announce his problems.

[5] We discuss alternative mechanisms in detail later.

Dawsey, A.E. and Ausubel, L.M. (2002) note that in some cases agents prefer to avoid legal proceedings.

Gertner, R. and Scharfstein, D. (1991) analyze how firms choose between legal proceedings through Chapter 11 and out-of-court mechanisms.

- The third possibility is to undertake 'no action to solve the problem'. In this case the debtor waits for the creditor's reaction to his insolvency.
- The last possibility is to initiate official proceedings. Creditors can also choose this strategy, if they failed to settle the problem before the start of bankruptcy proceedings.

In our paper, we focus on informal mechanisms[6]. We define a few possible ways for the resolution of the problem. A court may dismiss an action of bankruptcy for some reason[7]; if it does not, the court adjudicates the conflict. If the suit is dismissed or if the parties do not accept the court's decision, they may use alternative mechanisms.

The fourth stage. Note that it is highly important to determine how the liquidation and reorganization of the debtor company will be conducted. The liquidation and reorganization proceedings should give appropriate incentives to all parties in the process, including the manager, the debtor, and the creditors[8]. For example, a well-designed absolute priority rule gives incentives to the manager not to loot the firm's assets before the problems become apparent[9]. It is also important to maximize the firm's expected value. The literature pays significant attention to the how bankruptcy proceedings operate, as they are one of the best ways to maximize the firm's value[10].

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[6] Different aspects of bankruptcy legislation are widely discussed in the literature:
[Ayotte, Yun, 2004];
[Berkovitch, Israel, 1999];
[Giammarino, Nosal, 1996];
[Povel, 1999];
[Aghion, Hart, Moore, 1992];
[Vitryansky, 1999].

[7] The legislation of each country defines the characteristics of insolvency. If a court is unable to ascertain their presence, it can dismiss the action.

[8] In the following works problems concerned with reorganization proceedings and ways to solve them are discussed:
[Aghion, Hart, Moore, 1992];
[Bebchuk, 2000];
[Bebchuk, 1988].

[9] [Akerlof, Romer, 1993];
[Hart, 2000];
[Longhofer, 1997, p. 249—267].

[10] [Adler, Barry, 2001];
[Aghion, Hart, Moore, 1992];
[Bhattacharyya, Singh, 1999];
[Hansen, Randall, 1998];
[Hart, Drago, Moore, 1997];
[Hausch, Ramachandran, wps2230];
[Hausch, Ramachandran, 2002];
[Hotchkiss, Mooradian, 1999];
[Stromberg, 2000].

Bankruptcy rules

It is obvious that the basic rules of the institution of bankruptcy include bankruptcy legislation. However, we argue that the rules that the institution of bankruptcy is based upon are not restricted to legislation. In order to determine what other rules form the core of the institution of bankruptcy, it is necessary to analyze the strategies that companies use to sustain business relations. These strategies are strictly connected with the form of the institution of bankruptcy.

Usually, every firm uses the same set of strategies; we will now describe this set. We focus our attention on the following question: how is a firm able to avoid or resolve the conflict by employing various strategies? In the previous section we described a possible sequence of events and the different types of insolvency problems. We did not, however, consider the characteristics of creditor-debtor relations, which is crucial to our analysis.

We outline the following strategies, which range from informal to formal[11]:

— relational contracting,
— network enforcement,
— private enforcement,
— administrative levers,
— sphere of law.

There are two extreme cases: one is nonintervention of outside parties in business relations, and the other is total dependence on state intervention to solve the problems (see Table 1). In the table we give only the specific transaction costs associated with each strategy. Such costs as the costs of drawing up a contract or reaching an agreement, the costs of enforcing the contract, and the costs of monitoring are independent of the choice of strategy.

We will now define each strategy. We distinguish two components in the strategy **'*relational contracting*'**:

— a relation based on personal trust,
— self-enforcing agreements[12].

In the first component personal trust between the agents plays an essential role. This type of relationship is a result of previous long-lasting relations between companies and of an accumulation of reputation capital. Another source of trust is personal relations between top managers of companies. Every transaction should be considered in the light of past experience and future perspectives of their relations. Possible conflicts are solved through negotiations between officials. In such

[11] Our analysis is based on the papers by [Hendley, Murrell, Ryterman, 2000; 1999].
[12] [Telser, 1980].

relations there is no room for outside intervention — intervention may result in a cessation of collaboration.

The second component of this strategy is self-enforcing agreements. Telser points out that "in a self-enforcing agreement each party decides unilaterally whether he is better off continuing or stopping his relations with the other parties. He stops if and only if the current gain from stopping exceeds the expected present value of his gain from continuing"[13]. Self-enforcing agreement is implemented through a series of contracts. The main sanction to prevent opportunistic behavior in such relations is a refusal to sign the next contract. Self-enforcing agreements are based on the company's reputation, not on personal trust. Intervention of outside parties to enforce agreement is not allowed.

The border between these two components is not distinct, and we group them into one strategy. On one hand, it is hardly possible to imagine a situation where companies rely only on personal trust and would not try to evaluate the incentives of their partners to cooperate to be sure of their behavior. On the other hand, accumulation of reputation capital through long-lasting relations may lead to personal trust. It is also worth mentioning that in both cases the firms would not allow their conflict to become public, because they value each other's public reputation.

Relational contracting: the Russian case

The most attractive feature of informal strategies, especially relational contracting, is the maintenance of secrecy; this creates great difficulties in the illustration of such strategies. Hendley, Murrell, and Ryterman (1999) conducted an investigation of such strategies used by Russian enterprises and showed that methods such as business meetings of officials of various levels, informal meetings and discontinuing trade are widely used in practice (see Table 2).

Various sociological surveys demonstrate the high attractiveness of informal solutions (especially through negotiations) to economic agents (both to firms and individuals) in Russia. Simachev (2003)[14] points out that 80 percent of respondents (Russian enterprises) prefer to use informal methods such as negotiations versus formal solutions through the arbitrage courts. Barsukova (2004)[15] reveals that in the case of default 24% of entrepreneurs would appeal to court and 54% would try to come to an agreement through negotiations.

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[13] [Telser,1980, p. 27.]

[14] [Simachev, 2003, p. 2].

[15] [Barsukova, 2004, p. 163—164]. (Барсукова, 2004).

Here we can rely only on circumstantial evidence. Relational contracting could possibly be masked as barter schemes. Usually enterprises that use barter are characterized by high overdue liabilities. From a formal (legal) point of view, creditors should initiate bankruptcy proceedings in order to attempt to recover their money. But in practice they continue their relations and agree to enter transactions with overpriced barter payments. The creditors do this, because they view barter as a means of avoiding the payment of public debt[16]. Relational contracting can be discerned in repeated non-monetary transactions.

An example of 'relational contracting'[17]

Relations between the Open Joint-stock Company Cheliabinski Metallurgical Industrial Complex ("MECHEL") and their workers could be treated as relational contracting, and in particular as a self-enforcing agreement.

The workers had two organizations to present their interest in negotiations with "MECHEL": the trade union "Edinenie" and workers' committee. The workers of the enterprise can be considered to be a creditor, since at one point (November 1998) they had not received their wages for more than six months. At the end of 1997 the total sum of the liabilities of "MECHEL" to the federal and regional budgets and to non-budget funds was 558 billion rubles[18]. In 1997, debts to suppliers were equal in value to the material costs of "MECHEL" for 4.9 months[19]. According to the existing bankruptcy code, the trade union, workers' committee, tax administration and other creditors could cooperate in order to initiate bankruptcy proceedings. Nevertheless, newspapers wrote that workers did not want to initiate bankruptcy proceedings and wished to begin negotiations. The workers did not even want to stop production by strike, but rather wished to attract the attention of the top management of "MECHEL" in order to solve the problems. Their protest manifested in the following actions:

- on one Sunday workers of the heat-electric generating plant at "MECHEL" refused to leave their work places after the end of work time,

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[16] Desai and Goldberg (2000) touch these questions [Desai, Goldberg, 2000, p. 14—18].

[17] Information about relations between "MECHEL" and its workers were taken from newspaper Vechernii Cheliabinsk, 1998, p. 1. (Вечерний Челябинск, 1998).

[18] [Kuznetsov, Gorobets, Fominih, 2002, p. 32; 2002, p. 28—78]. (Кузнецов, Горобец, Фоминых, 2002, с. 28—78).

[19] [Ibid, p. 34].

- on the next Monday, their example was followed by the workers of railway workshop № 2, arc-furnace plant № 2 and part of the drop-hammer plant.

Workers chose this action because they did not want to stop the operation of the industrial complex and hoped to reach an agreement through negotiations. Their expectations were based on previous experience: in 1994 workers reached an agreement on wages with the management of "MECHEL" through a similar action.

Let us now turn to strategies based on interventions by outsiders. We start with ***network enforcement.*** Each company functions in a certain environment and can be viewed as a part of a group or a network. Networks are based either on formal (for example, financial industrial groups in Russia, registered business associations) or on informal (for example, social community, geographical location) features. The main feature of networks we are interested in is the extent of informational exchange between members, which provides a high level of informational transparency between firms within the network. The reputation of a company within a network is crucially important. A good reputation in a network implies contracts that are more profitable, a higher social status, a wide range of potential partners and other advantages. Fearing to lose their reputation, firms will strive to fulfill contract obligations. Aside from reputation, an internal code of behavior may also exist among network members, which works well by analogous mechanisms. Firms may face difficulties in applying this strategy to contacts with partners from outside the network.

Network enforcement: the Russian case

Personal connections were the main instrument in achieving goals in the Soviet period. Moreover, without friendly contacts it was almost impossible to manage a Soviet enterprise, since the set of informal contracts served as the only mechanism for overcoming the rigidities of the Soviet economy. The system of friendship ties (or *blat*) could not disappear all at once. It is well known that informal institutions prevail in an economy during transition periods. It is for this reason that most investigations into networks in modern Russia usually search for their origin in the Soviet period.

Steen (2000)[20] analyzes the behavior of Russian enterprises in transition. He demonstrates the existence of horizontal networks between en-

[20] [Steen, 2000].

terprises, and between state and private enterprises. He arrived at the following results:

"What is particularly interesting is that the top officials of state enterprises report a high level of contact (**73%** contact the top officials of private businesses monthly or more often). Contact with the top officials of private businesses is in fact more common than contact between the top officials of state enterprises themselves! And the contacts are mutual, with **74%** of the businessmen contacting the directors of state enterprises"[21].

Hendley, Murrell, and Ryterman (1999) showed that enterprises widely use an element of network enforcement — the dissemination of information about the behavior of an enterprise that did not honor its agreements (see Table 2).

An example of network enforcement

Kuznetsov, Gorobets and Fominih (2002)[22] note that enterprises in Russia form business groups (a typical kind of network) to avoid taxes via nonpayments inside the group. Here we give examples of how creating a network between enterprises helps to avoid the payment of debt to outsiders (to firms that did not join the network, to budgets of different levels).

They examined the following groups:

- Open joint-stock company "MECHEL" — Cheliabinski metallurgical industrial complex;
- Moscow petroleum refinery;
- Perm potassium group;
- Nizgnekamsk group;
- Uralski car factory;
- Tolyatinskaya group: joint-stock company "Sintezkauchuk".

The authors show that the creation of an (informal) business group helps its members to manipulate their liabilities. All these groups are characterized by the existence of overdue liabilities. At the same time members of the group did not have any complaints against each other and were ready to give additional credits.

We will consider the example of the open joint-stock company "MECHEL" more closely. Kuznetsov, Gorobets and Fominih[23] outline the following members of an informal network:

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[21] [Ibid, p. 8.]

[22] [Kuznetsov, Gorobets, Fominih, 2002, p. 72].

[23] [Ibid, p. 32—38]. All information mentioned in this example was taken from this article.

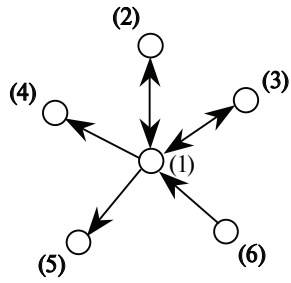

Figure 1. Structure of the group

(1) Open Joint-Stock Company Cheliabinski Metallurgical Industrial Complex ("MECHEL")
(2) MECHEL — bank
(3) Trade union organization of the joint-stock company "MECHEL"
(4) State Enterprise Vladivostokckoye Division "Promsurieimport"
(5) Closed Joint-Stock Company "Basis-Invest"
(6) Glencore International AG.

Figure 1 gives the structure of the informal group "MECHEL". Arrows depict the existence and the direction of financial flows or flows of goods.

In 1996—1997 "MECHEL" had a high level of liabilities to federal and regional budgets and to non-budget funds. As mentioned above, at the end of 1997 the total sum of liabilities was 558 billion rubles. In 1997 debts to suppliers were equal in value to material costs of the complex for 4.9 months. Federal and regional authorities attempted to get their money back, while outside creditors (for example, the Joint-Stock Company "Baikalskoe Rudoupravlenie") initiated bankruptcy proceedings. At the same time (in 1997) Glencore gave 100 million dollars and "Chase Manhattan" bank gave 12 million dollars to "MECHEL" on a loan backed by Glencore. Such behavior demonstrates different attitudes toward authorities, the Joint-Stock Company "Baikalskoe Rudoupravlenie" and Glencore. This could be explained by the fact that Glencore was a part of the informal group "MECHEL", and "Baikalskoe Rudoupravlenie" was not. We did not find any evidence of conflicts between the members of the group, and thus we may assume that they were happy with the situation.

This is an example of how informal network enforcement helps members of the network at the expense of other economic agents to reap extra profits. Thus, we show how it is possible to avoid the formal rules of insolvency and tax legislation, and we underline the fact that informal strategies in some cases lead to inefficient outcomes for society.

The next strategy is ***private enforcement***. This strategy implies the intervention of a third party (a non-official outsider) that has no business relations with either party in the transaction and has no personal interest in this transaction. Before signing a contract, the parties agree upon an intervention of an independent arbiter,

who should resolve any conflicts arising between the partners; both parties agree in advance to follow the arbiter's decision. It is worth mentioning that these decisions usually have no legal force. In developed countries it is an arbitrage, while in transition economies like Russia private enforcement is usually based on threats of violence. Such enforcers usually belong to organized crime groups. In Russia concepts such as 'the mafia' or '*krysha*' ('roof') are usually used. Parties are forced to fulfill their obligations under threat of violence. First the company's manager may receive a warning that he will have problems if his company does not pay. If the company decides to not pay off the debt, a third party kills the manager. Usually the first step is quite sufficient to force fulfillment of obligations. Economic agents choose this strategy when both parties feel uncertainty about the intentions of the partner and the country's judicial system; in fact, they do not trust the state institutions in general. It is possible that illegal means will be used to enforce legal rules (for example, one of the partners might enforce the court's decision in this manner). Another important point here is that private enforcement is not free of charge; moreover, a manager could face additional problems in the future (hold up problems arising from a dependence on private enforcers).

Private enforcement: the Russian case

It is widely discussed in the mass media that raiders play a significant role in the economic activities of Russian enterprises. As far as we know, the concept of 'raider' is unique to Russia.

By definition, "raiders are companies that change the structure of property rights of the enterprise-victim in their own favor or in favor of an anonymous customer" [24].

Raiders position themselves as an instrument to increase the efficiency of enterprises: they take over an inefficient business in order to resolve its problems and make it efficient. In addition, we note that while raiders are non-state structures, they sometimes use state structures to actually take over an enterprise[25].

A raider acting in favor of an anonymous customer is an example of enforcement by a third private party. A raider operates independently of both parties and uses an entire range of available instruments (see information on the methods raiders employ in order to capture enterprises in Appendix 1.3, "*Russian Raiders*"). In order to solve the insolvency problem, a creditor may use a raider's services to acquire the debtor's property. We may consider this to be punishment for delinquency and repayment of outstanding debt.

[24] http://www.nacbez.ru/security/article.php?id=1340

[25] This is discussed in the section on administrative levers.

We have discussed the activity of a raider as an example of private enforcement, but using raiders is not the only method of private enforcement. Now we will turn to violent entrepreneurship, and we will pay special attention to violence partnerships. We have taken the following definition from the book by Volkov "Violence entrepreneurship": it is "a set of business functions of violence structures based on the skillful use of organized force and information, which provides favorable institutional conditions for the economic activity of a client's enterprise"[26]. Additional information about the functions and appearance of such structures is to be found in Appendix 1.3 "*Violent entrepreneurships*."

In 1994, 15% of enterprises chose to use private security agencies[27]. According to a 1996/7 investigation[28], 11% of enterprises were ready to use methods based on violence, 42% had experienced these methods themselves, 53% indicated high level of expenses on security. Volkov (2002) explains this by the poor enforcement of court decisions; he notes that some respondents said that though they have an official court's decision, they still would choose to enforce its implementation by employing private structures. In some cases, the parties even preferred not to go to court at all and to resolve conflicts with the help of informal groups.

An example of private enforcement [29]

Here we present as an example of private enforcement a widely spread situation of financing by clients. A Ukrainian family moved to St. Petersburg to do business. They organized a trade firm under the patronage of the "Komarovskaya" informal group (their violence partner). They specialized in the wholesale trade of marketable goods at low prices and promised to deliver goods after prepayment. This firm collected a certain sum of money, yet did not deliver any goods and disappeared. Later the family started a new firm; thus all of their initial clients lost the money they had paid in advance. If the clients tried to get their money back, they had a "talk" with the "Komarovskaya" informal group.

This illustrates a situation where a debtor (the Ukrainian family) has a more powerful violence partner than its creditors (clients), or their clients

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[26] [Volkov, 2002].

This citation is from "Violent entrepreneurship in modern Russia. Ch. 2. Theory of violent entrepreneurship" // Economic Sociology. 2002. Vol. 3. N 2. P. 32. The translation is our own.

[27] [Tambovtsev, 1997, p. 76]. (Тамбовцев, 1997).

[28] [Radaev, 1998, p. 129, 174, 185]. (Радаев, 1998.)

[29] [Volkov, 2002, p. 33].

did not have any violence partners at all. In this case both parties agreed with the decision of a private third party, the "Komarovskaya" informal group, which forced the creditors to remit their debts.

This, however, is not the end of the story. One day two highly-placed mafia representatives came from Siberia in the interest of an entrepreneur who had paid money in advance to the firm, but had not received any goods. The firm returned the money and paid the required forfeit.

This example illustrates a situation in which a debtor (the Ukrainian family) has a less powerful violence partner than its creditors (an entrepreneur from Siberia). In this case both parties agreed with the decision of private third parties represented by the "Komarovskaya" informal group and two mafia representatives.

In both cases informal third parties, not the creditors and debtor, resolved the conflicts and all participants agreed to follow their decisions.

Now we turn to possible state intervention into relations between companies. First consider ***administrative levers***. A company can use state influence to enforce a partner to pay off a debt. A creditor may contact the Antimonopoly Committee with the purpose of testing the position of the debtor company on the market. There is another interpretation of this strategy that is quite common in transition economies[30]. During the command economy period, managers had built up friendship ties with government officials in various authorities. Managers can now use these ties to influence their partners. The price for using administrative levers in this case is a bribe.

Administrative levers: the Russian case

The second interpretation of the strategy "administrative levers" is closer to Russian conditions. This can be explained by the lack of development in formal structures that companies in developed economies usually use, such as the Antimonopoly Committee, tax structures, etc. The weakness of formal mechanisms makes their use inefficient for economic agents, and they prefer not to use them. It seems more profitable for managers to use their former connections[31].

Bessolitsin and Kuzmichev (2005)[32] point out that during the command period strong connections between bureaucrats and the managers of enter-

[30] Especially if the transition is from the command to the market economy.

[31] In such interpretation there are some intersections with the strategy "network enforcement".

[32] [Bessolitsin, Kuzmichev, 2005, p. 214—215]. (Бессолицын, Кузьмичев, 2005, с. 214—215).

prises were widespread. But their description of the relations between bureaucrats and managers is closer to network characteristics. They depict state officials as an important link in a long chain that gives managers the opportunity to reap additional profit. Nevertheless, such relations could undergo transformations during the transition period, and managers could use their old ties to influence their partners.

Steen (2000)[33] investigates the existence of networks of the different types described above. He also briefly touches on the contacts between representatives of government and the heads of enterprises. Steen points out that "Business leaders are quite often contacted by leaders in local government, in the regions and in the cultural sector. One striking difference among politicians is the rather high contact between the Federation Council and leaders of private businesses (60% reporting contacts), while only 35% in the State Duma contacts business leaders"[34].

Steen also points out that these connections can be more complicated than simply between enterprises and representatives of government. Earlier we spoke about close and intensive relations between state and private enterprises. Steen (2000) suggests that "state enterprise leaders are especially active as intermediators between state and market"[35]. This means that managers can influence each other by using their connections with state enterprises and do not need to spend time and effort establishing connections with the representatives of government directly. For the heads of state enterprises, one of the most profitable and easiest strategies was not to restructure the operation of their factories and strive to update their production process, but rather to use relations established during the Soviet period in order to "vegetate at the expense of the state".

Lambert-Mogiliansky, Sonin and Zhuravskaya (2005) determined the existence of asymmetric bargaining power in bankruptcy proceedings in cases when an enterprise attracts the interest of regional authorities. They conclude: "Political influence of regional governors transformed bankruptcy into the mechanism that allowed large firms to leave outside claim holders unsatisfied... We argue that a possible reason for this is the capture of regional divisions of bankruptcy courts and analyze the consequences of this capture"[36]. This means that one of the parties participating in the bankruptcy proceedings (here authors are speaking about debtors) uses the powers of regional authorities to resolve the case in the debtor's favor. Polonsky and

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[33] [Steen, 2000].
[34] [Ibid, p. 8].
[35] [Ibid, p. 18].
[36] [Lambert-Mogiliansky, Sonin, Zhuravskaya, 2005, p. 16].

Aivazian (2000) also point out this fact. They wrote: "some enterprises have more power and influence than others. As a rule, large enterprises enjoy good connections at the level of the local administration. In fact, **'large companies and authority representatives are often closely linked**: their interests are interconnected organisationally, in material form and personally' (The Role of Consulting Services in Corporate Restructuring of Russian Enterprises. Moscow, The Russian Privatisation Centre, 1998)"[37].

In considering administrative levers, we could not help mentioning raiders; they widely use connections with various state structures in performing captures (see Appendix 1.3). Lawyers and other economic agents point out that raiders are able to operate in Russia because of the high level of corruption in government structures, in the executive branch, and in the courts[38]. Many also draw attention to the fact that investigating agencies, in intervening in corporate conflicts, take the side of one of the parties[39]. Under these conditions, impartial investigation and decree are empty words.

An example of administrative levers[40]

In the following example we can find evidence of the existence of administrative levers that may be able to change the bargaining powers of the parties. Consider the bankruptcy process of the company "Sibur-Neftehim". In the beginning of 2003 (March 12) the arbitral court of the Nizhegorodskaya region opened the bankruptcy proceedings of the company. It was a supervision procedure. In July, 2003, the new head of the company, Petr Krupnov, announced the financial recovery of the company and the end of bankruptcy by voluntary settlement. Indeed, Krupnov and Medvedev, chairman of the board of directors, noted that the company would not go bankrupt thanks to the "sincere attention paid to the enterprises of the company by the top officials of the Nizhegorodskaya region"[41]. First the vice-governor of the Nizhegorodskaya region was elected to the board of directors. The company "Sibur-Neftehim" then reached a voluntary settlement with its creditors, as dated 7 October, 2003, in court documents. Later, the Closed Joint Stock Financial Company "Liding", one of the creditors, appealed against this decision, but the Federal Arbitral Court of Volgo-Viatskogo Region declined

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[37] Based upon [Polonsky, Aivazian, 2000].

[38] Source: http://www.klerk.ru/print.php?43501.

[39] Ibid.

[40] Source: http://www.garweb.ru/project/vas/news/smi/03/07/20030719/6945501.htm. Morozova O. "Sibur-Neftehim" hopes to escape bankruptcy by means of "Gazprom" and local government // Kommersant-Nijni Novgorod (on-line). № 126.

[41] Ibid.

its appeal[42]. It seems very strange that the company managed to overcome all financial difficulties in a short time and easily came to a settlement with its creditors (a company usually spends at least a year in bankruptcy). We argue that the participation of local authorities increased the ability of the company to achieve an agreement with its creditors.

The last strategy is based on law; we are interested in the bankruptcy legislation. The **'*Sphere of law*'** has two components:

— A threat of initiating bankruptcy proceedings,

— Filing a lawsuit.

Here state enforcement mechanisms are used to threaten a company that does not fulfill its obligations. In the case of insolvency, the creditor sends the debtor notification that he is prepared to go to court if the debtor does not pay in the course of few days. It is worth mentioning that the threat must be credible. If the debtor realizes that it is too costly for the creditor to appeal to court, he will not pay off the debt. We should also point out that relations between companies should be registered officially via a contract. The attractiveness of this behavior lies in the legal transaction costs as compared to court proceedings: no lawyer fees, no costs associated with the publicity of financial problems, etc. However, the debtor's behavior must be credible, or otherwise the strategy will not be attractive. The fear of loosing one's reputation may be a credible commitment.

If the debtor's commitment to cooperate is not credible, the creditor may prefer to initiate legal bankruptcy proceedings. Both parties accept the court's decision, as they are unable to solve the problem differently. There is one crucial point that pertains to solving insolvency problems via the sphere of law: the public disclosure of information about existing problems. In the case of insolvency, the company loses its reputation, the trust of its partners and employees; the company's value decreases. All these factors make appealing to the field of law unattractive if there are other available alternatives. Here it is also important to have a "good" contract, since a court needs valid legal reasons to initiate court hearings. The direct costs of legal proceedings, such as lawyer's fees and transaction costs like wasted time, also determine the attractiveness of this strategy. The size of these costs depends on the efficiency of the judicial system. There are two separate stages of implementing the bankruptcy law: first the court must come to a decision, and then this decision must be implemented. If state enforcement mechanisms do not function well, then firms will experience difficulties in attempting to implement court decisions, and for this reason the use of 'field of law' strategy decreases.

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[42] Source: http://raud.spb.ru/news/b_1282.shtml.

‘Sphere of law’: the Russian case

Let us to begin our discussion with how agents view legislation and formal rules. Tables 3—8 present the opinions that Russian enterprises have of insolvency legislation: how they estimate the quality of bankruptcy laws in protecting their rights, what they would wish to be changed in the rules or in the enforcement mechanisms, and what firms prefer to do in the case of conflicts. Hendley, Murrel and Ryterman (1999) achieved interesting results in the analysis of the behavior of Russian enterprises in the 90-s (see table 2).

The attractiveness of legal mechanisms depends not only on the general environment, but also on certain characteristics of the enterprise. Simachev (2003)[43] points out that for small business it is irrational to involve arbitral courts to solve disputes, because the expected benefits are much smaller than the expected costs associated with the legal process. His survey shows that only large companies would prefer to initiate legal proceedings.

Simachev (2003)[44] notes that 22 percent of the respondents (Russian enterprises) prefer to use threat to initiate formal proceedings, than to immediately file with an arbitral court. He also shows that the magnitude of this mechanism has a strong positive correlation with the clarity of the legislation, the size of possible penalties, and the ease with which violation can be proven in court. If both agents understand that a violation took place and that it would be difficult to escape penalty, then it will be more profitable for both of them to use threats.

An example of the ‘sphere of law’[45]

We give an example of how parties achieve voluntary settlement through arbitral court.

The debtor is the Federal State Unitary Enterprise “Kronshtadski Morskoi Zavod” (Федеральное государственное унитарное предприятие «Кронштадтский морской завод»).

Its main creditors are the Limited Liability Company “LEMZ-Izmeritelnue priboru” (ООО «ЛЭМЗ-Измерительные приборы») and the Federal State Unitary Enterprise, Central Scientific Research Institute “Granit”

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[43] [Simachev, 2003].

[44] [Ibid, p. 2].

[45] Source: http://www.aksnews.ru/m/3699/bankrotstwo_kronshtadskogo_morskogo_zawoda.html.

(Федеральное государственное унитарное предприятие «Центральный научно-исследовательский институт “Гранит”»).

The creditors (in 2000 and 2002) initiated bankruptcy proceedings twice and in both cases the parties attained voluntary settlement. We have no information about any attempts to reach an agreement through alternative mechanisms. Thus we conclude that the behavior of the parties in this case was based on the strategy of “sphere of law”. It is difficult to estimate the efficiency and profitability in this particular case. In 2000, when the parties came to a voluntary settlement, the debtor agreed to fulfill its obligations before 1 March 2002; however, it did not do this due to difficulties with one of its partners. Nevertheless, the creditors agreed a few years later once again to conclude a voluntary settlement with the creditor. The debtor commenced fulfillment of its obligations in 2003.

To sum up this approach (see Figure 2), we define the main groups of factors that influence the choice of strategy:

— behavioral features,
— the characteristics of transaction,
— the nature of mutual relations with potential partners,
— the institutional environment,
— the availability of information.

First of all, agents should take into consideration that their potential partner is (i) boundedly rational and (ii) may sometimes prefer opportunistic behavior. These facts are important in anticipating the behavior of one’s partner in the future, and to some extent limit his trustworthiness.

Secondly, it is important to look at what the transaction entails. If the debt is small enough, it may be expedient to “forgive” it if insolvency arises; thus the choice of strategy may not be important. Agents in choosing a behavioral strategy should carefully consider delays in the transaction due to specific investment, or uncertainty. In our view, behavioral strategies and governance structures have much in common.

Thirdly, trust, bargaining power and the partner’s reputation influence the agent’s choice. As we can see from Table 1, there are strategies where trust and reputation play an important role, and strategies where these factors do not play any role. These components determine the degree of the creditor’s loyalty. If relations between parties are based on personal trust, or both parties have favorable reputations, then the creditor’s loyalty will be relatively high. Loyalty is also taken into account in choosing strategies. The higher the degree of loyalty, the more preference will be given to strategies based on informal mechanisms and the easier it will be for parties to escape the intervention of a third party. Bargaining power also plays an es-

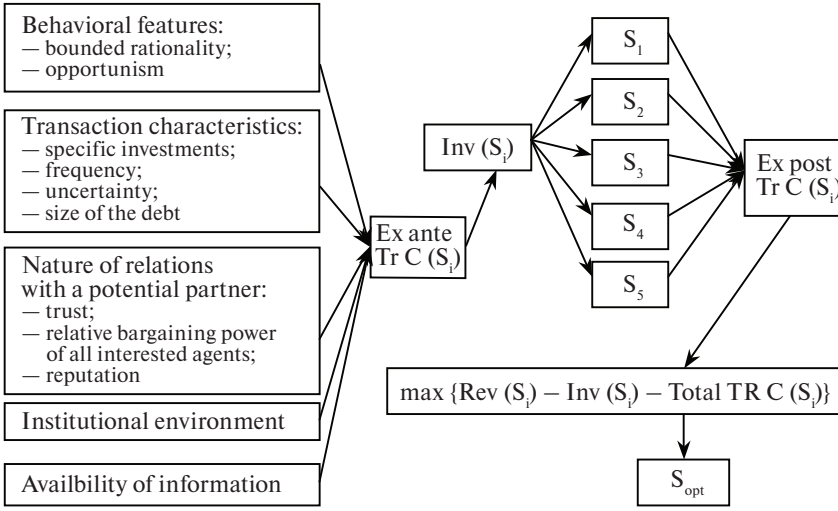

Figure 2. Choice of an optimal behavioral strategy

Total TR C (S_i) = Ex ante Tr C + Ex post Tr C (S_i)

S_i: behavioral strategy *i* of the company (relational contracting, network enforcement, private enforcement, administrative levers, sphere of law).

S_{opt}: optimal behavioral strategy of the company.

Total Tr C (S_i) : expected total transactional costs if strategy *i* is adopted.

Ex ante Tr C (S_i): expected ex ante transactional costs (these appear before the company chooses a strategy to govern a transaction; these costs depend on what strategy the company chooses).

Ex post Tr C (S_i): expected ex post transactional costs (these appear after the company chooses a strategy to govern a transaction; these costs depend on what strategy the company has chosen).

Inv (S_i): investments in the chosen behavioral strategy *i*.

Rev (S_i): expected revenue from the transaction given the chosen behavioral strategy *i*.

sential role in the choice of strategy. On one hand, firms may prefer a formal resolution of disputes if the distribution of bargaining power is asymmetric. However, on the other hand, a firm that has a stronger position may be able to influence the choice of strategy and thus force its partner to choose a strategy that is preferable for the stronger firm. Agents should estimate not only their bargaining power, but also the bargaining power of potential partners with third parties that can potentially influence their relations.

Fourthly, factors such as the institutional environment and available information may be regarded as being mutually dependent, and in some cases we may state that the completeness of information and its availability to parties fully depends on the institutional environment. We treat them separately here, because we wish to separate a general factor that is independent of a particular transaction from a factor that varies from one transaction to another. The institutional environment includes exogenous factors, such as confidence in the judicial system, anticipations with regard to political stability and possible changes, expectations of partner's behavior in "standard" situation, etc.

Fifthly, the properties of information also play an important role. The distribution of information among companies about the main characteristics of the transaction and distribution of information between companies and third parties influence the choice of strategies. For example, if the state (a third party) does not have sufficient information to make a decision, then firms owned by the private sector will turn to private third party enforcement or attempt to resolve problems through negotiation.

It is worth mentioning that an optimal strategy may consist of more than one of the strategies outlined above. For example, an agent may first attempt to resolve the dispute by informal mechanisms (relational contracting) and in case of failure he may resort to formal mechanisms (the sphere of law). On one hand, the probability of payment increases if an agent is able to adopt any strategy; on the other hand, it is too expensive to invest in each strategy. Therefore, the agent's problem is not really that of choosing one optimal strategy from a set of possible strategies, but rather that of formulating its optimal behavior by a combination of one or more strategies.

The concept of the institution of bankruptcy

The majority of investigations into bankruptcy or insolvency problems focus their attention on the formal component of the institution of bankruptcy[46]. They answer the following questions: whether or not alternatives to liquidation or reorganization proceedings exist; how the existing legislation or mechanisms could be changed to improve social welfare and to stimulate management to engage in non-opportunistic behavior; how well the existing legislation has been written, and

[46] [Hart, 2000];
[Li, Shan, 1999, p. 1—24];
[Berkovitch, Israel, Zender, 1997, p. 487—497];
[Aghion, Hart, Moore, 1992].

whether or not it serves the goals it is supposed to. For this reason, most researchers pay attention to the problems that arise from having imperfect laws, they dwell upon the fairness of law and the degree of maturity of enforcement mechanisms; they do not usually consider the informal components of bankruptcy.

As we can see from Table 1, bankruptcy is not only restricted to legal proceedings that are associated with high transaction costs. One can draw an analogy between the institution of bankruptcy and an iceberg: only a small part can be seen above the water (bankruptcy legislation), while the rest is hidden under the water (informal agreements, alternative rules).

***The institution of bankruptcy** is a complex system consisting of 1) a set of rules, both formal and informal, which regulate relations between debtors and creditors in the case of insolvency; 2) a set of enforcement mechanisms, and 3) a set of interpretations of rules that determine how these rules can be used and how they should be followed.*

We will now comment on the structure of the institution shown on Figure 3. The core element here is a set of rules: they lie at the heart of the institution. These rules prescribe what behavior is appropriate in any given situation; we are interested in the insolvency problem. Obviously, rules without any enforcement mechanisms do not work, as agents have no incentives to follow them. Thus, the second level, or ring, consists of enforcement mechanisms.

The rules and enforcement mechanisms on which the institution of bankruptcy is based can be divided into three groups depending on the strategies used by companies to solve the problems as described in the previous section. The first group consists of all the regulations for bankruptcy proceedings existing in the legislation. These rules should be known to all economic agents, or at the very least every agent should know where he could learn them. Punitive sanctions are usually registered in the law. Responsibility for the enforcement of these rules lies with the state authorities.

The second group consists of alternative bankruptcy rules, those that govern the interrelationships of particular economic agents. Companies may design their own rules to solve insolvency problems if they unite in a group or network[47]. Two options are possible. First, companies can base these rules on existing legislation[48], but use their own enforcement mechanisms. One advantage is that there is no need to spend extra money on the evaluation of new norms to govern their relations, and another is the avoidance of the judicial system and the possible loss of reputation associated with publicly revealed insolvency problems. This is a good method for

[47] As we mentioned above, it could be a formal or informal union.

[48] Companies could feel free to choose from any legislation in the world.

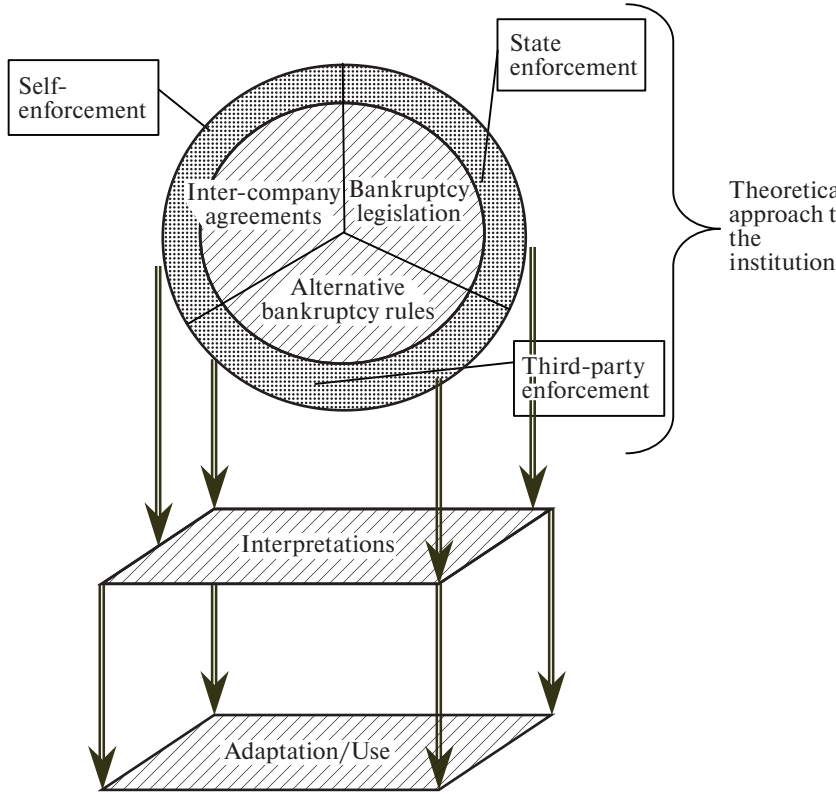

Figure 3. The structure of the institution of bankruptcy

solving problems that arise between network members, but it is not easy to use it to adjudicate conflicts with companies that do not belong to the group. The second option is possible when companies include insolvency provisions in their contract — they will use private enforcement mechanisms. If companies do not trust the judicial system and the state, then they are not concerned with how legal their rules are; they do not plan to use state enforcement mechanisms. Hence, we conclude that alternative bankruptcy rules can be formal or informal, and can either correspond to existing legislation or contradict it.

The third group of rules is comprised of rules that were formed as a result of long-lasting relationships between particular companies. It is difficult to outline the general characteristics of these rules since much depends on the specifics of the business relationships. But it is possible, and logical, to surmise that companies

will choose a friendly way to resolve the problem (for example, via a restructuring of the debt). We also believe that partners will not involve outsiders in order to resolve the problem, and they will strive to not reveal their problems to the public. Reputation and personal trust play are essential here.

In describing the structure of the institution of bankruptcy, we separate rules and enforcement mechanisms, and consider separately two other aspects (interpretation and adaptation of rules). Note that rules along with their enforcement mechanisms satisfy the theoretical concept of institution that is used in modern institutionalism[49] and in game theoretic approaches to institutions. If the theoretical concept of institution is the same as in practice, we need only to formulate a set of appropriate rules. However, agents often understand and follow the same rules in different ways. In order to explain this phenomenon, it is necessary to include the aspects of interpretation and adaptation of rules in the structure of the institution of bankruptcy.

Table 9 presents the interconnections between the choice of strategy, the rules, and the possible use of bankruptcy proceedings and summarizes the main ideas given above. We show links between the rules that form the institution and the strategies that companies employ. In addition, we present possible variants of using bankruptcy legislation by parties for each strategy in the table.

All three groups of rules with their corresponding enforcement mechanisms should be considered from the point of view of their interpretation. There are three essential components that should be considered to understanding this aspect: cognition, strategic thinking and information. First, we should note that not all information is available to everyone. When agents choose their behavioral strategy, they analyze the relative efficiency of various strategies using available information. Therefore, it is at this stage that we first note an inconsistency between actions and rules[50]. Secondly, cognition: agents rely upon personal and common mental models when they make decisions. Culture, cultural beliefs, general informal norms (customs, habits etc.) may influence the way of thinking. It is possible to modify culture, but it is a very long process and one institution by itself cannot accomplish it. For this reason, we view mental models as an exogenous variable. The Mental model that is prevalent in society may influence the understanding of laws. The last component of interpretation is the strategic thinking of agents. Agents often prefer to maximize their utility, and to this end they estimate in aggregate a set of rules and enforcement mechanisms. This is how opportunistic behavior may appear. Agents will choose the interpretation that satisfies their interest as much as possible, but this may cause losses in social welfare.

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[49] For example, the widely discussed concept of institution given by Douglas North.

[50] For example, you cannot be sure that your counteragent has no influence over the judge. This problem was widespread in Russia in the middle of the 90-s.

The last level is the aspect of adaptation of rules, and this is where agents decide on their behavior. Agents observe rules and enforcement mechanisms, formulate their opinion on how they should be used, and choose their optimal behavioral strategy. Their behavior defines the framework of the institution of bankruptcy.

An external observer is able to see only part of the structure of the institution of bankruptcy. This observable part consists of rules, enforcement mechanisms and the ways agents use these rules. However, even these components are somewhat hidden. For example, it is hard to gain access to the specific details of agreements between companies, illegal practices in private enforcement, etc.

Further discussion of the Russian peculiarities of the institution of bankruptcy

In this paper, we focus on the solutions that can be used by companies before starting bankruptcy proceedings or resorting to formal rights spelled out in the bankruptcy legislation. We analyze the factors that influence a firm's decision on behavioral strategies. We conclude that in Russia it is more profitable for enterprises to use informal methods to resolve conflicts in various situations of economic activity. One of the reasons why it is so popular to resolve problems by informal mechanisms in Russia lies in its history. As pointed out by researchers[51], the main problem of radical reforms in the beginning of 90-s was the "old" informal institutions that could not be changed quickly. Law or new formal institutions (as reformers wish to view laws) became irrelevant in the emerging Russian market and this is one of the key factors that stymied development. Statistical evidence is given below that illustrate various aspects of the institution of bankruptcy, and in particular formal proceedings.

Table 10 gives an overview of certain financial indicators and the efficiency of bankruptcy law. The law was first adopted in 1993, a second revision was published in 1998, and the last version of the law was introduced in 2003. We pay special attention to the two laws dated 1993 and 1998. Table 10 stresses the inefficiency of

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[51] [Kapelushnikov, 2001] (Капелюшников, 2001);
[Polterovich, 2001] (Полтерович, 2001);
[Treisman, 1995];
[McFaul, 1995].
Also it is worth mentioning other papers where authors outline similar ideas:
[Hay, Shleifer, Vishny, 1996];
[Hendley, 1998, p. 93—127 (a)];
[Hendley, 1998, p. 91—119 (b)].

the first law: we see high levels of outstanding debts and low levels of bankruptcy proceedings.

Table 11 presents an estimation of the efficiency of bankruptcy law in Russia conducted by the World Bank. Table 9 focuses on the second version of the law. This law is characterized by less transaction costs for the initiation of bankruptcy proceedings compared to the 1993 version. One might think that the performance of Russia with respect to bankruptcy is rather good. Compared to other countries, in Russia there is a low average duration of insolvency proceedings, and high involvement of courts in the process; the expected cost of proceedings is just 4% of the estate. The Goals-of-Insolvency Index is higher then in most other countries, notably those with high income.

These results seem strange in the light of the statistics on the use of bankruptcy legislation that demonstrate preferences for informal mechanisms (see the comments on Russian evidence for various strategies and Table 13) and in light of the estimation of the quality of existing bankruptcy codes (see Appendix 1.4)[52]. Table 12 presents confidence in formal institutions like the legal system, the civil services and police. The data shows that agents do not trust formal institutions; this fact by implication is evidence of the prevalence of informal institutions. Tables 14 and 15 reflect the estimations of the probability to assert a firm's rights and to implement court decisions. The correlation between these estimations and the size of the firm as measured in number of employees is high. We see that it is easier for large firms to achieve their goals in disputes both with other firms and with authorities.

Such facts cannot be evidence of an efficient insolvency code and institution of bankruptcy. What are the reasons for these contradictory conclusions? A possible answer can be found in Radugin and Simachev (2005)[53]. To wit, the bankruptcy law was used as a way to reallocate property rights: it was easier to change the owner by using bankruptcy laws than via takeover proceedings. However, we can discern another peculiarity for the Russian case: the relative cost of bankruptcy proceedings is lower for agents interested in the reallocation of property rights that for agents interested in the fulfillment of engagements by the debtor. There is one serious defect in these cases: the code that existed up to that moment made it possible to bankrupt efficient companies.

This was one of the main arguments to change the bankruptcy legislation for the third time. Russia passed a new bankruptcy law in 2002 and, as can be seen from Table 10, the number of initiated bankruptcy proceedings fell. On one hand, this could be treated as a solution to the problem mentioned above. On the other,

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[52] The second bankruptcy code (1998) is analyzed in appendix 1.4 and in the report by the World Bank.

[53] [Radugin, Simachev, 2005. p. 49] (Радыгин, Симачев, 2005, с. 43—70).

this may simply mean that it is more difficult now to initiate bankruptcy proceedings and the debtor has greater flexibility in avoiding bankruptcy. The advantages and disadvantages of this situation have been widely discussed in the literature concerning pro-creditors and pro-debtors bankruptcy codes, but researches have not yet reached a consensus.

Concluding remarks

In this paper we discuss the possible causes of the insolvency problem and consider various issues that may arise. This analysis helps us to understand the origin of rules that form the institution of bankruptcy. We show that the behavior of individuals in the framework of the institution of bankruptcy is defined not only by legislation and by appropriate enforcement mechanisms. Each agent's choice of set of rules (or strategies) depends on the behavioral features of both parties, on the transaction characteristics, on the nature of mutual relations with potential partners, on the type of information available to parties, and on various features of the institutional environment.

As a result we introduce a new understanding of the institution of bankruptcy. This concept includes not only bankruptcy legislation as a single set of rules, but also alternative rules that regulate the behavior of debtors and creditors. We define the main components of the institution of bankruptcy: formal ones based on existing code, informal ones that are used in relations of debtors and creditors and informal ones based on intervention of third party.

We discussed the particular features of strategies used by Russian enterprises, and illustrate each behavioral strategy by a case from Russian evidence. These cases show that economic agents in Russia do not trust formal institutions, but prefer to use informal relations to resolve problems and usually rely on private third parties, mostly because they feel it is cheaper.

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Appendix 1.1
Strategies — general characteristics

Table 1. Strategies used to govern business relations

Strategy	Level of personal trust between agents	Role or counteragent's reputation	Use of legislation	Transaction costs
Strategies based on two-sided relations				
Relational contracting	High	Insignificant	None	Bargaining costs (when partners solve appearing problems)
	Intermediate	Significant	Minimal use	Making of contracts
Strategies based on private enforcement				
Network enforcement	Depends on the nature of a network	Significant	Minimal use	Informational transparency of a network
				Collective action (free riders problem)
				Protection against third-party
Private enforcement	Low	Insignificant	None or illegal means might be used to enforce legal rules	Making of contracts
				Costs of using private structures
				Protection against third-party Mutual dependence (hold-up problems)
Strategies based on public enforcement				
Administrative levers	Intermediate	Intermediate significance	Parties use legislation to persuade each other	Search for a partner Protection against third-party Mutual dependence (hold-up problems)
Field of law	Intermediate	Intermediate significance	Law as a way to threaten a partner	Making of formal contracts
	Low	Insignificant	Totally based on law	Costs of using judgment system Decrease of company's value

Appendix 1.2
Statistics on transactional strategies of Russian enterprises

Table 2. How the sales and purchasing department deals with customers that did not honor agreements[54]

Purchasing department			Sales department		
Method[55]	**1**	**2**	**Method**[56]	**1**	**2**
Formal business meetings between lower level officials of the trading partners	76.38	7.51	Stopping trade with the enterprise	68.5	5.76
Formal business meetings between the general directors of the trading partners	56.44	8.52	Filing a claim in arbitrage court	60.98	5.69
Use of arbitrage courts	25.46	5.40	Sending pretension or other notices suggesting a possible court action	58.23	5.16
Informal meetings between counterparts in the two enterprises	23.01	7.39	Forcing the enterprise to pay a financial penalty	57.32	4.65
Intervention by other enterprises	15.34	5.34	Telling other enterprises about the behavior of an enterprise that did not honor its agreement	47.56	4.41
Intervention by officials of the local government	10.43	4.41	Reporting the enterprise to a local government organ	14.02	2.39

1 — Percentage of enterprises using the method

2 — Average scale score for those using method[57]

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[54] This table based on the article of Hendley, Kathryn, Peter Murrell, and Randi Ryterman, 1999. We took only strategies that had been used by more that ten percent on companies.

[55] The question was as follow: during past two years how important were the following methods in helping your company to solve arising problems?

[56] The question was as follow: whether your enterprise has used or threatened to use this method of dealing with customers that did not honor their agreements with your enterprise during the past two years?

[57] Heads of sales and purchasing departments was asked to evaluate effectiveness on a scale from 0 to 10, where '0' — the method was not effective and '10' — the method was very effective.

Appendix 1.3
Private enforcement: Russian Raiders and Violent entrepreneurships

Russian Raiders

Here we present information from the site "National Security" («Национальная безопасность») about the main steps of raiders to capture business action and about prices.

The first step is collection of information about real economic characteristics and value of the business. Prices are in the range from 5 000 up to 20 000 of dollars.

The second step is estimation of the ability of the victim to prevent a takeover. Here means physical potential (competence and status of protective structures) and economic or political potential (interests of large business structures or federal authorities). Prices are in the range from 3 000 up to 10 000 of dollars.

The third step is elaboration of a takeover plan. There is two main types of takeovers — forced capture and capture without coercion. Prices are in the range from 10 000 up to 30 000 of dollars.

The fourth step is the capture according to plan. The total price is about 700 000 of dollars. Main expense items are the following:

- an agreement with tax official,
- a "required" court decision,
- an execution of court decision by officer of justice,
- a neutralization of force departments (police, Office of Public Prosecutor),
- a violence capture.

The fifth step is provision of supplementary activity, that include such activities as initiation of criminal case, a short plot on TV, keeping persons in isolation, adoption of governmental regulation and so on. The total price is about 580 000 of dollars.

Source: http://www.nacbez.ru/security/article.php?id=1340

Where do they come from?

"Large protection companies are in fact privatized segments of the state security and intelligence organs. In Petersburg, for instance, the firm Zaschita was created by the North-Western Anti-Organised Crime Unit and is considered to belong to the MVD, while the protection companies Tornado, Komkon and Northern Palmira are headed by former KGB-FSB officers and are, accordingly, the domain of this ministry. Though the companies are financially and organizationally separated from the state organs they have access to information and operative resources of the latter through personal connections and informal relations. Many directors of private protection companies openly admit the fact of 'mutually beneficial co-operation' and 'friendly ties' as well as financial aid to the public security sector by the private one. The activity of private protection companies is formally supervised by the Department of Licences and Permissions of the MVD." (p. 750)

What do they offer?

Volkov maintains, "the private protection company provides the standard set of 'roof' services to other business agents and 'solves' their 'questions.'" (p. 750) He outlines following main functions (or main supplied services):

- protection,
- contract enforcement,
- dispute settlement,
- debt recovery,
- information gathering,
- organizational consultancy.

Nobody does not scruple to use private company …

Volkov states an example (from Operativnoe prikrytie, 1996, 6, p. 9): "... in 1992 the protection enterprise Komkov successfully solved the question of a large debt recovery for the Petersburg branch of Sberbank Rossii, the biggest state commercial bank, and subsequently became its permanent enforcement partner." (p. 750)

Source: Volkov, V. 1999, p. 741—754.

Appendix 1.4
Field of law

Table 3. Estimation of quality of the insolvency law depending on competence in laws (in percentage term of total number of respondents in each group)

Does bankruptcy code protect rights of your firm?	"Ignoramus"	"Expert"
No	29.5	45.6
Not sure	57.4	39.8
Yes	13.1	14.6
Total	100	100

Source: Development of demand on law regulation of corporate governance in private sector. Part 2. NISSE Report. 2002. http://www.nisse.ru/analitics.html?id=rs&part=p2

Table 4. Estimation of quality of the insolvency law depending on infringement of firms' rights (in percentage term of total number of respondents in each group/ in parentheses — number of respondents)

Does bankruptcy code protect rights of your firm?	Is there any infringement of firms' rights and interests during last three years?			
	No	Not sure	Yes	Total
No	42.5 (94)	26.1 (12)	63.6 (21)	42.3 (127)
Not sure	41.6 (92)	65.2 (30)	24.2 (8)	43.3 (130)
Yes	15.8 (35)	8.7 (4)	12.1 (4)	14.3 (43)
Total	100 (221)	100 (46)	100 (33)	100 (300)

Source: Development of demand on law regulation of corporate governance in private sector. Part 2. NISSE Report. 2002. http://www.nisse.ru/analitics.html?id=rs&part=p2

Table 5. Complaints to the state depending on the firm's size (in percentage term of total number of respondents in each group)

Infringement of firms' rights by the state	Number of workers			In general
	100 or less persons	101—500 persons	More than 500 persons	
No complaints	87.6	74.8	60.4	79
There are complaints	12.4	25.2	39.6	21
Total	100	100	100	100

Source: Development of demand on law regulation of corporate governance in private sector. Part 2. NISSE Report. 2002. http://www.nisse.ru/analitics.html?id=rs&part=p2

Table 6. Complaints to the non-state partners depending on the firm's size (in percentage term of total number of respondents in each group)

Infringement of firms' rights by non-state partners	Number of workers			In general
	100 or less persons	101 — 500 persons	More than 500 persons	
No complaints	78.4	65.1	64.6	71.1
There are complaints	21.6	34.9	35.4	28.3
Total	100	100	100	100

Source: Development of demand on law regulation of corporate governance in private sector. Part 2. NISSE Report. 2002. http://www.nisse.ru/analitics.html?id=rs&part=p2

Table 7. What should be changed in bankruptcy law?

Subject to change	Number of firms	% of number of answers	
		Total	Without taking uncertain answers into consideration
Rules/codes of the law	97	32.8	51.9
Legal proceedings	32	10.8	17.1
Execution of courts decisions	58	19.6	31.0
Not sure	109	36.8	—
Total	296	100	100

Source: Development of demand on law regulation of corporate governance in private sector. Part 2. NISSE Report. 2002. http://www.nisse.ru/analitics.html?id=rs&part=p2

Table 8. What did firms do when their rights in the sphere of insolvency were affected?

Used strategies	Percentage of total number of respondents
To declare	40.6
Threat to use law	12.5
Nothing from mentioned above	46.9
Total	100

Source: Simachev, Y. 2003.

Appendix 1.5
Strategies, rules and solutions

Table 9. Behavioral strategies, rules, solutions to insolvency problems (IP) and usage of bankruptcy legislation

Strategies	Group of rules	Expected solution of IP	Possible variants to use bankruptcy law
Relational contracting	Intercompany agreements	Debt restructuring	Rare law uses for signing voluntary agreement
			Liquidation proceeding as a way to sever relations with partner
Network enforcement	Alternative bankruptcy rules	Fulfillment of engagements	Main principles of existing bankruptcy legislation can be used to solve problems (without opening a formal bankruptcy proceeding)
			Liquidation proceeding as a way to sever relations with partners
Private enforcement			Main principles of existing bankruptcy legislation can be used to solve problems (without opening formal bankruptcy proceeding)
Administrative levers	Bankruptcy legislation	Fulfillment of obligations in compliance with the court decision	Companies base their actions in the case of insolvency on bankruptcy legislation, but they have different bargaining power
Field of law			Threat to initiate bankruptcy proceeding
			Companies base their actions in the case of insolvency only on bankruptcy legislation

Appendix 1.6
Efficiency of formal institutions in Russia

Table 10. Main financial indicators of Russian firms and using of formal bankruptcy mechanism

	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Outstanding liabilities, milliard rubles	—		249.6	538.0	782.2	1309.2	1445.3	1675.2	1667.6	1558.8	1469.2*
Including: outstanding liabilities to a supplier, milliard rubles	—	56,8	122.3	245.9	344.7	586.0	619.5	712.5	754.0	710.3	671.0*
Debts on credits and loans in banks, milliard rubles	—	45.1	91.4	123.8	164.7	514.0	708.6	965.0	1828.4	2475.3	2840.2
Outstanding taxes, milliard rubles	—	19.3	57.4	106.2	162.3	228.3	275.2	473.4	475.0	521.9	524.37[a]
Debts on wages, milliard rubles	—	—	—	55.6	53.7	77.0	43.7	31.7	29.9	30.6	32.3**
Number of references to court	—	—	1108	3740	5687	12781	15583	24874	55934	106 647	14277
Concerned bankruptcy proceedings	74	231	716	1226	2269	8337	10933	19041	47762	94531	9695

Sources: www.budgetrf.ru,
Vestnik Vusshego Arbitragnogo Suda,
http://nalog.1co.ru/stats/index.shtml (сайт Министерства Российской Федерации по налогам и сборам).

* — Data on 05.2003

** — Data on 07.2003

[a] — Data on 02.2003

Table 11. Efficiency of Bankruptcy

Economy	Actual Time (in years)	Actual Cost (% of estate)	Goals of Insolvency Index	Court Powers Index
East Asia & Pacific	2,8	17	49	66
Europe & Central Asia	3,2	15	51	57
Latin America & Caribbean	3,7	15	46	63
Middle East & North Africa	3,7	13	47	57
OECD: high income	1,8	7	77	36
South Asia	5,4	9	35	46
Sub-Saharan Africa	3,5	17	35	70
Russian Federation	1,5	4	58	67

Source: http://rru.worldbank.org/DoingBusiness/SnapshotReports/Default.aspx, http://rru.worldbank.org/DoingBusiness/Methodology/Bankruptcy.aspx

Actual Time (in years)

Time is recorded in calendar years. The time measure captures the average duration that insolvency lawyers estimate is necessary to complete a procedure.

Actual Cost (% of estate)

The cost figures are averages of the estimates in a multiple-choice question, where the respondents choose among the following options: 0—2 percent, 3—5 percent, 6—10 percent, 11—25 percent, 26—50 percent, and more than 50 percent of the insolvency estate value.

Goals-of-Insolvency Index

The measure documents the success in reaching the three goals of insolvency: to maximize the total value of proceeds received by the creditors, shareholders, employees and other stakeholders; to rehabilitate viable companies and liquidate unviable ones; to reduce investor risk by maintaining the absolute priority of claims in bankruptcy. The total Goals-of-Insolvency Index ranges from 0 to 100:

— 100 means perfect efficiency,

— 0 means that the insolvency system does not function at all.

Court-Powers Index

The measure documents the degree to which the court drives insolvency proceedings. The index is scaled from 0 to 100, where higher values indicate more court involvement in the insolvency process.

Table 12. Confidence in Institutions: percentage of respondents reporting various levels of confidence in institutions [58]

	Legal system		Police		Civil Service	
	Russia, genera public (1991)	Russia, purchasing managers (1997)	Russia, general public (1991)	Russia, purchasing managers (1997)	Russia, general public (1991)	Russia, purchasing managers (1997)
Great deal	10.9	1.9	7.5	0.6	9.8	1.2
Quite a lot	27.3	33	27.7	22.2	38.2	16.7
Not very much	44.5	48.1	44.4	49.4	37.1	49.5
None at all	17.3	17	20.5	27.8	14.8	32.5

Source: Hendley, Kathryn, Peter Murrell, and Randi Ryterman. 1999

Table 13. What are the reasons for firms not to appeal to the law in the case of infringement of their rights? (in percentage term of total number of respondents in each group)

Reasons preventing judicial recourse	Sample in general	How much times did enterprise appear in arbitral courts			
		Never	1—2	3—5	More than 5
Firms do not believe in fair investigation of a suit	13	10	13	15	19
It is difficult to forecast issue of suit due to antipathy of legislation	27	16	33	44	31
Firms do not believe in execution of court decision	24	16	18	31	43
Threat to face the opposition of a defendant	6	5	2	10	9
Duration of legal procedure	25	20	32	21	28
High cost of legal procedure	18	17	14	23	19
Secrecy considerations	4	3	5	3	5
There are more effective mechanisms to resolve disputes than court	24	27	29	15	21
Something else	14	17	9	13	17
Not sure	17	24	16	3	14
Number of respondents	259	100	56	39	58

Source: Simachev, Y. 2003.

[58] Values in the table are shown as they appear in the article of Hendley, Murrell and Ryterman. Perhaps there are some misprints — there are sums different from 100%.

Table 14. Estimation of probability to assert firm's rights in arbitral court in the case of dispute (estimation bases on the difference between percentage of respondents who answer "yes" and percentage of respondents who answer "no")

Opponent in dispute	Number of workers			On average of sample
	not less or equal 100	101—500	More than 500	
Authorities	–14.3	+10.7	+14.9	–1.3
Other firms	+58.9	+70.9	+93.6	+68.6

Source: Simachev, Y. 2003.

Table 15. Estimation of probability of execution of court decision in favor of the firm (estimation bases on the difference between percentage of respondents who answer "yes" and percentage of respondents who answer "no")

Opponent in dispute	Number of workers			On average of sample
	not less or equal 100	101—500	More than 500	
Authorities	–13.0	+7.8	+29.8	+0.6
Other firms	+43.2	+56.3	+63.8	+50.8

Source: Simachev, Y. 2003.

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