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## Protection of Employees' Rights in Insolvency

The law of the Russian Federation of 26 October 2002 on Insolvency (Bankruptcy) regulates the bankruptcy of corporate entities. As for the issues of bankruptcy of natural persons, the relevant reforms have already been developed, but they are not in force yet. It is planned that they will be introduced within the next year and a half. It is worth mentioning that the institution of insolvency or bankruptcy law in Russia cannot be referred to any single branch of law, since it is of a complex nature and consists of norms of various branches of law. Legislation in this field is developed in accordance with a common pattern: general law – special law – other legislation. General laws include, first of all, the Civil Code of the Russian Federation, the Labour Code of the Russian Federation, and the Code of Arbitration Procedure of the Russian Federation. Special laws are the Law on Bankruptcy of 2002, Federal Law on Specifics of Insolvency (Bankruptcy) of Credit Organisations, and Federal Law on Specifics of Insolvency (Bankruptcy) of Entities of Natural Monopolies of Fuel and Energy Sector. Other legislation includes subordinate legislation, decrees, and other official documents clarifying and complementing specific law enforcement practices are available.

The main purpose of the bankruptcy procedure is rehabilitation of enterprises and restoration of the enterprise to financial stability. In addition, basic laws related to protection of employees' rights in case of the liquidation of the enterprise should be mentioned. First, the Constitution of the Russian Federation establishes the right of any citizen of the country not only to free labour but also to "remuneration without any discrimination whatsoever" (Article 37). Further, the Civil Code determines the order of priority of satisfying the claims of creditors in case of liquidation of the enterprise (Article 64). Employees belong to the second grade of priority according to the constitution. The Labour Code of the Russian Federation regulates all aspects of relations between the employer and the employee. In particular, a number of articles deal with protection of employees in case of termination of the labour contract on the liquidation of the enterprise. For example, in Articles 180 and 318, the issues of compensation to specific categories of employees (inhabitants of the Far North, the Heroes of the Russian Federation, persons injured as a result of the accident at the Chernobyl NPP, etc.) are dealt with. The law on bankruptcy includes all of the requirements specified in the above listed Codes. In this paper, the system of protection of employees' rights in case of insolvency, its shortcomings and problems, and measures aimed at opposing the former and solving the latter will be considered in more detail.

To commence, it is important to discuss the basic provisions of the insolvency / bankruptcy law of 26 October 2002. Firstly, an enterprise having an indebtedness exceeding 100,000 roubles, which is overdue by 3 months, may be considered as insolvent (Article 6). Secondly, an application to have a debtor made bankrupt may be submitted by the debtor itself; by a creditor or by the authorized body. In practice, applications for the commencement of enterprise bankruptcy are submitted less frequently by debtors themselves and more frequently by the Federal Tax Service. The reason for such active participation of state bodies in the initiation of bankruptcy procedures is to protect the interests of the State as a creditor and its interest in the survival of business, which means preservation of jobs. It is difficult to determine whether such an active position of the State in asserting its interests is good or bad. On the one part, this encourages the development of a civilized and socially responsible culture of conducting business, but, on the other part, it has an adverse impact on the economy, particularly where insolvent entities are allowed to continue operating in business. In this connection, industries such as agriculture, housing and public utilities may be mentioned. The chart below shows the levels of arrears of wages with respect to various branches of economy, from which it will be

seen that the level of arrears of wages payable to agriculture personnel is the highest with arrears of housing and public utilities enterprises (transport companies, city electric networks, etc.) being comparable.

With respect to the law governing insolvency and bankruptcy, the participants in the insolvency proceedings are the following:

- The debtor;
- The creditors;
- The bankruptcy administrator (appointed by the court from among the members of a self-regulated organisation of bankruptcy administrators that has been selected by creditors);
- The authorised bodies;
- The federal executive authorities, executive authorities of subjects of the Russian Federation, and local authorities;
- The person having provided security for financial rehabilitation.

Russia's law provides for five insolvency procedures: observation, financial rehabilitation, external management, competitive proceedings and amicable agreement.

*Observation* is introduced for the purpose of establishing the debtor's financial condition and ability to settle the creditors' claims in full. In the course of this procedure, certain restrictions are imposed on the powers of debtor's management bodies; in particular, such restrictions relate to actions, which may cause any decrease in the book value of property. The first meeting of creditors is convened, at which the decision is made about the fate of the enterprise.

*Financial rehabilitation* consists of full settlement of debts to creditors and restoration of current solvency of the enterprise. This procedure provides for a third person granting a loan for the settlement of the creditors' claims.

*External management* is introduced in cases where there is a possibility of the restoration of efficient production at the enterprise or the profitable sale of the business to the interests of the creditors. After observation, financial rehabilitation, or external management, the enterprise may withdraw from the bankruptcy proceedings and continue its existence.

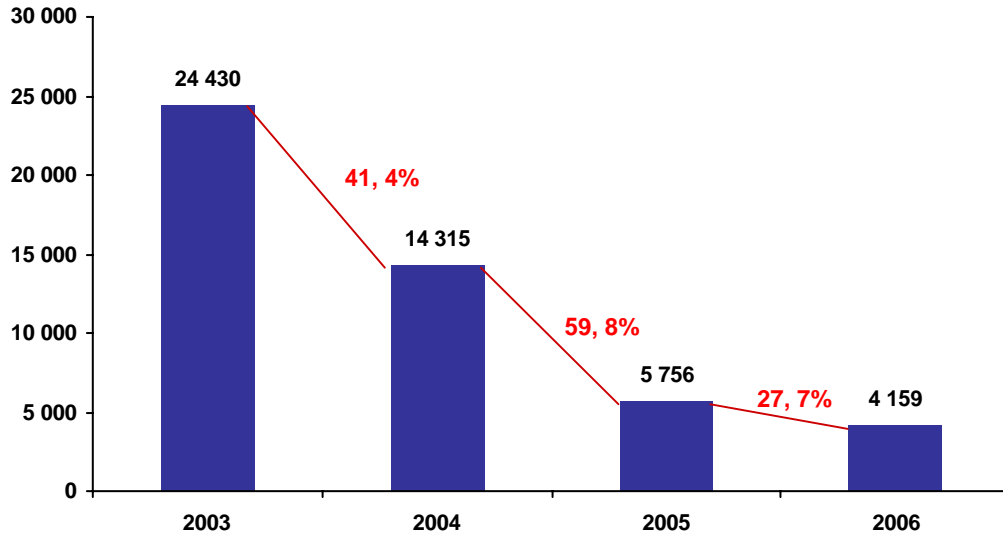
If, however, the procedure of *competitive proceedings* is commenced, it will result in liquidation and sale of the enterprise for the satisfaction of claims of the creditors.

*Amicable agreement* may be achieved at any stage of bankruptcy. However, the current practice shows that financial rehabilitation is very seldom introduced to bankrupt enterprises; external management is introduced more frequently but most cases result in the commencement of competitive proceedings (according to the statistics of the SOAM under the RF CCI and International Management Problems Institute). The most widespread pattern of bankruptcy proceedings for the time being in the Russian Federation consists of observation followed by competitive proceedings. This does not provide for the settlement of the debtor's claims. Although the debtor may settle the claims with respect to wages at any stage, in reality, this is very seldom the case and former employees have to wait until the debtor's assets are sold for their wage claims to be settled. This may take up to one and a half years.

Special attention has to be paid to the order of priority of creditors' claims, which, in accordance with the Law, are divided into three orders. First, settlement is made to individuals where the debtor is liable for causing harm to life or health; second, arrears of wages are paid; and third, debts to other creditors, such as banks, corporate entities, tax bodies, and others, are settled. Legal costs incurred to conduct the bankruptcy procedure, remuneration of the bankruptcy administrator, current utility payments, wages of personnel working after the commencement of the bankruptcy procedure, and receivables arising after the commencement of the proceedings are paid in priority.

The law obliges the debtor to pay debts first to its personnel and only thereafter, to banks and other creditors. Such an order of priority is intended to increase personnel's protection in case of crisis. In practice however, the position appears to be quite different and is evidenced by annual statistical data. The causes of the problem will be considered below. The dynamics and the structure of the arrears overdue may be seen in the charts below.

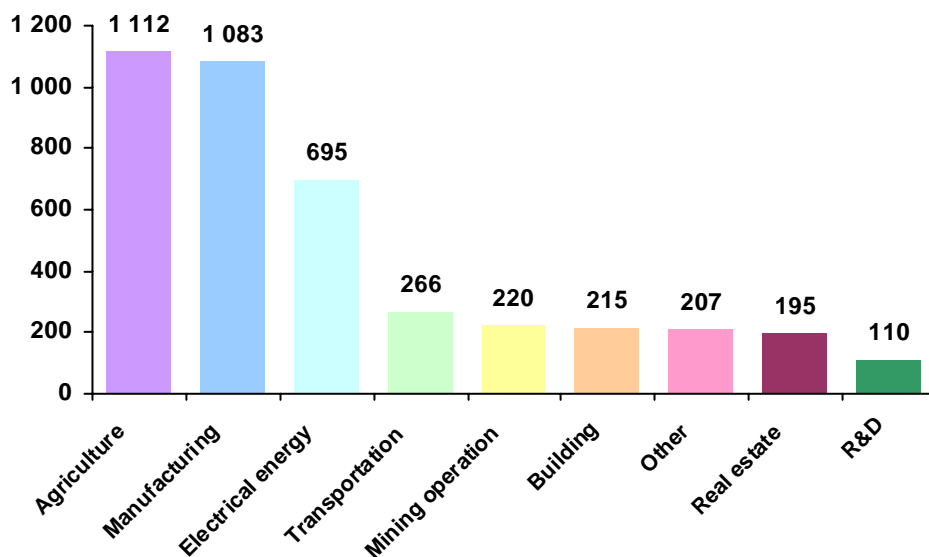
Chart 1: Dynamics of overdue arrears of wages, on a year-by-year basis, million roubles.



Source: Rosstat, 2007

The considerable positive dynamics in reducing arrears of wages results from firstly, the strengthening of national economy as a whole; secondly, the more efficient operation of market mechanisms making enterprises compete for labour resources; and thirdly, special attention on the part of the State to the problem of arrears of wages and establishment of efficient mechanisms to identify and punish enterprises that are acting unfairly by intentionally using personnel's labour "on credit".

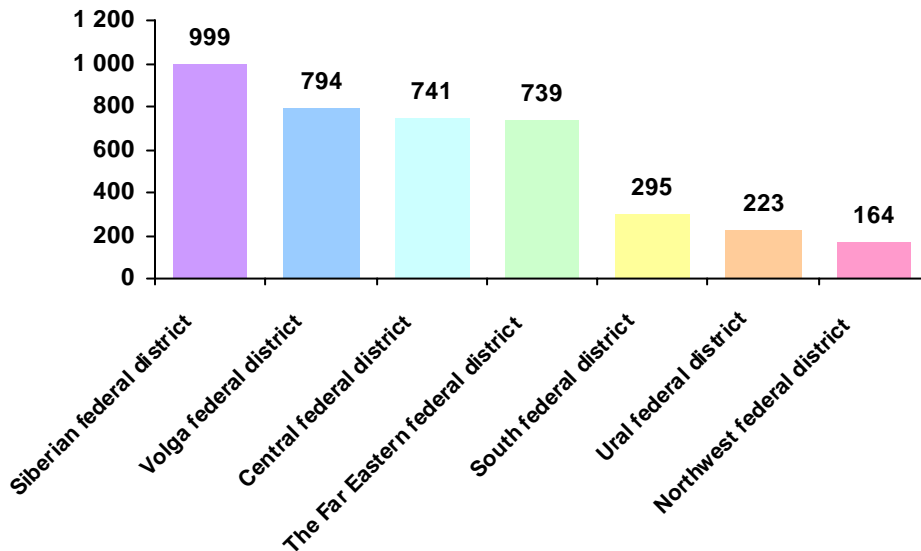
Chart 2: Structure of overdue arrears of wages with respect to branches of industry, million rubles, 2006



Source: Rosstat, 2007

As explained before, enterprises operating in agriculture, housing and public utilities have serious problems with the payment of wages, resulting, first of all, from systemic problems in these industries, which cannot be solved without active assistance of the state in the form of specific benefits and subsidies. The same is true for the Research and Development Industry. In the industry and construction sectors, arrears of wages to personnel result from inefficient management or following deliberate policies to accumulate debts to personnel, when employees have to work for months actually without pay, and money is used for other purposes.

Chart 3: Structure of overdue arrears of wages with respect to federal districts, million roubles, 2006



Source: Rosstat, 2007

The largest debts are in the most rapidly developing federal districts, where old and new enterprises have to survive in a tight competition and pass through acute stages of crisis often reflected in the non-payments of debts.

Any serious crisis suffered by an organization inevitably affects its personnel. If the enterprise is not brought out of such a condition in due time, it may have negative social consequences such as employment layoffs and non-payment of wages. In addition, if the organization is of social significance to the city, region or country, then its economic problems turn into social and political problems of the region or city. All over the world, employees are a rather poorly protected category of creditors; however, laws guaranteeing employees' rights in case of employer's insolvency are established in most countries. Although Russia's legislation in the sphere of bankruptcy is ranked by the European Bank of Reconstruction and Development among the best in the CIS and Eastern Europe, its practical application shows that a number of issues are not settled efficiently, including issues related to the protection of employees' rights in case of insolvency. The laws now in force in Russia make it possible for an unfair employer to reduce personnel costs by using loopholes in the legislation. Although Article 134 of Federal Law on Insolvency (Bankruptcy) establishes that payment of wages of persons working or having worked under labour contracts have the second order of priority, in practice, due to a variety of circumstances, the rights of preferential creditors are actually not secured and difficult to exercise. It should be noted that difficulties in efficient implementation of the law result not only from inconsistencies in the legislation but also from inadequate quality of implementation by local executive bodies. Analysis of the application of the Federal Law on Insolvency (Bankruptcy) carried out by experts of the Ministry of Labour and Social Relations, the SOAM under the RF CCI and International Management Problems Institute has revealed the following problems<sup>1</sup>:

<sup>1</sup> Baygereev M. Report at the social session// Materials of the International Conference in 2005 "Effective anti crisis management in Russia. World practice in crisis management ".M. 2006- p.173

- employees have no right to apply to the arbitration court for the commencement of bankruptcy proceedings against the debtor;
- the duration of up to 1.5 years for the realization of the property of the debtor;
- the possibility of the enterprises having insufficient liquid assets for settlement of the arrears of wages;
- inherent inconsistencies in the Federal Law On Insolvency (Bankruptcy) and uncertainty of the procedure for the participation of employees' representatives in the meeting of creditors;
- absence of external incentives for taking timely measures aimed at prevention of organization's bankruptcy;
- The debtor's assets become almost worthless, enterprise's business contacts are broken and the business actually comes to an end. In such a situation, employees lose not only their jobs but also the hope for payment of their wages, since the company's property would be realized at a minimal price<sup>2</sup>.
- Insufficient support by the bankruptcy administrators in terms of finance and personnel, which often results in non-optimal, inefficient and non-transparent bankruptcy procedures.

Under such circumstances, one can hardly speak of comprehensive protection of an enterprise's employees<sup>3</sup>.

To settle these problems, complex changes of the entire bankruptcy legislation, establishment of a new employees' rights protection law and improvement of the application of the Law are necessary. In 2004, the state turned its attention to the problem and appropriate instructions were given to the Government aimed at taking urgent measures to secure employees' rights for timely and full payment. This was organized between the Government of the Russian Federation, trade unions and employers' associations. In pursuance of the decisions made, a plan was developed aimed at co-ordinating of activities of social partners at the federal level to solve the problem. The Ministry of Health and Social Development of the Russian Federation continuously monitors the completeness and timeliness of payment of wages by all forms of organizations. Based on the results, the Government of the Russian Federation submits a report to the President on a quarterly basis. These measures proved to be effective, with the results shown in Chart 1.

The planned measures provide for not only tight control over compliance with labour law and civil law, but also for making amendments to the existing laws and working out the basic principles of establishment of a Fund Guaranteeing Employees' Rights. The purpose of all these efforts taken by the government, the business and the society is aimed at protecting the most vulnerable participants in bankruptcy proceedings, the employees, against acute social consequences of financial insolvency.

Establishing the Guarantee Fund for payment of wages is being worked out concurrently with exercising control over compliance with the law. World practice offers several approaches to such a fund<sup>4</sup>.

The first is that any employer is responsible only for that employer's employees. The principle consists of the establishment of a financial structure similar to a bank. The employer opens an account in the name of the employee and transfers to such account the amounts determined by the law (depending on the amount of wages). As long as the employee has labour relations with the employer, he \ she is not allowed to withdraw funds from such account. In case of termination of labour relations, including termination due to insolvency, the employee may receive such funds which would include due account for inflation and interest accrued by the financial institution for using the monies. With respect to Russia, the applicability of such

<sup>2 3</sup> Trapitsyn A. Report at the plenary session.//Materials of the International Conference in 2005 "Effective anti crisis management in Russia. World practice in crisis management ".M. 2006 - p. 60-61

<sup>4</sup> Zabramnaya E., Legal regulation: Protection of employee right in case of bankruptcy// Effective anti crisis management in Russia. 2005. 35-p.18-19

approach is rather low, since the majority of employers now transfer in full the taxes and charges provided for by the law, including the unified social tax.

The second approach is based on the principle of mandatory social insurance followed in countries like Belgium, Holland, Sweden, Denmark, France, Norway, Germany, Spain, Australia, Greece, Switzerland, Ireland, Portugal, Japan, Israel, and Argentina. In these countries, employers are jointly liable and payments to the Fund are mandatory for all employers. In a number of countries like Greece and Portugal, the State participates in financing guarantee funds together with imposing responsibility on the employers. In Japan, a mixed pattern of establishment and financing of the fund is in force: a portion of funds comes from the State and the rest from the employers. Joint financing of the fund by the employer and employees is a rare pattern existing, for example, in the Netherlands.

The Japanese model of formation of the Fund appears to be the most acceptable for Russia for a number of reasons. First, imposing an obligation for financing the Guarantee Fund, in full or in part, by the employee in the form of insurance premium runs counter to the Constitution of the Russian Federation. Second, financing of the Fund solely at the expense of the employer is also impracticable due to the heavy social burden that would be imposed on businesses. Third, passing of obligations of employees' protection to the State only has an obvious disadvantage that the State becomes fully responsible for the errors of insolvent businesses. There is no incentive for development of social responsibility of business in such a model.

Thus, for the time being, the most probable pattern for establishment of such a Fund in Russia is deemed to be a mixed model with financing shared by industry and the State. To make the established system function efficiently, amendments will have to be introduced to the existing legislation granting the employee the right to transfer its claim to the Fund and granting the Fund, in turn, the right to recover the claim in the name of the employee. The introduction of a new link – the Fund – into the “employee – enterprise” relationship settles the problem of poor institutional organization of employees. At present, neither trade unions nor employees have any functioning mechanism for the recovery of arrears of wages. It is expected that any employee who has not been paid wages for a period exceeding three months would be able to apply to the Fund. Employees would be able to receive their money without delay and avoid the delays connected with a bankruptcy procedure. Further, the social responsibility of heads of enterprises would inevitably increase, since they will have to deal with a powerful and well-organised structure that will be able to recover the debt. Any employee will have the choice: either to wait until the end of the proceedings, without guarantee of full payment of the claim, or apply to the guarantee fund for the immediate payment of amounts due. It is also expected that the Fund will maintain a register of organisations that have arrears of wages for more than 2 months in their books, which will be a good alternative to administrative penalties.

Work on the establishment of the Fund has been carried out for a number of years already. The variants of financing that are most economically and socially acceptable are being calculated; the pattern of payments in case of the “insured event” and the rules of management of the Fund are being developed and this new institute will soon function in our country. The expected results include more comprehensive securing of employees' rights, relief of social tension and improvement of financial discipline and involvement of civil society in the settlement of social and labour relations by way of civilized solutions of problems instead of strikes, hunger-strikes and protests. In addition, a new system of guarantee funds will create favourable conditions for ratification by Russia of the Convention of ILO of 23 June 1992 no.173 On Protection of Employees' Claims in Case of Insolvency of their Employer, and Article 25 of the European Social Charter of 3 May 1996, The Right of Workers to the Protection of their Claims in the Event of the Insolvency of their Employer<sup>5</sup>.

Awareness of the problem, close attention thereto and focusing of efforts on finding the solution to the same give grounds for the hope that one of the most important issues in the development of any business and society – the issue of employees' protection – will be soon settled in Russia.

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<sup>5</sup> Baygereev M. Report at the social session.//Materials of the International Conference in 2005 “Effective anti crisis management in Russia. World practice in crisis management”M. 2006- p.178,

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