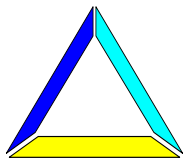
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**S31**

# The Implicit Bankruptcy Ban in the Farm Sector

## 1. Executive Summary

On November 26, 2002, the draft law on "On Amendments to the Law of Ukraine: On Stimulation of the Agriculture Development for the Period 2001-2004" was adopted in the second reading in the Verkhovna Rada. This draft suggests to re-enact the moratorium on bankruptcy of agricultural enterprises in Ukraine.

Bankruptcy procedures can be filed against insolvent enterprises which are unable to pay their overdue debts. Bankruptcy procedures thus help creditors to recover their property. For a commercial bank one of the prerequisites for granting a credit is the possibility of getting outstanding credits back from the debtor via a bankruptcy procedure, which should be regarded as a factor that favours agricultural crediting. From an economic point of view, bankruptcy is a necessary element to encourage the efficient use of production resources and to guarantee fair competition between enterprises in a market economy.

The German Advisory Group and the Institute for Economic Research and Policy Consulting have addressed the issue of bankruptcy from both a legal and an economic point of view in previous policy papers.[1] The goal of this paper is to point out peculiarities of the bankruptcy legislation for agriculture in Ukraine, and to discuss whether it is useful to declare a ban on bankruptcy. It is recommended:

- Not to declare a formal moratorium on farm bankruptcies, as it represents a very negative signal to investors, and may make the state liable for unrecoverable debts;
- Instead, to bring the legislation on agricultural land sales in line with the requirements of bankruptcy procedures in order to make bankruptcy a possible option for farm enterprises and their creditors;
- To ensure the viability of the farm sector and jobs in rural areas in other ways than through bankruptcy legislation.

[1] Advisory papers L6, L23, Q13.

## 2. Legal Issues of Insolvency in Ukraine

> **insolvent:** Unable to meet debt obligations.
>
> **bankrupt:** A person, firm, or corporation that has been declared *insolvent* through a court proceeding and is relieved from the payment of all debts after the surrender of all assets to a court-appointed trustee.
>
> **zombie:** A *bankrupt* or *insolvent* company which continues to operate […].
>
> (from: www.investorwords.com)

According to Ukrainian bylaw bankruptcy is defined as the inability of a debtor to renew his creditworthiness and to meet the creditors' claims in no other way but via liquidation procedures.[2] From the beginning of 2001 the new law "On Debtor's Solvency Renewal or Bankruptcy Declaring" (thereafter Bankruptcy Law) came into force, which is more debtor-biased than the previous one; there are also special provisions for certain groups of debtors.[3] The new law has generally made the bankruptcy procedure ever more complicated, lengthy and expensive, as already pointed out in earlier papers of the German Advisory Group.

In order not to repeat these arguments, we would like to point out only a few issues which may be relevant in the case of farm bankruptcies, or which should be considered by decision makers in agricultural policy.

### a) The debtor's obligation to deliver a plan for re-organisation

According to the law, the debtor only gets the court's approval to file a bankruptcy case when he presents a plan for the **re-organisation** of the enterprise. The usefulness of such an obligation has to be questioned. If the debtor had a good idea to restructure the enterprise in order to make it profitable again, why should he start a bankruptcy procedure? If, on the other hand, the debtor has no idea how to save the farm enterprise through re-organisation, he is barred from the bankruptcy procedure despite the fact that this is the very moment where such a procedure is required. The passage in the law has obviously been included to discourage managers from declaring their enterprises bankrupt. But this is not the purpose of a bankruptcy law. Quite on the contrary, it has to serve the purpose to make such a procedure easier for all interested sides.

### b) Overloading of the bankruptcy code with issues of corporate governance

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[2] Law of Ukraine "On Debtor's Solvency Renewal or Bankruptcy Declaring" as of May 14, 1992, #2343-XII

[3] For more details, please see advisory papers L23 "The New Bankruptcy Draft Law" and Q13 "Does Ukraine need More Bankruptcies?"

The passage implicitly tries to address the problem of asset-stripping and purposeful bankruptcy. This goal may be worthy, but it is completely misplaced in a law regulating bankruptcy procedures. Asset-stripping and similar misbehaviour have to be dealt with in the context of corporate governance. This fraud problem primarily exists in such cases where the director of the farm is not the owner of the farm and its assets. Regarding agriculture, we may think of a director of a cooperative farm who sells part or all of the produce or assets into his own pocket and declares bankruptcy afterwards. But no bankruptcy law can prevent this behaviour, but only sound control mechanisms which the finally the owners have to organize. This system of checks and balances is called "corporate governance" and has to be addressed in laws separate from bankruptcy.

Cooperative farms may need better regulations to avoid that the managing director makes use of his information advantage to cheat to co-owners. A supervisory board may be advisable in this case. But according to the Ministry of Agricultural Policy, only 3/4 of the restructured large farms have not more than 10 owners; of these 26% of farms with one owner and 48% with 2-10 owners. Moreover, even enterprises with many founders usually lease their land from their owners, which means that the most important asset these co-owners possess is not part of the bankruptcy asset.

### c) Fraud: Bankruptcy as a means to get rid of debts

Under a functioning legal framework, it is unlikely that a notorious asset stripper will declare his enterprise bankrupt. He would basically slaughter the cow he has been successfully milking. He will rather try to keep the enterprise afloat as long a possible.

Nevertheless, fraud in the form of purposeful bankruptcy cannot be totally ruled out when the legal and administrative system is weak and thus vulnerable to corruption. One can, for instance, imagine that bankruptcy becomes a way of getting rid of accumulated debt and starting anew. In Russia, where there have been far more farm bankruptcy cases than in Ukraine, anecdotal evidence suggests that in over one half of the cases, after bankruptcy the same manager ends up in control of the farm again. This prevents the purging effect of bankruptcies which should provide a farm with new owners and managers. In many cases, it appears that local authorities exercise a strong influence on the choice of new (old) managers for a farm enterprise, and without the support of the local administration, a potential investor has no chance of convincing the local share owners to rent him their land.

It is a difficult question whether it is useful to stigmatise a manager/owner who has driven an enterprise into bankruptcy by including him into a debtor register. Restrictions saying that the manager is prohibited from running the same farm after bankruptcy would surely be useful.

### d) Is the investigation into fraud issues a task of the appointed liquidator?

The liquidator's main task is to control the debtor’s management to secure the company's assets. He is also supposed to assess the financial position of the debtor. Moreover the trustee is obliged to uncover a fictitious or premeditated insolvency (article 13 clause 9 of the Bankruptcy Law).

This latter responsibility is surely useful in general, but it has to be questioned whether it should be in the focus of the liquidator. If the liquidator suspects fraud previous to the insolvency, he should of course notify the court, which may then initiate a criminal investigation. But to repeat the principles mentioned above, the bankruptcy law, bankruptcy procedures and the liquidator should primarily deal with compensating the creditors of an insolvent enterprise, and should refrain from becoming detectives.

## 3. Special Regulations Regarding Farm Insolvency

When the Law of Ukraine "On stimulating agricultural development in 2001-2004" as of January 18, 2002 came into force the point of the Bankruptcy Law, which provided for a ban on bankruptcy of agricultural enterprises up to January 1, 2004, became invalid. Thus, now agricultural enterprises are subject to the Bankruptcy Law. But some special features of the bankruptcy law as well as open questions regarding its consistency with other laws relevant to the farm sector have so far practically prohibited bankruptcy cases in agriculture. These peculiarities shall be discussed in the following.

### a) Compatibility with the land code

The question concerning the land share of the enterprise-debtor which could become part of the bankruptcy asset is regulated by the Land Code of Ukraine. Creditors' claims for a land plot that is supposed to be under agricultural production are met only in those cases when there are no other assets which could be claimed (article 139 of the Land Code). To satisfy creditors' claims, the land parcels have to be sold in the process of an open (advertised) auction.

However, when it comes to own land as a part of the bankruptcy mass, there seem to be contradictions between the bankruptcy law and the land code: on the one hand, the debtor’s land has to be sold, but on the other hand it is prohibited to sell agricultural land in Ukraine until 2005 (Chapter 10 of the Land Code). This makes the possibility of liquidating an agricultural enterprise which owns some agricultural land very disputable.

### b) Priority to sell land to neighbouring farms

The Bankruptcy Law stipulates some special procedures for agricultural enterprises (article 44) and farmers (article 50) which make the initiation of a bankruptcy case further unattractive. Even if bankruptcy cases would represent an exception to the general ban on land sales, neighbouring agricultural enterprises and farmers have a preferential right to buy immovable assets in the process of agricultural enterprise liquidation (article 44, clause 3).

Taking into account that the land has to be sold in the course of an auction, the number of permitted bidders would be reduced by this special clause. From the creditors’ point of view this probably means that the expected price will be lower compared to a situation of a real open bid. In economic terms, this rule also means that the assets will not be transferred to the owner which will use them most efficiently.

### c) Consideration of seasonality of revenues

According to the law the liquidator has to take into account the seasonality of agricultural production and its dependence from weather conditions. This means that creditors' claims should be satisfied by the revenues received only after harvest (article 44 clause 5).

This clause provides the debtor with an excuse to postpone the liquidation ever longer, thereby decreasing the likelihood that the creditors' claims will finally be satisfied. However, it is a basic requirement of proper farm planning that the liquidity of the farm enterprise has to be ensured over the total production cycle.

Additionally, the law also stipulates the possibility to prolong the re-organisation for 1 year if the debtor's financial situation became worse because of a natural disaster or other unfavourable conditions. This provides the debtor with even more possibilities to postpone the liquidation.

### d) Involvement of local authorities

The decision of the creditors' committee to apply for an agricultural enterprise's re-organisation can be made only with the participation of a local authority representative (article 44 clause 6). In that case there is a danger that local authorities will exercise pressure on creditors to ask the court for re-organisation, even though creditors may be rather interested in the liquidation of the enterprise.

**Result: An informal ban of farm bankruptcies is already in force!**

Due to the unfavourable procedure for a creditor of an agricultural enterprise, there have been hardly any bankruptcies in the Ukrainian farm sector up until now. This is an abnormal situation in a market economy even during a phase of growth. In Germany there were 559 bankruptcies of farms in 2002; which corresponds to 0.14% of all operating farm enterprises. This share is very small in comparison to other economic sectors. In the construction industry bankruptcies occur twenty times as much. The reason for the relatively low share of bankruptcies in German agriculture is that most farm own large shares of their land which they can sell consecutively in case of a financial bottleneck.

## 4. The economic consequences of a missing possibility for bankruptcy

It makes little practical difference if bankruptcy of agricultural enterprises is merely infeasible, as seems to be the case today, or if it is formally banned. Both alternatives result in a practical ban of bankruptcies. Some economic consequences of such a ban are discussed in the following.

The ban on bankruptcies for agricultural enterprises which is part of the draft law mentioned in the beginning of this paper would mean that a farm that is not able to pay back credits or other financial obligations in due course could remain in business, and that the creditors of this farm would be deprived of their property without compensation. Apart from being an obstacle to a better functioning credit system in agriculture, such a bankruptcy ban would seriously bias competition

between agricultural enterprises, and would finally lead to lower prices and profits in Ukrainian agriculture. The effects will be described in detail in the following.

### a) Impacts on farm efficiency, access to inputs and capital

A ban on bankruptcy would basically mean that unprofitable farms could remain in business without restructuring debts, assets and management. The difficult question is what impact a restructuring or liquidation of a certain share of unprofitable enterprises in Ukraine would have. Most bankruptcies in western economies result in a re-deployment of the assets of the firm to new owners and are thus likely to be put to a more profitable use. This process stimulates changes in management as well as new investments.[4]

On the contrary, the absence of bankruptcy procedures would certainly lead to a conservation of current structures and thus **less supply of land and facilities** to competing farms who work more efficiently and wish to expand their business activities. In other words, limited resources will continue to be wasted on inefficient farms while other farms, very often newly established private farms, have limited opportunity to grow.

Moreover, allowing bankrupt farms to remain in business will lower the average profitability of farms compared to a situation where bankruptcy is a really forcing farm owners and managers to run their enterprise with more financial discipline. The **threat of insolvency creates incentives for producers to improve** their efficiency, including the reorganization of the enterprise as a way to avoid bankruptcy.

But also the **access to farm inputs** will be negatively affected. Chemical and seed suppliers, for example, have to invest more resources in identifying trustworthy and truly solvent customers, if they must worry that a large share of the farms are actually losing money and will have difficulties paying back credits. The result is a higher risk premium that must be paid by all customers, making inputs more expensive for all farms. Of course, the input suppliers gain experience over time and develop their 'black lists', but this is time consuming and expensive and involves a lot of costly 'learning by losing' operations.

The poor **access of farms to credit** is a major impediment to agricultural development. Particularly long-term credit is a problem in a country where the trust between creditors and debtors is still weak. If there is no possibility for creditors to claim financial liabilities from a debtor enterprise within a sound and efficient legal framework, then this enterprise is not attractive for financial institutions. Under such conditions risks from crediting increase substantially because the borrower is not encouraged to stick to the terms of a credit contract. In this situation what matters in drawing up a contract and keeping to its terms is personal relations between partners as well as informal methods of getting debts re-paid. A ban on farm bankruptcy makes it much more risky for banks to invest in agriculture, and would thus not help Ukrainian agriculture to invest in new technologies and machinery, a prerequisite to become more competitive on domestic and export markets.

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[4] Morris Duney. On legal guaranteeing of bankruptcy //Visnyk "Silske hospodarstvo reformuetsa", #6, 1997

As a consequence of all these individual disadvantages, the total **price environment of the farm sector will remain unfavourable** since any price is burdened by a risk premium when the goods and services bought or sold on a non-cash basis. Prices for inputs financed by a trade credit will be higher because the supplier is uncertain as to whether to the farmer will really pay later. The same applies to credit interest rates, which will carry a high risk premium because banks can not be sure if they can recover their capital. Product prices, on the other hand, will be lower when sales are made on the basis of forward contracts because the trader will demand a higher risk discount from the farmer in the case of non-delivery.

### b) Impacts on other sectors of the economy

Bankrupt farms which cannot be forced into a bankruptcy procedure will most probably be ailing for years without enough cash and financial resources to invest. They will work on the lowest technological level, using less quality seeds, fertiliser, pesticides and advanced machinery. This will **negatively affect Ukrainian farm input industries**. Moreover, ailing enterprises will most likely not be able to deliver quality products in sufficient and regular quantities. Especially exports are subjected to rigorous controls in importing countries. Processors and exporters need dependable quality production at home if they are to succeed abroad.

The insecurity about the repayment of debts which would originate from the farm sector would spread like an infectious disease in rural areas and also **affect other sectors' access to credit**. If input suppliers or processors lack the means to recover their debts from farms, they will themselves pose a higher risk to credit suppliers. Banks will simply be reluctant to lend money to firms dealing with the farm sector. This points out the importance of secure property rights without sectoral exceptions.

As long as bankruptcy procedures are possible in non-agricultural sectors, the absence of bankruptcies in the Ukrainian farm sector means an **implicit taxation** of other sectors. Especially when the state (rayon and oblast administrations) gets involved in bailing out financially bankrupt farm enterprises (either directly with financial support, or indirectly in the form of foregone tax revenues), input suppliers or processors, this involves public funds which finally have to be paid from taxes raised from all economic sectors. In this case, the contribution of the farm sector would be negligible due to the tax exemptions, which it is currently enjoying.

### c) Consistency with a market-oriented economic system

The Ukrainian government is struggling hard to be acknowledged as a true market economy. But it is often forgotten that it is the very nature of a market economy that those who make decisions also take the **financial responsibility for private decisions**. This accountability principle is at the core of any functioning market system, because only then will private decisions create both private and public welfare. Currently the Ukrainian farm sector is spared from financial liability.

However, the lack of appropriate bankruptcy procedures allows farms to destroy instead of create value, and a formal ban of bankruptcies would fix that in legal terms. This leads to the consequence that farm directors and managers would have no real incentive to manage their enterprises as properly as if they were confronted with hard budget constraints. In western countries, bankruptcy is primarily feared

by the owners, but also the management of an enterprise, because it will be made responsible for the insolvency, which will lead to the replacement of the management board. In the absence of bankruptcy procedures there are **less incentives to maintain and develop sincerity and trustworthiness**, and the need for acquiring new farm management skills will not be obvious to those who can, with some tricks at hand to ensure the own income from draining the farm's resources, survive on a low entrepreneurial level.

Bankruptcy is one of the basic principles of a market economy and the possibility to file bankruptcy procedures is an essential part of western economic systems. It is an important means to ensure property rights of people willing to entrust money to others in one or the other form. These procedures are hundreds of years old and apply to any private economic entity, which is a clear sign that they have been regarded as most essential ingredients of a market economy. A **bankruptcy ban means to abolish market principles** in Ukrainian agriculture to a large extent, and to push the countryside some way back to where it has been under socialism, when enterprises could accumulate losses with few if any consequences.

## 5. Social Aspects of Bankruptcies in Agriculture

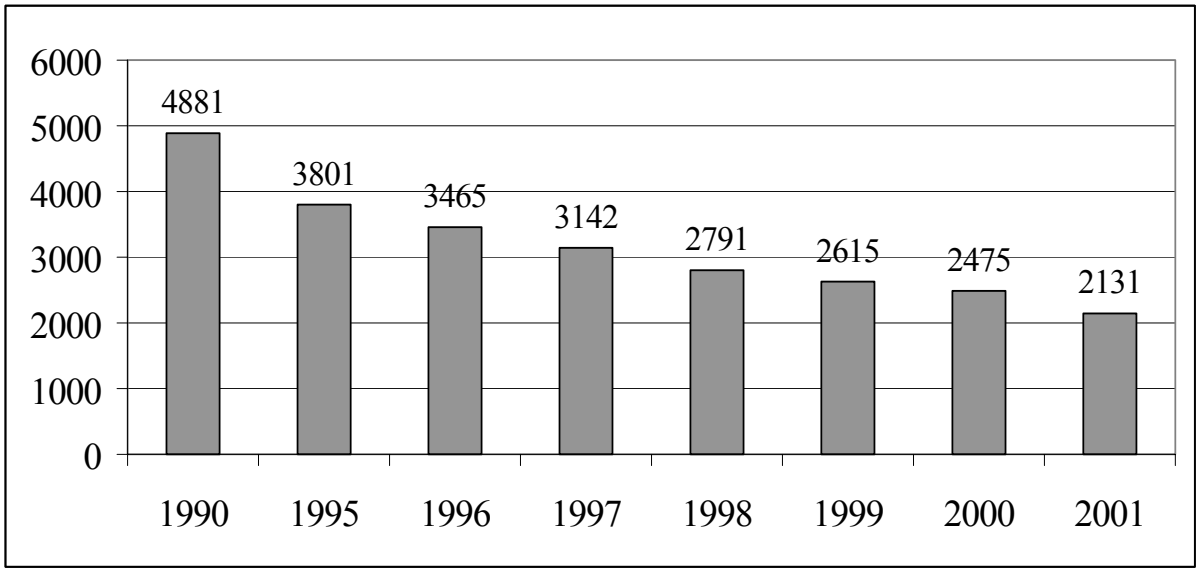
Social disruptions following the bankruptcies of major enterprises are a serious concern for both politicians and ordinary people in Ukraine. Even those who agree with the described positive aspects of an effective insolvency system fear that increased bankruptcy cases will eventually lead to a domino effect of bankruptcies leading to increased rural unemployment. Some farms still are the sole employer in particular villages, and others still offer or host social services like kindergartens, elementary schools, communal services and others. These fears are of course justified to a certain extent. Opening the possibility of bankruptcies in the Ukrainian countryside may cause changes in ownership structures, employment patterns, responsibilities for social services, and many other things. However, we would like to argue in favour of some courage to allow such changes. When discussing the results of changes, we always need to weigh the negative against the positive effects.

### a) Employment

In developed market economies bankruptcy procedures are used to re-group the assets and resources of enterprises, to re-new their activities, and thus to maintain and create jobs. During this process part of the employees may lose their jobs. In Ukraine this can be very unpleasant because usually there are few other job opportunities in rural areas.

On the other hand, agricultural enterprises are over-staffed. Agriculture contributes approximately 15% to GDP, while 23% of the labour force is still employed in agriculture. In large privatised enterprises, staff is released in great numbers already today. As figure 1 shows, agricultural enterprises are gradually losing their role as the main rural employers.

**Figure 1. Annual average employment on agricultural enterprises, thousand persons**




Source: State Statistics Committee of Ukraine

During the last decade the employment on medium and large agricultural enterprises decreased more than twice. In 2001 alone the number of workers decreased by 344 thousand or 13.9% compared to the previous year. It is questionable whether this process would be accelerated by introducing a system of better protection for property rights (i.e. insolvency procedures) of those people who lend to farmers and thus help to maintain and create jobs! The wish to save employment through the banning of bankruptcy proceedings against farms is backward looking.

### b) Sustainable incomes of rural inhabitants

Another undesirable social outcome of farm bankruptcy can be an instability in rural incomes. About 60% of the former CAE members are pensioners, which lease out their land shares from former the CAE and receive land lease payments in exchange which now represents a substantial part of their income[5]. The bankruptcy of the lesser can leave them without these payments at least for a certain period of time. This problem could perhaps be tackled by introducing an obligatory insurance against insolvency which could be deducted from land lease and wage payments of farms. Such insurances are common in sectors like insurance companies or banks. But due to the importance of the Ukrainian farm sector for the incomes of rural pensioners, such an institution might make sense at least for a limited period of time. But it can only work without overwhelming moral hazard problems when the control mechanisms of corporate governance in Ukraine are improved simultaneously.

[5] Advisory paper S19 "Social Security Challenges in Rural Ukraine – The Case of Rural Pensioners"

### c) Support of social infrastructure

The "social sphere which is often cited as an important element in the total system of rural service provision. On the other hand, it is questionable whether the provision of public services belongs in the hand of now private businesses. To maintain an outdated institutional set-up – like the social sphere being embedded in private farms – by means of the bankruptcy law is questionable. Regardless of whether the hosting farm enterprise is profitable or not, the responsibilities regarding social services need to be shifted to the rural municipalities as fast as possible. The possible insolvency of a farm enterprise is all the more a reason to accelerate, and not to curb, this inevitable process.

## 6. Recommendations

### Refrain from formally banning bankruptcies in the farm sector

Taking into account that farm bankruptcies have been made practically impossible today by the special exceptions applying for this sector, a ban on farm bankruptcies would change nothing in the real world, apart from representing another negative signal to potential investors in the Ukrainian farm sector. Instead, agricultural policymakers should present a clear road towards a revision of the bankruptcy code which would make bankruptcies of farms possible at all.

### Improve the incentives for managers to work profitably

For every private person it is self-evident that he or she cannot constantly spend more money that he/she earns. Why these basic economic rules should not apply to farm enterprises is hard to understand.

In the first place, as a result of bankruptcy the managers of some enterprises may lose their jobs. Probably this is the main reason why political forces lobby for a bankruptcy ban. But one has to see the positive side of the coin as well. It is natural that a manager who does not face the necessity to stick to hard budget constraints will not initiate the changes on the farm which are needed to make the farm profitable.

### Deal with corporate governance separately

Bankruptcy procedures are no substitute for sound regulations on corporate governance, particularly in enterprise with many owners. To include corporate governance in the bankruptcy laws will mean that internal control mechanisms simply will start to work too late when the carriage is already in the mud.

Nevertheless, the decision on whom to select as a new manager of an enterprise having been re-organised after bankruptcy must be more transparent. One might specifically exclude managers who have driven a farm into bankruptcy from the list of applicants in a more or less restrictive way. Whether such regulations belong into the bankruptcy code is questionable; again, they should rather be added to the laws dealing with corporate governance.

### Make bankruptcy procedures less debtor-biased

The bankruptcy procedure in Ukraine is quite debtor-biased, thereby increasing the currently high creditor risks in Ukraine. The bankruptcy law rather seems to be

designed to prevent bankruptcies instead of facilitating them. The debtor bias leads to the currently observed situation that only few bankruptcy procedures end with the liquidation of the enterprise.

**Abolish the special provisions for agriculture**

As has been shown above, there is no need for special rules applying to agriculture in the bankruptcy law. They are the reason that bankruptcy procedures do virtually not exist in agriculture, because creditors consider it useless to challenge a debtor enterprise when it is a farm. This discourages investments in the farm sector, even though these investments are desperately needed.

**Create alternative employment opportunities in rural areas**

To alleviate possible negative consequences of farm bankruptcies, policy should direct its efforts to creating new jobs in rural areas. Job losses in the farm sector are already widespread today, and it is not likely that the ban on farm bankruptcy prevents a further tide of dismissals. Improving labour mobility and quality as well as increasing opportunities to find a job outside agriculture would be much more rewarding than just preserving old structures.

**Invest more in education and management training**

Most financial crises of farms are caused by insufficient skills of farm managers. Research has shown that even under unfavourable conditions some Ukrainian agricultural enterprises do manage to produce efficiently.[6] These enterprises are successful because they have a better management, produce more competitive products, make better use of market advantages, and have a good business reputation, which eases their access to credit. But also the management skills of the future farm directors have to get more attention from public policy. Increased investments in farm management education and training would surely be highly rewarding. Finally, if bankruptcy procedures have the goal to replace unable managers, there have to be good alternatives on the job market.

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April 2003

[6] Advisory paper S16, "Organizational forms of restructured agricultural enterprises in Ukraine: what conclusions can be drawn?" – IERPC, November 2002; Advisory paper S12, "Competitiveness of milk production in Ukraine" – IERPC, October 2002.