

IN THE NAME OF THE RUSSIAN FEDERATION

CONSTITUTIONAL COURT  
OF THE RUSSIAN FEDERATION

Judgment

of 6 June 2000 No. 9-II

in the case concerning the review of the constitutionality of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)” in connection with a complaint filed by the Tverskaya Pryadilnaya Fabrika OJSC.

Moscow, 6 June 2000

The Constitutional Court of the Russian Federation composed of Presiding Judge N. V. Seleznev and Judges M. V. Baglay, Yu. M. Danilov, L. M. Zharkova, G. A. Zhilin, V. D. Zorkin, V. O. Luchin, V. G. Strekozov, O. S. Khokhryakova,

in the attendance of A. V. Goryunov and Yu. K. Ivanov, representatives of the Tverskaya Pryadilnaya Fabrika OJSC that submitted its constitutional complaint to the Constitutional Court of the Russian Federation; Permanent Representative of the State Duma to the Constitutional Court of the Russian Federation V. V. Lazarev, Representative of the Council of the Federation A. V. Popov,

pursuant to Article 125 (Section 4) of the Constitution of the Russian Federation, Subsection 3 of Section 1, Sections 2 and 3 of Article 3, Subsection 3, Section 2 of Article 22, Articles 36, 74, 86, 96, 97 and 99 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”,

in an open hearing, examined the constitutionality of the provisions of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)”.

The reason for the consideration of the case is a complaint of the Tverskaya Pryadilnaya Fabrika OJSC about violation, by the above provision, of its constitutional rights and freedoms guaranteed by Articles 19 (Sections 1 and 3), 46 (Section 1) and 55 (Section 3) of the Constitution of the Russian Federation. The ground for the consideration of the case is the discovered uncertainty of whether the provisions challenged by the applicant are in conformity with the Constitution of the Russian Federation.

Having heard the report of Judge-Rapporteur V. D. Zorkin, statements by the parties, an intervention by O. A. Naumov for the Supreme Arbitration Court of the Russian Federation; and having considered written submissions and other materials, the Constitutional Court of the Russian Federation

e s t a b l i s h e d :

1. In its complaint, the Tverskaya Pryadilnaya Fabrika OJSC challenges the constitutionality of the provision of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)” of 8 January 1998, according to which external bankruptcy administrator within three months from the moment of commencement of external administration bankruptcy proceedings, has the right to repudiate a debtor’s contract that has not been performed by the parties in full or in part, if it is a long-term contract (concluded for a period of over one year).

On 1 April 1996, the Tverskaya Pryadilnaya Fabrika OJSC entered into a real estate lease agreement (manufacturing building) with the Tverskaya Manufaktura CJSC for a period until 31 December 2000. On 15 December 1996, the parties concluded a supplementary agreement according to which the Tverskaya Pryadilnaya Fabrika OJSC would acquire the right to purchase the leased building by the end of the contractual term, and the purchase payments were agreed to be part of the rent payments. When the external administration bankruptcy proceedings commenced in the Tverskaya Manufaktura CJSC on 3 February 1999, the external bankruptcy administrator announced repudiation of the contract for the reason that it was concluded for a period of over one year and demanded return of the leased building; however, the Tverskaya Pryadilnaya Fabrika OJSC did not comply with the demand.

The external bankruptcy administrator brought a lawsuit to the Arbitration Court of the Tver Region, which, on 5 July 1999, delivered a decision ordering the Tverskaya Pryadilnaya Fabrika OJSC to return the disputed immovable property to the Tverskaya Manufaktura CJSC. The court relied on the possibility of unilateral termination of long-term contracts of a debtor by an external bankruptcy administrator provided in Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)”. The proceedings on the appeal filed by the Tverskaya Pryadilnaya Fabrika OJSC were stayed by the Arbitration Court of the Tver Region pursuant to Section 2, Article 98 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, as the Tverskaya Pryadilnaya Fabrika OJSC filed a complaint to the Constitutional Court of the Russian Federation seeking review of the constitutionality of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)” applied in its case.

The applicant argues that the challenged norm unreasonably provides preferences to one of the parties to a contract and impairs the other party, which acts in good faith. In the applicant’s opinion, the principles of equality before the law and the court, equality of rights and freedoms of man and citizen, the right to judicial protection are thereby violated, and disproportionate restrictions are imposed on the right to possess and to use property, which is

contrary to Articles 19 (Sections 1 and 2), 46 (Section 1) and 55 (Section 3) of the Constitution of the Russian Federation.

2. Pursuant to the Constitution of the Russian Federation, everyone shall have the right to have property, possess, use and dispose of it both personally and jointly with other people (Section 2, Article 35); in the Russian Federation the freedom of economic activity shall be guaranteed (Section 1, Article 8); everyone shall have the right to freely use his abilities and property for entrepreneurial and other economic activities not prohibited by law (Section 1, Article 34).

Within the meaning of the above-mentioned provisions, the term “property” comprises any possessions related to the exercise of the right of private and other forms of property, including proprietary rights, in particular the rights to possess, use and dispose of property, if these rights were lawfully acquired by the owner. The implementation of the proprietary rights is based on the general legal principles of inviolability of property and freedom of contract that presume equality, autonomy of will and property autonomy of the participants in civil law relations, impermissibility of arbitrary interference of anyone in private affairs.

The rights to possess, use and dispose of property and freedom of contract of civil relations participants stipulated by Articles 8, 34 and 35 of the Constitution of the Russian Federation, including determination of the grounds and the procedure for their creation, alteration and termination, as well as the scope of their protection and legitimate restrictions shall be regulated by law as follows from Articles 71 (Section “c”) and 76 (Section 1) of the Constitution of the Russian Federation. However both the possibility of restrictions itself and their nature shall be established by the legislator not arbitrarily, but in accordance with the Constitution of the Russian Federation, in particular its Article 55 (Section 3), which prescribes that the rights and freedoms of man and citizen may be restricted by federal law only to the extent necessary to protect the fundamentals of the constitutional order, morals, health, the rights and lawful interests of others, and to ensure defense of the country and security of the state. The restrictions of the right of property, proprietary rights and freedom of contract in civil relations shall meet the requirements of fairness, shall be proportionate to the constitutionally significant aims of protecting the rights and lawful interests and shall be prescribed by law.

3. Civil legislation regulating relations of participants in civil transactions, including those who exercise entrepreneurial activities, is based on the principles of freedom of entrepreneurial activity, recognition and protection of property (Article 8 of the Constitution of the Russian Federation), which are fundamentals of the constitutional order of the Russian Federation, and on free use of one’s property for entrepreneurial activities and exercise of the

right to possess, use and dispose of property guaranteed in the Russian Federation (Section 1, Article 34; Section 4, Article 35 of the Constitution of the Russian Federation).

Accordingly, the Civil Code of the Russian Federation establishes that the fundamentals of the civil legislation are inviolability of property, freedom of contract, impermissibility of arbitrary interference in private affairs (Section 1, Article 1). The freedom of civil law contracts within its constitutional meaning implies respect of the principles of equality and concurrence of the will of the parties. Consequently, contractual obligations regulated by the civil legislation and, therefore, the procedure of contracts termination in the sphere of proprietary relations shall be based on equality of the parties, autonomy of their will and their proprietary autonomy (Section 1, Article 2 of the Civil Code of the Russian Federation).

Pursuant to the Civil Code of the Russian Federation, termination of a contract is possible upon agreement of the parties, and if the parties have not reached such agreement, it may be terminated by a court upon a request of one of the parties due to a fundamental breach of the contract by the other party or in connection with substantial alteration of the circumstances provided that certain conditions of the Civil Code of the Russian Federation are present. The claim for termination of a contract may be filed by a party with the court only upon receipt of the other party's notice of refusal in response to an offer to terminate the contract or absence of such response within the period stipulated in the offer or established by law or contract, and in the absence of such period within thirty days (Sections 1 and 2, Article 450, Sections 1 and 2, Article 451, Section 2, Article 452).

However, the Civil Code of the Russian Federation provides for exemptions from this common procedure of terminating contracts. If withdrawal from a contract is permitted by law or contract, the contract shall be considered as terminated or altered after one of the parties withdraws from it in full or in part (Section 3, Article 450). As follows from the challenged provision of Subsection 3, Section 2, Article 77 of the Federal Law "On Insolvency (Bankruptcy)" taken together with the mentioned norm of the Civil Code of the Russian Federation, the external bankruptcy administrator is vested with the right of discretionary unilateral withdrawal of the debtor's contracts, without consent of the counterpart, if these contracts are concluded for a period of over one year.

Thus, the challenged norm constitutes a restriction of the freedom of contract as one of the fundamentals of civil legislation and ultimately a restriction of the constitutional rights and freedoms, above all the freedom of entrepreneurial activities. It may be recognized as permissible only if it does not violate the requirements of the Constitution of the Russian Federation, in particular those established in Article 55 (Section 3).

4. Article 77 of the Federal Law “On Insolvency (Bankruptcy)” is part of Title V (Articles 68–96) regulating external bankruptcy administration (judicial rehabilitation), which is a bankruptcy procedure applied to a debtor with an aim to restore his paying capacity through transfer of powers to manage the debtor’s affairs to an external bankruptcy administrator.

External bankruptcy administration is introduced by a decision of an arbitration court if there are reasonable grounds to believe that an actual possibility to restore the debtor’s paying capacity is established. As follows from Section 1, Article 1, Section 1, Article 65, Section 3, Article 67, Articles 68–96 of the above-mentioned Federal Law, this procedure constitutes an interference of the state in civil law relations which is exercised with an aim to protect the rights and lawful interests of others (the creditors) and as such results in certain restrictions of the right of property, free use of possessions, the rights to possess, use and dispose of property, and the freedom of contract.

Among the means aimed at restoring the debtor’ paying capacity, Articles 69 and 70 of the Federal Law “On Insolvency (Bankruptcy)” provide for such consequences of external bankruptcy administration as removal of the debtor’s executive manager from his office and vesting an external bankruptcy administrator with the management of the debtor’s affairs, and a moratorium on the satisfaction of the creditors’ monetary claims and the debtor’s mandatory payments.

Alongside with that, the Federal Law provides for a procedure in which the debtor’s transactions may be invalidated at the stage of external bankruptcy administration. Article 78 establishes the following possibilities of invalidation of the debtor’s transactions by an arbitration court upon application of an external bankruptcy administrator: invalidation of a transaction on the grounds provided by the civil legislation of the Russian Federation, including the one concluded by the debtor before the introduction of external bankruptcy administration, – (Section 1); invalidation of a transaction entered into by the debtor with an interested person if the performance of this transaction caused or may cause damages to creditors (Section 2); invalidation of a transaction entered into or made by the debtor with one of the creditors or another person after the petition for the debtor’s bankruptcy was accepted by an arbitration court and (or) within six months before the petition for the debtor’s bankruptcy was filed, if this transaction results in preferential satisfaction of claims of certain creditors before the others (Section 3); invalidation of a transaction entered into by the debtor, who is a legal person, after the institution of bankruptcy proceedings or within six months before the petition for the debtor’s bankruptcy was filed, if it relates to the payment (allotment) of an interest (share) in the debtor’s property to a shareholder of a debtor, who is a legal person, due to exit from the legal person (Section 4).

Unlike Article 78, the challenged provision of Paragraph 3, Section 2, Article 77, vests the external bankruptcy administrator with the right to declare withdrawal from the debtor's contract, i.e. at his discretion, if he finds it reasonable to terminate unilaterally any contract of the debtor without applying to court and on the sole ground that they are concluded for a period of over one year. Therefore, from among the factors preventing restoration of the debtor's paying capacity the legislator focuses on the mere fact of concluding a contract for a period of over one year (irrespective of whether a particular long-term contract is such obstacle indeed).

This is the reason why the challenged provision differs in its nature and aims from the other provisions of Article 77, which directly tie the right of an external bankruptcy administrator to withdraw from the debtor's contracts to specific factors that actually prevent restoration of his paying capacity, namely: if the performance of a contract causes damages to the debtor as compared to similar contracts concluded under similar circumstances; if the contract achieves exclusively long-term positive effect for the debtor; if there are any other factors preventing restoration of the debtor's paying capacity.

As a result, the counterparties to the debtor's contracts that are concluded for a period of over one year are deprived of the possibility to assert their rights, *inter alia* in court, which establishes whether there are factors that really prevent restoration of the debtor's paying capacity and constitute grounds for withdrawal from the debtor's contract by the external bankruptcy administrator (Section 2, Article 77), or whether there are factors and grounds for the debtor's transaction to be invalidated by an arbitration court upon the application of the external bankruptcy administrator, when such possibility is foreseen by federal law (Article 78).

Legal equality of the parties to a civil law contract based on the provisions of Articles 8 (Section 1), 19 (Sections 1 and 2), 34 (Section 1) and 35 (Section 2) of the Constitution of the Russian Federation, is thereby excessively restricted: a counterpart as one of the parties to a contract finds himself to be in an unequal position compared to the other party and to the other categories of counterparts (whose contracts may be terminated only in the presence of specific factors actually preventing restoration of the debtor's paying capacity). Such restriction is not necessary from the standpoint of the requirements of Article 55 (section 3) of the Constitution of the Russian Federation.

Basically, in this case an arbitrary criterion is introduced, which is contrary to the principles of proportionality and fairness, which should be respected in restricting the freedom of contract and the rights to possess, use and dispose of property, and which imply the necessity to provide for a fair balance between public interests and the rights of private persons in contractual relations.

Thus, the provision of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)” vesting an external bankruptcy administrator with the right to unilaterally withdraw from the debtor’s contracts on the sole ground that they are concluded for a period of over one year, irrespective of whether there are any relevant factors that actually prevent restoration of the debtor’s paying capacity and thereby depriving the counterparts of the possibility to challenge this unilateral termination in court, constitutes disproportionate restriction of the freedom of economic activity and, consequently, the freedom of contract, and the right to freely use one’s property for entrepreneurial activities, the rights to possess, use and dispose of property, which are guaranteed by the Constitution of the Russian Federation, and violates the principle of legal equality and therefore does not conform to the Constitution of the Russian Federation, its Articles 8 (Section 1), 19 (Sections 1 and 2), 34 (Section 1), 35 (Section 2) and 55 (Section 3).

Concluding from the above and pursuant to Sections 1 and 2 of Article 71, Articles 72, 75 and 100 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, the Constitutional Court of the Russian Federation

h e l d :

1. To recognize the provision of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)”, of 8 January 1998 pursuant to which an external bankruptcy administrator within three months from the moment of commencement of external administration bankruptcy procedure has the right to withdraw from the debtor’s contract that had not been performed by the parties in full or in part if it is a long-term contract (concluded for a period of over one year), as non-conforming to the Constitution of the Russian Federation, its Articles 8 (Section 1), 19 (Sections 1 and 2), 34 (Section 1), 35 (Section 2) and 55 (Section 3), since this provision allows the external bankruptcy administrator to terminate unilaterally the debtor’s contracts on the sole ground that they are concluded for a period of over one year irrespective of whether there are any relevant factors present, which prevent restoration of the debtor’s paying capacity.

2. Pursuant to Section 2, Article 100 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, the court judgments delivered in the case of the Tverskaya Pryadilnaya Fabrika OJSC on the basis of the provisions of Paragraph 3, Section 2, Article 77 of the Federal Law “On Insolvency (Bankruptcy)” which are recognized as unconstitutional by this Judgment, are to be reconsidered by courts according to the established procedure.

3. Pursuant to Sections 1 and 2, Article 79 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, this Judgment shall be final and shall not be subject to any appeal, it shall come into force immediately upon pronouncement, it shall be directly applicable, and shall not require confirmation by other authorities and state officials.

4. Pursuant to Article 78 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, this Judgment shall be published in the Collection of Laws of the Russian Federation and *Rossiyskaya Gazeta*. The Judgment shall also be published in the Bulletin of the Constitutional Court of the Russian Federation.

Constitutional Court  
of the Russian Federation

No. 9-II