

IN THE NAME OF THE RUSSIAN FEDERATION

CONSTITUTIONAL COURT  
OF THE RUSSIAN FEDERATION

Judgment  
of 16 May 2000 No. 8-II

in the case concerning the review of the constitutionality of certain provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” in connection with a complaint of Timber Holdings International Limited.

Moscow, 16 May 2000

The Constitutional Court of the Russian Federation composed of Presiding Judge V. G. Yaroslavtsev and Judges N. S. Bondar, N. V. Vitruk, G. A. Gadzhiev, T. G. Morshchakova, Yu. D. Rudkin, A. Ya. Sliva, O. I. Tiunov, B. S. Ebzeev,

in the attendance of S. V. Vodolagin, PhD in Law, representative of Timber Holdings International Limited, which 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, Representatives of the Council of the Federation Yu. S. Pilipenko and A. V. Popov, attorneys,

pursuant to Section 4, Article 125 of the Constitution of the Russian Federation, Subsection 3, Section 1, Sections 2 and 3 of Article 3, Subsection 3, Section 2 of Article 22, Articles 36, 74, 86, 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 Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”.

The reason for the consideration of the case is a complaint of Timber Holdings International Limited regarding violation, by Article 104 of the Federal Law “On Insolvency (Bankruptcy)”, of the provisions of Section 3, Article 35 of the Constitution of the Russian Federation.

Having heard the report of Judge-Rapporteur G. A. Gadzhiev, statements by the parties’ representatives, expert opinion of V. F. Popondopulo, 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. Article 104 of the Federal Law “On Insolvency (Bankruptcy)” of 8 January 1998, regulating the legal regime of a debtor’s possessions that shall not be included into the bankruptcy estate, states, *inter alia*, that social housing funds, preschool institutions and municipal service infrastructure, which are vitally important for the region, shall be transferred, as prescribed by Subsections 1–3 of the said Article 104, to the possession of the municipality (Section 4) as are and with no additional conditions (Section 5).

As follows from the submitted materials, the Arbitration Court of the Vologda Region declared Sudsky LDK-A LLC insolvent (bankrupt) and commenced insolvency proceedings in order to secure the creditors’ claims. The trustee in bankruptcy did not include a boiler-house, which was part of the production complex belonging to the debtor, in the bankruptcy estate because that facility is vitally important for the village Suda, Cherepovets District, Vologda Region, as it is the only source of heating and, therefore, pursuant to Article 104 of the Federal Law “On Insolvency (Bankruptcy)” shall be transferred to the possession of the municipality. The principal creditor of Sudsky LDK-A LLC, Timber Holdings International Limited, sued for invalidation of the boiler-house transfer or for compensation of its cost. The Arbitration Court of the Vologda Region rejected the lawsuit with reference to Article 104 of the Federal Law “On Insolvency (Bankruptcy)”.

In its complaint to the Constitutional Court of the Russian Federation, Timber Holdings International Limited argues that taking property out of the bankruptcy estate and its transfer to the possession of the municipality in effect hinders complete satisfaction of the creditor’s claims depriving him of his entitlements. The complainant believes that such exclusion of property from the bankruptcy estate is, in its essence, nothing less than a compulsory – pursuant to law – taking of private property without prior and equal compensation, which contradicts the requirements of Section 3, Article 35 of the Constitution of the Russian Federation.

2. Pursuant to Articles 96 and 97 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, a law or its provision challenged by an individual, is subject to scrutiny by the Constitutional Court of the Russian Federation only to the extent that it was applied in the complainant’s case and affected his rights.

In fact, in the complainant’s case the only applied provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” were those concerning the transfer of vitally important objects to the municipality within insolvency proceedings. Moreover, they were applied to the extent that they do not concern proprietary relations between the debtor and the municipality, but to the extent that they regulate proprietary relations between the debtor and his creditors: in insolvency proceedings tangible objects and enforceable claims that form

bankruptcy estate are subject to public sale in order to satisfy the creditors' claims, that is why the transfer of objects listed in Section 4, Article 104 of the Federal Law "On Insolvency (Bankruptcy)" infringes the proprietary rights and lawful interests of the creditors as well.

Therefore, only to this extent are the provisions of Section 4, Article 104 of the Federal Law "On Insolvency (Bankruptcy)" subject to scrutiny in the present case. The Constitutional Court of the Russian Federation does not evaluate whether these provisions secure the constitutional rights of municipalities or whether the municipalities are protected by administration of justice.

3. Pursuant to Section 3, Article 35 of the Constitution of the Russian Federation, no one may be deprived of property otherwise than by a court decision; taking of property for state needs may be carried out only on condition of prior and equal compensation.

The term "property" used in this Article, by its constitutional meaning, comprises particular rights *in rem* and enforceable claims, including those belonging to creditors. This approach was used by the Constitutional Court of the Russian Federation in Judgment of 17 December 1996 in the case concerning the review of the constitutionality of Subsections 2 and 3, Section 1, Article 11 of the Law of the Russian Federation "On Federal Fiscal Police Authorities" of 24 June 1993, and corresponds to the interpretation of this term which is given by the European Court of Human Rights when applying Article 1 of Protocol No. 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms.

Consequently, the creditors' enforceable claims and lawful interests within insolvency proceedings are subject to protection under Section 3, Article 35 of the Constitution of the Russian Federation.

4. Social housing funds, preschool institutions and the municipal service infrastructure which are vitally important for the region, while they are the debtor's immovable property, are used not for his personal advantage only but also for public interests protected by the State. Therefore, any actions taken in order to make them function and to maintain their designated purpose are relations of public nature. In regulating these relations, the legislator, on the grounds of public purposes, is entitled to provide that certain life support facilities shall be transferred to the respective municipality. Thereby the distribution of functions of a social state among the levels of public authority is also ensured (Article 7 of the Constitution of the Russian Federation).

The exemption of the facilities mentioned above from the bankruptcy estate and their transfer – affirmatively prescribed by law – to the possession of the municipality is a permissible restriction of the debtor's right of private property, set out for the purpose of protection of rights and lawful interests of others (Section 3, Article 55 of the Constitution of the Russian

Federation). At the same time, one may not fail to take account of private interests, in particular the interests of the debtor and creditors within insolvency proceedings.

5. Under Section 2, Article 74 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, the Constitutional Court of the Russian Federation decides the case relying on the analysis of not only the literal meaning of the normative act under review, but also the meaning these norms acquire from their place within the hierarchy of legal acts and also in law-enforcement practice.

The transfer of assets to the possession of municipal governments under Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”, in its literal meaning, is deprivation of a debtor-proprietor of his possessions. However, the analysis of the current law-enforcement practice demonstrates that trustees in bankruptcy and arbitration courts interpret this provision as excluding any probability that the decrease of the bankruptcy estate is anyhow compensated to the debtor.

In this regard, the provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” constitute excessive, disproportionate, to the constitutionally significant purposes, and, thus, arbitrary restriction of the debtor’s right of property and, therefore, creditors within insolvency proceedings; they derogate constitutional right of private property, and hereby contradict Article 55 (Sections 2 and 3) of the Constitution of the Russian Federation. The legislator, pursuant to the principles of the rule of law state, has to regulate the transfer of the right of property, particularly the forfeiture of this right, on the basis of legal equity and justice principles in accordance with the Constitution of the Russian Federation.

These requirements are also applicable to the compensation to be paid to the debtor-proprietor in insolvency proceedings. This compensation should be proportionate to ensure fair balance between public and private interests. Analogous opinion was expressed by the European Court of Human Rights, which presumes that compensation for infringement in the property right stems from Article 1 of Protocol No. 1 to the Convention for the Protection of Human Rights and Fundamental Freedoms; this Article provides, *inter alia*, that “no one shall be deprived of his possessions except in the public interest and subject to the conditions provided for by law and by the general principles of international law”.

According to the opinion of the European Court of Human Rights, the taking of property without reasonable compensation calculated on the basis of its cost, as a rule, constitutes disproportionate interference that cannot be regarded as justifiable. However, the European Court of Human Rights does not interpret Article 1 of Protocol No. 1 as providing for a right to get full compensation, so far as some factual situations require that public interests connected with the need to ensure a higher level of social justice, should be taken into consideration and

that would determine the necessity to reduce the compensation to the amount which is below its market value (*Sporrong and Lönnroth* Judgment of 23 September 1982, Series A no. 52, § 69; *James and Others v. the United Kingdom* Judgment of 21 February 1986, Series A no. 98, §§ 50, 54; *Lithgow and Others v. the United Kingdom*, Judgment of 8 July 1986, Series A no. 102, §§ 109, 122).

6. Article 8 (Section 2) of the Constitution of the Russian Federation proclaims the recognition and equal protection of private, state, municipal and other forms of property as one of the fundamentals of the constitutional order. However, in determining reasonable compensation for property taken for public purposes, such protection should be based on the principle of fairness.

Full compensation for social housing funds (having regard to the existing level of rent), preschool institutions and municipal service infrastructure, transferred to the possession of municipal governments would not correspond to this principle, since these assets are not only unprofitable, but also normally burdened by some extra charges necessary to keep them in operation. Alongside with that, the rights of municipalities to dispose of assets listed in Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” are significantly limited by their duty to maintain the designated purpose of such assets. For the same reasons, the transfer of such assets to the possession of municipalities does not mean that municipalities are considered as priority creditors (e.g. in case there are any arrears on local taxes).

Consequently, the social function of assets listed in Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” is itself a burden that takes from the market value. Therefore, in this context the legislator is entitled to provide for reasonable limits of compensation to be paid for the purpose of protecting the proprietary rights and lawful interests of the debtor and, accordingly, creditors in insolvency proceedings. Fair and proportionate compensation that ensures the balance of public and private interests does not violate the requirement of prior and equal compensation for property taken for state needs, which stems from Section 3, Article 35 of the Constitution of the Russian Federation.

However, the provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”, within the meaning attributed to them in law-enforcement practice, do not allow the debtor-proprietor to have reasonable compensation that ensures a fair balance between the public and private interests in the course of transferring the assets listed therein to the possession of municipalities and, therefore, to this extent are not in conformity with Article 55 (Sections 2 and 3) of the Constitution of the Russian Federation.

7. According to Article 35 (Section 3) of the Constitution of the Russian Federation, no one may be deprived of property otherwise than by a court decision. The Constitutional Court of

the Russian Federation has stated on many occasions that in certain cases, when the taking of property is necessary for public purposes and serves as a preventive measure, the way to implement the constitutional guarantee for the right of private property set out in Article 35 (Section 3) of the Constitution of the Russian Federation is an *ex post* judicial review (Judgments of 17 December 1996 in a case concerning the review of the constitutionality of Subsections 2 and 3, Section 1, Article 11 of the Law of the Russian Federation “On Federal Fiscal Police Authorities”; Judgment of 20 May 1997 in a case concerning the review of the constitutionality of Sections 4 and 6, Article 242 and Article 280 of the Customs Code of the Russian Federation; Judgment of 11 March 1998 in a case concerning the review of the constitutionality of Article 266 of the Customs Code of the Russian Federation, Section 2, Article 85 and Article 222 of the Administrative Offences Code of the RSFSR).

Public purposes, for which objects excluded from the bankruptcy estate pursuant to Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” may be transferred to the possession of municipalities, justify this taking, which is deemed to serve as a preventive measure necessary to protect the vital interests of the people. However, the right to an *ex post* judicial review of this transfer cannot be restricted.

In exercising judicial review of the legality and validity of assets transfer pursuant to Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”, courts shall not restrict themselves to formal acknowledgement of the grounds for the application of this norm. On the contrary, they have to examine on the merits if the transferred assets fall within the category of social housing funds, preschool institutions or municipal service infrastructure, to what extent they are vitally important for the region, at whose expense they were built. Disputes between the debtor, his creditors and the State about the amount of compensation with respect to the transfer of a particular object are justiciable as well.

However, the provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”, within the meaning attributed to them in law-enforcement practice, do not provide for workable judicial protection of the rights of debtors-proprietors or creditors within insolvency proceedings and thus are not in conformity with Articles 35 (Section 3) and 46 (Section 1) of the Constitution of the Russian Federation.

8. According to Section 4, Article 79 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, when a decision on the unconstitutionality of a normative act results in a regulatory gap, the Constitution of the Russian Federation shall be directly applicable.

Pursuant to this requirement, when assets are transferred to the possession of municipalities under Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”,

the constitutional principles of protection of private property have to be relied on, in particular, the principle of impermissibility of excessive restrictions on private property (Section 2, Article 8; Article 35 and Section 3, Article 55). This means that reasonable compensation for the assets has to be paid to the debtors-proprietors. In this regard, the current civil and financial legislation shall be applied until further legislative regulation regarding the amount of compensation and the mechanisms of interbudgetary relations ensuring implementation of the federal government bodies' decisions resulting in increase of public expenditures on different levels of budgetary system is enacted,. Given the conclusions made in this Judgment, Article 306 of the Civil Code of the Russian Federation, according to which if the Russian Federation enacts a law that terminates any right of property, the losses thereby inflicted on the owner, including the cost of the assets, have to be compensated by the State, shall be applied in particular. The disputes between the debtor, creditors and the State about the amount of compensation shall be decided in arbitration courts.

Concluding from the above and pursuant to Sections 1 and 2, Article 71, Articles 72, 74, 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 provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)”, to the extent that they provide for transfer of social housing funds, preschool institutions and municipal service infrastructure, which are vitally important for the region, to municipalities to be used in accordance with their designated purpose as conforming to the Constitution of the Russian Federation.

To recognize the provisions of Section 4, Article 104 of the Federal Law “On Insolvency (Bankruptcy)” to the extent that, within the meaning attributed to them in the current law-enforcement practice, they allow transfer of social housing funds, preschool institutions and municipal service infrastructure, which are vitally important for the region, to municipalities without reasonable and fair compensation to be paid to debtors-proprietors in insolvency proceedings, that would ensure balance between public and private interests, and do not allow judicial review of such transfer on the merits as non-conforming to the Constitution of the Russian Federation, its Articles 35 (Section 3), 46 (Section 1), 55 (Sections 2 and 3).

2. The legislator shall determine the amount and procedure of payment of reasonable and proportionate compensation to debtors in insolvency proceedings and the mechanism of implementing the decisions of federal bodies of state power resulting in an increase of public expenditures on different levels of budgetary system.

3. Pursuant to Subsection 12, Section 1, of Article 75, and Section 4 of Article 79 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, until the necessary amendments to the legislation are made, courts and other law-enforcement authorities and officials, in order to implement the guaranties provided for in Article 35 (Section 5) of the Constitution of the Russian Federation, shall directly apply the norms of the Constitution of the Russian Federation and the civil and financial legislation in force, with regard for the conclusions made in this Judgment.

4. 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, and shall be directly applicable.

5. Pursuant to Section 2, Article 100 of the Federal Constitutional Law “On the Constitutional Court of the Russian Federation”, the court judgment delivered in the case of Timber Holdings International Limited is to be reconsidered according to the established procedure.

6. 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

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