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**The Development of Insolvency Procedures
in Transition Economies:
A Comparative Analysis**

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*The Development of Insolvency Procedures in Transition
Economies:
A Comparative Analysis*

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Introduction

It is now well recognised that one of the main causes of the slow process of transition in former socialist countries is the low level of development of some of the basic institutions of the market economy. One of the most fundamental changes in Central and Eastern Europe (CEE) was the introduction of a new legal framework, based on private property and its supporting institutions, designed to encourage, facilitate, protect and regulate the new system's operations. However, change has been slow in many areas and the relevant institutions remain under-developed, a major barrier to the market system's further development. Bankruptcy law is one such area and its under-development has strong ramifications for the transformation process. The aim of this working paper is to review bankruptcy law and its institutions across a range of transition economies, making comparisons with the situation in mature market economies.¹

A major feature of a market system is its dynamic selection mechanism whereby stronger, more efficient units replace the weaker and less efficient, and new processes and products replace older ones. Some entrepreneurs and firms are unable to withstand competitive pressure and exit the market, their resources, all being well in the macro-environment, moving to more efficient employment. The Schumpeterian concept of *creative destruction* encapsulates this dynamism. In transition countries the inherited economic structure faced dramatic change involving substantial enterprise closure and adjustment. The selection mechanism had, and has, a particularly important role to play.

Bankruptcy law (or insolvency proceedings) regulates the selection mechanism. It establishes the procedures for the orderly exit of failed enterprises and the re-entry of their assets, along with other resources, into new firms and activities. Insolvency procedures also provide a legal assurance for potential investors and creditors that, even in the case of financial distress and business failure, there will be legal processes at work to prevent a rush on the assets of the distressed firm. The distribution of its estate amongst creditors will also be carefully regulated.

Systemic transformation in CEE countries is closely bound with changes in enterprise and managerial behaviour and the creation of an environment conducive to new investment. Insolvency procedures are of critical importance here. Across the CEE region lack of experience with the market mechanism, as well as uncertainties and information asymmetry put shareholders, financiers and creditors at a serious disadvantage in comparison to the managers of distressed firms. Furthermore, opportunities for fraudulent behaviour, probably greater in early transition than in a well-established market economy (notwithstanding the occasional dramatic appearance of an Enron type event), discourages individuals and companies from developing relationships with new firms. A well functioning insolvency law redresses some of these imbalances providing a reasonable guarantee for financiers, creditors and suppliers of such firms.

¹ Our review encompasses eight transition economies (Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania and Slovakia) and we also draw on experience in Germany, the USA and the UK. For a detailed analysis of the insolvency laws in transition economies see Balcerowicz, Gray and Hoshi (1998); Mitchell (1997); Neidenowa and Lowitzsch (2003); Završak and Lowitzsch (2002); Lowitzsch and Bormann (2002); Kallies and Lowitzsch (2002); Bormann and Lowitzsch (2001); Lowitzsch and Neusel (1999). For the development of insolvency laws in mature market economies see Ziegel (1994); Berglof and Rosenthal (2000).

Bankruptcy laws also play an important credibility-enhancing role in the transformation process itself: they signal to enterprises that if they cannot withstand competitive pressures they will not survive. However if the laws are deficient or the administrative capacity is weak there will be much scope for fraudulent behaviour by managers and other stakeholders.

Insolvency laws and corporate governance

In any market economy, mature or emerging, entrepreneurship and private enterprise is associated with risk and the possibility of failure. An important dimension of the legal system of private property is the allocation of obligations and responsibilities of different agents in the event of financial distress. Uncertainty and information asymmetry mean that it is not always possible to identify the cause of business failure. Moreover, given the separation of ownership and control, these conditions create room for managerial opportunism. Bankruptcy law is a key legal institution in a market system, designed to ameliorate the adverse effect of information asymmetry and to punish fraudulent behaviour by company managers. Its importance to transforming, 'emerging market', post-communist economies can hardly be underestimated.

The separation of ownership and control in corporate capitalism is a familiar feature. Economists in mature market economies have been aware of the potential for conflict of interest and misuse of managerial authority at least since the publication in 1932 of Berle and Means's famous study, **The Modern Corporation and Private Property**. In the presence of information asymmetry and uncertainty, the relation between managers and shareholders and financiers is a classic 'agency problem' (Fama, 1980; Fama and Jensen, 1983) the effects of which can be alleviated by appropriate contracts and incentive packages and the imposition of clearly defined rules and regulations. Bankruptcy laws have evolved over a long period so as to minimise agency costs, prevent and penalise managerial opportunism, and provide protection for creditors and financiers. They help ensure that the private property system can function and prosper. The economic and legal mechanisms of corporate governance have evolved to align the interests of owners and managers ensuring that an appropriate level of oversight is exercised by owners' and creditors' representatives, and that any managerial opportunism is detected and penalised by both the market mechanism and the legal framework (for a survey of literature on corporate governance, see Shleifer and Vishny, 1997). When firms are in financial distress and likely to enter the bankruptcy process the normal rules of market economy behaviour may be affected: managers may be tempted to hide the truth from shareholders and creditors to prolong their own tenure; they may engage in excessive risk taking as a last resort to save the firm and their jobs; and they may embark on transactions favouring some creditors over others which would not have been possible if the facts had been known to all stakeholders. Effective bankruptcy procedures aim to protect the interest of investors as well as shareholders from unscrupulous managers on the one hand and to prevent further indebtedness of the firm on the other.

Government and insolvency procedures

Although governments in almost all transition economies have adopted modern bankruptcy laws (similar to those in mature market economies) they have not always been fully committed to their underlying principles and logic. After ten to thirteen years of systemic transformation some governments have still not accepted that not all pre-transition enterprises can survive in the new market system. Instead of allowing bankruptcy and re-organisation under new ownership, some large companies ~~in some cases~~ have been excluded from the operation of bankruptcy laws, scarce financial resources wasted on their unsuccessful subsidisation, motivated by political rather than economic concerns. Of course the same can happen even in mature market economies where governments sometimes engage in (frequently pointless) efforts to save large firms from closure. Returning however to CEE the transformation experience shows, in our view, that the universal application of insolvency processes is essential for three reasons. First, to signal commitment to systemic change. Second, to force enterprise managers to change their behaviour and engage in serious restructuring. Third, to speed up the reallocation of resources from insolvent firms to new private concerns.

Starting insolvency proceedings

Insolvency law should ensure that bankruptcy is embarked upon systematically, efficiently, fairly, and quickly. In this sense, the insolvency procedure complements both company and contract law. A sound insolvency process provides investors and lenders with the guarantee that, in the event of financial distress, appropriate provisions are in place, firstly, to raise the alarm (that is, inform the interested parties) and, secondly, deal with their claims in an equitable and orderly fashion. Two main issues exist: what should trigger insolvency?, and where should responsibility for declaring insolvency lie?.

Insolvency triggers

To be efficient, insolvency procedure has to be triggered by a clear, specific and verifiable criteria to enable those in charge to improve the survival chance of distressed enterprises and to protect creditors. Three different criteria have been used in transition economies for this purpose and, as we shall see below, they all produce somewhat ambiguous results:

- i.1. The cash flow or ‘illiquidity’ notion when the firm is unable to pay debts falling due;
- ii.2. The balance sheet or ‘over-indebtedness’ notion when a firm’s assets fall short of its liabilities;
- iii.3. The notion of ‘impending’ or ‘imminent insolvency’.

The most common bankruptcy trigger is the first one, the inability to pay due debts. However, except for Hungary, other countries under review here employ the first two or even all three criteria – though the latter are usually of less importance.

Table 1 - Insolvency triggers in post-communist economies and Germany

Country	Illiquidity	Over-indebtedness	Imminent illiquidity
Bulgaria	Yes	Yes	No
Croatia	Yes	Yes	No
Czech Republic	Yes	Yes	Yes
Germany	Yes	Yes	Yes
Hungary	Yes	No	No
Poland	Yes	Yes	No
Romania	Yes	No	Yes, since 2002
Slovakia	Yes	Yes	No

Source: from a variety of materials as cited in footnote [4.???](#)

Illiquidity. The traditional cash-flow based definition is a convenient easily observed indicator. Naturally, the practice of late payment should not be confused with inability to pay.

Over-indebtedness. While this balance sheet notion is theoretically a better reflection of the financial situation of a company overburdened by debt, in practice, given the problems in estimating the value of assets especially in transition economies, it cannot provide a satisfactory basis for insolvency. The valuation of a company in financial distress requires a special ‘over-indebtedness’ balance sheet, identifying the current open market value of company assets and their respective liquidation value.

Imminent illiquidity. This relatively new trigger aims at early start of the insolvency process by encouraging managers to provide information to market participants. This trigger is effective only if appropriate incentives for management exist (for example, the discharge of residual debt or the ability of managers to stay in post, as in recent German legislation). The ‘imminent illiquidity’ criterion has been applied in only two transition countries (Romania and Croatia), notwithstanding the fact that there are no precise measures for assessing imminent illiquidity and no incentives for managers to declare such a state. In these circumstances this trigger is likely to remain idle.

Who declares insolvency? When is the right moment?

The moment when insolvency should be triggered is clearly of critical importance, a moment when information asymmetry between the debtor and others may generate seriously perverse incentives and inefficient outcomes. It is essential that all stakeholders are made aware of possible insolvency as early as possible. Even in mature market economies with developed financial markets and institutions financial distress may not always be picked up sufficiently early on by the financial press and markets. Managers are in the unique position of knowing the affairs of a company and any imminent problems it may face. They may embark on opportunistic behaviour to benefit themselves by engaging in highly risky undertakings to prolong their position. Thus, although as a rule insolvency procedure may be triggered by either the debtor or by a bona fide creditor some argue that managers should be required by law to declare their insolvency within a short period of realising that a debt default is likely. In the UK

and Germany, for example, the managers of a defaulting company are required to file a petition in court within three weeks of a default.² The rules governing the triggering of insolvency proceedings are summarised in table 2 below.

Table 2 – Triggering insolvency, rights and obligations

Country	Right to initiate the process	Managers' obligation to initiate the process	Legal sanctions
Bulgaria	Debtor, creditor, liquidator	Within 15 days	Liable for damages
Croatia	Debtor, creditor	Within 21 days	Liable for damages
Czech Republic	Debtor, creditor	No specified period but obligation to file without delay	Liable for damages,
Germany	Debtor, creditor	Within 21 days	Civil and criminal liability for damages
Hungary	Debtor, creditor, court	None / no period (the original obligation was lifted in 1993)	Liable for damages,
Poland	Debtor, creditor	Within 14 days	Civil and criminal liability for damages
Romania	Debtor, Creditor, Commercial chamber	Within 30 days (since 2002)	Liable for damages
Slovakia	Debtor, creditor liquidator	Within 60 days	Liable for damages

Source: from a variety of materials as cited in footnote [4.???](#).

In Hungary a bankruptcy law was passed in 1991 and came into effect in January 1992, (for details, see Balcerowicz et al, 1998, ch.7). From the outset managers were required to declare insolvency if a company had payments arrears of over ninety days. Some 22,000 petitions for bankruptcy were launched in 1993. The ‘automatic trigger’ was removed in September of that year, but by that time the accumulation of debt arrears had effectively stopped, payment discipline was strengthened, and creditors had become more active in filing for insolvency. However, after removing the declaration obligation of managers, debt started to accumulate again, especially to the least rigorous debt collector – the state. This tendency was brought to a halt only after the behaviour of budgetary organisations became more strict against notorious debtors in 1995 (see Mitchell, 1997).

In the Czech Republic, by contrast, only 350 bankruptcy petitions were filed in 1992 (and 1,098 in 1993).³ The massive difference between the two countries was at this

² In the UK, the obligation is even stricter as the managers are also required to file this petition if they ‘should have reasonably known’ that the company is insolvent. Prosecutions for violation of this rule are not uncommon (see Franks and Torous, 1992). For a more detailed analysis of the personal liability of managers, see Sealy (1994). Managers’ obligation to declare insolvency was only recently added to Romanian legislation through Ordinance 38/2002.

time largely due to the legal obligation of the managers in Hungary to file for bankruptcy in case of default. Following much debate, the Czech Republic amended this aspect of the bankruptcy law in 1996 and placed the burden of declaration on the management (creditors retained their right to petition the court) though without a time limit.

In Poland, too, the number of declarations was relatively low (compared with the total number of enterprises), especially in the first two years of transition (1990, 1991). It is worth adding that Poland was in the privileged position of having a bankruptcy law at the start of reforms in 1990. The law, originally adopted in 1934, was not abolished during the communist period. From 1992 there was a sharp increase in number of bankruptcy petitions (to a peak of 5,249 in 1993). In the second half of the 1990s the number of insolvency declarations dropped significantly to 2,300-4,400 per annum. Here, the problem was not the absence of the obligation on managers to declare insolvency but poor law enforcement. Despite a clear legal requirement for a bankruptcy declaration within 14 days of default, managers ignored the obligation without fear of prosecution. But delays often meant that the financial position of many enterprises deteriorated further. This also had its knock-on effect in that each year a large proportion of petitions was rejected ~~each year~~ by the courts at the start of, or during the insolvency procedure because debtors had insufficient assets even to cover the costs of the legal procedure itself.⁴ It may be reasonable in these circumstances to have a provision, as in the UK, whereby the cost of insolvency proceedings is covered by public funds if the assets of the insolvent firm are insufficient.

The insolvency process

Once a petition for insolvency is launched and a court agrees to hear the case, the debtor faces two fundamental options: liquidation or reorganisation. The debtor and creditors put forward their views and, generally, the court makes the final decision on which of the two basic options to pursue.⁵ In either case, it is necessary to stop all claims against the debtor to provide conditions for the court, or court appointed trustee, to conduct her/his duties. In the liquidation case the reason for stopping individual creditors from exercising their rights is to ensure that all creditors are treated fairly according to their place in the priority list and that there is an orderly winding up of the company. In reorganisations relief from creditors has a different function and needs careful consideration.

³ The liquidation process in the Czech Republic applies to solvent firms and, therefore, is not comparable to the situation in Hungary where firms in default have to file for either reorganisation or liquidation. For details see Balcerowicz, et. al., 1998, Chapter 5.

⁴ In 1997 a new provision was introduced to the law allowing the imposition of two kinds of penalties on managers for not declaring insolvency in time. First, managers became liable for any damage to creditors and may be sued by them. Second, the manager was to be deprived of the right to run another economic activity on his own (sole entrepreneurship) or manage another company, unless he could prove that he was not guilty of breaking the law. Subsequently (July 4, 2002) the latter penalty was declared unconstitutional by the Supreme Court (Dz. U. 113, Pos. 990).

⁵ In some developed market economies a debtor is entitled to opt for reorganisation and, while the managers remain in office, it prepares a reorganisation plan to be submitted to the creditors and the court within a specified time limit (the case of the USA and 'chapter 11 bankruptcy'). In other countries (for example the UK), the court appoints an official (administrator or trustee) to investigate the possibility of preparing a reorganisation (or settlement), which still has to be submitted to creditors and the court for approval. If the reorganisation plan is not approved by creditors the firm has to go to liquidation. For details, see Balcerowicz, et. al, 1998, Chapter 2.

Relief from creditors

The automatic relief from creditors' claims takes the pressure off the debtor giving a chance to negotiate with creditors to formulate a reorganisation plan. But automatic relief also enables opportunist managers to use reorganisation to prolong their tenure. Such managers may well know that the chances of a successful reorganisation are small but may try to utilise this route for their own interests. The crucial point is whether relief from creditors is automatic or has to be approved by a court or by the creditors themselves. In the USA a ninety days automatic stay of claims for firms filing for a Chapter 11 bankruptcy exists – a device much criticised by some legal scholars and economists. In the UK, however, firms may enter the reorganisation option (known as *administration*) only with the support of creditors and the approval of the court. Once an *administrator* is appointed claims against the company are frozen for ninety days to give the administrator a chance to prepare a reorganisation plan.

The experience of transition economies has been varied with regard to automatic relief. In Hungary, the bankruptcy law initially made the 90-day relief automatic but since the September 1993 amendments it has been subject to the discretionary vote of creditors. This change was made in response to creditors' claims that managers had abused the provision. Managers of the debtor companies prepare the reorganisation plan.

In the Czech Republic, since 1993, debtors have had a 90-day protection period during which they can produce a 'settlement plan', which must meet certain conditions and has to be approved by the bankruptcy court. During the 90-day period claims against the firm are frozen (except for the claims of employees and the state arising from current operations). This provision was particularly aimed at helping newly privatised Czech firms (many suffered heavily from the burden of past debts) to negotiate with their creditors and find a solution if at all possible. Under special circumstances, the protection period could also be extended by another ninety days. By 1996, however, it was felt that the post-privatisation urgency of supporting privatised firms had diminished. The protection period was then restricted to firms with more than 50 employees. Czech bankruptcy procedure also allows for a 'compulsory settlement' after a trustee has been appointed to wind up the company when the debtor firm may present a 'compulsory settlement' plan to the court. This plan is subject to the approval of creditors and the court and must meet a number of stringent conditions, including ascertaining the 'honest intention' of the bankrupt firm by the court (see Hoashi, Mladek and Sinclair, 1998).

The Polish insolvency law is very much creditor oriented. A debtor opting for reorganisation may petition the court for a settlement plan with creditors but this must be accepted by the court and is then subject to creditor approval. A stay of claims is possible if the satisfaction of secured creditors is provided for in the settlement.

Annuling the ~~failed~~ debtor firm's transactions prior to insolvency

Bankruptcy laws usually contain provisions giving the creditor and court-appointed officials the power to annul the debtor's property transactions prior to insolvency if they were inconsistent with the principle of equal treatment of all creditors or were fraudulent. This usually concerns property transfers made within a certain period before bankruptcy was filed involving insiders or favouring a particular creditor. Of course it is not always easy for creditors to prove the debtor's intention to prejudice them and so it is necessary to establish clear rules under which creditors can examine previous transactions. The period in which transactions can be disputed should be fairly short – in general less than a year.

Liquidation versus Reorganisation?

Once a firm becomes insolvent it is important that liquidation/bankruptcy permits the widest possible range of remedial actions. A well-designed bankruptcy process prevents reduction in asset value during insolvency and maximises debt recovery for creditors either through liquidation or through reorganisation. Although liquidation is quicker it need not be the optimal solution. Reorganisation, on the other hand, provides the possibility of revitalisation of the company and, if successful, will produce better results. In many mature market economies, this alternative is strongly enshrined in the law (for example in the Chapter 11 option under US bankruptcy laws).⁶ Of course an efficient insolvency law should prevent premature liquidation but it should also speed up the winding up non-viable firms.

Reorganisation has been of even greater importance in transition economies where, for many companies, the causes of financial distress often lay outside the firm itself (be it state owned or private). In the early post-communist period state owned firms faced financial distress because the systemic change affected their markets adversely. When there was a large volume of inter-enterprise debt some firms faced financial difficulty not because of their own operations but because other firms had not paid their invoices. Private firms, especially SMEs, were often linked to the state sector and financial distress was transmitted to them via their many linkages with the SOEs. Attempts to push those enterprises to bankruptcy would have been, in many cases, premature. Many of those enterprises were able to resolve their problems and operate successfully in a market economy. Additionally, in the early stages of transition, when a large number of enterprises remained state owned awaiting privatisation, care should have been taken to avoid premature liquidation, that is, to distinguish between viable and non-viable enterprises.

Reorganisation, however, should be utilised prudently and not as an excuse to prolong the reign of incompetent managers. Oversight by outside agents, for example the representative of creditors or a court-appointed trustee, would be a reasonable compromise. Moreover, within this option, the possibility of other forms of debt work out should be provided for, for example, debt forgiveness, reduction in interest

⁶ Even in the UK, where reorganisations were rather exceptional, a change is taking place. Until recently, the large majority of insolvencies (about 90%) resulted in liquidation. Receivership was the next most used option while administration applied to only a small fraction of cases (about 1%) – see Balcerowicz, et. al, 1998, Chapter 2. In March 2002, the British government introduced an Enterprise Bill to parliament with measures to make 'administration', and not 'receivership', the normal route in insolvency, trying to encourage the reorganisation of insolvent firms.

payment, or debt-for-equity swap, in return for commitments by managers on such matters as changes in boards, production lines, investment plans and asset structure.

Experiences in the more advanced transition economies may be instructive. In Hungary, with massive insolvency declarations in the early operation of the bankruptcy law and a strong emphasis on reorganisation, the fear of a large-scale closure of firms was unfounded. As many as 67% of the firms that applied for reorganisation in 1992 succeeded in completing a reorganisation plan.⁷

In the Czech Republic however the law created inherent obstacles to reorganisation. Indeed, the 'ordinary settlement' and 'compulsory settlement' options imposed extremely difficult conditions. Furthermore, in the Czech bankruptcy law, the creditors were unable to propose a 'settlement plan'. Consequently, only one in 1,000 of bankruptcy filings succeeded in completing a reorganisation plan in the first two years of the application of the bankruptcy law.

In Poland, too, there has not been much room for debtor restructuring within the insolvency procedure as the court conciliation (or settlement) option is a rather inflexible process when compared with reorganisation processes in mature market economies. As a result, the number of 'settlements' in the 13 years of transition has been very low. To prevent premature closures in the early transition period, the government introduced the 'Enterprise-Bank Financial Restructuring Programme' in 1993 to speed up the restructuring of state-owned commercial banks and their heavily indebted state enterprise clients (for details see Gray and Holle, 1998 and Balcerowicz and Bratkowski, 2001). It is worth noting that such arrangements, outside of formal insolvency procedures, also exist in mature market economies (see Gilson, John and Lange, 1990 and Franks and Torous, 1994). The Programme was a success, mainly due to its unusual style: instead of centralisation of bad debts in a special new institution, the programme required banks and their indebted clients to work out a solution in a limited time, reducing the indebtedness of both and making them of value to potential private investors. In recent years intensive work has been going on in Poland ~~on to~~ prepare a new bankruptcy law which will be more reorganisation oriented than the present one.

Reorganisation can only be effective if it ~~avoids~~ prevents opportunistic behaviour among creditors. While creditor agreement for a reorganisation plan is essential, no group should be treated more favourably than others (for example the small number of large creditors against the often large number of small creditors). With the exception of secured creditors who should retain seniority over mortgaged assets, all classes of creditors should be involved in the reorganisation plan and a majority of them should accept the plan. Although the approval percentage varies in different countries (and in practice has often been relaxed when it has been too restrictive), a reasonable majority (for example two thirds) seems to be the common threshold in countries which are sympathetic to reorganisation. A high approval percentage gives disproportionate power to small creditors (and disadvantages large creditors) and a small approval percentage may disenfranchise too many creditors.

⁷ For details see Szanyi (1996). Furthermore, in Hungary, a 'debtor consolidation' form of restructuring was introduced in order to encourage some of the firms in financial distress to reach 'out of court' settlements with their creditors (and achieve the same outcome as 'reorganisation') but in a simpler manner.

In any case, the reorganisation period must be time-limited and the creditors must always have the option of revoking their initial agreement and convert the process to liquidation. An increased creditor role in the insolvency process provides greater assurance for creditors and boosts the credit market. The characteristics of the reorganisation option are summarised below in Table 3.

Table 3 – Reorganisation options in CEE and Germany

Country	Options	Time limit for submitting proposal	Period	Approval condition
Bulgaria	Reorganisation	30 days	Trade sale within 30 days	Simple majority and ½ of volume of claims
Croatia	Reorganisation Trade sale	No later than final distribution meeting	Trade sale within 30 days	Simple majority of each group and ½ of volume of claims
Czech Republic	Continuation, compulsory settlement, settlement	90 days (with 90 days extension possible)	Not foreseen	Compulsory settlement simple majority and ¾ of volume of claims; settlement - the same rule but prohibition to obstruct
Germany	Reorganisation	No later than final distribution meeting	Not foreseen	Simple majority of each group and ½ of volume of claims with prohibition to obstruct
Hungary	Moratorium, Settlement	90 days and 60 days extension possible	Not foreseen	Simple majority and 2/3 of volume of claims
Poland	Continuation, Trade sale, Compulsory settlement	Compulsory settlement within 30 days from court decision	Not foreseen	Compulsory settlement - majority vote of 2/3 of value of claims, Continuation - simple majority of creditors committee
Romania	Plan, Reorganisation	Plan within 30 days after verification meeting,	Within 3 years	2 of 6 debtor categories approve by majority vote of 2/3 of value of claims, none is treated worse than in liquidation
Slovakia	Continuation, Priority of trade sale, Auction	Proposal within 15 Days before Debtors Assembly	Not foreseen	Majority vote of 2/3 of value of claims

Source: from a variety of materials as cited in footnote [4.???](#)

Replacing managers

Once the reorganisation option is selected, a decision has to be made on whether existing managers should remain in charge of the firm.

On one hand, the managers know the firm's potential as well as its problems better than an outsider (a court appointed trustee) who enters the company cold. Moreover, if managers know that their position will not be undermined they may be more willing to file for bankruptcy early, as soon as they become aware of signs of the potential insolvency. This allows them time to prepare a rescue plan before financial distress gets out of control. This is the procedure followed in many market economies such as the United States and transition economies such as Poland and Hungary. Czech bankruptcy law includes one option which permits the management to remain in charge during the protection period and prepare a reorganisation plan. In the first ninety days of protection, the managers may propose an 'ordinary settlement' plan to the court. Provided the plan meets various conditions and is approved by the court, a 'settlement administrator' is appointed by the court to oversee the process.

On the other hand, there is the argument that managers may opt for imprudent policies and embark on desperate measures to try to reverse the firm's fortunes with consequent damage to creditors. For this reason in many countries managers are deprived of their posts once the firm enters the insolvency process. In the UK the declaration of default leads immediately to the appointment by the bankruptcy court of a *liquidator* (to wind up the company), a *receiver* (to recoup the assets of a secured creditor) or an *administrator* (to prepare a reorganisation plan). In Germany and the Czech Republic too, the courts appoint an official to oversee the fate of an insolvent firm (whether liquidation or reorganisation). Given the importance of protecting creditors from opportunistic behaviour, sadly too common in transition economies, there may be an argument for ensuring that an outsider (appointed by creditors) is in overall supervision of the firm.

Asset disposal

If the insolvent firm opts for liquidation, or if the managers or administrator (trustee) are unable to prepare a reorganisation plan acceptable to creditors and the court, resulting in the conversion of the process to liquidation, the assets of the debtor have to be sold and the proceeds distributed amongst the creditors in a particular order of priority established by law. The disposal of assets involves a court appointed official (liquidator) and various degrees of court involvement. An efficient liquidation process should maximise the proceeds of asset disposal in as short a time period as possible – and this requires an appropriate incentive package for the liquidator (more on this later). Two issues need to be discussed in some detail here.

First, the position of secured creditors is relevant as it influences the decision on whether or not to reorganise as well as the asset disposal process and, by definition, the level of satisfaction of creditors. Second, given that the asset disposal process plays a particularly important role in transition economies – facilitating new entry and reallocating assets to new and more profitable activities – its organisation deserves special attention.

Secured creditors

While bankruptcy is a system for *terminating* the debt collection process, replacing other penalties imposed on defaulting debtors, secured lending is a system for *facilitating* debt collection. The latter works by improving security and information so that borrowers can more easily prove their creditworthiness, and lenders can make loans with less risk and collect those loans more easily. Even though bankruptcy and secured lending serve different ends, they are closely inter-linked: when bankruptcy terminates the debt collection process, it may also terminate or curtail the collection of secured loans (Fleisig 2000).

Although in Western economies much credit is unsecured, the widespread insistence on security in transition economies indicates that credit extension is not simply a function of price. In many cases a prospective borrower who is unable to furnish collateral, will simply be refused credit altogether rather than being charged a higher rate. According to the World Bank, for a loan secured by real estate, a borrower could in general expect to obtain a loan more than eight times larger, repayable over a period of time more than ten times longer, at an interest rate about 50% lower than the borrower offering no collateral. For a loan secured by movable property, the loan terms for the same borrower would fall somewhere in between those of unsecured loans and those of loans secured by real estate ([Debtor-Creditor Rights Working Group, 1999](#); Fleisig, 2000).

Given the role and importance of secured credit, the legal systems in mature market economies almost always give secured creditors priority over others and also allow them to claim their security outside the bankruptcy process. However, some systems of bankruptcy (for example in Hungary and Poland) have deviated from this principle by delaying the claims of secured lenders, subsuming them to other claims with less seniority prior to bankruptcy, giving some types of unsecured claims priority over the claims of the secured lender, or even setting them aside. Thus, in the worst case, the collateral securing a loan can be sold and the proceeds used to satisfy other claims (such as debt to the state, unpaid wages of workers, attorney's fees and costs of the bankruptcy court) before those of the secured creditor. These practices undermine the legal system of security, increase the risk and cost of capital, reduce the total amount of credit and inhibit increased economic activity.

The rights and interests of secured creditors may conflict with the intention to preserve the value of the firm, since preserving the firm means holding those rights in abeyance, with the attendant risk that any reorganization will diminish their value. The individual interest of a particular creditor, who has bargained for security, conflicts with those of unsecured creditors when it comes to the withdrawal of assets essential to running or reorganising the business. The conflict is exacerbated when the procedure aims at reorganising a company or disposing of its business on terms more favourable than that secured by liquidation. In this situation even for the most ardent exponents of the principle that bankruptcy law should respect pre-bankruptcy entitlements it would be difficult not to recognise that some sacrifices have to be made by secured creditors in order to help to maximise benefits for the creditors as a whole.

One way of balancing competing interests is to recognise secured creditor's rights but to restrict their execution for a given short period. Another possible solution is to provide for arrangements whereby secured creditors could be compelled to accept a

change of status or a diminution of priority in the interests of the general body of creditors. If rehabilitation rules are to be effective they must be flexible. They should prevent any sensible plan being substantially delayed by a dissenting minority. They should also allow for such a plan to be imposed on that minority (albeit with suitable safeguards) for the benefit of the interested parties as a whole. Table 4 summarises the position of secured creditors in CEE and Germany.

Table 4 - Secured creditors in CEE and Germany

Country	Priority of secured creditors	Priority of unsecured over secured claims	Amending rights of secured creditors
Bulgaria	Absolute priority	Debts to the state	Stay of execution* and change of status possible
Croatia	Absolute priority	Debts to the state	Stay of execution possible change of status if sold as going concern
Czech Republic	Relative priority, 70% directly, 30% as unsecured claims	Debts to the state	Stay of execution possible
Germany	Absolute priority	None	Stay of execution possible
Hungary	Relative priority, 50% directly, 50% as unsecured claims	Debts to the state	Stay of execution possible
Poland	Relative priority, 50% direct, 50% as unsecured claims	Debts to the state, 50% before secured creditor	Stay of execution possible
Romania	Relative priority after budgetary debts	Debts to the state	Stay of execution and change of status possible
Slovakia	Relative priority, 30%	Debts to the state (from subtracted 30%)	Stay of execution possible

Notes: * 'Stay of execution' refers to preventing secured creditors from seizing their security and 'change of status' refers to altering the priority of secured creditors.

Source: from a variety of materials as cited in footnote [4.???](#)

Reallocating the assets of insolvent firms

An important economic function of bankruptcy is the efficient re-allocation of assets from non-viable to viable use. Transition economies and the firms in them, inherited not only debt but also capacities (assets) that were created to meet the logic of central planning rather than the market. Those assets had to be reorganised within the same company, sold to a new owner, or scrapped. In early transition governments were of course concerned with the fate of the inherited assets of state enterprises. There was a wide-spread belief, that restructuring or elimination of companies' assets would contribute to large scale unemployment, the disruption of co-operation networks, and recession. In a number of countries special measures were introduced to prevent or delay the initiation of the insolvency proceedings in SOEs or companies in privatisation schemes. In the Czech Republic and Slovakia, for example, firms participating in

voucher privatisation were exempt from the bankruptcy law. In Romania, SOEs were also, and remains, exempt. Countries with strong trade union movements, especially Poland, also had serious difficulties with the extension of the effect of bankruptcy laws to large loss-making SOEs.

Restructuring and sale of assets was initially undertaken by companies themselves, writing off non-viable parts of their portfolio and loss making activities to improve their financial position. Downsizing was carried out by managers exactly for the purpose of avoiding insolvency. However downsizing took place even in countries without an effective insolvency system.

In Hungary reorganisation plans focussed mainly on providing financial relief. Debt rescheduling, write-off of penalties, interest reduction and immediate cash payment to small creditors were the most common features although they also contained longer-term proposals for restructuring. The initial step in this direction was usually the sale of redundant assets (especially real estate). In many cases, however, major assets were sold prior to bankruptcy the revenues raised were usually used to finance daily activities. Many 'drifting companies' lost much of their asset value in this way. Revenues were also used for debt repayment and not for the creation of new capacities or the purchase of new assets. New loans were extended only sporadically (Gray, Schlorke and Szanyi, 1996).

From a wider perspective it is also important to know how assets sold in bankruptcy are used by new owners. Hungarian experience shows that it was efficient to sell firm as going concerns. This experience seems to be reflected in some of the most recent amendments to bankruptcy laws in Poland, Croatia and Bulgaria, where the sale as a going concern (trade sale) is favoured to other methods. Real estate also tended to be sold quickly. Machinery and equipment not part of a going concern was usually scrapped. Efficiency of asset use in new arrangements tended to depend mainly on the quality of new owners with large foreign companies making best use of such assets.

The Institutional Framework

The effectiveness of insolvency procedures is closely related to the development of the legal institutions of a market economy, in particular the capacity of the legal system. Insolvency proceedings rely heavily on the ability of the bankruptcy courts to process petitions and this, in turn, depends on the quantity and quality of the judicial personnel involved – most importantly, the insolvency judges and the court appointed insolvency practitioners.

The courts

Unlike East Germany, where systemic transformation was marked by a 'permanent replacement of the Eastern elite by the Western elite' with a long-standing experience of the market system, the CEE countries at the start of transition faced shortages of court personnel, specialised chambers and competent administrators. Administrative capacity was not developed at a fast enough pace to cope with the rapid growth of cases resulting from the operation of the market system. Another, still existing, problem is a poor (traditional) system of legal education which produces judges with insufficient knowledge of economic and financial issues.

In the Czech Republic court involvement has been one of the major causes of the slowness of the system – for every decision affecting creditors, the court-appointed trustee has to seek the approval of the judge overseeing the case. In the case of a sale other than by auction this includes even the prices at which the bankrupt firm's assets are sold (see Hoashi, Mladek and Sinclair, 1998, for a detailed discussion). In Poland, where the court takes a limited number of crucial decisions in insolvency cases, leaving others to the court appointed trustee, processing individual bankruptcies still takes much time and courts are considered to be slow. In short, this inefficiency may be explained by the still-underdeveloped administrative capacity of the courts burdened by fast growth of cases and still poor knowledge of economic issues by judges.

These limitations lead us to the conclusion that, in transition economies in general, the involvement of courts in insolvency proceedings has to be kept to the minimum. Otherwise insolvency cases will not be dealt with in reasonable time limits. The role of the court (and the insolvency judge) should be to start the process and to appoint an insolvency practitioner. Also the court should be involved at important points of the proceedings such as the approval of any reorganisation plan, its extension, and at the end when the case is being completed.

Remuneration and accountability of insolvency practitioners

Insolvency practitioners, who are not in short supply like judges, can take charge of the process once appointed and be legally responsible for the implementation of proceedings. If so, they may be held accountable for their actions, as they are in mature market economies. It is therefore important that the insolvency procedure include legal sanctions and appropriate rewards and penalties for the court-appointed officials. Insolvency practitioners have significant discretion over the assets of a debtor enterprise especially their disposal. They must be competent, able to act impartially and be insured or bonded against loss through fraud or other malpractice. They should be able to assess risk, and conduct an insolvency case in a cost-effective way.

Uncertainty and asymmetric information, and the difficulty of monitoring the insolvency practitioners, creates a classic 'principal-agent' problem with adverse implications for the completion of the bankruptcy process. Effective remuneration schemes provide one way of bringing their interest into line with those of creditors and owners. A proper incentive structure will tie the remuneration of insolvency practitioners to the proceeds earned from asset disposal or with the nature of recovery of the company upon successful reorganisation.

The experience of transition economies provides us with many negative lessons. In the Czech Republic, until June 1996, the administrators' fees, as set by law, were based on a fixed schedule subject to a maximum, which was generally regarded as very low, and was not paid until the end of the procedure. The administrators' incentive to maximise the recovered value of assets was therefore weak. On the one hand, not many good and honest lawyers were prepared to become administrators and, on the other hand, the low pay created conditions for misconduct and misuse of the position of trust.

Remuneration schemes for administrators and liquidators may affect outcomes. If they are rewarded for keeping firms in operation and maintaining them as going concerns,

they may prefer this option even against the interest of creditors. This was the case in Hungary, where the strong position of insolvency practitioners enabled them to reorganise debtors even if they had filed for liquidation. Hence, a considerable share of liquidation petitions ended with workouts and the sale of going concerns (Szanyi, 2000).

While the remuneration of insolvency practitioners is crucial in creating the right incentives for them to maximise the value of recovered assets or creditor satisfaction, they must also be held accountable for their actions and maintain appropriate professional standards of quality. It is essential that insolvency practitioners are properly qualified. Insolvency is a very complex and interdisciplinary process and, therefore, general qualifications will not provide the required breadth and depth of technical knowledge and practical understanding. Furthermore, experience, particularly in countries where insolvency and insolvency legislation is relatively new, is limited.

To ensure that insolvency practitioners have appropriate training and are subject to some form of professional monitoring, it is necessary to officially register the insolvency practitioners with a professional organisation.⁸ Such a professional association may be responsible for: keeping a register of official members, exercising oversight on the profession; monitoring the performance and compliance with statutory requirements and standards; testing members' suitability, competence and insurance/bonding arrangements; imposing sanctions on members who bring the association into disrepute (for example if they are found guilty of misconduct by courts); formulating best practice guidance; defining case administration standards; and setting professional education standards; proposing changes to the duties of practitioners and amendments to the laws, preventing scrupulous practitioners from misusing their position of trust, and others.

VI. Summary and Conclusions

In the early stage of transition to a market system, the former socialist countries inherited a large number of inefficient state owned enterprises, many of them insolvent. Governments responded to the problem differently. In some countries (Romania) governments protected big enterprises from bankruptcy by taking them out of the insolvency law and spent huge amounts of public money to keep them afloat. However, for a variety of reasons (mainly the short-sighted political interests of parties in power), governmental restructuring programmes generally failed. In other countries, however, a different approach was chosen. The original 1992 bankruptcy law in Hungary introduced an automatic trigger mechanism which resulted in massive bankruptcy filings in the early transition period. The Hungarian approach was more effective than the Romanian: massive restructuring was forced on insolvent enterprises, while Romania still faces the problem of 'white elephants' inherited from communist times.

The lesson is that insolvency law can speed up the all important selection process in transition economies and should be applied universally. Exemptions are harmful to enterprises and sectors, as they merely delay necessary restructuring. From the

⁸ In the Czech Republic, the commission preparing a new bankruptcy law intends to introduce a compulsory membership of the association of insolvency practitioners or court administrators in order to prevent unscrupulous administrators from continuing to practice in another district even when they are found guilty of misconduct in one district. Naturally, the administrators, are strongly opposed to this compulsory membership. See *Prague Business Journal*, May 13-19, 2002.

macroeconomic point of view they are not only expensive, but also slow down the reallocation of resources and growth of the economy.

Two deficiencies can be identified in the insolvency systems of transition economies: the shortcomings of the insolvency laws themselves, and weaknesses in their execution. The latter can be mostly explained by the underdevelopment of institutions needed for the law to operate. As far as the law itself is concerned, in addition to their limited coverage, there are problems relating to how the law regulates the triggering of insolvency procedures, and the rules governing the obligation of a manager to file for bankruptcy once the insolvency criterion is met. If the responsibility of managers is not backed by strong incentives then the number of petitions will be low and the insolvent companies will prolong their activities, increasing creditors' risk exposure. The next important issue is the range of options available once the insolvency procedure is initiated, and specifically the room for reorganisation of the debtor company. Reorganisation has been of great importance in transition economies since, for many companies, the causes of financial distress often lay outside the firm itself, whether state owned or private. The approach adopted differed in individual countries. While the Hungarian law was reorganisation oriented, in Poland the bankruptcy law inherited from pre-war times and applied for the whole transition period leaves very little room for the reorganisation of the debtor company. Therefore, to prevent premature closures in the early transition period, a special financial restructuring programme was introduced in 1993 to speed up the restructuring of state-owned commercial banks and their heavily indebted state enterprise clients. In the past couple of years work has been going on to introduce a new bankruptcy law which will definitely be more pro-reorganisation.

While insolvency laws have been subject to numerous amendments in transition countries the shortcomings of the legal institutions necessary for their efficient operation have been much more difficult and time consuming to resolve. Serious shortages of appropriately skilled and experienced personnel lead us to the conclusion that, in transition economies in general, the involvement of courts in insolvency proceedings has to be kept to the minimum. The role of the court should be to start the process and to appoint an insolvency practitioner. Also the court should be involved at the important points of the proceedings such as the approval of any reorganisation plan, its extension, and its completion. The insolvency practitioners, who are not in short supply like the judges, can take charge of the process once appointed and be legally responsible for its implementation. As in mature market economies they should be held responsible for their actions. It is therefore important that the insolvency procedure includes legal sanctions and appropriate rewards and penalties for the court-appointed officials.

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