The Insolvency Law of Central and Eastern Europe

Twelve Country Screenings of the New Member and Candidate Countries of the European Union and Russia: A Comparative Analysis

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

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Introduction Part 1

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I. Background

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 witnessed in these countries was the introduction of a new legal framework, based on private property and its supporting institutions, which were designed to encourage, facilitate, protect and regulate the operation of the new system. However, in many areas the change has been slow and the relevant institutions remain undeveloped, acting as major barriers to the further development of the market system. The bankruptcy law, which is a basic and inseparable element of the private law system, is one of these undeveloped areas with strong ramification for the transformation process.

In the past fifteen years, almost all transition economies have adopted modern bankruptcy laws as part of their efforts to build and strengthen the institutions of a market system. The early pioneers of transition have even revised their bankruptcy laws once or twice in this period. The essential features of these laws are based on the bankruptcy codes of developed market economies but there are also important differences in the scope and some of the provisions of these laws in different countries. So far, there has not been any systematic evaluation of these laws in terms of either their comparison with bankruptcy laws of other countries or the extent to which they facilitate or hamper the

development of the market system. Although in many transition countries, bankruptcy laws have been in place for only a short period of time and therefore there is insufficient experience with the outcome of their implementation, it is still possible to evaluate them conceptually by comparing them with the laws in established market economies.[1]

This introduction focuses on the development of bankruptcy laws and accompanying institutions in selected transition economies. Thus it presents the deficiencies of insolvency procedures and institutions and their impact on the behaviour of companies and their managers, and the security of creditors' interests. It also assesses the mechanisms designed to reduce the cost of managerial opportunism, prevent fraud, and improve corporate governance. In this first section, we will discuss the economic importance of the bankruptcy laws. The second section presents the coverage of insolvency laws in the countries under consideration, highlighting the attempts by some government to limit the applicability of the law for political reasons. Section III discusses the importance of the obligation by, and incentives of, the debtor company to initiate the insolvency proceedings. Section IV considers some institutional aspects of the insolvency proceedings. Section V analyses the insolvency process once it is initiated. Section VI reviews the rules governing the disposal of the assets in bankruptcy. Section VII concludes.

1. Insolvency Proceedings as a Dynamic Selection Mechanism

A major feature of a market system is its dynamic selection mechanism whereby the strong and efficient units replace weaker and less efficient ones, and new processes and products replace older ones. Some entrepreneurs and firms are unable to withstand the competitive pressure

[1] For the development of insolvency laws in mature market economies, see EU Best Project on Restructuring, Bankruptcy and a Fresh Start, Final Report of the Expert Group, Brussels2003; see also J. S. Ziegel, Current Developments in International and Comparative Corporate Insolvency Law, Oxford: Clarendon Press1994; E. Berglof, H. Rosenthal, The Political Economy of American Bankruptcy: The Evidence from Roll Call Voting, 1800-1978; 2000, at http://web.mit.edu/polisci/polecon/www/14pe.pdf.

and exit the market, enabling their resources to move to more efficient employment. The Schumpeterian concept of creative destruction encapsulates this dynamism. The establishment of the new system in transition countries accentuated the selection process and gave it more prominence than in mature market economies. The inherited economic structure was unsuitable to a market system and had to undergo a dramatic change, requiring the closure of many enterprises and changes to the operation of many others. The extensive private sector development in the early transition period, and the high rate of entry and exit of new firms, also highlighted the operation of the selection mechanism.

The exit of resources during the systemic transformation processes may take place through the classical exit processes such as bankruptcy and reorganisation or through non-classical methods such as restructuring, downsizing, informal arrangements, etc. (See Figure 1). Despite being very important in all transition economies, the latter forms of exit are conducted under general civil or commercial laws of these countries. The classical exit processes, however, are regulated by special laws coming under "the insolvency procedures".[2]

The aim of the bankruptcy law (or the insolvency proceedings) is to regulate the selection mechanism. It establishes the procedures for the orderly exit of failed enterprises and the re-entry of their assets and other resources into new firms and new activities. Moreover, the insolvency procedures provide a legal assurance for potential investors and creditors that even in the case of business failure, there will be legal processes at work to prevent a rush on the assets of the distressed firm and to regulate the distribution of the estate of the bankrupt firm amongst its creditors.[3] Furthermore, in respect to the extremely low pro rata payment for creditors, insolvency proceedings rather prevent additional loss than the recovery of investments or credit though.

[2] For details see the introductory chapter in L. Balcerowicz, C.W. Gray, I. Hashi, Enterprise Exit Processes in Transition Economies, Budapest 1998: CEU Press; hereafter referred to as BGH.

[3] In some countries, such as the U.K., this process is referred to as the 'insolvency procedure' when the subject of financial distress is a firm. The term 'bankruptcy' is reserved for individuals. In this book the terms 'bankruptcy' and 'insolvency' are used interchangeably.

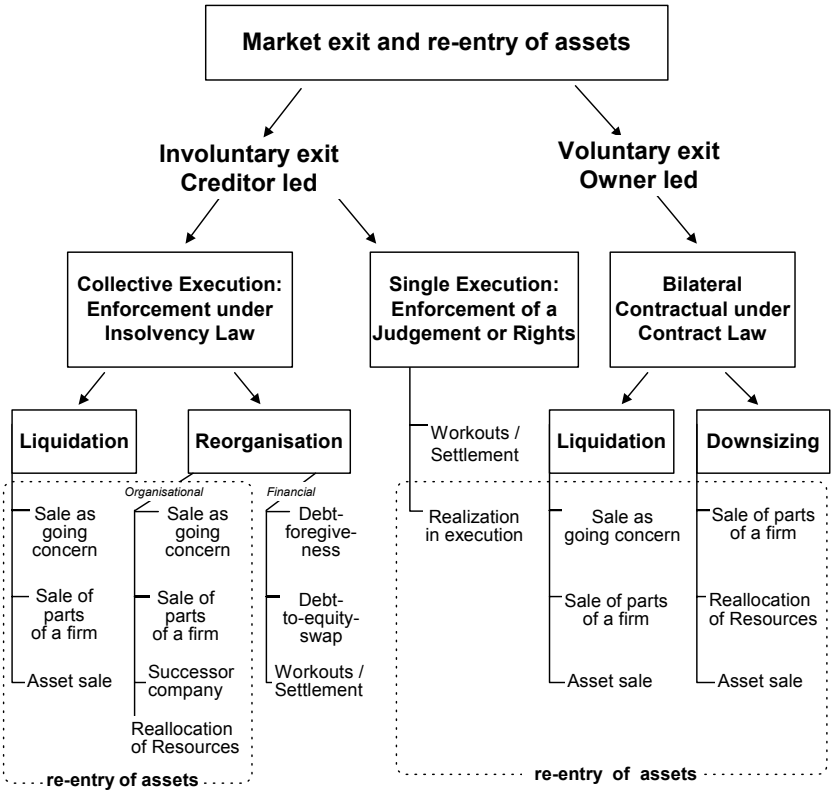

Figure 1 - Re-Allocation of Assets from Non-Viable to Viable Use

The systemic transformation in CEE countries is closely bound with changes in the behaviour of enterprises and their managers and the creation of an environment conducive to new investment (by domestic and foreign investors). For this reason, the insolvency procedures play an even more important role than in established market economies. The greater uncertainty, the lack of experience with market mechanism, and the greater information asymmetry put shareholders, financiers and creditors at a serious disadvantage in comparison to the managers of distresed firms. Furthermore, the opportunity for fraudulent behaviour, which is greater in early transition than in an established economy,

discourages individuals and companies from developing relationships with new firms. A well functioning insolvency law provides a reasonable guarantee for financiers, creditors and suppliers of such firms.

2. Restructuring and Privatisation

In transition economies, the insolvency process is closely linked to two other fundamental processes of early transition: restructuring and privatisation. Restructuring requires the former state owned enterprises to change into market oriented firms by altering their behaviour from a passive administrative unit in the planning apparatus to an active independent agent making value maximising decisions for their own.[4] There was also a need for the radical change of the government's aproach to state-owned companies in order to make them market oriented and not government protected at the expense of tax payers. The restructuring process, invariably, involved financial distress and potential or actual insolvency and the exit of resources (reductions in the output of unwanted products and the resources employed in those activities, downsizing or closure of plants or enterprises, etc.). The bankruptcy law would facilitate the restructuring process. The privatisation process on the other hand, highlighted the plight of heavily indebted firms which could not be privatised as going concerns. The bankruptcy law provided the opportunity to deal with past debts and insolvency in order to speed up the privatisation of – in fact- bankrupt firms (for example, the so-called "liquidation" route in Poland). The opportunity was of course not utilised in all countries.[5]

[4] At macroeconomic level, many old sectors had to shrink and create room for new sectors (especially light industry and services).

[5] In the Czech Republic, e.g., enterprises in the voucher privatisation programme were exempted from the application of the bankruptcy law while in Romania, the bankruptcy law excluded SOEs altogether.

A related instrument used in transition economies is administrative restructuring.[6] It embraces a wide range of different programmes, which, however, have the following common features[7]: the main goal is restructuring of debt; the proceedings are administered by a special state agency or by the state institution controlling the banking sector or security market; provisional stay of enforcement is introduced or a group of enterprises is temporarily exempted from formal insolvency proceedings; the state agency investigates the financial situation of the debtor, supports the negotiations between the debtor and the creditors and, often, decides on reorganisation or liquidation of the debtor. The programmes are usually temporary and limited to a certain category of enterprises, e.g. to certain sectors, often to banks as creditors and large enterprises and banks as debtors.

Apart from the above, bankruptcy laws play an important role in the transformation process itself: they provide credibility for the regime change by signalling to the enterprises that if they cannot withstand the competitive process on their own, they will not survive (and that the previous soft budget constraint regime which made their survival possible has come to a definite end). Only then will enterprise managers change their expectation and become subject to the bankruptcy constraint. However if the bankruptcy laws are deficient or the administrative capacity is underdeveloped, there will be much room for fraudulent behaviour by managers and other stakeholders and the insolvency process will be used for the purpose of fraud.

3. Insolvency Laws and Corporate Governance

The separation of ownership and control associated with corporations (limited liability and joint stock companies), especially in the chaos of

[6] Administrative restructuring programmes have also been implemented in numerous non transition countries, e.g., India, Philippines, Indonesia, Korea, Malaysia, Thailand, Portugal.

[7] For more details see A. Bormann and N. Spitsa, Specific features of insolvency law in Eastern European transition countries, Jahrbuch für Ostrecht, 2007, Volume 1, pp. 11-36.

early transition, allowed the managers of these companies a privileged position from which they could engage in self enriching activities. There was very little, if any, knowledge and experience of this type of company and the role and responsibilities of its managers. Economists in mature market economies, of course, have been aware of the potential for conflict of interest and misuse of the managerial position at least since the publication in 1932 of Berle and Means's 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"[8] which can have adverse effect on resource allocation within these firms. The resulting misallocation of resources can be alleviated by the formulation of appropriate contracts and incentive packages, and the imposition of clearly defined rules and regulations. The bankruptcy laws in mature market economies have evolved over a long period of time so as to minimise the agency cost, prevent and penalise managerial opportunism, and provide protection for creditors and financiers in order for the private property system to function and prosper.[9]

In mature market economies, the economic and legal mechanisms of corporate governance have evolved to ensure that the interests of owners and managers are aligned, that an appropriate level of oversight is exercised by the representatives of owners and creditors,[10] and that

[8] See F. E. Fama and C. M. Jensen, Agency Problems and Residual Claims, Journal of Law and Economics, 26: 327-349 (June)1983.

[9] It was precisely the absence of a legal framework, together with duties and responsibilities of managers in the early phase of the development of capitalism in former socialist countries, that led to the widely used descriptions such as "wild west" and "primitive accumulation".

[10] It is well recognised that excessive intrusion in the work of management will interfere with their ability to make effective decisions and their risk assessment. Excessive monitoring by large block-holders may indeed impair their work and lower the performance of the firm (see e.g., B. Holmstrom and J. Tirole, Market Liquidity and Performance Monitoring, Journal of Political Economy, 51, 1993, pp. 678-709; P. Aghion and J. Tirole, Formal and real authority in organizations, Journal of Political Economy, 1997 Vol.105 (1), pp. 1-29; M. Bukhart et al., Large Shareholders, Monitoring and the Value of the Firm, Quarterly Journal of Economics 1997, 112, pp. 693-728; and F. Allen, G. Gale, Comparing Financial Systems, Cambridge Mass., The MIT Press 2000).

any managerial opportunism is detected and penalised by both the market mechanism and the legal framework.[11] Of course, when firms experience financial distress and are likely to enter the bankruptcy process, the normal rules of behaviour may be affected: managers may be tempted to hide the truth from shareholders and creditors as long as possible in order 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 or owners which would not have been possible if facts were known to all stakeholders. Bankruptcy procedures are extensions of the legal framework which come into effect when companies suffer from financial distress. Their aims are to protect the interest of investors as well as shareholders from scrupulous managers on the one hand, and to prevent further indebtedness of the firm on the other.

4. Fundamental Issues Addressed by Bankruptcy Laws

Bankruptcy laws in mature market economies have evolved over time in response to changing economic conditions and the political and economic strength of different interest groups.[12] But, irrespective of how they have developed, all bankruptcy laws have to respond to a number of fundamental problems faced by in financially distressed firms: (a) how should a 'run on the assets' of the firm be prevented; (b) how should the conflict of interest between the creditors and debtors be handled and who should be able to decide the future of the firm's operations; and (c) what should be the appropriate level of state intervention or court involvement in the process? We will discuss how the bank-

[11] See also World Bank Global Insolvency Law Database, Principles and Guidelines for Effective Insolvency and Creditor Rights Systems; for a survey of literature on corporate governance; see A. Shleifer and W. R. Vishny, A Survey of Corporate Governance, Journal of Finance 1997, 52 (2), pp. 737-783.

[12] For an analysis of the underlying political and ideological considerations and the role of different political parties in shaping the U.S. bankruptcy laws in the last century, see E. Berglof, H. Rosenthal, The Political Economy of American Bankruptcy: The Evidence from Roll Call Voting, 1800-1978, 2000.

ruptcy laws of the mature market economies deal with these questions before considering the response of laws in transition economies.[13]

a)

How should a "run on the assets" of the financially distressed firm be prevented? When the information on a firm's financial distress becomes public, creditors will try to seize the firm's assets in an attempt to recover their claims against the firm. If unchecked, this rush will lead to the discontinuation of the firm's operations and speed up its collapse. There will be no hope of an orderly full or partial exit and the firm's asset would not be sold at their maximum value. What is more important is that some creditors who are not quick enough to grab some of the assets will lose out altogether. There is a strong likelihood that the 'absolute priority rule (APR)', which is a major underpinning of the property rights laws, will be violated. In order to prevent such costly rush, all bankruptcy laws provide for a stay of claims against the firm, including the suspension of interest payment (on unsecured loans), once a bankruptcy petition is filed. Other procedures will then be set in motion to regulate the process, prevent a fall in the value of assets and enforce APR. Claims of secured creditors will be settled first, followed by the claims of creditors with higher priority before unsecured creditors of lower priority receive anything.[14] At the bottom of the priority list are the shareholders who will receive something only if all creditors are paid in full. In order to ensure that managers of debtor firms do not engage in fraudulent transactions and property transfers before their insolvency in order to benefit some creditors or stakeholders, most bankruptcy laws also include provisions for the annulment of such

[13] For a review of the bankruptcy laws in mature market economies and their relevance to transition economies, see I. Hoshi, Bankruptcy, Reorganisation, and Liquiditation in Mature Market Economies: Lessons for Economies in Transition, in: Balcerowicz, L., Gray, C. W., Hashi. I. (eds.), Enterprise Exit Processes in Transition Economies, CEU Press: Budapest 1998.

[14] In some countries the claims of secured creditors are dealt with outside the bankruptcy process. More on this later.

transactions if they are considered to have been aimed at violating the APR or simply fraudulent.[15]

b)

How should the basic conflicts of interest between creditors and the debtor firm and amongst creditors themselves be handled? What should be the debtor-creditor orientation of the bankruptcy law? When a firm is in financial distress, conflicts will appear amongst various stakeholders. The owners and managers would be interested in resolving the situation and return the firm to financial health. This is generally achieved through the reorganisation route involving the restructuring of firm's debts and even further borrowing. Some creditors, however, may want to cut their losses short and retrieve their claims (or as much of it as possible) quickly. This is generally achieved through the liquidation of the debtor firm. Those with security may feel that it is in their interest to seize their charge, even though this may prevent the firm from continuing its normal activities and reduce its 'going concern' value. Other stakeholders such as the government or employees will be interested in the continuation of the firm's operation and the maintenance of employment. A related question is whether the bankruptcy law should facilitate and encourage rather than discourage reorganisation and debt restructuring. The bankruptcy laws in different countries have different orientation in the treatment of creditor-debtor relationship and in their preference for the reorganisation option. Moreover, bankruptcy codes with a preference for reorganisation are also generally more debtor oriented while those with a preference for liquidation are usually more creditor oriented.

To sum up, the emphasis and orientation of bankruptcy codes regarding the conflict of interest between debtors and creditors vary widely in mature market economies. In some countries like France and the U.S., the law has a clear preference for the debtor and for the reor-

[15] This is usually referred to as Actio Pauliana. For a detailed discussion of the provisions in the U.K. law, see I. A. Fletcher, Voidable Transactions in Bankruptcy: British Law Perspective, in: Ziegel J. S. (ed.) Current Developments in International and Comparative Corporate Insolvency Law, Oxford: Clarendon Press 1994.

ganisation of the firm's operations while in others like the U.K. and Germany, the creditors' rights are given greater prominence and weight, and the insolvency procedures are more likely to lead to liquidation rather than continuation. In the U.S., the managers of the debtor firm remain in possession during the reorganisation period while in the U.K. and France, a court appointed takes charge of the firm to prepare and oversee the reorganisation plan. In Germany, the court appointed official supervises the existing management during the reorganisation period. Although the restructuring of debt in a reorganisation may involve some renegotiation of the terms of debt contracts, and therefore some deviation from APR, in most countries, the majority of creditors have to approve the reorganisation plan. Only in France, where the court appointed trustee prepares the reorganisation plan without the need to obtain the approval of creditors, is there the possibility of serious distortions caused by the violation of APR.

c)

What is the optimum level of involvement of the state in the bankruptcy process? At one extreme, the state may establish the basic rules of the game and allow the stakeholders to reach a market-based agreement subject to arms-length supervision by courts. The U.S. and U.K. laws fall in this category – despite their different approach to the conflict of interest between debtors and creditors, the procedure is largely market based and involves negotiations between various stakeholders with minimum court involvement. In the U.K., even the 'receiver' is appointed by the charge holder and not by a court and can pursue his function without needing the approval of the court. Of course, the situation has not always been like this: in the U.S., the Chandler Act (the 1938 Bankruptcy Law) required the bankruptcy process to be under the control of an independent trustee supervised by courts and monitored by the Securities and Exchange Commission to ensure that negotiators involved in the bankruptcy reorganisation process acted in the best interest of all stakeholders. But the evolution of the bankruptcy practice showed that the agents involved in the process preferred to opt for a process in which contracting parties could negotiate directly and reach

an enforceable agreement.[16] In Germany, on the other hand, courts are involved in all stages of the process from the approval of the bankruptcy petition and the appointment of trustees or administrators to the approval of all the major decisions made by these court-appointed officials such as the list of creditors, the sale of assets and the final distribution list. Here, the involvement of courts, strengthens the creditor-orientation of the law and gives greater priority to the enforcement of APR. The debtor company is usually run by, or under the supervision of, a court appointed trustee while a reorganisation plan is prepared and put to creditors' vote. At the other extreme, in France, the state and courts are involved very heavily from the onset of financial distress to the completion and implementation of a reorganisation or liquidation plan. The court determines the scope and power of the administrator and approves the reorganisation plan which is prepared by the administrator, even if it is not approved by creditors – a major difference between the French and other mature market economies' insolvency codes.

II. Government and Insolvency Procedures

One of the crucial lessons of fifteen years of transition is that the state should reduce its direct involvement in the affairs of enterprises as soon as possible and leave the owners and managers of enterprises to make their own decisions on the basis of conditions warranted or dictated by

[16] Under the Chandler Act, firms were generally expected to file under Chapter X which involved courts and SEC involvement. The independent trustee not only managed the company but also was the only one who could propose a reorganisation plan. But, gradually, firms realised that (although this was not in the spirit of the Act) they could file under Chapter XI of the Chandler Act which did not include the above restrictions and allowed the managers to remain in charge and prepare a reorganisation plan. For a discussion of the historical development of the bankruptcy laws in the U.S.

the market. The state should concentrate its efforts on building and consolidating the institutions of a market economy and a stable macroeconomic environment. Attempts at intervention in support of some enterprises or some industries, which are largely motivated by political considerations, have been generally counterproductive. Insolvency proceedings are no exceptions.

Although governments in almost all transition economies have adopted modern bankruptcy laws (very similar to those in mature market economies), they have not always been fully committed to the underlying principle and logic of these laws. After thirteen to fifteen years of experience[17], many of these governments have still not accepted the fact that not all pre-transition enterprises can survive in the new market system either because the structure of demand has changed dramatically or because they are structurally inefficient. Instead of allowing these white elephants of socialism to go bankrupt and make room for the re-entry of much of their assets under new ownership, governments in a number of transition countries have excluded these companies from the operation of bankruptcy laws and wasted scarce financial resources on their unsuccessful subsidisation. In most cases, the real motives behind this policy have been political and electoral, rather than economic.[18] The repeated write-off of debts, exemption from bankruptcy laws while in the process of privatisation, and the exclusion of SOEs from bankruptcy laws are examples of such attempts.

In some countries, Albania and Romania, for example, the so-called 'strategic enterprises' were transferred to a restructuring agency in order to return them to financial health. They were excluded from the operation of the insolvency procedures and also not included in the privatisation programmes. The experience has been largely negative:

[17] See also EBRD Legal Indicator Survey: assessing insolvency laws after ten years of transition, 2003, at http://www.europeanrestructuring.com/chapters/pdfs/EBRD.pdf.

[18] However, it has to be pointed out that also in mature market economies, governments are sometimes engaged in rescuing large firms from bankruptcy through subsidies, restriction of competition, etc. But these interventions are exceptional and, even then, in most cases they often do not work.

state subsidies were used to delay the closure and ultimate bankruptcy of these enterprises.

In terms of the application of the bankruptcy laws, the lesson from advanced transition economies (Hungary for example) and from countries which have been less determined in their reform policies (Romania for example) is that the universal application of the insolvency process is essential in (a) signalling the commitment of the government to the systemic change; (b) forcing enterprise managers to change their behaviour and engage in serious restructuring; and (c) speeding up the reallocation of resources from insolvent old firms in old sectors to private new firms in new sectors. In practice, however, there has been much deviation from this principle and bankruptcy laws have been subject to many exceptions and exclusions.

Interestingly, with the exception of the Czech and Slovak Republics (both only since 2007), Estonia, Russia (although the relevant regulations of the new Insolvency law of 2002, as it was the case in the previous law of 1998, have not come into force yet) the majority of the transition countries have not yet tackled the problem of consumer insolvency. All mature market economies have well developed provisions for the bankruptcy of individuals (which are not just households or consumers, but also owners of very small, micro, enterprises. Given the importance of micro-enterprises in TEs, it is essential that legal provisions to deal with this type of bankruptcy are also put on the statute book.

Table 1 shows, that in some countries, the state allocates itself additional powers and imposes a variety of exclusions, exceptions and extra-procedural measures. These measures, as the experience of Romania and other countries trying to protect some sectors or companies from bankruptcy show, are counter-productive. The treatment of insolvency is basically an issue for private law and all subjects should be treated equally. The state's interests are of course represented in the insolvency process in the normal manner – either as a creditor or as the owner of the enterprise in distress. As such it can introduce special measures such as delayed repayment of debt or write-off of old debts,

etc. There is no need for additional intervention power which could only be used for political reasons.[19]

One of the frequently heard arguments for state intervention in insolvency procedures is the danger of mass bankruptcies and mass unemployment, the so-called "domino effect" that may occur if there is no "potential brake" on the automatic application of the procedures. The experience of countries like Hungary shows, that despite of the avalanche of filings for bankruptcy at the time of the introduction of the new bankruptcy law, the recession in Hungary was not deeper or very much different from that in other transition economies (more on this later). On the contrary, the massive wave of bankruptcies contributed to the acceleration of the restructuring process.

Table 1 – The Coverage of Insolvency Procedures in Selected Transition Countries and Germany

Country	Physical Persons	Legal Entities: Exemptions /Special Rules for
Bulgaria	Only merchants Art. 607a Commercial Code (CC)	Some sectors (e.g. non-commercial legal persons) are subject to special rules, Art. 612 CC
Croatia	Only merchants Art. 3 I Bankruptcy Law (BL)	Legal entities in the military and defence-sector unless with the approval of the Ministry of Defence; Farmers and private Pensions Funds exempted
Czech Republic	No restrictions, § 3 III Insolvency Code (IC); consumer insolvency, §§ 389 et seq. IC	Some exceptions, i.a. the Czech State, municipal entities, the Czech National Bank, Social State Security Fonds, several other State Fonds, Public Universities, and Political Parties in elections, § 6 IC
Estonia	No restrictions, § 8 Bankruptcy Act (BA)	The State or Local Governments are exempt
Germany	Consumer Insolvency / Minor Proceedings §§ 304-314 Insolvency Statute (IS)	Corporation under public law supervised by a Land (state) exempted if foreseen under state law

[19] State intervention can be done via an agency such as the German Treuhandanstalt or the Hungarian Privatisation Agency in the mid 1990s. These agencies were mainly interested in fast privatisation by sales, selling most of the companies free of public debt with the price covering only the cost of debt alleviation.

Country	Physical Persons	Legal Entities: Exemptions /Special Rules for
Hungary	Not applicable, §§ 2, 3 Reorganisation and Liquidation Law (LRL)	Some types of property (e.g. of firms in the military-sector, real estate with pending restitution claims) are exempt § 4 III-V LRL
Latvia	Not foreseen in the Law on the Insolvency of Undertakings and Companies (LIUC)	Insurance companies / Insurance brokers' companies / Credit institutions / Investment brokers' companies Art. 2 II, III and III[1] LIUC
Lithuania	Not foreseen, neither in the Enterprise Bankruptcy Law (EBL) nor in the Law on Restructuring of Enterprises (LRE)	Art. 1 II, IV EBL special rules for: Banks / Credit Unions / Insurance firms / Agricultural firmss / Intermediaries of public trading in securities (these are all exempt from LRE, Art. 1 IV, VI) and for management companies, open-ended investment companies
Poland	Only entrepreneurs, Art. 5 I Bankruptcy and Reorganisation Code (BRL); farmers are exempted	Schools and independant public health sector entrtprises as well as institutions and organizations created by or in execution of parliamentary laws are exempted, Art. 6 BRL
Romania	Only merchants, Art. 1 I Judicial reorganization and bankruptcy Code (JRBC)	Numerous exemptions (e.g. enterprises in privatisation Art. III law 82/2003; enterprises in the regies autonomes Art. 130 JRBC); special rules for banks and insurances
Russia	Physical persons, individual entrepreneurs, heads of peasant farms, Ch.10, Art. 202 Federal Law on Insolvency (FIL)[20]	Treasury enterprises, institutions, political parties, religious organizations exempted, Art. 1 II FIL; agricultural, financial, town-forming, strategic enterprises, insurance companies, natural monopolies subject to special rules, Art. 169 et seq. FIL
Slovakia	No restrictions, § 1 Bankruptcy and Reorganisation Code (BRC)	State or local government organizations and specified organisation, § 2 BRC
Slovenia	Only independent entrepreneurs, Art. 4(1) Statute on Coercive settlements, Bankruptcy and Liquidation (SCSBL); consumer insolvency debated	Special rules for insurance companies (Art. 193 - 198 Insurance Act), banks (Art. 147 Bank Act), investment funds (Art.148 - 151 Act on Investment Funds), trusts

[20] In force only regarding individidual entrepreneurs; not effective in respect to the remaing subjects, ammendments of federal legislation required.

III. The Initiation of the Insolvency Proceedings

The insolvency law should ensure that this process is embarked upon systematically, efficiently, fairly, and quickly. In this sense, the insolvency procedure complements both Company Law and Contract Law. A sound insolvency procedure provides the investors and lenders with the guarantee that, in the event of financial distress, appropriate provisions are in place to, firstly, raise the alarm about the situation (i.e., inform the interested parties) and, secondly, deal with their claims in an equitable and orderly fashion. Thus, potential investors will be concerned with two main issues: the trigger mechanisms, and the responsibility for the declaration of the insolvency status.

1. The Trigger Mechanism

The insolvency procedure has to be triggered by clear, specific and verifiable criteria in order to make correct information available to all stakeholders, especially the creditors. The most commonly used criteria which, as we shall see below, sometimes produce ambiguous results are:

a) The cash flow, or 'illiquidity' notion, i.e., when the firm is unable to pay its due debts;
b) The balance sheet, or 'over-indebtedness' notion, i.e., when a firm's assets fall short of its liabilities;
c) The notion of 'impending' or 'imminent insolvency'.

The most common criterion is the first one, i.e. the inability to pay due debts. Illiquidity, as a traditional cash-flow based definition used in all of the countries under consideration, is a convenient indicator and can be observed more easily.[21] However except for Hungary, other coun-

[21] Naturally, the practice of 'late payment' of bills should not be confused with the 'inability to pay' of a debtor.

tries under examination employ the first two or even all three criteria – though the latter are usually of less importance (see Table 2).

Table 2 - Insolvency Trigger Criteria in Selected Transition Countries and Germany

Country	Illiquidity	Over-Indebtedness	Imminent Illiquidity
Bulgaria	Yes	Yes	No
Croatia	Yes	Yes	Yes
Czech Republic	Yes	Yes	Yes, since 2008
Estonia	Yes	Yes	No
Germany	Yes	Yes	Yes
Hungary	Yes	No	No
Latvia	Yes	Yes	Yes
Lithuania	Yes	EBL: Yes, in definition of insolvency / LRE: No	No
Poland	Yes	Yes	Yes, for reorganisation procedure, since 2003
Romania	Yes	Yes, since 2006	Yes, since 2003
Russia	Yes	Yes, but only for physical persons	Yes, since 2002
Slovakia	Yes	Yes	No
Slovenia	Yes	Yes	No

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 inaccuracies of estimating the value of assets especially in transition economies, it cannot provide a satisfactory basis for insolvency. The valuation of the company in financial distress requires a special "over-indebtedness" balance sheet[22], identifying the

[22] The continuous judicial involvement of the German Supreme Court (BGHZ 125, 141, 146; Verd. July 12th 1999 - II ZR 87/ 98, ZIP 1999, 1524; Verd. Dec.18th 2000 - II ZR 191/ 99; last Verd. Jan. 8th 2001 - II ZR 88/ 99, ZIP 2001, 839) illustrates the complexity of the issue.

assets of the company with their current open market value and their respective liquidation value. In West European countries, the difficulties of deciding the status of insolvency on the basis of an inventory of assets alone has led to a combined "Two-Tier Method":

(1) An arithmetic rule for insolvency in respect to balance sheet and the liquidation value of assets;
(2) The correction of the liquidation value in case of a positive "survival and return" forecast on the "going concern" basis.

Table 3 shows the use of the "over-indebtedness" criterion and whether this is combined with the "two-tier method". Only in two transition countries (Croatia and the Czech Republic) the Two-Tier method has been used.

Table 3 – The Use of "Over-Indebtedness" Criteria in Selected Transition Countries and Germany

Country	Definition of Over-Indebtedness	Combined Two-Tier Method
Bulgaria	Art. 607a II, 742 I CC only commercial companies	Not foreseen
Croatia	For legal entities Art. 4 VIII sentence 2 BL	Yes
Czech Republic	For legal entities and merchants § 3 IC	Yes
Estonia	For legal entities and physical persons § 10 II BA – only if detected in execution proceedings	Not foreseen
Germany	For legal entities § 19 II IS	Yes
Latvia	For legal entities Art.3 I LIUC	Not foreseen
Lithuania	For legal entities Art. 2 VIII, 9 V EBL	Not foreseen
Poland	For legal entities Art. 11 II BRL	Not foreseen
Romania	For legal entities and merchants Art. 3 JRBC	Not foreseen
Russia	For physical persons Art. 3 I FIL	Not foreseen
Slovakia	For legal entities § 3 BRC	Not foreseen
Slovenia	For legal entities (not independent entrepreneurs) Art. 2 SCSBL; no statutory definition, but by jurisdiction	Not foreseen

Note: "Over-indebtedness" is not applied as a criterion in Hungary.

The calculation of the going concern value of the firm, based on its expected survival, is subject to greater uncertainty in transition countries. To measure and compare the possible future survival and return chances of enterprises suffering from financial distress in the new market economies proves to be extremely difficult. On the one hand, there is an insufficient number of trained personnel in enterprises, courts, ministries and banks, who can undertake this task. On the other hand, the available data on assets of enterprises (whether deliberately or because of poor management) are unreliable both in their methodology and value in many of these countries. Furthermore, the presence of uncertainty and asymmetric information means that the accurate estimation of the two sets of values are extremely problematic and doubtful. Thus - especially in not advanced transition countries - the successful implementation of the "Two Tier Method" in the near future remains doubtful and over-indebtedness remains a problematic insolvency trigger.

Imminent illiquidity. This relatively new insolvency trigger aims at an early start of the insolvency procedure by encouraging the managers to provide information to market participants. Being the only party with access to the relevant information, the debtor may be the only party able to declare this state. But this trigger is effective only if appropriate incentives are provided for the managers of the debtor company (e.g., the discharge of residual debt or the ability of managers to stay in power, as in the German legislation). However, perverse incentives (such as the desire to gain shelter from the claims of a single creditor and personal management) may encourage firms to "escape into bankruptcy".[23] As Table 4 shows, the "imminent illiquidity" criterion has been applied in six transition countries, even though there are no precise measures for assessing imminent illiquidity and with the exception of Poland there are no economic incentives for the managers to declare the state of imminent illiquidity. Therefore it is reasonable to expect that this trigger mechanism is likely to remain idle.

[23] For details see Kirchner, Ökonomische Theorie des Insolvenzrechts (Economic Theory of Insolvency Law), 1997; summary: http://www.insolvenzverein.de/archiv/veranstvorbei02/Arbeitsbl.htm.

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Table 4 – Imminent Illiquidity Criterion in Selected Transition Countries and Germany

Country	Definition	Criteria	Economic Incentives
Croatia	Art. 4 VII BL	No criteria	None
Germany	§ 18 II sentence 1 IS	No precise criteria concerning length of forecast period; min.½ year	Discharge of residual debt §§ 286 – 303 IS; Personal management §§ 270 et seq. IS
Latvia	Art. 3 I LIUC	No precise criteria	None
Poland	Art. 492 BRL, only for preliminary rehabilitation	No precise criteria	Financial restructuring via settlement Art. 504 BRL; personal management Art. 497 et seq. BRL; proposition of Plan Art. 502 BRC
Romania	Since 2003; Art.3 lit.b) IRBC	No criteria	None
Russia	Since 2002 Art.8 FIL	No criteria	None

Note: "Imminent Illiquidity" is not applied as a criterion in Bulgaria, Estonia, Lithuania, Hungary, Slovakia and Slovenia.

2. Declaration Mechanism

The triggering of the insolvency process is one of the important points at which the information asymmetry between the debtor and others may generate serious perverse incentives and inefficient outcomes. It is essential that all stakeholders are made aware of its possible invocation as soon as possible. Even in mature market economies with developed financial markets and institutions, it is recognised that a firm's financial distress may not always be picked up sufficiently early by the financial press and markets. Managers are in the unique position of knowing the affairs of a company and the potential imminent distress. They may embark on opportunistic behaviour aimed at benefiting themselves, by for example engaging in highly risky undertakings in order to prolong their position and possibly save the company. Thus although as a rule the insolvency procedure may be triggered by either the debtor itself or

Table 5 – Triggering the Insolvency Proceedings in Selected Transition Countries and Germany

Country	Right to Initiate the Process	Managers' Obligation to Initiate	Legal Sanctions
Bulgaria	Debtor/Creditor/Liquidator/Agency for public collections Art. 625 CC	Within 15 days, Art. 626 CC	Liable for damages, Art. 627 CC
Croatia	Debtor/Creditor Art.39 I BL	Within 21 days, Art. 39 IV BL	Liable for damages, Art. 39 VII BL
Czech Republic	§ 97 II IC in case of an imminent illiquidity only debtor	No period, "without delay", §98 I IC	Liable for damages, § 99 I IC
Estonia	Debtor/Creditor § 9 BA	No period, "without delay",§§ 180, 306 CC, § 36 CivC	Civil liability §§ 187, 315 CC, § 37 CivC; Penal liability § 380 Penal Code
Germany	Debtor/Creditor §13 I IS	Within 21 days, see relevant company legislation	Civil and penal liability for damages, see relevant company legislation
Hungary	Debtor /Creditor /Liquidator §§ 22pp, LRL; Com-mercial Register Court § 84 I CRC; Reorg.: only Debtor §7 LRL	None / no period (original obligation was lifted in 1993)	Liable for damages, § 54 LRL; Criminal liability § 290 I, II, VI Criminal Code, but additional requirements
Latvia	Debtor / Creditor/s / Insolvency Administrator / State authorities, Art.36 LIUC	Art 42 I, II LIUC as soon as one criteria is given	Civil liability Art. 1635,1642,1645 CivC, Art.169 CC; Penal liability Art.111pp LIUC
Lithuania	Art. 5 I,II EBL Creditor/Owner/ Head of firm admin./Liqui-dator Art. 4 I, 5 I, IV LRE Head of firm admin./Creditor(s)	Art. 8 I EBL	Art. 10 XI LBE limited civil liability of manager/owners; Art. 6.263 CC delictual liability; penal liability Art.208,209, 210 Crim.Code

Poland	Debtor / Creditor / Liquidator / Art. 21 BRL; in Preliminary Rehabilitation procedure only Debtor Art. 494 BRL	Within 14 days, Art. 21 I BRL	Civil (Art.21 III BRL, Art.299, 479 Com. Comp.Code CCC) liability and penal liability (Art. 373 pp BRL, 586 CCC)
Romania	Debtor Art.25 / Creditor Art. 26 § I JRBC	Within 30 days, Art. 27 § I JRBC (since 2002)	Liable for damages, §27 IV JRBC; liability of managers extended in 2006
Russia	Debtor / private and state creditors, Art. 7 I FIL; 224 Code of Commercial Procedure	Within one month, Art.9 FIL	Art.10 II FIL subsidiary liability for claims emerged after expiration of Art.9 FIL period
Slovakia	Debtor/Creditor/Liquidator, Art. 11 I BRC	Within 30 days, § 11 II BRC	Liable for damages, § 11 IV BRC
Slovenia	Debtor/Personally liable partner /Creditor /Administrator after unsuccessful coercive settlement /Employees, Art.3 SCSBL	Within 2 months, Arts. 12, 13 Act on Financial Operation of Companies	Liable for damage, Arts. 19, 20 Act on Financial Operation of Companies

by a bone fida creditor, it has been argued that the managers should be required by law to declare their insolvency within a short period of realising that their company may default on its debt. In the U.K. and Germany, for example, the managers of a defaulting company are required to file a petition in court within three weeks of a default.[24] Table 5 summarises the rights to, and the obligation for bankruptcy filing as well as the legal sanctions against offending managers in different countries. In all countries both debtors and creditors have the right to file for bankruptcy. In some countries, other agents such as the liquidator (e.g.,

[24] In the U.K., 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. Further-more, the existence of over a thousand prosecutions for violation of this rule in the U.K. confirms that some managers will continue to have this tendency (see Franks / Torous, 1992). For a more detailed analysis of the personal liability of managers, see Sealy (1994).

Bulgaria and Slovakia) or institutions such as the chamber of commerce (e.g., Romania until 2006) or the Commercial Register Court (e.g., Hungary) can also file for bankruptcy. In almost all countries (except Hungary), managers are also obliged by law to declare their insolvency either without any delay (as in the Czech Republic) or within a specified period ranging from two weeks (in Bulgaria and Poland) to two months (in Slovenia).[25] The table also shows that the offending managers are liable for any damage caused by their action. In Romania this liability was recently extended embracing even the premature filing of a petition.

A brief review of different experience of the advanced transition economies gained in the early transition may highlight the importance of the declaration rule, and especially the obligation of the managers. In Hungary, where at the very beginning of the operation of the bancruptcy law managers were required to declare insolvency if a company had arrears over ninety days, there were some 3,500 reorganisation and nearly 10,000 liquidation declarations in April1992 alone (the total number reached some 22,000 filing by the end of 1993).[26] The "automatic trigger" was removed in September 1993, but by this time the accumulation of debt arrears had effectively stopped, payment discipline was strengthened, and creditors had become more active in filing. 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 changed and became more strict against notorious debtors in 1995.

In the Czech Republic, in contrast, there were only 350 filings for bankruptcy in 1992 (and 1,098 in 1993).[27] The massive difference

[25] In Romania the managers' obligation to declare the insolvency situation was only recently added to Art. 25 § I JRBC through Ordinance 38/2002.

[26] The 1991 Bankruptcy Law came to effect in Hungary in January 1992 and the wave of declarations started on 1 April, after the expiry of the 90-day period. For details, see BGH, Chapter 7.

[27] The liquidation process in the Czech Republic applies to solvent firms and, thus, is not comparable to the situation in Hungary where firms in default have to file for either reorganisation or liquidation. For details see BGH, Chapter 5.

between the two countries was at this time largely due to the legal obligation of the managers 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 (as compared with the total number of enterprises), especially in the first two years of transition (1990, 1991).[28] From 1992 there was a sharp increase in number of filings for bankruptcy (to the peak of 5,249 in 1993). In the second half of the 1990s the number of insolvency declaration dropped significantly and stayed at an average of about 2,700 filings a year. Here, the problem has been not the absence of the obligation by managers to declare insolvency but the poor enforcement of the law. Despite a clear legal requirement for a declaration within 14 days of default, the managers ignored this obligations and no prosecution was initiated to stop this behaviour. As a result of the delay in the publication of information, the financial position of enterprises deteriorated further and a big portion of petitions every year was rejected by courts at the start of, or during the insolvency procedure due to the insufficient assets of the debtor to cover the costs of the procedure alone. Only in 1997 new provision for legal sanctions were introduced in the Polish Bankruptcy law, making offending managers liable for the damage caused to creditors and enabling the courts to deprive them of the right to run another economic activity on their own or manage another company.[29] From then on the number of filings has increased to reaching a peak of 10,794 in 2004.

[28] It is worth adding that Poland was in the privileged position of having a Bankruptcy Law available at the start up of reforms in 1990. The Law, originally adopted in 1934, was never abolished during the communist economic regime.

[29] The latter penalty was declared unconstitutional by jurisdiction of the Supreme Court of 4.7.2002, Dz. U. 113, Pos. 990, but reintroduced slightly modified with the new bancruptcy code in 2003.

IV. The Institutional Framework

The effectiveness of the insolvency procedure is closely related to the development of the legal institutions of a market economy, in particular the processing capacity of the legal system. The 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. In this section we discuss some of the institutional obstacles to the operation of an insolvency law.

1. Involvement of Courts

The nature and level of court involvement in the bankruptcy process reflects not only the type of bankruptcy law in each country but also the attitude of the state to bankruptcy and its consequences. As in mature market economies, courts in transition economies, too, are involved in the insolvency proceedings to varying degrees. Unlike East Germany, where the 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 were characterised by a shortage of court personnel, specialised chambers and competent administrators organised in professional associations. Also in the course of transition the administrative capacity was not developed at a sufficiently fast pace to cope with the rapid growth of court cases resulting from the operation of the market system and the increased role of the judiciary in new economy. Another, still existing, problem is poor (traditional) system of legal education which produces judges with insufficient knowledge of economic and financial issues. It would have been possible to design a system with minimum court involvement so as to minimise the impact of their insufficient institutional and administrative capacity. But in almost all of countries, governments chose bankruptcy systems with heavy involvement of courts, giving rise to fairly slow bankruptcy proceedings.

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 and its extension and at the end when the case is being completed.

The experience of transition countries, though different in this respect, strongly supports the conclusion reached above. In some countries, like the Czech Republic, the level of court involvement has indeed been one of the major causes of the slowness of the system – for every decision affecting creditors, the court-appointed trustee had to seek the approval of the judge overseeing the case. In the case of a sale other than by auctions this included even the prices at which the bankrupt firm's assets are being sold for.[30] In Poland, where the court takes a limited number of crucial decisions in insolvency cases, leaving other tasks to the court appointed trustee, the processing of 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 courts burdened by the fast growing number of economic cases and still poor knowledge of economic issues by judges. Of course, it should be pointed out here that, in most of the countries under consideration, the level of court involvement has been only one of the factors behind the slowness and inefficiency of the insolvency system. 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 the implementation of the 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.

[30] For a detailed discussion of the old law in the Czech Republic see I. Hashi, J. Mladek, A. Sinclair, Bankruptcy and Owner-Led Liquididation in the Czech Republic, in: Balcerowicz, L., Gray, C. W., Hashi. I. (eds) Enterprise Exit Processes in Transition Economies, Budapest: CEU Press, 1998.

2. Remuneration of Insolvency Practitioners and their Accountability

The insolvency practitioners (administrators and liquidators)[31] appointed by courts have significant discretion over the assets of a debtor enterprise, especially when it comes to the disposal of these assets. The insolvency practitioners should be expected to be: competent, able to act impartially, 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. The presence of uncertainty and asymmetric information, and the difficulty of monitoring the insolvency practitioners, creates a classic 'principal-agent' problem and adverse implications for the completion of the bankruptcy process. The method of remuneration of these practitioners is 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 level of proceeds earned upon the disposal of assets, or 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 thus was 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.[32] However, the remuneration of administrators and liquidators may affect the outcomes of procedures. 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

[31] They are variously referred to as trustee, liquidator, administrator, supervisor, receiver or receiver and manager, curator, official or judicial manager.

[32] The Prague Business Journal, of May 13-19, 2002 speaks of administrators acting as estate agents completing lucrative deals in their own interest. The method of remuneration of administrators, however, improved significantly after the June 1996 amendments.

liquidators enabled them to perform reorganization of debtors even if they had filed for liquidation. Hence, considerable share of liquidation filings ended with workouts and the sale of going concerns.[33]

While the remuneration of insolvency practitioners is crucial in creating the right incentive for them to maximise the value of recovered assets or creditor satisfaction, they must also be held accountable for their actions and be subject to maintaining appropriate professional standards of quality. Therefore first of all it is essential, that insolvency practitioners have proper qualifications; their knowledge and practical understanding should be tested by impartial examination. It needs to be underlined that insolvency proceeding is a very complex and indeed interdisciplinary process and, therefore, general qualifications will not provide the required breadth and depth of technical knowledge and practical understanding. Furthermore, experience in countries where insolvency and insolvency legislation is relative new, are in fact limited.

In order 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.

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.

The professional association may also help members with the provision of a collective insurance policy. Given that members are legally responsible for their actions and can be sued for taking wrong decisions on asset disposal or for having inflicted losses on third parties,

[33] M. Szanyi, Reorganisation,Liquidation,Bankruptcy as a Means of Privatisation, Budapest: ÁPV Rt., 2000.

Table 6 – The Position of Insolvency Practitioners in Selected Transition Countries and Germany

Country	Qualifications required	Remuneration	Liability
Bulgaria	Art. 655 CC, since 2006 Ordinance - university degree / special exam - only physical persons or partnerships - 3 years relevant experience - public list	Art. 661 CC flexible, determined by Creditors Assembly and approved by the court	Exclusion from List / Art. 663 CC fines and liable for damage / compulsory insurance
Croatia	Art.21a BL Licence system – special exams – public list	Art.29 VII BL progres-sive fee scale acc. to asset value – Art.39a BL covering fund for pauperism	Art. 28 I BL liable for damage / compulsory insurance Art.28 VI BL
Czech Republic	§ 21 IC, Court chooses from public list - individuals and firms - Administrator Law sets criteria: i.e., special exam / university degree; transitiory rules til 2014	§ 38 IC by Court acc. to Ordinance which is not yet enacted (before 2008 degressive scale acc. to asset value / flat fee for each creditor)	Exclusion from List § 13 II Administrator law / liability for damages § 99 IC
Estonia	§§ 56-59 BA only natural persons - Licence system - Public list - Special exam	by Court acc. to Ordinance, degressive fee scale acc. to asset value, min. / max. limits, reimburse-ment of expenses	§§ 24, 67pp BA for damage, claim to be filed within 3years; compulsory insurance; exclusion from list for 5years
Germany	§ 56 IS Court chooses suitable expert with technical competence (fully approved Lawyers as a rule)	by Court according to Ordinance, progressive fee scale according to asset value	§ 60 IS liable for damage
Hungary	§§ 14, 27a LRL physical persons/legal entitities - public auctions to enter list - government register - Ordinance regulates professional profile	§ 59 LRL – covering fund for pauperism – liqu.: 5% of revenues – / § 17II LRL reorg.: 1% of book value	deletion from the register e.g. § 27a V LRL; liability for breach of duty § 339 Civil Code
Latvia	Art.13 of LIUC natural persons only – Certified by Insolvency Agency – lawyers, economists, managers	Art.24 LIUC determined by Creditors` Assembly / based on recovered sums or fixed sums posible	Art.25 I LIUC liability for damages; annulment of certificate Art.13 I LIUC; compulsory insurance deposit Art.15 II LIUC

Lithuania	Art.11 I EBL / Art.17 III LRE and Govmt.Resolution: natural or legal person - higher education - licence system - 2-3 years practical experience - Special exam - certification commission	Art.11 VI, 23 IX, 36 IV,V EBL / Art.17 Vi, IX LRE amount and payment procedure negotiable, subject to approval by Creditors Committee	Art. 11 VI EBL / Art 17 XI LRE, liable for all losses inflicted through his fault
Poland	Court chooses from public list - individuals / partnerships - Admin. Law sets criteria: i.e., special exam / university degree / 3year practice, clear record of conviction; transitiory rules til 2010	Art. 162 BRL by Court: max 5% of asset value, if continuation of enterprise max 10% of profits	Exclusion from List; Art. 160 BRL liable for damage; Art.296 Criminal Code penal liable; Administrator Law requires compulsory insurance
Romania	Art. 17 IV JRBC, Ordinance 86/06 physical persons and legal entitities - certified accountants or degree in economics, law, engine-ering - 5 years of practice; public list run by regional courts	Art. 17 I JRBC, Ordinance 86/06: flexible acc. to Value of assets, no of employees, etc.; determined by majority of Creditors Assembly	Art. 41 Ordnance 86/06 liable for civil damages; disciplinary measures; compulsory liability insurance; penal responsibility
Russia	Art. 20 FIL university degree; russian citizenship; membership in self-regulating organisation; 2 years of practice; 6 months training; special exams; clear record of conviction	Art. 26 FIL monthly remuneration not less than RUR 10,000; additional fee for success if decided by the creditors' meeting and approved by the court	Art. 25 I, II FIL exclusion from the self-regulating association for violation of internal rules; disqualification by court; liability for breach of duty of care
Slovakia	Ordinance8/05 - physical persons, legal (foreign) entities - clear criminal record, trustworthiness, necessary qualification	by Court acc. to Ordinance, lump sum and fee acc. to Value of sold assets	Exclusion from List / § 12 I Law on Administra-tors: liable for damage / compulsory insurance
Slovenia	Slovenian citizens only, physical persons - Lawyers, economists or others with higher education and 3 years of relevant practice, public list Art 78a SCSBL	Art.83 SCSBL and Ordinance sets criteria for remuneration, e.g. size of insolvency estate, #of claims, #of employees	Art. 80 SCSBL Liable for damage; Art. 78c SCSBL revocation of licence

and that the fear of such legal responsibility may distort their decisions, the insurance provided by their professional association would reduce

the burden of potential losses significantly. Table 6 summarises the present position of insolvency practitioners in the countries under consideration.

V. The Insolvency Process

Once a petition to embark on insolvency procedure is placed by a debtor or creditor(s), and a court agrees to hear the case [34], the debtor faces two fundamental options: liquidation or reorganisation, though here different terminologies are used to describe the process in individual countries.[35] The debtor and creditors put forward their views and, generally, the court makes the final decision on which option be pursued.[36] In either case, it is necessary to stop all claims against the debtor

[34] It is important to point out that in many cases and in many countries, the court may refuse to hear the case if the assets of the debtor company are insufficient to cover the cost of the insolvency proceedings. This is a serious problem e.g. in Poland, where every year a substantial portion of bankruptcy filings are rejected for that reason alone. This fact may be well commented with the opinion that petitions are too late and this probably proves that penalties envisaged for imprudent managers are not regularly enforced as they should. Therefore it is reasonable to have a provision, as in the U.K., that the cost of insolvency proceeding is covered by public funds if the assets of the insolvent firm are insufficient.

[35] The procedures may be referred to as bankruptcy, liquidation, administration, arrangement, receivership, official or judicial management or reorganisation / restructuring.

[36] In some developed market economies a debtor is entitled to opt for reorganisation and, while the managers remain in office, prepares a reorganisation plan to be submitted to the creditors and the court within a specified time limit (e.g. Chapter 11 in the U.S.). In other countries (e.g. the U.K.), the court appoints an official (administrator or trustee) who investigates the possibility of preparing a reorganisation (or settlement), which would still have to be submitted to creditors

in order to provide conditions for the court or the court appointed trustee to conduct her/his duties. In the case of liquidation option, the reason for stopping individual creditors from exercising their rights is to ensure that all creditors receive equal treatment depending on their place in the priority list and that there is an orderly winding up of the company. But in the case of reorganisation, the issue of relief from creditors has a different function and needs careful consideration.

1. Relief from Creditors

The automatic relief from creditors alleviates the pressure on the debtor and gives it a chance to negotiate with creditors to formulate a reorganisation plan. However, automatic relief also enables opportunist managers to embark on the reorganisation option in order to prolong their tenure. Such managers may well know that the chances of a successful reorganisation is small but will try to utilise this route for their own interests. The crucial point is whether the relief from creditors is automatic or a possibility that has to be approved by a court or by creditors. In the U.S., there is a ninety days automatic stay of claims for firms filing for a Chapter 11 bankruptcy – a point which has been much criticised by some legal scholars and economists. In the United Kingdom, however, firms may enter the reorganisation option (known there as administration) with the support of creditors and the approval of the court only. Once an administrator is appointed, there is a stay of claims against the company for a period of ninety days in order to give the administrator a chance to prepare a reorganisation plan.

The experience of transition economies has been varied in this respect. In Hungary, initially, the Bankruptcy Law made the 90-day relief from creditors automatic but since the September 1993 amendments, it has been subject to the discretionary vote of creditors. This change was made in response to the criticism by creditors that the

and the court for approval. Even when the reorganisation option is chosen, the reorganisation plan may not be approved by the creditors and the firm would have to go to liquidation. For details, see BGH, Chapter 2.

managers had abused the relief provision. In all cases, the managers of the debtor companies prepare the reorganisation plan.

In the Czech Republic, after the 1993 amendments, the Court offered the debtor a 90-day protection during which it could produce a 'settlement plan', which has to meet certain conditions and has to be approved by the Court. During the protection period there is a stay of claims against the firm (except for the claims of employees and the state arising from current operations). This provision was particularly aimed at helping the newly privatised Czech firms (many of whom 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.[37]

On this point, the old Polish insolvency law was very much creditor oriented. A debtor, who opted for reorganisation, could place a petition with a court for a settlement plan with his creditors. A syndic judge could reject this petition if there was any evidence of misconduct by the debtor. Only if a syndic judge accepted the petition, was it to be subject to the creditors' decision exercised through voting at the creditors' assembly, a stay of claims being possible if the satisfaction of secured creditors was provided for in the settlement.[38] With the introduction of the new Bancruptcy and Rehabilitaion Code in Oct. 2003 this concept was abolished giving way to the debtor oriented "rehabilitaion procedure". In the case of "imminent illiquidity" it provides exclusivly

[37] Until 2005 the old Czech bankruptcy procedure allowed for a 'compulsory settlement' after a trustee has been appointed to wind up the company. During this period, the debtor could present a 'compulsory settlement' plan to the court. This plan was subject to the approval of creditors and the court and had to meet a number of stringent conditions, including the ascertaining of the 'honest intention' of the bankrupt firm by the court.

[38] A petition for restructuring of debts may be rejected by a court if a debtor: a) was already declared bankrupt in the last five years, b) had already a court conciliation agreement in the past, c) had falsified the books (failed to prepare the accounts properly), or d) refused to assist in establishing the value of debtors' estate.

the debtor with the possibility to file for "rehabilitation" and to propose a plan including the possibility of personal management as well as financial restructuring via settlement.[39] The regulation has been widely crisised among legal scholars as well as practicioners since the automatic releif from creditors as for example the ninety (for big companies 120) days automatic stay of claims for entrepreneurs filing for may encourage firms to "escape into bankruptcy".[40] Furthermore the criteria of "imminent illiquidity"seems to unprecise and thus problematic.[41]

The experience of other countries indicates that there is a general suspicion that the managers of financially distressed firms may abuse the automatic relief. Instead, firms should have the possibility of benefiting from a period of 'relief from debt' subject to the approval of courts or creditors in order to ensure that they do genuinely search for a solution. There is also much criticism of the long period of relief - usually 90 days which in some countries even may be extended by another 30 days.[42] There is no genuine reason why the preparation of a reorganisation plan should take so long. It may be more effective if the basic period is shortened but its extension is made subject to the approval of creditors, or with the creditors having the right to end the period immediately if they so prefer.

2. The Annulment of the Debtor's Transactions Prior to Insolvency

Bankruptcy laws usually contain provisions that give 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

[39] A petition for rehabilitation is not possible if a debtor: a) was already declared bankrupt or subject of a liquidation in the last five years, b) had already a rehabilitation proceeding in the last two years.

[40] See J. Lowitzsch, Insolvenzrecht Polen (the Polish Insolvency Law), 2007, in: S. Breidenbach et al. (Eds.); see also D. Niedzielska in Rzeczpospolita of Jan.28th 2003, "The Filig of Bancruptcy" (pl.).

[41] See above III. 1.

[42] E.g. in the Czech Republic, § 115 IC; another example is Hungary with 90 days and a 60 days extension possible, § 11 III, 13I HuBC.

Table 7 – Annulment of Pre-Petition Transactions in Selected Transition Countries and Germany

Country	Regulation to annul / invalidatetransactions	Valid period before insolvency for *actio pauliana*	Burden of proof for fraud / *mala fide*
Bulgaria	Rescinding Action, Art. 647; Invalidity Suit, Art. 646 II CC	1-3 years depending on motive Art.645,647 CC	Creditor / Insolvency Administrator
Croatia	Rescinding Action, Art. 127 – 144 BL	3 months to 10 years depending on motive	Reversal of Burden of proof in case of Close Relationships and Wilful Disadvantage Art.132BC
Czech Republic	Invalidity Suit §§ 235,239 IC; parallel proceedings not possibility, § 42aCivC	3 years § 240 IC, in exceptional cases up to five years § 242 IC	Creditor / Insolvency Administrator
Estonia	Invalidity Suit § 109pp BA	1-5 years depending on motive § 110 BA	Creditor / Trustee unless transaction within 6 months before proceeding § 110 II BA
Germany	Rescinding Action, Art. 129 – 147 IS	3 months to 10 years depending on motive Art. 130 pp IS	Reversal of Burden of proof in case of Close Relationships and Wilful Disadvantage § 130pp IS
Hungary	Rescinding Action, § 40 LRL; Invalidity Suit § 203 I CivC	90 days to 5 years depending on motive, § 40 I LRL	Reversal of Burden of proof for Invalidity Suit §203 I CivC
Latvia	Rescinding action Art. 69-71 LIUC	1month-5years depending on motive Art.69–71 LIUC	Insolvency Administrator / Creditors
Lithuania	Invalidity Suit Art. 11 III 8. EBL, in case of fraud bancruptcy Art 20 EBL; Rescinding Action Art.6.66 III CC	36 months, Art.11 III 8.EBL; 5 years (fraud), Art 20 EBL; 1 year prescription period, Art. 6.66 III CC	Reversal of Burden of proof in case of relatives and Incongruent coverage, Art. 6.67 CC

Poland	Rescinding Action Art. 527-534 Civil Code; Invalidity Suit Art. 127 et seq. BRL	up to 5years Art. 534 CivC; 2 months - 1 year, Art. 127 BRL	Reversal of Burden of proof for Invalidity Suit Art. 527 IV CivC
Romania	Rescinding Action, Art. 80 JRBC	3 years, Art.80 lit. c) JRBC; 120days for transactions from which creditor received more than he would have in insolvency Art. 80 lit. f)	Administrator
Russia	Rescinding Action Art. 103 III FIL / Invalidity Suit Art. 103 VI, VII, 206 I FIL	Rescinding Action 6 months Art. 103 III FIL; Invalidity Suit (in certain cases) 1 year, Art. 103 V, 206 I FIL	Creditor / Administrator
Slovakia	Rescinding Action, §§ 57 pp BRC	1-5 years, § 57 BRC depending on motive	Creditor / Insolvency Administrator
Slovenia	Rescinding Action Arts. 125-130 SCSBL	1 year before the opening of insolvency proceedings Art. 125 II SCSBL	Creditor/Trustee unless: (1) payment of debt that was not due or (2) trans-action within 3mon-ths before petition Art. 125 IV SCSBL

Note: The "Rescinding Action" seeks to set aside pre-petition transactions such restoring the parties to their original positions while the "Invalidity Suit" concerns transactions considered null and void by the law.

Note: The usual "Burden of proof" is reversed by a – rebuttable – assumption that the debtor or concerned third party acted with the relevant intention.

of equal treatment of all creditors (Actio Pauliana), or were fraudulent. As a rule this concerns transfers of the debtor's property made within a specified period before the bankruptcy filing, which were made to insiders or favoured a particular creditor and enabled him to receive more than he would have received in an orderly liquidation. Of course it is not always easy for creditors to prove the debtor's intention to prejudice them and, therefore it is necessary to establish clear rules under which creditors can examine past transactions. In limited number of circumstances, the burden of proof may even be shifted and the debtor may be required to prove that the disputed transactions were

made in good faith. Similarly, the period in which transactions can be disputed should be fairly short – in general less than a year.

Table 7 summarises the rules governing disputed pre-insolvency declaration transactions and the burden of proof in selected countries. As the table shows, the period in which transactions can be disputed and annulled can be quite long in some countries, up to five or even ten years, depending on the motive for such actions. In many countries, too, the insolvency practitioner has the power to shift the burden of proof that a transaction was made in good faith to the debtor. These are usually applied in a limited number of circumstances (e.g. relatives, or persons with a close relationship to the debtor).

3. Liquidation versus Reorganisation?

Once it is established that a firm is insolvent, it is important that the procedure retains the widest possible range of actions for the agents involved (primarily the creditors of course). A well-designed insolvency law prevents the reduction in the value of assets during the insolvency and maximises debt recovery for creditors either through liquidation or through reorganisation. Although liquidation is quicker, it will not necessarily be the optimal solution for all parties involved. The reorganisation option on the other hand provides the possibility of revitalisation of the company and, if successful, will produce better results. Currently, systemic change from dominating productive to dominating service industry is underway whereby the nature of assets is also changing from prevailingly tangible to prevailingly intangible assets (e.g. intellectual property rights, know how etc.). The value of intangible assets is closely connected with their owners and depends on available markets, so that reorganisation will usually produce greater value than liquidation.[43] The general shift towards reorganisation which is currently observed at least in Europe is attributable to this underlying development. In many mature market economies, this alternative is strongly enshrined in the law

[43] See C. Paulus, Entwicklungslinien des Insolvenzrechts, in: KTS 2000, no. 2, pp. 239 et seq., p. 247.

(e.g., the Chapter 11 option under the U.S. bankruptcy laws)[44]. Of course an efficient insolvency law should prevent premature liquidation, but it should also speed up the winding up non-viable firms.

There is an extensive literature and long running debate, largely based on the American experience, on the efficiency of the reorganisation process and whether or not the reorganisation option imposes a significant cost to creditors through the violation of the absolute priority rule.[45] In brief, it is argued that reorganisation may lead to opportunistic behaviour and excessive risk taking by managers aimed at prolonging their tenure. It also increases the bargaining power of the firm (its managers and equity holders) at the expense of creditors. Moreover, as the reorganisation plan has to be approved by a majority of all classes of creditors, some junior and small creditors will obtain greater bargaining power than warranted by their share of total outstanding credit. In response, it has been pointed out that managers have a strong incentive (both their jobs and their reputation in the managerial labour market) to perform well under reorganisation, particularly as they are under much closer observation and monitoring by debt holders. Also, during the reorganisation period, creditors can (and often do) impose a variety of restrictions on managers – such as a maximum debt-asset ratio, a minimum market capitalisation level, maximum administrative expenses, and restrictions on asset disposal and investment. Any renegotiation of terms of debt is with the agreement of senior creditors, who would agree to such alterations only if it is in their interest, i.e., if what they

[44] Even in countries like the United Kingdom, 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 options while the administration option applied to only a small fraction of cases (about 1%) – see BGH, Chapter 2. In March 2002, the British government introduced an Enterprise Bill to the Parliament, in which it has taken measures to make 'administration', and not 'receivership', the normal route in insolvency, trying to encourage the reorganisation of insolvent firms.

[45] For a survey of the literature and an assessment of the arguments for and against reorganisation, see I. Hoshi, Bankruptcy, Reorganisation, and Liquiditation in Mature Market Economies: Lessons for Economies in Transition, in: Balcerowicz, L., Gray, C. W., Hashi. I. (eds.), Enterprise Exit Processes in Transition Economies, CEU Press: Budapest 1998, and sources cited there.

receive under reorganisation exceeds that under liquidation. As Bird and Jackson have pointed out, in the course of reorganisation, the senior creditors may "convey an interest to anyone they please" as they have reached the conclusion that any change to the original terms of the contract is "in their interest" (Baird and Jackson, 1988, p. 743).

Although the bankruptcy laws of transition economies were predominantly based on the German insolvency code, their treatment of the creditor-debtor conflict as well as their preferences for the liquidation-reorganisation choice can be very different. The specific characteristics of the transition process highlight the special relevance of the reorganisation option for transition economies. For many companies, the cause of financial distress was not in the revenue-cost streams of the firm but often lay outside the firm itself. State owned firms faced financial distress because the systemic change affected their input and output 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 defaulted on their debts. 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. It would have been premature to push these enterprises to bankruptcy only because they had defaulted on due debts. Many of these enterprises would be able to resolve their problems and operate in a market economy successfully if they are allowed some time to restructure their debts. 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, i.e., to distinguish between viable and non-viable enterprises.[46]

The reorganisation option, 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 work out should be provided for. Examples of such actions are: debt forgiveness, reduction in interest payment, debt for equity swap, and similar mea-

[46] This is linked to the problem of the 'positive survival and return forecast' discussed in the context of the insolvency triggers; see above III. 1.

sures in return for commitments by managers such as changes in the composition of the boards, changes in production lines, investment plans and asset structure.

Although the bankruptcy laws in all countries include the provisions for reorganisation, the emphasis on this option is very different in different countries. The advanced transition economies have had a variety of experiences which can provide useful examples for countries with less experience in insolvency proceedings. In Hungary, with massive insolvency declarations at the early operation of the bankruptcy law (discussed above) 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 proceeded to complete a reorganisation plan.[47] In the Czech Republic, however, the law created inherent obstacles to reorganisation. The 'ordinary settlement' and 'compulsory settlement' options involved meeting extremely difficult conditions.[48] Furthermore, in the Czech bankruptcy law, the creditors were unable to propose their own '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, the court conciliation (or settlement) option was a rather inflexible process when compared with reorganisation processes in mature market economies and, as a result, there have been only a

[47] For details see M. Szanyi M., Market Exit in Hungary 1990-1994, manuscript, Warsaw: CASE Foundation 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' settlement with their creditors (and achieve the same outcome as the 'reorganisation') but in a simpler manner.

[48] These include acceptable arrangements for the satisfaction of 45% of the non-priority claims in two years (under ordinary settlement) and 33% of non-priority claims in one year (under compulsory settlement). Given the very high inter-enterprise debt at the early stages of transition, it was almost impossible to meet these conditions. On top of this, the debtor had to establish her/his 'honest intentions', to proceed with reorganisation, thus adding to other less subjective difficulties. For details, see I. Hashi, J. Mladek, A. Sinclair, Bankruptcy and Owner-Led Liquididation in the Czech Republic, in: Balcerowicz, L., Gray, C. W., Hashi. I. (eds) Enterprise Exit Processes in Transition Economies, Budapest: CEU Press, 1998.

small number of reorganisations under the 'settlement' option in 13 years of transition. In order 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.[49] The Programme was a success, mainly due to its untypical pattern: instead of centralisation of bad debts in a special new institution, the Programme required banks and their indebted clients to work out a solution during a limited time, reduce the indebtedness of both and make them of value to potential private investors.[50] These shortcomings of the old Bankruptcy Law have been taken into consideration and the new polish Bankruptcy and Rehabilitation Code of 2003 thus is much more reorganisation oriented.

In mature market economies too, there are arrangements outside the bankruptcy procedures which are often employed to speed up the process. In the United States, the 1978 Bankruptcy Reform Act (and its supplementary legislation in 1994), provide for a formal, but privately arranged 'workout' as an option for financially distressed firms. Workouts involve negotiations between debtors and creditors over a reorganisation plan which is agreeable to creditors but would also avoid lengthy court-based litigation. This type of agreement is obviously cheaper and speedier but it cannot benefit from court protection, stay of claims, tax advantages and bank borrowing on favourable terms, benefits that are available to firms in court-based reorganisation. This path is particularly beneficial if firms have fewer creditors, the main creditors are banks and

[49] For details, see W.C. Gray and A. Holle, Classical Exit Processes in Poland: Court Conciliation, Bankruptcy, and State Enterprise Liquiditation, in: Balcerowicz, L./ Gray, C. W. / Hashi. I. (eds.), Enterprise Exit Processes in Transition Economies, Budapest: CEU Press 1998 and E. Balcerowicz and A. Bratkowski Restructuring and Development of the Banking Sector in Poland: Lessons to Be Learnt by Less Advanced Transition Countries, CASE Reports no. 44, Warsaw: CASE 2001.

[50] In addition to these special mechanisms, general procedures such as court conciliation agreement, civil conciliation agreement, bankruptcy procedure, and liquidation procedure were also applied in the Programme.

financial institutions and when firms have more intangible assets (whose value may be lost during a long drawn out procedure).[51]

The creditor-debtor orientation of the law can be judged by several criteria: a) Does the bankruptcy process aim, ex ante, to preserve the firm as a going concern? b) Does the process encourage or discourage reorganisation, and how difficult are the conditions for reorganisation? c) Do managers of a defaulting firm remain in charge during the reorganisation period? Table 9 summarises the characteristics of the reorganisation option in the countries under consideration.

The time limit for submitting a reorganisation option varies across countries, ranging from two weeks to four months and some times it is possible to extend the period. The reorganisation option, 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. To facilitate the reorganisation option, it is also necessary to avoid opportunistic behaviour amongst creditors, especially when one group tries to withhold its consent to a reorganisation plan in order to strike a better bargain (hold-outs). While it is essential to retain the agreement of creditors for a reorganisation plan, it is crucial that some creditors are not 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 the mortgaged assets, all classes of creditors should be involved in the reorganisation plan and a majority of them should accept the plan.

[51] For details of a study of eighty financially distressed firms engaged in private workouts, see Gilson, John, Lange 1990, and for a comparison of the performance ofworkouts and reorganisations in a sample of 82 firms, see Franks / Torous (1994). In the U.K. large firms in financial distress often embark on an informal procedure known as the 'London approach', originally devised by the Bank of England in the 1970s (http://www.bankofengland.co.uk/londapp.htm). This procedure, which is not a part of the Insolvency Act, seeks to restructure the firm's finances with the unanimous agreement of creditors, and without publicity (which may damage the firm's position in the market).

Table 8 – Features of Reorganisation Options in Selected Transition Countries and Germany

Country	Regulation	Time limit for submitting proposal	Reorganisation period	Approval rate of creditors / group of creditors
Bulgaria	Reorganisation (Reorg.) Art.696, Sale as going-concern (TS) Art.706a CC	30 days, Art. 698 CC	TS: in 30 days, Art. 706a CC	Simple majority and ½ of value of claims, Art.705 CC
Croatia	Reorg. Art. 213-265 BL; TS Art. 163a-163m BL	No later than final distribution meeting, Art. 214 BL	not foreseen	Reorg.: Simple majority of each group and ½ of value of claims Art. 240 BL; TS:majority and ½ of value of claims Art.163aIII BL
Czech Republic	Reorg. §§ 316 et seq. IC, (special rules for insurances and banks)	10 days before first creditors meeting, then 120 days § 318 II IC	As set in reorg. Plan, § 340 IC	Simple majority of every group of creditors according to their value of claims, § 347 I IC
Estonia	Rehabilitation (Reh.) / Cont. § 129EBA	1st creditors general meeting § 129III BA	not foreseen	Simple majority § 81 BA
Germany	Reorg. Plan, §§ 217-269 IS	No later than final distribution meeting § 218 IS	not foreseen	Simple majority of each group & ½of value of claims §244I; prohibition to obstruct §245 IS
Hungary	Reorg.: §§ 7-10 LRL; Composition in liquidation, §§ 41, 44, 45 LRL	Reorg.: 90 days and 60 days extension possible § 11 III, 13 I LRL	not foreseen	Reorg. § 9 IV LRL: ½ of creditors of due claims, ¼ of creditors of immature claims and 2/3 of all claims; Composition in liquidation § 44 I LRL: ½ of creditors holding 2/3 of claims
Latvia	Settl.: Art.77-86 LIUC; Reorg.: Art. 87-99 LIUC	Settl.: until auction of the property of a debtor Art. 77 LIUC; Reorg.: only if Settl. not proposed / rejected / revoked, Art.89 LIUC; within 2 months from decision Art.93 LIUC	Art. 94 III LIUC max. 10 years	Settl.: 3/4 of value of claims if less than ½of the total amount (2/3 if ½or more) of claims concerned Art.82 LIUC; Reorg: 2 of 3 groups` appro-val by majority vote of ½ of value of claims, if at least one of them would be treated worse in bankruptcy Art.95 IV LIUC

Lithuania	Art.28, 29 EBL – Composition agreement (Comp.); Art 13 LRE – Restructuring Plan (Restr.Plan)	Art.28 III EBL – Comp. until court order to liquidate firm; Art 15 VIII LRE max.4 (ext.1) months for Restr.Plan	Art 13 II LRE - Reorg. Period max.4 (ext. 1) years	Art. 15 IV LRE – majority vote of 3/4 of all proven claims when voting collectively; Art 15 V LRE – qualified majority when voting in groups (all mandatory groupts + 2/3 of aggregate amount of claims must vote in favour).
Poland	Reh. Art. 492 et seq., Settl. 267 pp; Cont. Art 51, 180 pp, 312; TS Art. 316 p.BRL	Settl.: 30 (ext.90) days from opening decision Art.267BRC ;Reh.SMEs3 (others4) months Art. 519 BRL	not foreseen	Reh./Settl. simple majority vote in each group of 2/3 (in early meeting 3/4, Art. 45) value of claims, Art. 285, 510 BRCle
Romania	Plan, Art. 94 pp; Reorg. Art. 103 pp JRBC	Within 30 days after Verification Meeting Art. 94 JRBC	Effecting Plan within 3 years Art.95 III JRBC	2 of 4 groups approve by majority vote of 2/3 of value of claims, none treated worsethan in liquidation, Art. 101JRBC
Russia	Pre-trial Reh.Art.31 FIL; Financial Reh.(FR), Ch. 5 FIL; External administration (EA), Ch. 6 FIL; Composition, Art. 150 II, 162, 164, 167 FIL	FR Art.76II FIL: 15days before Creditors' Assembly; EA Art.106 I FIL: within 1 month from appointment,	FR Art. 80 VI FIL: 2 years; EA Art. 93 II FIL: 18 (ext.6) months,	FR and EA Art.15 II, 107 III FIL: simple majority of creditors Composition Art. 150 II FIL: simple majority and all secured creditors
Slovakia	Reorg.: §§114 pp BRC; Discharge of residual debt for physical persons §§166et seq.BRC	Reorg.: anytime before court decision on bankruptcy	not foreseen	Majority vote in creditor assembly and in each group of creditors, § 148 BRC
Slovenia	Financial Reorg. within coercive settl. Art. 46 – 58 SCSBL	3 months for Financial Reorg. Plan Art.46 SCSBL	not foreseen	60% vote of value of claims Art. 56. SCSBL

Although the approval percentage varies in different countries (and in practice it has often been relaxed when it has been too restrictive), a reasonable majority (of for example two thirds) seems to be the common threshold in the countries under consideration. A high approval

percentage gives disproportionate power to small creditors (and disadvantages large creditors) and a small approval percentage it may disenfranchise too many creditors. As Table 8 shows, he approval process in the countries under consideration is relatively uncomplicated, with a simple 2/3 majority of creditors, accounting for over 50% of the value of credits being the criteria in most countries. Also, in Bulgaria, Estonia, Hungary, Russia and Slovenia, creditors are not grouped into different categories with the approval of all or most categories necessary for the reorganisation option. This is in complete contrast to the provisions in some mature market economies. Given the problem of 'hold outs', and the lack of experience with the bankruptcy in transition, the policy of treating creditors as one group may in fact speed up the very slow reorganisation process.

The reorganisation period should be time-limited and the creditors must always have the option of revoking their initial agreement and convert the process to liquidation. An increase in the role of creditors in the insolvency process provides greater assurance for creditors and encourages the credit market. But only in Latvia, Lithuania, Romania and the Russian Federation the law envisages a period ranging from 1 to 10 years under reorganisation, with other countries remaining silent on this point. In these countries, generally, the creditors are able to assert their right and stop the process if they feel it is taking unduly long time.

4. Replacement of Managers

Once the reorganisation option is selected, a decision has to be made on whether the existing managers should remain in charge of the firm or not. On the one hand, there is the argument that 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 would be more willing to file for bankruptcy early, as soon as they become aware of signs of the potential insolvency.[52] This would allow them time to pre-

[52] This may be achieved by providing incentives for managers to declare insolvency as early as possible, as it has been done in Germany (see Table 5).

pare a rescue plan before the 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.

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 and consequently harm the creditors. For this reason in many countries the managers are deprived of their posts once the firm enters the insolvency process. In the U.K., the declaration of default leads immediately to the appointment 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) by the court. In Germany and the Czech Republic[53], too, the courts appoint a court official to oversee the fate of an insolvent firm (whether it is liquidation or reorganisation). Given the importance of protecting creditors from opportunistic behaviour, which is common in transition economies, there may be an argument for ensuring that an outsider (appointed by creditors) is in overall supervision of the firm.

VI. Disposal of Assets

If the insolvent firm opts for the 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

[53] The Czech bankruptcy law includes one option (§§ 115 et seq.) under which the management remains in charge during the protection period and prepares 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.

(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 of an appropriate incentive package for the liquidator (more on this later). Two issues need to be discussed in some detail here.

Firstly, 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. Secondly, 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.

1. The Position of 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.[54]

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.[55] According to the World Bank, for a loan secured by real estate, a borrower could expect to obtain a loan more than eight times larger, repay-

[54] See Fleisig, "Integrating the Frameworks for Bankruptcy and Secured Transactions: Economic Issues", CEAL Issues Brief No.1 Oct. 2000.

[55] See Debtor Creditor Rights Working Group, Report of Working Group on Debtor Creditor Rights, paper at the Washington, D.C. Symposium on 09.29.1999.

able 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.

Given the role and importance of secured credit, the legal systems in mature market economies almost always give secured creditors priority over other creditors and also allow them to claim their security outside the bankruptcy process[56]. However, some systems of bankruptcy (for example in Romania, Latvia, Poland Croatia and Bulgaria) 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.[57] 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 the related social benefits of increased economic activity. As a solution to avoid giving priority to these unsecured debts it is proposed to file a fixed or a floating lien in the debtor's property at the time that the debt to the state or workers was created. Other debtors, both secured and unsecured, could be made aware of the borrower's obligation to these lien holders, and thus of its creditworthiness.[58]

[56] One exception being the U.K. Insolvency Proceedings which allow the seizing of secured assets only if this does not stop the operation of the debtor altogether. But even here, the secured creditor has the right to appoint a 'receiver' to speed up the process of orderly liquidation in order to dispose of the said security in the interest of the lien holder.

[57] This is not to be confused with regulations allowing security interests and other transfers to be set aside where they were taken in circumstances such that it would be unfair to the general bankruptcy creditors to allow the priority, for example, where at the time of the grant of the security interest the debtor was insolvent and the security was given for past value or by way of preference of one creditor at the expense of others. See ab. V.2.

[58] Fore details, see Fleisig, "Integrating the Frameworks for Bankruptcy and Secured Transactions: Economic Issues", CEAL Issues Brief No.1 Oct. 2000 p. 2 et seq.

Table 9 - Position of Secured Creditors in Selected Transition Countries and Germany

Country	Priority of secured creditors	Priority of unsecured over secured claims	Interference of reorganisation with rights of secured creditors
Bulgaria	Absolute priority, Art.722 I Nr.1 CC / Art.634 III CC	Debts to the state, Art. 638 I CC	Stay of execution and change of status possible[i], Art.706 CC
Croatia	Absolute priority, Art. 81 BL	Debts to the state, Art. 83 Nr. 4 BL	Stay of execution possible, change of status if sale as going concern, Art.163 a BL
Czech Republic	Absolute priority §§ 298 et seq. IC; less 5% liqudation and 4% admin. costs	None	Stay of execution possible if Reorg. Plan provides for
Estonia	Absolute priority § 153 BA	Max 15% deduction for costs of proceedings § 146 BA	Stay of execution possible § 182, Credit for Continuation of business may be given priority § 186 BA
Germany	Absolute priority, § 170 IS	None	Stay of execution possible, § 213 IS; compensation for use, §172 I IS
Hungary	Absolute priority §§ 57lb, 49d LRL	None	Stay of execution possible, §§ 12 III, 34, 35, 38 LRL
Latvia	Absolute priority, registered lien independently executable Art. 68 LIUC	State debts, wages for workers, payment to companies for agricultural products, Art. 107 LIUC	Stay of execution in settlement / reorganisation procedure possibile Art.90 II LIUC
Lithuania	Art. 34 EBL / Art. 14 I 1), III LRE – Absolute priority, registered lien independently executable	Only legal and administrative costs (Art 36 EBL)	Stay of execution possible if Restructuring Plan does not provide for the sale of pledged property

Poland	Absolute priority Art. 306 et seq.; registered lien indipendingly executable Art.314, 327 BRL	Chosen privileged personal creditors debts, Art. 346 BRL	Stay of execution in settlement procedure possible, Art. 141, 146 BRL
Romania	Absolute priority, Art. 123 JRBC	None	Stay of execution and change of status possible, 103, 104 JRBC
Russia	Absolute priority, except 1st/2nd priority claims arisen before security established Art. 82 VI, 136 IV no. 5 FIL	New money, obligations occured after opening decision, public utility expenses of Ent.cont. Art.134 I FIL	Stay of execution possible, e.g. EA Art. 95 FIL, if sale collides with continuation of enterprise Art. 111 I FIL
Slovakia	Absolute priority, § 94 BRC	Only specified claims arisen after the begin of bankruptcy § 87 BRC	Stay of execution, § 114 I BRC
Slovenia	Absolute priority Art.131-134 SCSBL	None	Stay of execution possible Art. 36 SCSBL

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

Table 9 presents the position of secured creditors and identifies the restrictions on their rights in selected group of countries.

The rights of secured creditors may be in conflict with preserving the value of the firm, as the latter must nearly always require a stay of execution of the secured creditors' rights and a risk that they will be diminished in the course of the reorganisation proceedings. The individual interest of a particular creditor who has bargained for security is in conflict with that of unsecured creditors when it comes to the withdrawal of assets essential to the running of the business and for its reorganisation. The conflict is exacerbated when the procedure aims at reorganizing a company or disposing of its business on terms more favourable than that secured by liquidation. In this situation even for the most ardent advocates of the principle that insolvency law should respect pre-insolvency entitlements it seems difficult not to conceed that

some sacrifices have to be made by secured creditors in order to help to maximise benefits for the creditors as a whole.

One solution to balance the competing interests is to recognise the secured creditor's rights but to restrict their execution for a given short period (if the period is substantially long, the secured creditor's rights will be undermined). Another possible solution is to provide for arrangements under which 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.[59] If rehabilitation rules are to be effective, they must be flexible in their approach and must provide procedures for preventing a sensible plan being substantially delayed by a dissentient minority and allow the plan to be imposed on that minority (albeit with suitable safeguards) for the benefit of the interested parties as a whole.[60]

2. Efficiency of the Reallocation of Assets of Insolvent Firms

A further important economic function of bankruptcy is the efficient allocation of assets from non-viable to viable use. Transition economies are particular from this respect too, since they inherited from the previous regime not only debt but also capacities (assets) that were created to meet the logic of central planning rather than the market. These assets needed to be either reorganised within the same company, sold to a new owner, or scrapped. While the reorganisation option may facilitate the restructuring debtor's company, the liquidation option leads either to assets restructuring carried out by a new owner, or to the partial or total elimination of physical assets.

[59] The issue is part of a wider debate on the extent to which bankruptcy law should have a redistributive role which goes beyond the avoidance of suspect transactions and the conferment of super-priority to certain types of debt; compare Debtor Creditor Rights Working Group, Report of Working Group on Debtor Creditor Rights, paper at the Washington, D.C. Symposium on29.9.1999.

[60] Under the "cram down" procedure of Chapter 11 of the American Bankruptcy Code the court can impose on any class of creditors, including secured creditors, a plan which varies their rights (e.g. by extension of the period of payment) so long as the plan is fair and equitable.

At the early stage of transition the governments of course were 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.[61] Countries with strong trade union movements also had serious difficulties with the extension of the effect of bankruptcy laws to large loss-making SOEs.[62] The restructuring and sale of assets was initially undertaken by companies themselves, writing off the non-viable parts of their portfolio and their loss making activities in order to improve their financial position. Downsizing was carried out by managers exactly for the purpose of avoiding insolvency.[63] However downsizing took place even in countries without an effective insolvency system.

An analysis of the Hungarian reorganisation plans showed that their contents were mainly financial relief. Debt rescheduling, write-off of penalties, interest reduction and immediate cash payment to small creditors were the most common items of the plans. The plans also contained longer-term proposals for the restructuring of activities. The initial step in this direction was usually the sale of redundant assets (especially real estates).[64] Revenues from asset sale were usually used for

[61] In the Czech Republic and Slovakia for example firms participating in the voucher privatisation scheme were exempt from the bankruptcy law. In Romania, SOEs were, and still are, exempt too.

[62] This was particularly the case in Poland, but there were similar examples in other transition economies too.

[63] The magnitude of the process was estimated at a 20-40% reduction in employment and production in Poland, Czech Republic and Hungary. The different bankruptcy regimes of the three countries affected mainly the sequencing and timing of social costs occurring with market exit. For details BGH, Chapter 4.

[64] In many cases, however, major pieces of assets were sold already prior to the bankruptcy procedure. The revenues from asset sale were usually used for further financing daily activities. Many "drifting companies" lost much of their asset value this way.

debt repayment and not for the creation of new capacities or the purchase of new assets. New loans were extended only sporadically.[65]

From a wider perspective it is also important to know how the assets sold in bankruptcy are used in the hands of new owners. Hungarian experience shows that firms sold as going concerns or complete sets of assets were sold most efficiently.[66] Real estates were also sold quickly, after environmental clean up, and used for new and different activities such as office space (and less frequently as workshop or other production premises). Machinery and equipment which were not part of a going concern were usually scrapped. Furthermore, a comparison of bankruptcy-related asset sale with ordinary asset transfers[67] indicated no major difference in the efficiency of the use by new owners. This means that assets sold in bankruptcy procedure, were used in similar patterns by new owners as if it was purchased outside the bankruptcy process. The efficiency of the usage did not depend on the procedural background of the asset. It mainly depended on the quality of new owners.[68] The successful restructuring of bankrupt firms' assets depended very much on the presence of strong foreign investors. Going concerns were also sold at better conditions. A bigger part of their activity was maintained or recreated, and sales prices were also substantially higher. No strong evidence was found for the impact of the bankrupt firm's quality (e.g. the level of indebtedness) on the efficiency of the asset use.

[65] W. C. Gray, S. Schlorke, M. Szanyi, Hungary's Bankruptcy Experience, 1992-93, The World Bank Economic Review 1996, 10(3): 425-50.

[66] This experience seems to be reflected in some of the most recent amendments to bankruptcy laws e.g. in Poland, Croatia and Bulgaria, where the Sale as a going concern (Trade Sale) is favoured to other methods.

[67] M. Szanyi, Life After Death: Is It Efficient to Reallocate the Assets of Financially Distressed Firms?, Institute for World Economics, Working Paper no. 120, October 2001.

[68] Large and properly capitalised foreign companies were most efficient.

VII. Summary

1. Recent Trends

In the EU-15 policy guidelines prepared by the European Commission as a reaction to findings of the Best Procedure Project include incentives for early reaction to financial difficulties, easy access to reorganisation and speedy and efficient liquidation proceedings.[69] Accordingly, the following priorities have determined the insolvency law reforms in EU-15: (1) incentives for reorganisation[70]; (2) incentives for informal workouts[71] and administrative restructuring[72]; (3) priority for new money[73]; and (4) incentives for debtor's petition in the case of imminent illiquidity (esp. in Germany 1999). In response to this development, in the last years, most Eastern European countries[74] have either fundamentally reformed existing laws (Croatia, Bulgaria, Romania, Russia), adopted new insolvency laws (e.g. Lithuania 2001, Estonia 2003, Poland 2003, Czech and Slovak Republics both 2006) or are planning a funda-

[69] For further detail on the project see H. Reichenbach and S. Herrero Rada, Entrepreneurship, business failure and starting afresh: the work of the European Commission, in: Price Waterhouse Coopers, The European Restructuring and Insolvency Guide 2005/2006, London 2005, pp. 22-25.

[70] E.g. Germany 1999; France 2005: "sauvegarde", debtor-in-possession; Italy 2004: composition for small enterprises, external administration for large enterprises; England and Wales 2002-2003: incentives for administration and voluntary arrangement; the Netherlands 1999: moratorium with a special stay; Sweden 2004: reorganisation and tax incentives.

[71] E.g. France, 2005: reform of "procédure de conciliation"; Italy 2000: voluntary code of conduct for banks based on the London approach; the Netherlands: recent court orders recognising out-of-court agreements where dissenting creditors acted against the principles of reasonableness and fairness.

[72] E.g. Italy 2004: filing with the Ministry for Productive Activities for large enterprises; Portugal 2004: debtor-creditor negotiations under control of the Institute for support of small enterprises for small enterprises, tax incentives for consenting creditors and employees acquiring shares of their enterprises.

[73] E.g. Germany 1999; Italy 2004; the Netherlands 1999; Sweden 1987.

[74] See also A. Bormann and N. Spitsa, Specific features of insolvency law in Eastern European transition countries, Jahrbuch für Ostrecht 2007, Volume 1, pp. 11-36.

mental reform for the next years (Latvia 2007, Hungary 2007). The main joint issues of the reform are:

- improvement of reorganisation proceedings (e.g. Lithuania 2001, Estonia 2003, Poland 2003, Czech and Slovak Republics both 2006 and Latvia – reform planned);
- stricter state control over administrators (e.g. Latvia 2006, Hungary 2005, Bulgaria 2003);
- simplified proceedings for debtors-in-absentia (e.g. Estonia 2005: facilitation of commencement, Hungary 2005: automatic commencement by the registration court).

However, some problems have not yet been addressed or not been efficiently dealt with by the reforms in the past. The most obvious examples are:

- long commencement period (e.g. Czech Republic: 3 months or more, Lithuania: 3 months, Hungary: 60 days, Croatia: 2 months, Slovakia: 30 days;
- slow proceedings (e.g. Slovakia: up to 5 years, Croatia, Romania);
- reorganisation still inefficient in all Eastern European countries;
- low recovery rates for creditors in liquidation, partly due to late commencement (e.g. Hungary, Slovakia);
- only a few laws (Czech and Slovak Republics, Estonia, Russia) provide for special provisions for consumer insolvency.

2. Conclusions

In the early stage of transition to a market system, the former socialist countries inherited a large number of inefficient state owned enterprises, with many of them suffering from insolvency. Different governments responded to the problem differently, and brought about different results. In some countries (like Romania for example) subsequent governments protected the 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, governmental restructuring programmes turned out to be a total failure, but the government continued to inject money and write off the debts of these enterprises. The main reason for these actions was the short-sighted political inter-

ests of parties in power. In other countries, however, the opposite approach was chosen. The original 1992 bankruptcy law in Hungary introduced an automatic trigger mechanism which resulted in a massive bankruptcy filings at the early stage of transition. The Hungarian approach turned out to be 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 of these experiences is that the 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 involved, as they only delay the necessary restructuring. From the macroeconomic point of view they are not only expensive, but also slow down the reallocation of resources and growth of the economy.

There are two types of deficiency that can be identified in the insolvency systems of transition economies developed over the past 12-15 years: the shortcomings of the insolvency laws themselves, and deficiencies in the execution of insolvency laws. The second group can be mostly explained by the underdevelopment of institutions that are necessary for the law to operate.

As far as the first group of deficiencies is concerned, in addition to the limited coverage of insolvency laws, there are problems relating to how the law regulates the triggering of the insolvency procedure, 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 (as in the Czech Republic at the early stage of transition), then the number of filings would be very low and the insolvent companies would prolong their activities at the growing risk of creditors. The second important issue concerns the range of options available once the insolvency procedure is initiated, and specifically the room for reorganisation of the debtor company. The reorganisation option has been of even greater importance in transition economies than it has been in mature market economies as, for many companies in post socialist countries, the causes of financial distress often lay outside the firm itself, be it state owned or private. However the approach differed in individual countries. While the Hungarian law was very 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 in order to prevent premature closures in the early transition period, the 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.

While insolvency laws have been subject to numerous amendments in transition countries in order to deal with their obvious defficiences, the shortcomings of the legal institutions necessary for the efficient operation of insolvency laws have been much more difficult and time consuming to resolve. At the start of transition, CEE countries were characterised by a shortage of court personnel, specialised chambers and competent administrators organised in professional associations. Also in the course of transition the administrative capacity was not developed at a sufficiently fast pace to cope with the rapid growth of court cases resulting from the operation of the market system and the increased role of the judiciary in the new economy. A continuing problem is the poor system of legal education which produces judges with insufficient knowledge of economic and financial matters. 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 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 and its extension and at the end when the case is being completed. 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 the implementation of the 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 includes legal sanctions and appropriate rewards and penalties for the court-appointed officials.