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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1. Introduction

a) Historical Background

The Bulgarian insolvency law has its origin in 1897 and was based on the Italian Commercial Code. By the Law of 29 March 1932, a "precautionary concordat" was introduced based on the German model. This regulation has been effective until 30 June 1951 when the Commercial Law containing provisions on the precautionary concordat and insolvency in general was abolished. After the collapse of the command economy in 1989, insolvency proceedings have again become a necessary institute for creditors' satisfaction, and the corresponding legal regulations were introduced by Decree no. 56 on Economic Activities. Finally, the current regulation was adopted in 1994 by amending Part IV of the Commercial Code (hereinafter referred to as CC) of 1 July 1991.

b) Reform Objectives

The CC was substantially amended in 2000 und 2003[123]; the amendment contained the following important provisions:

- extended control of the insolvency administrator by a stronger position of the creditors' meeting[124] in relation to the court concerning appointment, control and replacement of the administrator and Determination of his remuneration;
- acceleration of the insolvency proceedings by shorter terms;
- introduction of special provisions on liquidation in insolvency instead of a reference to the Code of Civil Procedure (hereinafter referred to as CCP);
- introduction of a new control organ;

[123] Several amendments of 2000, e.g. the three-stage protection, were abolished by the amendment of 2003, see A. Katzarski, Targovski zakon - Komentar (in Bulgarian), Sofia 2003, p. 28 et seq.

[124] See D. Parusheva, The new opportunities for creditors in insolvency proceedings after the 2000 amendment (in Bulgarian), Pazar i Pravo 2000, XII, p. 36.

- introduction of debt-equity-swap in reorganisation;
- introduction of a special examination, continuing education and insurance obligation for insolvency administrators.

By recent amendments of 2005 und 2006, the following provisions were introduced:

- amendment of the legal definition of insolvency;
- two-stage channel of appeal;
- stronger protection of employees during insolvency proceedings;
- introduction of examinations for admission and extended insurance obligation for insolvency administrators;
- amendments concerning the obligations for publishing according to the new Law on Commercial Register.

2. Commencement of Insolvency Proceedings

a) Principles of Procedure and Legal Protection

The insolvency proceeding is a written proceeding following an insolvency petition which leads either to commencement of proceedings or to the rejection of the petition by the court or, under certain conditions, to the termination of proceedings. Pursuant to Art. 621 CC, the CCP is to be applied to insolvency proceedings by analogy, as far as the CC does not contain special provisions. Art. 621a CC inserted in 2006 prohibits change of venue for insolvency proceedings determined by law and introduces the principle of official investigation. In addition, the provisions of CCP on termination of proceedings by approval of the parties and on the basis of withdrawal of the petition or the action by the creditors are not applicable.

Two stages of proceedings can be determined:

1. commencement of insolvency proceedings pursuant to Art. 630 et seq. CC (Determination of illiquidity or over-indebtedness of the debtor and preparatory measures for satisfaction of creditors),

2. if a reorganisation plan is not approved or not fulfilled adjudication of the debtor as bankrupt should be declared pursuant to Art. 710 et seq. CC (satisfaction of creditors as a result of liquidation of debtor's assets).

Both stages of proceedings can be combined on the basis of application of the debtor,[125] the insolvency administrator, a creditor or the Agency for State Claims by the court if it is evident that the continuance of the debtor's business activities endangers the assets (Art. 630 para. 2 CC). This decision should be met as a part of the court order on commencement or, at the latest, before the end of the term for proposing the reorganization plan, one month after the end of the term for giving notice by creditors.[126] Apart from these two exceptions, the insolvency proceedings consist of the above two stages.

If debtor's assets are not sufficient, the first court order consists of commencement, adjudication of the debtor as bankrupt and termination of proceedings (Art. 632 CC). If the debtor covers the court costs in advance he can avoid the termination of proceedings. The court costs are estimated by the court considering the specific features of the case and have to be covered within a term determined by the court according to Art. 629b CC (introduced in 2006). Pursuant to Art. 631 CC, the court can reject the insolvency petition if it is established that the financial difficulties of the debtor are temporary or he possesses sufficient assets to meet his obligations in relation to all creditors, whereby the creditors' interests should be not endangered. Since 2003, the debtor has a claim for damages according to Art. 631a CC if the creditor who had filed the insolvency petition acted deliberately or with gross negligence.[127]

If the proceedings are commenced on the basis of a creditor's petition, the burden of proof lies upon the debtor. If the petition is filed by

[125] The debtor is not allowed to withdraw the petition, since declaration of his insolvency is not only a right, but also a duty, Court Order no. 248/08.04.2002 of the Supreme Cassation Court, Pazar i Pravo 2003, VII, p. 46.

[126] The provision of the 2000 amendment was hereby abolished see A. Katzarski, Targovski Zakon - Komentar (Commentary to the CC), Sofia 2003, p. 29.

[127] The term damages in the sense of this article embraces all direct pecuniary and non-material damages. If the petition is filed by several creditors they are jointly liable.

the debtor, the court has to collect evidence ex officio. In contrast to court decisions in civil cases, the court orders in insolvency cases are effective erga omnes. The court order on commencement of insolvency proceedings is provisionally enforceable pursuant to Art. 634 CC. All court orders (e.g. Art. 630 (1) (2), Art. 631 and Art. 632 CC) are published only by registration in the Commercial Register since 2007.[128] An appeal can be lodged within seven days after publication.[129] The debtor has a claim for damages according to Art. 631a CC if the creditor who had filed the insolvency petition acted deliberately or with gross negligence and the petition was rejected by the court.

Pursuant to Art. 634a et seq. CC, measures for protection and administration of debtor's assets, appointment of the insolvency administrator and determination of creditors' claim, including their amount, legal ground, privileges and attached securities, follow the court order on commencement. However, a provisional insolvency administrator can be appointed before the interim court order on protection of debtor's assets according to Art. 629a CC. After the creditors give notice of their claims and the claims are approved by the court, the first stage of proceedings ends.

If no reorganization plan is agreed upon and approved or it is not fulfilled, the adjudication of the debtor as bankrupt as the second stage of proceedings follows. Only after adjudication debtor's assets are seized, i.e. the debtor is not authorized to administrate them or to dispose of them. After realisation of assets and distribution of proceeds, the insolvency proceeding ends with a report of the insolvency administrator before the court and the creditors' meeting.

[128] The new Law on the Commercial Register became effective on 1 July 2007. Almost all court decisions and amendments to the articles of association of corporations which had to be published in the official gazette, must now be published only in the Commercial Register.

[129] According to the case law, only the parties participating in the proceedings in trial court have the right to lodge an appeal, although court orders are effective erga omnes.

b) Scope and Applicability

According to Art. 608 para. 1 CC, the insolvency law is only applicable to merchants, and the insolvency is therefore defined as "merchant's insolvency". Commercial companies (Art. 64 CC) and co-operatives, with the exception of housing construction co-operatives, are regarded as merchants. Insolvency proceedings can be commenced also in relation to commercial companies in liquidation. The court order on commencement of insolvency proceedings interrupts liquidation, includes adjudication of the debtor as bankrupt (Art. 630 para. 2 CC) and termination of the insolvency proceeding.

The insolvency law is also applicable to dormant partners, even if they are no merchants, but invested in a merchant's business (Art. 609 CC). If the insolvency proceeding is commenced in relation to a partnership, it is, at the same time, commenced in relation to partners with unlimited personal liability (Art. 610 CC). This concerns general partnerships, limited partnerships and capital limited partnerships as well as their unlimited partners. If unlimited partners are merchants, separate insolvency proceeding can be opened, but, generally, only one insolvency proceeding is commenced.

The so-called insolvency proceeding upon death is conducted in the case of death of a sole proprietor or of an unlimited partner. The insolvency proceedings are commenced in relation to the heirs who accepted the inheritance, irrespective of the fact whether they are merchants. The pre-condition according to substantive law is that the deceased was a merchant and insolvent at the time of death. Additionally, the petition must be filed within one year after death. The liability of the heirs is limited by the amount of the deceased's estate. It is also possible to commence insolvency proceedings against a merchant or an unlimited partner whose firm or, respectively, name has already been deleted from the Commercial Register. Pre-conditions for commencement are the same as in the case of insolvency upon death.

c) Special Regulations

Provisions on insolvency proceedings do not apply to non-profit associations, foundations, state-owned and state-funded municipal institutions

and state-owned institutions which are not funded from the state budget, irrespective of the fact whether they conduct commercial activities. Further exceptions are regulated by Art. 612 CC concerning:

- merchants whose enterprises are public, i.e. owned by the state or a municipality to more than 50% or are formed under a special law (e.g. the Law on the Bulgarian Railways);
- enterprises with state monopoly. According to Art. 18 para. 4 of the Constitution, this concerns such areas of business as railway transport, post, telecommunication, generation of nuclear energy, manufacture of radioactive products, nuclear weapons, explosives and biological weapons.

The insolvency of such enterprises should be governed by a special law which, however, has not been enacted yet.

Due to the deep economic crisis in 1993/1994 which led to bankruptcies of several banks, special provisions were inserted into the Bank Insolvency Law[130] (hereinafter referred to as BInsL) and, in 2006, into the Law on Credit Institutes (hereinafter referred to as LCI):

- formal pre-conditions for commencement are revocation of the bank licence due to illiquidity (Art. 8 BInsL, Art. 36 para. 2 LCI) or Determination of illiquidity in liquidation (Art. 125 or 130 LCI);
- substantive pre-conditions for Determination of illiquidity (Art. 36 para. 2 LCI) are: (1) the bank has not fulfilled a due obligation in cash for more than seven working days or (2) equity capital is negative or (3) in liquidation, the bank has not fulfilled a due obligation in cash for more than 60 days;
- the insolvency petition can only be filed by the Central Bank; in liquidation, the liquidator or the Fund for Securing Bank Deposits can initiate insolvency proceedings;
- creditors' ranking differs from the general ranking in Art. 722 CC.

Due to public interest, special regulations of the Insurance Code govern the insolvency of insurance companies.

[130] DV no. 92/2002; See for details: P. Laleva, Important issues of insolvency proceedings according to the new Bank Insolvency Law (In Bulgarian), Pazar i Pravo 2002, X, p. 46; L. Ilieva, Legal succession in connection with the purchase of a bank in insolvency proceedings (in Bulgarian), Pazar i Pravo 2002, VI, p. 50.

d) Grounds for Opening Insolvency Proceedings

Apart from illiquidity, over-indebtedness constitutes a ground for opening insolvency proceedings against corporations.[131] In contrast to the German Insolvency Law, imminent illiquidity is not a ground for insolvency under the Bulgarian Commercial Code.

In Art. 608 para. 1 CC, illiquidity is defined as the inability of a merchant (1) to pay his due monetary debt from a commercial transaction or (2) a debt to a public authority (municipality or state) in connection with his business or (3) to fulfil a private obligation in relation to the state. Since 2006, it is sufficient that the obligation should become due soon. The debtor's debts to a public authority are determined accordint to Art. 108 LTSSP (Law on Tax and Social Security Procedure). Pursuant to Art. 608 para. 3 CC, illiquidity is assumed if the debtor did not fulfil his obligation from a commercial transaction within 60 days or if it is only possible for him to settle his debts in full or in part in relation to some (but not all) creditors. Moreover, the illiquidity must be lasting.

According to the legal definition in Art. 742 para. 1 CC, a trading company is over-indebted if its assets are insufficient to settle the monetary debts. In this context, it is problematic whether the court should calculate the asset value according to regulations on the book value for operating companies or to regulations on assessing the value in liquidation. Apart from special rules on bank insolvency, the court estimates the asset value independently.

e) Persons Entitled and Persons Obliged to File the Petition

The insolvency proceeding can be initiated as a result of a written petition by the debtor or his liquidator, one of his creditors in a commercial transaction or, in the case of debts to a state authority in connection with the debtor's business, by the Agency for State Claims (Art. 625 CC). After Art. 628a CC has been introduced in 2006, it is clarified that the service of the insolvency petition of a creditor interrupts the running of

[131] Only limited liability companies, joint-stock companies and capital limited partnerships according to Art. 607a para. 2 CC.

time for the purposes of limitation in connection with the underlying claim.[132]

Under the CC, the debtor is obliged to file for insolvency within 30 days after illiquidity or over-indebtedness occurred (Art. 626). The petition must be submitted by the debtor, his heir, the management body, the liquidator or an unlimited partner of a trading company or, in the case of over-indebtedness, a member of the management body. If the petition is filed by a representative, he must possess an explicit power of attorney. In the case of breach of duty to file, the persons obliged to file the insolvency petition are jointly liable in relation to creditors according to Art. 627 CC.

3. Institutional Framework

a) Courts

The insolvency court (Art. 613 et seq. CC) commences the insolvency proceedings, decides on actions for a declaratory judgment and on actions for rescission as a trial court, approves the reorganization plan, calls the creditors' meeting and organizes protection of the insolvency estate. Proper venue is the district court at the debtor's location at the moment of filing. From 2006, actions for a declaratory judgment and actions against decisions of the creditors' meeting are within jurisdiction of different court chambers. Against the basic orders of the insolvency court (Art. 613a para. 1 CC), appeals should be lodged directly to the Supreme Cassation Court; against other orders of the insolvency court,

[132] The interruption of the running of time for the purposes of limitation is effective until the termination of the insolvency proceeding. This provision also applies to creditors, who join the proceeding at a later moment,from the moment of petition service. If the petition is rejected, the running of time for the purposes of limitation is not interrupted. The effect of termination is remains unchanged.

appeals should be filed to the competent appeal court (Art. 613a para. 2 CC). In order to accelerate insolvency proceedings, the channel of appeal has been reduced from three to two stages already in 2003.[133]

b) Insolvency Administrator, Provisional Insolvency Administrator, Public Insolvency Administrator

From 2000, the court decision on the appointment of the insolvency administrator depends on the decision of the creditors' meeting if the selected candidate meets the requirements determined by law. In addition to the provisional and permanent insolvency administrator, the position of a public insolvency administrator was introduced. According to Art. 655 para. 2 CC (as amended in 1998), persons who have a criminal record, are relatives of the debtor or a creditor, are creditors in the insolvency proceeding or are biased due to their relation to the debtor can not be appointed as insolvency administrator. Insolvency administrators should have a university degree in law or economics, have an additional qualification as insolvency administrator (since 2003), have practiced in this profession for at least three years and be registered by the Ministry of Justice, whereby the register is published in the Official Gazette. Since 2006, the administrator has to pass an examination for admission and to conclude an indemnity insurance contract.[134] The insurance compensates damages which are caused by intentional or negligent non-performance of his professional duties. The minimum insurance amount is BGN 10,000 per proceeding and BGN

[133] For further details see N. Madanska, Legal basis oft he approval by the court in the insolvency proceedings (in Bulgarian), Pazar i Pravo 2003, VI, p. 46; see also A. Katzarski, Targovski zakon - Komentar (in Bulgarian), Sofia 2003, pp. 31 et seq.

[134] It is regulated by a joint Order by the Ministries of Justice, of Economy and of Finance on the Selection, Qualification and Control of the Insolvency Administrator of 2005. According to the Order, the administrators are obliged to pay a levy amounting to two minimum wages per annum to the Ministry of Justice (currently approx. BGN 320); from this source, the training of administrators is to be funded. If an administrator does not pay the levy, he will be deleted from the register.

25,000 in total. The administrator can also enter into an additional insurance contract with a higher insurance premium or covering additional risks. The duties of an administrator can be performed by individual persons, but also by groups of persons. In the latter case, the decisions must be met unanimously and all activities should be performed jointly; all members of the group are jointly liable.

Apart from representation of the debtor's enterprise and administration of usual business activities, the administrator has the following functions according to Art. 658 CC:

- control of the debtor's activities according to Art. 635 para. 1 CC;
- examination and making an inventory of debtor's assets;
- representation of the debtor in court;
- proposal for a reorganisation plan according to Art. 696 CC;
- realisation of debtor's assets.

The remuneration of the administrator is determined by the court according to the decision of the creditors' meeting. The administrator is obliged to perform his duties with the care of a "good merchant" (Art. 660 CC). He has to submit reports on his activities to the court and to the creditors' committee each month and, additionally, at any moment on demand. At the end of proceedings, he has to submit the final report which must be approved by the court. According to Art. 663 CC, the court can impose fines up to the amount of the monthly remuneration if the administrator does not perform his duties or does perform them without due care. Moreover, the administrator has to compensate damages to the debtor and the creditors caused by him deliberately or negligently.

The provisional administrator must prepare a written report on the cause of illiquidity, the status of the assets and on measures taken for asset protection as well as on the possibility of recovery within 14 days from the commencement. Since 2000, he must, additionally, compile a

creditors' list and amounts of claims; the data in the list must be based on the debtor's books. The administrator is obliged to present this list to the first creditors' meeting (Art. 669 para. 2 CC).[135]

By the amendment to the CC of 2000, the position of the public insolvency administrator was introduced. In contrast to the provisional insolvency administrator, the public insolvency administrator can be proposed by the debtor or creditor(s) who filed the insolvency petition and appointed by the court. Like the provisional insolvency administrator, the public administrator is appointed for a limited period of time, if the insolvency administrator originally appointed by the creditors' meeting did not start to perform his duties or the creditors' meeting can not agree on one candidate or the selected candidate does not meet the requirements of the CC or the provisional or permanent administrator was dismissed.[136]

c) Creditors' meeting and creditors' committee

The first creditors' meeting is conducted on the day determined by the court in the commencement order, whereby no term is stipulated by law.[137] Pursuant to Art. 669 para. 2 CC, all creditors included in the list prepared by the provisional administrator are entitled to participate. In this context, it is problematic that the provisional administrator decides solely on the basis of debtor's books who should participate in the first meeting, although the creditors are entitled to give notice of their claims

[135] Pursuant to Art. 690 para.1 CC, the insolvency administrator is obliged to submit a report on the claims not accepted by him to the court if objections were raised. An appeal should be possible against the respective court order. However, precedents on this point are at variance; see. M. Bobatinov, Approval of the administrator's report on debtor's assets (Bulgarian), Pazar i Pravo 2003 II, p. 46.

[136] See Art. 657 para. 1 no. 2, 3, 4, 5 and 6 or Art. 2 CC.

[137] The first meeting must take place as soon as possible after the commencement order in line with the aim of accelerating the proceedings, see D. Parasheva, New possibilities for creditors in the insolvency proceedings after the 2000 amendment (In Bulgarian), Pazar i Pravo 2000, XII, pp. 36 (37).

thereafter.[138] The meeting is conducted by the insolvency court, since 2000 by the judge who examined the insolvency petition and not, as previously, by the presiding judge.

As before, the creditors' meeting must hear the provisional administrator's report and elect the permanent insolvency administrator and, if necessary, the creditors' committee. Since 2000, the decisions of the first meeting are met by a simple majority of creditors from the provisional administrator's list according to Art. 668 para. 1 CC.[139] Apart from creditors and the judge, the provisional administrator is also obliged to attend the first meeting; the debtor is entitled, but not obliged to attend. The subsequent creditor's meetings, the so-called simple meetings, can be called by the administrator after the approval of accepted claims. Pursuant to Art. 674 CC, a creditors' meeting can be called also by the court on its own initiative or on the basis of an application of the debtor, the administrator, the creditors' committee or of creditors who hold one fifth of claims. The creditors' meeting has i.a. the following functions:

- election of the administrator if he has not already been elected (Art. 672 para. 2 CC);
- dismissal and replacement of the administrator;
- determination and change of the administrator's remuneration;
- election or replacement of member of the creditors' committee;
- determination of valuation method to be applied to the debtor's property, of the method of payment to creditors and of the experts' remuneration and
- since 2003, determination of the procedure for realisation of debtor's assets. If the court can not make a decision, the administrator should decide on that.

The decisions of the creditors' meeting are binding for all creditors, including those who were absent. For that reason, Art. 679 CC contains the right to contest unlawful decisions of the creditors' meeting or decisions which damage a substantial group of creditors in order to

[138] See D. Parusheva, New possibilities for creditors in the insolvency proceedings after the 2000 amendment (In Bulgarian), Pazar i Pravo 2000, XII, p. 36

[139] And not as before with simple majority of the creditors attending the meeting in person or by proxy. The quorum of two creditors was also abolished.

protect creditors and the debtor. Decisions on such actions makes a different chamber of the insolvency court.

The creditors' committee is a body which can be elected by the creditors' meeting on a voluntary basis. It is comprised of at least three and not more than nine members who represent secured and not secured creditors. The creditors' committee assists and controls the administrator in connection with administration of debtors' property, examines the books and cash accounts and informs the court if the administrator does not fulfil his duties. Since 2003, the creditors' committee is entitled i.a. to make statements on the continuance of the debtor's business activities, on the remuneration of the provisional and permanent insolvency administrator, on realisation of assets and the administrator's liability.

d) Control Organ during Reorganisation

Since 2003, the so-called control organ can be established according to the reorganisation plan or to the decision of the creditors' meeting on the approval of the plan. The control organ controls the implementation of the plan approved by the court. Pursuant to Art. 700a para. 8 CC, the debtor's management bodies can decide on the following measures only upon approval by the control organ:

- change of corporate form by the debtor's enterprise;
- winding-up or transfer of enterprises or of their substantial parts;
- transactions outside the usual course of the debtor's business;
- substantial changes of the debtor's business;
- substantial structural changes;
- long-term co-operation of major importance for plan implementation or termination of such co-operation;
- establishing or closing a branch office.

According to the prevailing opinion in the doctrine, this restriction must be entered into the Commercial Register, so that third persons can also be informed about the requirement of approval. Business activities for which approval is required, but not expressed are null and void in relation to creditors.

4. Insolvency Proceedings

a) Effect of Commencing the Insolvency Proceeding

In the court order on commencement, the moment of illiquidity or over-indebtedness is determined. After commencement, the debtor continues his business activities under supervision of the provisional administrator. He is entitled to conclude new contracts only after approval by the provisional administrator; his legal capacity is limited (Art. 635 para. 1 CC). The court can decide that the debtor should be not entitled to administer his property and to dispose of it, if it is established that the debtor endangers the creditors' interests by his activities (Art. 635 para. 2 CC). Since 2006, the debtor is allowed to participate in the insolvency proceedings in court in person or by proxy, as far as there is no exclusive power of the administrator for certain acts in proceedings.

Under Art. 640 CC, the debtor is obliged to disclose all information on his business activities and on his assets to the court and the provisional administrator within 14 days from the commencement. If he does not fulfil this obligation, the court can impose a fine amounting to BGN 500 to 1000. After this term, the debtor is still obliged to provide information about the status of his assets upon demand within seven days (Art. 640 para. 2 CC). The insolvency estate generally consists of the debtor's property at commencement and the property he acquired afterwards.[140] Pursuant to Art. 614, 615 CC, assets of the debtor and of unlimited partners execution of which is prohibited are not included in the insolvency estate.

[140] For sole proprietors and unlimited partners, also assets from the community of net property gains by marriage, which have been used for business, and a half of the remaining assets from the community are included into the insolvency estate. If the community is terminated or divided or net property gains are equalised within six months from the moment of illiquidity until the end of insolvency proceedings, these transactions are not valid in the context of insolvency.

aa) Protection of Debtor's Property and Provisional Measures

According to Art. 629a CC, provisional measures for protection of debtor's property, which can be ordered upon a creditor's application or ex officio even before the commencement, are the following:

- appointment of the provisional administrator and limitation of the debtor's legal capacity (Art. 635 para.1 CC);
- approval of the pledge, registration of an arrest mortgage or other measures for protection of the debtor's property;
- stay of execution proceedings with the exception of the execution of public claims (see Art. 638 CC),
- order to put the debtor's property under seal according to Art. 650 CC.

Apart from the administrator's control over the administration of the insolvency estate, additional measures aimed at protecting and increasing the debtor's property can be taken after commencement. The most important measures are:

- the right to choose between performance and termination of transactions performed only in part; the contract party can be entitled to compensation of damages under certain conditions (Art. 644 CC);
- the right to demand the payment of outstanding cash and non-cash contributions to the equity capital by limited (Art. 643 CC).

The insolvency court can also order putting of debtor's premises, equipment, vehicles and other assets under seal, if the insolvency estate is endangered by disposal, concealment or destruction. The seal is placed by the bailiff; he must submit his record to the court. The administrator is entitled to demand to take off the seal and to make an inventory of movable and immovable property, money, valuables, securities, contracts etc. as well as of all debtor's claims and property of third persons in debtor's possession within three days after his appointment. The inventory is made by both the bailiff and the administrator. After the inventory has been made, the administrator is liable for the seized property, unless it was handed over to the debtor or to a third person for keeping.

The court order on adjudication of the debtor as bankrupt must contain an order to seize the debtor's property.

bb) Effect on Court Proceedings and Contracts

After illiquidity or over-indebtedness has occured, only the creditor, but not the debtor is entitled to set-off. If the debtor sets off his claims, this transaction is not valid in relation to the insolvency estate, with the exception of the share which the creditor is entitled to in the framework of the insolvency proceedings. A set-off by the creditor can be performed if both claims were reciprocal, kindred and due before the commencement.[141] If the claims fell due or became kindred during the insolvency proceeding or as a result of the court order on commencement, the creditor is entitled to set-off after the commencement (Art. 645 CC). But also in these cases the set-off can be declared not valid in relation to other creditors if the creditor knew about the illiquidity or over-indebtedness of the debtor or about the commencement of insolvency proceedings when he obtained the claim.

"Third persons" of the insolvency proceeding, e. g. the garnishee can perform only in relation to the administrator after the commencement order has been published. Performance in relation to the debtor after the commencement order was issued, but before it was published discharges the garnishee from liability only if he had no knowledge of the commencement or if the transferred property is included in the insolvency estate (Art. 636 CC). Good faith is assumed, unless the opposite is proved. The so-called "new creditors" are those whose claims against the debtor arose after the commencement. Due to high risks, the debtor is entitled to pay these debts when they fall due, irrespective of the commencement order. If the debtor can not pay at this moment, the new creditors have equal rights with other creditors.

After the commencement order, there is a stay to all pending civil and commercial court and arbitration proceedings concerning property against the debtor.[142] Court proceedings in connection with labour law and in connection with separation of third party assets from the debtor's assets are excluded and can be commenced after the opening of insol-

[141] See L. Ilieva, Set-off in insolvency proceedings (In Bulgarian), Pazar i Pravo 2002, VI, p. 56.

[142] Art. 637 para. 1 sentence 2 CC contains an exception: if the court accepted a counterclaim or a plea of set-off by the debtor for the purposes of another court proceeding where the debtor is a defendant.

vency proceedings. If the claim was not registered or there was an objection against the claim in spite of registration, the proceedings should be recommenced, and the administrator should participate. The pronounced judgment determines the legal relation for the administrator, the debtor and all creditors.

There is a stay also to all execution proceedings concerning the assets which are a part of the insolvency estate. Pursuant to Art. 638 CC, this rule does not apply to property in relation to which protective measures under LTSSP were ordered or execution proceedings commenced. These proceedings will be terminated by the public bailiff or by other organs of the Agency for State Claims according to LTSSP. The interrupted proceeding is to be terminated if the claim is included into the list of insolvency claims. Seizures of property within execution proceedings are not effective in relation to insolvency creditors. Measures for protection of debtor's property under the Code of Civil Procedure and LTSSP are prohibited after the commencement of insolvency proceedings.

cc) Notice of Claims

Notice of claims must be given to the insolvency court within one month from publishing of the commencement order. Since 2006, the running of time for the purposes of limitation is interrupted by the notice according to Art. 685a CC. The insolvency administrator must prepare a list of claims within seven days after the end of the term for notice according to Art. 686 CC, so that the creditors are enabled to obtain information on acceptance of claims by the administrator. Pursuant to Art. 687 CC, public claims based on an effective administrative act and claims based on labour law which have arisen within one year before the commencement have to be inserted into the list ex officio. The provisional list of claims, the debtor's balance for the last year and the debtor's balance for the last month before the commencement must be laid out for public inspection in the registry office of the court and published in the Commercial Register. Further claims notice of which was given should be examined in the same proceeding. According to the new version of Art. 688 CC, it is allowed to give notice within two months after the end of the one-month term.

Debtors and creditors who gave notice of their claims within one month can contest the list. The administrator must answer the objections within three days according to Art. 690 para. 2 CC. The court approves the accepted and not disputed claims in a closed session by a court order immediately after the submission of the list (Art. 692 CC); the court examines objections in the presence of the administrator, the debtor and the creditor in a public session.

In insolvency proceedings against enterprises, which are at least to 50% state-owned and are to be privatised, the proceedings are suspended by the court order for four months to make the completion of privatisation transaction possible (§ 5 of Additional Provisions to the CC).

The orders are to be published in the Commercial Register; no legal remedy is allowed. However, creditors or the debtor can file an action for a declaratory judgment on the claim within seven days from the publishing of the court order on the approval of the list according to Art. 694 CC, if they have previously submitted objections against the list. The insolvency administrator is obliged to set aside certain reserves for satisfying claims in dispute in the course of liquidation or reorganisation.

On 1 January 2005, the Law on Protection of Employees in the case of Insolvency became effective, according to which a fund for securing employees' claims is to be established financed by monthly contributions of the employing company amounting to 0.5% of the payroll. The claim of the employees arises when the commencement order or the rejection of the petition due to insufficient assets is published, provided that the employees submit an application within 30 days. The provisions of the CC on claims from employment contracts apply to the claims of the fund against the insolvency estate. In the insolvency proceeding, the fund is represented by the Agency for State Claims.

b) Rescission and Invalidity of Antecedent Transactions

Legal transactions, which are concluded after illiquidity or over- indebtedness have occured, are null and void in relation to the insolvency creditors according to Art. 646 para. 2 CC, if they are aimed at:

- paying a monetary debt;

- concluding a contract on gratuitous transfer of assets from the insolvency estate;
- encumbrance of the assets in the insolvency estate with pledge, mortgage or other securities;
- concluding an inequivalent mutual contract.

Pursuant to Art. 646 para. 1 CC, legal transactions (e. g. performance of an obligation arisen before the commencement, encumbrance with pledge or mortgage or concluding a contract concerning assets from the insolvency estate), which are conducted after the commencement in violation of rules stipulated in the commencement order, are null and void in relation to insolvency creditors. However, this provision does not apply to the settlement of public claims or private claims of the state, which are executed according to LTSSP. The action to annul can be filed at commencement. The administrator can submit the action also after the commencement.

Apart from the cases of relative ineffectiveness, Art. 647 CC provides for rescission of the debtor's transactions detrimental for the creditors.

A substantial facilitation for the rescission during insolvency proceedings is that the bad faith of both parties has not to be proved. The onus of proof concerning the detriment and the detrimental intention lies with the plaintiff according to Art. 127 of the Code of Civil Procedure. The following transactions can be rescinded:

- gratuitous transactions within three years preceding the commencement of insolvency proceedings, with the exception of usual donations to the benefit of persons who have a connection to the debtor;
- gratuitous transactions to the benefit of third persons within two years preceding the commencement;
- transactions for substantially inequivalent consideration within two years preceding the commencement;
- settling monetary debts by transfer of ownership of assets from the insolvency estate within three months preceding the occurence of illiquidity, if the return of assets will increase the quota of creditors.;
- securing a heretofore not secured claim by pledge, mortgage or other security within one year preceding the commencement;
- securing a heretofore not secured claim of a partner or shareholder by pledge, mortgage or other security within two years preceding the commencement;

- transactions detrimental for creditors, one party of which is a person connected to the debtor, within two years preceding the commencement.

The action for rescission according to Art. 647 CC can be filed by the administrator within one year following the commencement. If the administrator fails to file, every creditor can submit the action. If the court declares the above transactions null and void, all revenues from these transactions transferred to the insolvency estate must be returned to the other party. If the assets from these transactions are not a part of the insolvency estate any more or if the revenues consisted of money, the contract party becomes an insolvency creditor.

c) Reorganisation

Forbearance, full and partial debt forgiveness, reorganisation measures and other measures and transactions for stabilisation of the debtor's enterprise are contained in Art. 696 CC since 1994. Upon approval of the reorganisation plan by an effective court order, the proposal for reorganisation becomes enforceable, so that an execution order can be issued in relation to an insolvency creditor (Art. 708 CC). The debtor, the administrator, one third of creditors with secured and unsecured claims, partners and shareholders who hold at least one third of the capital, unlimited partners and 20% of debtor's employees can propose a reorganisation plan. The proposal can be submitted within one month upon publishing the court order on the approval of the list of creditors' claims in the Commercial Register. Several plans can be proposed.

Pursuant to Art. 700 para. 1 CC, the plan must contain the degree of satisfaction of each creditors' group and the procedure and schedule of debtor's payments. The plan should also include guarantees of satisfaction of claims in dispute in pending proceedings. The possibility to file an action for a declaratory judgment under Art. 694 CC is taken into account, but the reorganisation proceedings are not impeded by this measure. In addition, the reorganisation plan must provide for guarantees to each creditors' group in connection with plan implementation, conditions for full or partial discharge of unlimited partners from their liability, effect of the plan on the situation of the debtor's employees and

legal and organisational details in connection with plan implementation. Since 2000, the term "separate part", i.e. an organisational unit which can conduct economic activities independently, is used in the case of sale of parts of the debtor's enterprise. Such separate parts can be sold as a going concern and continue to conduct business activities, so that creditors can be satisfied at a higher rate from the revenues. Under the effective insolvency provisions, the report on valuation of the debtor's assets and a draft contract signed by the purchaser, if the sale of a part is proposed; if the valuation report is lacking, it is a ground for the court to reject the plan. If the plan is approved by the court, the creditors' meeting should vote on the valuation report and then on the reorganisation plan.

Since 2003, the plan can contain debt-equity-swap, whereby a list of creditors who want to subscribe the shares has to be attached (Art. 700 para. 6 CC). If the debtor's assets are insufficient for satisfying all claims, the debt-equity-swap will be conducted at the nominal value of shares, otherwise, at the balance value. The debt-equity-swap can be conducted independently and even against the will of shareholders, so that this measure can be considered as expropriation.[143]

If the plan meets the above requirements, the court calls, within seven days after the expiry of the term for proposing the reorganisation plan, a creditors' meeting, which has to take place within 45 days. The creditors vote on the plan within their groups by simple majority of the claim amount. If creditors whose claims constitute more than a half of all accepted claims vote against the plan, it is deemed as not approved. An objection against the plan adopted by the creditors' meeting can be submitted within seven days after the voting; since 2006, creditors of claims in dispute who filed an action for a declaratory judgment are also entitled to file an objection. Finally, the plan is approved by the court and published in the Commercial Register if it meets the requirements of Art. 705 CC. According to this provision, all creditors within a creditors' group have equal rights and dissenting creditors should obtain the same amount as in the case of liquidation, unless the dissenting creditors declare their approval of the plan in the written form.

[143] See A. Katzarski, Targovski zakon - Komentar (In Bulgarian), Sofia 2003, p. 33.

If the plan is approved by the creditors' meeting, but not approved by the court, reorganisation is not possible according to Art. 701 para. 2 and Art. 707 a CC. The court approval of the reorganisation plan leads to the termination of insolvency proceedings (Art. 707 para. 1 CC). The debtor should be reinstated and enabled to conduct his business independently. However, the court can order that the insolvency administrator should remain in office and replace the officer of the debtor's company with general commercial power of representation or the former officer should be able to dispose of certain assets only upon approval of the administrator or the court. If the debtor does not fulfil the plan, the insolvency proceedings can be reinstated without proving illiquidity once more; in this case, a new reorganisation is not allowed according to Art. 709 CC. The approved reorganisation plan changes the amount of claims by partial debt forgiveness and forbearance. It is effective in relation to the debtor and to all debtors whose claims arose prior to commencement of insolvency proceedings. If the debtor's enterprise or its separable part are sold as a going concern, the disposals by the purchaser are null and void in relation to creditors, until the purchase price is paid (Art. 706 CC).

d) Status of Secured Creditors

According to Art. 638 para. 3 CC, secured creditors have the privilege of separate and preferential satisfaction of their claims if their interests are endangered. Otherwise, the claims are satisfied according to the general priority ranking of Art. 722 CC. For claims which are secured by pledge, mortgage or seizure under the Law on Special Pledge, there is an absolute priority.[144] In the second priority, claims secured by retention and in the third priority expenses incurred in the course of insolvency proceedings should be satisfied.[145] In the next ranks, employees' claims from

[144] See B. Balevski, Rights of creditors whose claims are secured by mortgage in the insolvency proceedings (in Bulgarian), Pazar i Pravo 2002, I, p. 39.

[145] This are court fees, remuneration of the administrator, salaries of employees and debts arisen after the commencement of insolvency proceedings in connection with continuation of the debtor's business activities, costs of administration,

the last year preceding the commencement, claims on alimony payments, public claims arisen before the commencement (taxes, customs levies, state fees, social security contributions etc.), claims of "new creditors" and, finally, other not secured claims are to be satisfied. If the above claims are satisfied in full, claims concerning interest payments based on law or contract on not secured claims arisen after the commencement, claims arisen in connection with a loan granted by a partner/shareholder to the debtor and claims arisen from gratuitous transactions are to be satisfied in the ninth rank (Art. 722 in connection with Art. 616 para. 2 CC). Claims of insolvency creditors on costs incurred by them in the course of insolvency proceedings rank last.

If claims secured by pledge, mortgage or retention can not be satisfied in full from the proceeds of collateral's realisation, secured creditors have the same status in the ranking as not secured creditors for the remaining amount of claim (Art. 724 CC). If the amount of proceeds from collateral's realisation is higher than the amount of the secured claim, the balance is transferred to the insolvency estate. After all claims have been satisfied in full, the remaining assets are transferred to the debtor.

e) Adjudication – Realisation of Debtor's Property

The court adjudicates the debtor as bankrupt and orders termination of his business activities in the commencement order or upon the expiry of the term for proposing the reorganisation plan. Seizure, realisation of debtor's assets and final distribution among the insolvency creditors are then ordered by the court. The debtor is not entitled to administer his property and to dispose thereof. The adjudication is provisionally enforceable. The adjudication court order is published in the Commercial Register and is effective erga omnes; an appeal against it can be lodged within seven days from the date of publishing. After adjudication order has been published, all claims against the insolvency estate become due

valuation and distribution of the insolvency estate, material support to the debtor and his family.

and non-monetary debts are transformed into monetary debts (Art. 617 CC).

The adjudication can, at any time, be prevented by concluding an out-of-court agreement. By a written contract between the debtor and all creditors, the claims approved in insolvency proceedings can be settled. This leads to termination of the insolvency proceeding, unless actions for a declaratory judgment under Art. 694 para. 1 CC have been lodged.

The insolvency proceedings can be reinstated on application of creditors with voting rights who hold at least 15% of claims, if the debtor does not fulfil his obligations under the contract. In the proceeding after reinstatement, illiquidity has not to be proven. Reorganisation can not be commenced in this case (Art. 740-741a CC).

Since 2003, Art. 717a et seq. CC govern realisation of debtor's assets.[146] Sale of property which is in joint ownership of the debtor and third persons (Art. 717m CC), of real estate encumbered by a mortgage, of debtor's shares in other legal entities (Art. 718 para. 2 CC), of apartments rented by employees (Art. 718a CC) and sale by direct negotiations with purchasers (Art. 718 para. 1 CC) are now regulated in detail. If the creditors' meeting did not decide on the realisation, the court should make the decision. On proposal of the insolvency administrator and considering the creditors' meeting decision, the court permits the sale of movable and immovable property and property rights as a whole or in parts or as individual objects. The sale is conducted at an open auction with secret bids. If no bids or only invalid bids are submitted or the purchaser does not pay the price, a new public auction with open bids should be conducted. The court order on transfer of ownership can be contested at the appeal court by the debtor or by other participants of the auction. If the realisation does not succeed, the court can permit direct sale or sale through an agent upon application of the insolvency administrator (Art. 718 CC). If the insolvency estate or a separate part of it is sold as a going concern, the amounts transferred to creditors should be not smaller than in the case of a piece-meal sale.

Upon distribution, the insolvency administrator submits his report on

[146] Previously, the realisation procedure was governed by lengthy provisions of the Code of Civil Procedure on execution proceedings, see A. Katzarski, Targovski zakon- Komentar (Commentary to the CC), Sofia 2003, p. 33.

administration and realisation of the insolvency estate as well as the final statement of accounts to the court. The court calls the final creditors' meeting at which the final statement of accounts is approved and the decision on not realised assets is met. If all claims are satisfied or no debtor's assets are left, the court orders termination of proceedings. If all claims determined in the insolvency proceeding, including interest and asset costs, are satisfied in full, the rights of the debtor can be restored after termination.[147] The proceedings on restoration of the debtor's rights is a separate court proceeding. The debtor or his heirs are entitled to apply for commencement. Within one month after publishing the the court order on termination of the insolvency proceeding, the creditors of approved claims can submit objections.

f) International Insolvency Law

Pursuant to Art. 757 CC, Bulgaria recognises judgments and orders of foreign courts in insolvency proceedings if they are issued by a state court at the location of the debtor and reciprocity is guaranteed. The powers of an insolvency administrator appointed by a foreign court are governed by the law of the state where the insolvency proceedings were commenced. However, they should not violate the Bulgarian ordre public (Art. 758 CC). Otherwise, the Bulgarian law will be applied if the dispute will be settled by a Bulgarian court.

If a debtor who possesses substantial property in Bulgaria is adjudicated as bankrupt by a foreign court, commencement of a new, additional insolvency proceeding is allowed under the CC. However, there is no legal definition of "substantial property". The additional insolvency proceeding can be initiated by the debtor, the insolvency administrator appointed by a foreign court or an insolvency creditor. The additional insolvency proceeding concerns only the debtor's assets situated in Bulgaria. If the insolvency administrator files an action for rescission in the main or in the additional proceeding, the action is deemed to be filed in both proceedings. An insolvency creditor whose claims were

[147] An exception of this requirement applies if the debtor became insolvent as a consequence of unfavourable development of the economic environment.

satisfied in part in the main proceeding is entitled to participate in the distribution in the additional proceeding. Pursuant to Art. 760 para. 3 CC, a reorganisation plan concerning the enterprise of a foreign insolvency debtor can only be approved with the consent of the insolvency administrator in the main proceeding. The main and additional proceeding are independent and und are connected separately. If a part of debtor's assets remains after the distribution in the additional proceeding, these assets are to be transferred to the insolvency estate in the main proceeding.[148]

Especially the court order on the commencement of insolvency proceedings against an insurance is effective not only in relation to the offices in Bulgaria, but to all branch offices in other EU member states and in third countries according to the Insurance Code.[149] If the insolvency proceedings against an insurance are commenced in another EU member state, the court order is also effective in Bulgaria.

g) Criminal Offences in Connection with Bankruptcy

The provisions in Part IV of the Bulgarian Criminal Code under the title "Offences against creditors" contain the following offences:

- failing to file for insolvency (Art. 227b para. 1, last amendment of 2006);

[148] For further details see P. Laleva, Recognition and legal effect of a court order on commencement of the insolvency proceeding by a foreign court (In Bulgarian), Pazar i Pravo 2002, II, p. 43; P. Laleva, International aspects of provisions on foreign creditors, insolvency administrators and the notice and approval of claims in the insolvency proceedings (in Bulgarian), Pazar i Pravo 2002, V, p. 32; P. Laleva, International aspects of the provisions on the insolvency estate (in Bulgarian), Pazar i Pravo 2002, IV, p. 33.

[149] After the court order on commencement of the insolvency proceedings against an insurance company is published in the Commercial Register, the register authority submits the order to the official publishing organ of the EU for publication and includes information on the applicable law, the competent court and the insolvency administrator. The Commission on Financial Control immediately informs the competent organs of other EU member states about the commencement of insolvency proceedings and its legal consequences.

- deliberate bankruptcy (Art. 227c);
- negligent bankruptcy (Art. 227d);
- failing to pay to an insolvent merchant (Art. 227e).

Apart from imprisonment (up to three years in the case of deliberate bankruptcy), the court can order that the convicted person is not allowed to hold certain public offices or to become a public servant or to practice a certain profession or to perform certain professional activities. There are still no provisions on criminal liability of insolvency administrators.

5. Summary and Perspectives

The new version of legal provisions on insolvency adopted in 2003 was aimed at accelerating the insolvency proceedings and, at the same time, at enabling the debtor to reorganise his enterprise. A new special and time-saving procedure for realising the debtor's assets, including regulations on an auction, was introduced instead of the reference to the inefficient[150] general provisions of the Code of Civil Procedure. In reorganisation proceedings, a new control organ and debt-equity-swap as a means of creditors' satisfaction were introduced. Further new regulations were enacted in 2005 and 2006. New provisions on the examination for admission and compulsory liability insurance of an insolvency administrator mean a real progress. New provisions on publishing court orders under the new Law on Commercial Register and better legal protection of debtor's employees in the insolvency proceedings are also positive. By contrast, the re-introduction of provisions on two-stages channel of

[150] See the criticism by the EBRD, EBRD Legal Indicator Survey: assessing insolvency laws after ten years of transition, Individual country assessments, 1998.

appeal instead of three seems problematic; however, it shall be necessary for acceleration of proceedings.

Whether these provisions prove worthwhile in practice and whether they are appropriate for addressing practical difficulties, which are, to a great extent, transition-related, remains to be seen. Hopefully, the insolvency proceedings will be less time-consuming in the future. A complete, systematic, clear and detailed regulation of insolvency proceedings would also be desirable. The restrictive rules on applicability of insolvency provisions remain problematic. However, the Bulgarian legal provisions on insolvency are generally based on the UNCITRAL Model Law as well as on the EU practice and EU Regulation no. 1346/ 2000 of 29 May 2000 on insolvency proceedings. Considering the fact that Bulgaria became a member state of the EU on 1 January 2007, it is probable that the economic policy of the government will not change.