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REPORT: SUGGESTED AMENDMENTS TO BIH BANKRUPTCY AND RELATED LAWS

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Chemonics International, Inc. and its subcontractors, Emerging Markets Group, Ltd. and the National Center for State Courts, were selected to implement USAID's Fostering an Investment and Lender-Friendly Environment (FILE) commercial law project in Bosnia and Herzegovina (BiH). The project, which was designed to run approximately three years, covers a variety of commercial law issues, including bankruptcy law and court administration.

During FILE's work in implementing BiH's bankruptcy laws, we discovered that several provisions of the laws, as well as the interplay between the bankruptcy laws and other substantive laws, impede efficient case administration and timely resolution. FILE has discussed these issues in detail with judges, trustees, and creditors during trainings, workshops and roundtables. The proposed amendments suggested below are the result of those discussions and represent a consensus or majority viewpoint among stakeholders.

I. Case Opening Procedures

Article 5 (RS Law only): Eliminate the requirement that the RS Government approve initiation of bankruptcy proceedings for state owned enterprises

In the RS Official Gazette, No. 38/03, two new paragraphs were added to Article 5:

> "(6) It is necessary to obtain prior agreement of the Republika Srpska government in order to initiate bankruptcy proceedings of the bankruptcy debtor with majority of state owned capital in its capital structure, in the period up until finalization of the restructuring procedure initiated by the Privatization Directorate or until finalization of initiated sale procedure of the offered state owned capital and until expiry of deadlines for execution of contracted conditions for sale.
>
> (7) If Republika Srpska government does not deny the agreement within 30 days from obtaining information from the bankruptcy judge on initiation of preliminary proceedings, agreement will be considered granted."

These provisions permit political interference in the bankruptcy process, with harmful effects on the bankruptcy system and the independence of the judiciary. The bankruptcy law provides a rational and transparent system for reorganization and liquidation of insolvent enterprises. It is an important component in economic reform efforts, providing methods to transfer companies and assets to productive use and settle unpaid debts.

The RS Government has often exercised the authority granted in Article 5 to halt bankruptcy proceedings that have been initiated by workers, other creditors, and the companies themselves. During FILE's activities in the RS, including its pilot case initiatives (i.e., shepherding cases through the system to demonstrate the efficiency and effectiveness of the bankruptcy process), FILE has faced uncertainty about the true intentions and will of the RS Government to allow insolvent companies to be rehabilitated through bankruptcy. In some cases, in fact, the RS Government reversed its earlier commitments to allow cases to proceed, often with unfortunate consequences for the companies.

Thus, Articles 5(6) and (7) of the RS Bankruptcy Law should be eliminated, thereby curtailing the RS Government's ability to influence and undermine bankruptcy. Eliminating

these provisions would also serve to further harmonize the Federation and RS bankruptcy laws.

Article 69(3) (Federation Law only): Eliminate the revision of privatization and detailed auditing of business operations

Article 69(3) of the Federation bankruptcy law, adopted by amendment in July 2004, has caused many problems in practice. The provision stipulates that an investigation of the privatization process and operations of a former state owned company must be completed before the opening of bankruptcy proceedings. This makes opening bankruptcy dependent on the prior completion of the investigation, though the nature and scope of investigation, as well at the responsible party, remain unclear.

Although practice has developed in such way as to minimize the potential misuse of this provision, the more sustainable solution is to eliminate the provision from the law and relieve trustees from this unnecessary task. The interests that the provision ostensibly protects can be safeguarded by a separate administrative proceeding outside of bankruptcy.

Article 13: The Law should identify the costs of procedure to be paid in advance

Article 13 provides:

1. If the petition is submitted by a creditor, the creditor is obliged to advance an amount determined by the Bankruptcy Judge to cover the expenses of the preliminary proceeding.
2. If the creditor does not provide the advance within 15 days, the Bankruptcy Judge shall reject the proposal with a decision.
3. If a bankruptcy proceeding is opened upon a proposal of a creditor, the amount advanced by the creditor is included in the expenses of the bankruptcy proceeding.
4. If the petitioner is the debtor, the court can exempt it from paying the advance, if it can prove that it has sufficient assets to fund the cost of a preliminary proceeding.

The costs of preliminary procedure include the costs and fees of court experts and preliminary trustees, as well as publishing required advertisements.

Since the law does not provide guidance relating to the amount of costs that must be paid in advance, judges have developed a practice of calculating the amount based on the size of the enterprise, the number of court experts required, and the value of the company's property. Under this practice, the costs of the preliminary procedure typically range from 1,500 KM to 5,000 KM (1,500 - 2,000 KM for small companies, and 2,500 - 5,000 for medium and large companies).

FILE suggests that Article 13 be amended to provide the calculation for costs to be paid in advance. For example, the costs could be a percentage of book value (perhaps a series of decreasing percentages, as proposed below for trustees' fees) or a fixed amount for all cases.

Article 44 (2): Clarify procedures for opening bankruptcy without the preliminary phase

Article 44(2) sets forth two circumstances under which a judge can allow the opening of bankruptcy proceedings without conducting the preliminary phase:

> 1. The Bankruptcy Judge may decide to open the bankruptcy proceeding without conducting a preliminary proceeding and without examining the reasons for opening of the proceeding, if the proposal for opening of the bankruptcy proceeding has been submitted by a Liquidator.
> 2. A bankruptcy proceeding can be opened directly if the petition to open the proceeding is submitted by a creditor who holds a final execution order, and that execution order has remained unsatisfied for 60 days. In this case, the Bankruptcy Judge makes a presumption that the existence of the obligation of the debtor and the inability of the debtor to pay has been proven.

The preliminary phase is the main cause of delay in bankruptcy cases, taking an average of 215 days.[1] In many cases, judges conduct the preliminary phase despite a request for direct opening from a creditor with a final execution order.

Judges point out that the main obstacle to using Article 44 is the need to assess the value of the property owned by debtor, in order to determine whether it will cover the costs of the bankruptcy procedure. In practice, judges will allow "direct opening" for larger companies, as there is a fair chance to liquidate some assets and cover the court's costs, while they will conduct a preliminary procedure for smaller and less known companies, mainly in order to search for information as to whether there is enough property to cover costs procedure.

FILE suggests that the law be amended to allow a judge to open a case without a preliminary procedure when a creditor with an execution order makes a deposit in compliance with Article 13 or when a debtor's petition states that book value of the assets is sufficient to cover the cost of the proceeding.

II. Bankruptcy Trustees

Article 237: Draft a clear regulation for trustees' fees

Article 237 provides:

> 1. The regulation on the fees and compensation for experts, interim bankruptcy trustees, bankruptcy trustees, and members of the board of creditors shall be adopted by the Minister of Justice within 3 months of the effective date of this law, and the amount of the fees, i.e., compensation, shall be determined by the Bankruptcy Judge in a decision, taking into account the scope of the activities and the value of the particular bankruptcy estate.
> 2. The bankruptcy trustee, the bankruptcy debtor, and the board of creditors, and also each and every creditor, have the right to appeal the decision referred to in the previous Paragraph.

[1] USAID FILE Project Performance Monitoring Plan Study and Report, September 2005.

There is great uncertainty regarding the determination of trustee fees. While trustees have proposed regulations, it is unlikely that the relevant authorities will find such proposals acceptable.[2] Many government officials and judges have already expressed their opinion that the suggested fees are unrealistic and would allow eat up all or most of the bankruptcy estate.

FILE suggests a regulation, or an amendment to Article 237, providing that trustee fees be calculated as a percentage of distribution. For example, the language could provide:

> *Bankruptcy trustees shall be entitled to a fee of xx KM plus reasonable compensation based on the amount of distribution and upon disbursement to creditors, not to exceed 25 percent on the first xx KM or less, 10 percent on any amount in excess of xx KM but not in excess of xx KM, 5 percent on any amount in excess of xx KM but not in excess of xx KM, and not to exceed 3 percent of any disbursements in excess of xx KM.*

Article 26: Accountability and Insurance of the Bankruptcy Trustee

Article 26 provides:

> 1. In case the bankruptcy trustee consciously breaches the responsibilities he is, according to this Law, under obligation to execute, he is under obligation to compensate for the damage caused in that way to all the participants of the bankruptcy proceeding. The exemptions from the aforementioned rule concern the liabilities of the bankruptcy estate which are not covered in full from the bankruptcy estate, if the bankruptcy trustee, at the time those liabilities were conceived, could not project that the bankruptcy estate shall not be sufficient for their coverage.
>
> 2. The bankruptcy trustee is under obligation to contract insurance coverage for accountability with an insurance firm, immediately after the acceptance of the position, for all the risks of accountability which are connected with his activity. The level of the insured sum is ascertained by the Bankruptcy Judge, taking into account the expected bankruptcy estate, as well as the special circumstances of the procedure. The Bankruptcy Judge can free the bankruptcy trustee of that obligation, in justified cases.

Judges and trustees complain that insurance companies are not writing policies for the insurance mandated by Article 26. Judges want to retain the insurance requirements, however, as they fear that judges and courts would otherwise be liable for trustees' mistakes.

Article 26 appears to provide for two different types of liability and insurance. Subsection 1 prescribes damages for which a trustee can be liable. While the language is somewhat vague,

[2] The RS Trustees Association submitted its version of the Regulation on Fees to the RS Ministry of Justice in May 2005, but no comments have been made to date. It is expected that the Working Group for Amendments in the RS Bankruptcy Law will review the submitted draft. Working Group members have, however, already expressed concern that the fees requested in the draft proposal are too high and will not be accepted. The Federation Ministry of Justice received a similar draft in July 2005. The Ministry submitted this draft to all commercial divisions and is gathering comments from bankruptcy judges.

it appears that the trustee is liable for any damages caused, whether intentionally, negligently, or otherwise.

Subsection 2 provides that a trustee must obtain insurance coverage for each case, with the judge establishing the amount of insurance. However, this section appears to mix the two types of insurance necessary in a case. It would seem appropriate for the judge – or the creditors – to set the amount of insurance needed for coverage of estate assets. But it may not be appropriate for a judge to set the insurance coverage for trustee malpractice in each case. In addition, this does not help improve the efficiency of the insurance market, as insurance companies may not want to continually issue separate policies as trustees are assigned cases and judges set insurance policy amounts.

Article 20 applies this provision to interim trustees (serving during the preliminary proceeding, before the bankruptcy is actually opened) and clarifies that it is the value of the property for which the trustee is responsible that must be insured. Article 20 states:

> The provisions of Article 26 of this law on the responsibilities and insurance of the bankruptcy trustee apply to the responsibilities and insurance of the interim bankruptcy trustee. The measure of the amount of insurance is the value of the debtor's property that the interim bankruptcy trustee is responsible for.

Because such insurance is not readily available in BiH, judges are routinely required to waive this requirement, taking advantage of the provision in Article 26(2) for exceptional circumstances and applying it in each case, thereby placing the bankruptcy estate and the creditors at risk and undermining the credibility of the bankruptcy system itself.

FILE recommends revising Article 26 to clarify that the trustee shall seek insurance on assets of the estate, and the judge, with input from creditors, will approve such insurance or provide further direction for acquiring insurance. A separate provision in the law should provide that all trustees must have insurance for personal liability in a minimum amount (perhaps 50,000 KM). It appears that BiH trustees may have limited judicial immunity for acts taken under a court order, e.g., payment of claims or restructuring of assets under a reorganization plan. Nonetheless, the drafters should consider limiting the amount of liability for trustees' negligent acts to either the market value of the estate or a specific amount.[3] Of course there are conflicting policy considerations in determining what acts the trustee should be protected from liability: too little protection could expose a trustee to excessive personal liability and dissuade capable people from becoming trustees; too much protection would jeopardize the goal of responsible estate management.

Article 23: Allow retired persons to be appointed as trustees

Article 23(4) provides in pertinent part:

[3] Under U.S. law, a bankruptcy trustee, acting within scope of his or her authority or under a court order, has judicial immunity. See Mosser v. Darrow, 341 U.S. 267, 274-75 (1951). However, such immunity does not extend to acts which are ultra vires or in breach of a trustee's fiduciary duty. It isn't clear whether the standard is an intentional breach of a fiduciary duty or gross negligence and there are conflicting decisions on this issue in U.S. courts. But in Mosser the Supreme Court noted that the way for trustees to avoid uncertainty about personal liability is to seek instruction from the bankruptcy court on difficult questions of judgment and to file periodic accounts with the court.

> 4. The following persons can not be appointed as bankruptcy trustees: …
>
> 5. persons who, according to a special law, could not be appointed as members of a supervisory institution or an institution for the representation of debtors…

Two views of this provision have been identified after lengthy discussions with judges. First, a majority of judges believe this provision forbids the appointment of a trustee who cannot be employed as director of the company. BiH labor law requires mandatory retirement of anyone who is 65 years old with at least 20 years of working experience. Since such persons cannot be employed as directors, judges conclude that they cannot be appointed as trustees.

For a minority of judges, however, this provision relates to affirmative restrictions other than retirement age (e.g., persons who are barred from serving as directors because of prior criminal activity), and they believe that retired persons can be appointed as trustees.

FILE suggests that Article 23 be amended to provide that retired persons are not excluded from acting as a bankruptcy trustees.

III. Automatic Stay

Law on Enforcement: Clarify automatic stay of enforcement actions during bankruptcy

Due to a lack of clarity of certain provisions of the enforcement and bankruptcy laws, there are cases where the bankruptcy judge does not allow stay of enforcement over the debtor's property. Articles 228 (Federation) and 231 (RS) of the enforcement laws state that provisions of other laws that relate to the stay or postponement of enforcement procedures are inapplicable. The enforcement law itself significantly restricts the postponement or stay of enforcement procedures, and does not envisage the stay in bankruptcy. On the other hand, the bankruptcy laws in both entities provide for an automatic stay of enforcement over the debtor's property. As a result of this inconsistency, some judges allow enforcement to continue if it was initiated before bankruptcy, which can have significant impact on the fair settlement of all creditors and revival of the debtor through reorganization.

Although a majority of judges allow for an automatic stay of enforcement procedures, amendments to the enforcement laws should be adopted to specifically acknowledge the stay in bankruptcy. This issue could also be resolved by providing that the bankruptcy law shall be lex specialis (see below).

Article 58: The automatic stay should include stay of enforcement by secured creditors

Based on Article 58 of the bankruptcy law, secured creditors can settle their claims over collateral in a separate enforcement procedure, thereby taking their claims and collateral outside of the bankruptcy procedure.

Secured creditors often wish to recover their collateral outside of bankruptcy, in a separate enforcement procedure, rather than awaiting the result of reorganization. By taking this approach, the secured creditors diminish the chances of reorganization as, in many cases, the debtor is unable to continue operations without the underlying collateral.

FILE recommends that Article 58(3) be amended to apply the automatic stay to secured creditors, precluding them from settling their claims outside of bankruptcy. The amendment

should also allow for terminating the stay upon the secured party's showing of undue hardship or that the collateral is not necessary for successful reorganization. The law already provides for replacing security that is crucial for continuance of operations. These measures should inspire banks to play a leading role in bankruptcy without impairing their rights.

IV. Preliminary Procedure

The Bankruptcy Law should specify requirements for a decision on preliminary procedure

Judges still render decisions on preliminary procedure even though the bankruptcy laws do not require or even mention such decisions. They justify this practice based on the need to render a decision to appoint a preliminary trustee and, if necessary, impose security measures. The argument follows that, as long as these decisions must be issued, there is no obstacle to calling these decisions a "decision on opening of preliminary procedure" and including other rulings.

If this practice is to continue, FILE recommends that the law be amended to require the court to render a decision on the opening of preliminary procedure within 45 days after the bankruptcy petition is filed. Such decision should include the appointment of the preliminary trustee and necessary court experts, any required security measures, scheduling the hearing on opening bankruptcy proceedings, and any other orders as necessary for the case to proceed in timely fashion.

Article 50 (Federation): Eliminate the suspension of proceedings due to an appeal against a decision opening bankruptcy

Article 50 provides:

> 1. If the petition to open the bankruptcy proceeding is denied, the petitioner may file an appeal, and if the petition is accepted, the bankruptcy debtor may file an appeal.
> 2. A final decision reversing the decision to open the bankruptcy proceeding must be announced publicly. The consequences of the reversed decision referred to in this Paragraph shall remain in force. In this event Article 48, Paragraph 1 of this law applies to the decision reversing a decision.

(RS Law adds another paragraph (Paragraph 2): "Appeal from previous Paragraph does not delay execution of the decision".)

Judges in the Federation believe that Article 50 causes undue delays in proceedings. For example, once an appeal is lodged, the trustee cannot assume his responsibilities and rights until the appeal is decided by the second instance court.

The Federation law should be harmonized with the RS Article 50.

V. Conflicts of Laws

The Bankruptcy Law should be "lex specialis"

The bankruptcy laws do not state that they are *lex specialis* in conflicts with other laws, i.e., that their provisions take precedence over other laws. This has caused several problems, mainly involving conflicts with enforcement or tax laws.

For example, on several occasions bankruptcy judges have been faced with a situation where the Tax Administration has already sealed the property of a taxpayer. The problem is how to conduct preliminary procedure in bankruptcy when all documentation has been sealed and the Tax Administration does not allow access to the property or related documentation. Most judges hold that sealed property of the debtor, even if it is sealed by the Tax Administration, cannot prevent the judge from conducting bankruptcy procedures, i.e. the bankruptcy law has priority over the tax laws.

FILE recommends a new provision to the bankruptcy law stating that, in all cases involving a conflict between the bankruptcy law and any other law, the bankruptcy law shall be *lex specialis*.

VI. Representation of the Debtor

The Law should be amended to identify who can represent the bankruptcy debtor

If, after a bankruptcy petition is filed by a debtor, the debtor does not have a director (e.g., the director has resigned) and a replacement has not been appointed, some necessary activities cannot be performed (e.g., representing the debtor in the preliminary proceeding, providing consent for adoption of a reorganization plan, etc.). Judges have not been able to identify a solution to these issues.

Similarly, judges believe that the director should represent the debtor on matters where the bankruptcy law requires the judge to hear the debtor's arguments. This holds true even in the RS, even though the opening of the bankruptcy automatically leads to termination of the director's labor contract.

FILE suggests that the bankruptcy law or Code of Civil Procedure be amended to state that a judge can, when necessary, appoint a temporary representative of the debtor company to perform specific duties. This could include amending the Code of Civil Procedure to provide for a temporary representative of a legal entity (currently the law only provides for appointment of temporary representatives for persons).

VII. Estate Property

The Law should provide for resolution of title issues

In BiH, it is often the case that companies that are insolvent and placed in bankruptcy proceedings do not have clear title to all or some of their assets, particularly real property. Under BiH law, clear title exists only if ownership of real estate in entered into Public Land Books. In recent decades, this basic principle became problematic for many reasons and now, according to some estimates, only 30 percent of existing real property in BIH has clear legal title. There are legal procedures to rectify this issue (civil and administrative procedures), but due to the enormous number of such cases and the backlog at the courts, this remedy is inefficient. In such a situation, bankruptcy judges and trustees have trouble meeting two requirements in bankruptcy: to sell debtor's property and close the bankruptcy as fast as possible.

The urgent nature of the bankruptcy procedure and the requirement that only property over which debtor's title is clear can be sold causes a dilemma for judges and trustees. In such cases, judges and trustees often decide to sacrifice speed to ensure a clear title. This approach results in delay of property sale and bankruptcy closure for several months or sometimes even several years (typically an action to clear title in civil court lasts at least 1.5 years).

It appears that the only systematic resolution of this issue would be to amend the bankruptcy law to grant the judge authority to sell property without clear title, provide third parties the right to object to such court decision, and provide protection to the buyer of such assets (including clarifying that he holds clear title to the purchased asset). Furthermore, any dispute over the judge's right to approve such sales should be a dispute over the proceeds of sale, not over the right to sell.

VIII. Extension of Deadlines

The Law needs to clarify when statutory deadlines can be extended

According to the bankruptcy law, the trustee must develop the bankruptcy plan within 60 days from the date of the reporting hearing. However, judges have found that, in some cases, this deadline was not realistic, due to problems with land books, documentation, etc. When such a situation occurs, the question arises as to whether extending the statutory deadline is allowable and, if so, who is authorized to do so. Judges believe that an appropriate solution is to empower the creditors' assembly to approve or disapprove such an extension request by the trustee. FILE agrees that this is a workable solution and that the law could be amended to explicitly provide for it.

IX. Court Decisions

The Law needs to set forth when the deadline for appeals begins to run

The bankruptcy law orders publishing of the court's decisions on the court bulletin board and in the Official Gazette. But it does not state when the deadline for filing an appeal starts to run and when other legal consequences occur. Deadlines for these types of cases should start from the moment when the last publication has been made, either on the court's board or in the Official Gazette. FILE recommends that the Code of Civil Procedure or bankruptcy law be amended to clarify this.

The Law needs to identify where and when court decisions should be published

The bankruptcy law does not state how the court's decisions must be published. Most judges state that it depends on the nature of the action that requires a decision. For example, judges state that under Article 18(2), decisions on security measures and appointment of a preliminary trustee must be published on the court board, and in the Official Gazette (in the Federation, this would include the entity and cantonal gazettes). Judges further agreed that when there are no legal consequences for the broader public, decisions can simply be posted on the court's board, unless otherwise provided by law.

FILE suggests that the Civil Procedure Law be amended to set forth when and where court decisions should be published.

X. Reorganization

Include procedures for amending a Reorganization Plan within bankruptcy

The bankruptcy law does not provide adequate procedures for amending a reorganization plan already submitted to the court. During several pilot and intervention cases, FILE observed that, due to time constraints, trustees are not able to negotiate all details of the reorganization plan with all creditors before it is submitted to the court and for public discussion. Thus, it is often the case that some amendments of the plan are necessary before voting. However, judges are very reluctant to allow any substantial changes to the plan, despite the provisions of Article 165 of the bankruptcy law.[4]

Judges make a determination of whether proposed changes to the reorganization plan constitute amendments of the existing plan or the submission of a new plan. The latter case would require repetition of the public discussion procedure, thereby extending proceedings for at least two months. In addition, the procedure for amending the plan is not clear, leaving the judge to decide whether it is necessary to have prior approval for amendments and, if so, by whom (the Board of Creditors or their Assembly).

FILE recommends that the bankruptcy law be amended to set forth the criteria for differentiating between a new and amended plan, and to provide a clear procedure for amendment.

Article 155(2): Eliminate requirement that cash is the only way to cram down creditors

It is often difficult for a trustee to develop a feasible plan of bankruptcy reorganization. One of the tools that a trustee can use is a "cram down," by which it is possible to force creditors to accept a reorganization plan that does not impair their rights more than the rights of other creditors. However, Article 155(2) of the bankruptcy law effectively limits cram down provisions to payment of cash to the creditor, rendering cram down ineffective since the creditors cannot be forced to accept equity in the debtor in place of cash or debt.[5]

We recommend that this condition be eliminated from Article 155(2). This will provide trustees with an easier path to force the creditors to accept the plan, not only offering them settlement of their claims through cash, but also forcing them to accept shares for the same purpose. This amendment would not affect the requirements of Article 170 that protect creditors.

[4] Article 165, Amendments to the Plan, provides: "The party that has filed the plan has the right to amend the contents of particular provisions in the plan in accordance with the deliberations at the hearing. The same hearing may include voting on the amended plan."

[5] Article 155(2) provides: "When the plan provides that certain creditors will acquire shares in the debtor as a legal entity, will become its stockholders, or will acquire certain rights to concern the activities of the debtor as an individual, declarations of consent of all such creditors shall be attached to the plan."