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Restructuring and Bankruptcy in Central and Eastern Europe

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This book is intended as a guide only and its application to specific situations will depend upon the circumstances involved.

Accordingly, it is recommended that the reader seeks professional advice regarding any problems that he encounters, and this book should not be relied upon as a substitute for such advice. Deloitte Touche Tohmatsu International national practices would be pleased to advise on any problems that arise.

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Design, illustration, typesetting and artwork by
The Deloitte Touche Tohmatsu International Studio, London.

ACKNOWLEDGMENTS

This report brings together, on a comparative basis, the findings of many months of work in thirteen countries of Central and Eastern Europe. By that token alone, the contributors are too numerous to mention individually in this brief preface and the authors therefore face the unwelcome task of selection.

We thank first all those in-country who took the trouble to assist us in our research; in particular for the insights into practice, rather than theory, which helped us to understand how the systems "work". Without their patience and candor, we would have gained a far less accurate reflection of what is actually occurring in the region.

Insofar as this report has achieved a breadth of vision and escaped from the strict confines of legal analysis, it is due to the contributions of a panel of advisors, operating as a Steering Committee who come from a number of different backgrounds and were able to provide valuable input at crucial stages of our work.

- Gail Buyske
Banker
- The Honorable Conrad K. Cyr
Judge, U.S. 1st Circuit Court of Appeals
- Dr. Kalman Miszei
Director, Institute of East-West Studies, Economist
- Dr. Rama Seth
Federal Reserve Bank of New York, Economist
- Sir John Vinelott
Judge, UK Chancery Division (Retired)

We have also learned much from the research and experience of other agencies active in economic development in the Region. We were indeed fortunate to benefit from the insights of key representatives through the functioning of an active and supportive Liaison Committee, comprising:

- EBRD
Andre Newburg, General Counsel
- European Insolvency Practitioners Association
Richard Turton, Director
- International Monetary Fund
Henry Schiffman, Counsel
- OECD
Stilpon Nestor, Deputy Director
- U.S. Treasury
Susan Himes, Advisor
- USAID
Laurie Landy, Senior Financial Advisor
- World Bank, Policy Research
Cheryl Gray, Senior Economist
- World Bank, Private Sector Development
Nena Manley, Attorney
- World Bank, Legal Department
Douglas A Webb, Attorney

We are also indebted to the wisdom of a panel of U.S. Bankruptcy Judges who have given voluntarily of their time and experience to assist us. These are judges Vincent Aug Jr., Sydney B Brooks, Samuel L Bufford, Leif M Clark, Francis G Conrad, A Jay Crystal, James A Goodman, Burton R Lifland, Geraldine Mund, George C Paine II, Elizabeth Perris and James Scott Sledge.

Finally, we thank our Project Officers at USAID: Pat Shapiro who provided the intellectual inspiration and gave us such a sure foundation to build upon, then Susan Gurley who kept us on track and aware of the wider picture.

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Special mention is also due to **Dr. Rama Seth**, an Economist at the Federal Reserve Bank of New York and a member of the Steering Committee, who made a significant contribution to the authorship of this report. Dr. Seth devised the framework for analysis of the survey results on a comparative basis and brought an intellectual rigor to the deduction of their implications and conclusions.

GLOSSARY OF TERMS AND ABBREVIATIONS¹

Term	Meaning
The Region	Albania, Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, FYROM, Poland, Romania, Slovakia, Slovenia.
FYROM	Former Yugoslav Republic of Macedonia.
CEE	Central and Eastern Europe.
SOE	State owned enterprise (including commercialized SOE's).
Bankruptcy	Used in its generic rather than specific sense to include (as appropriate) laws covering Reorganization and Liquidation.
Liquidation	Insolvent Liquidation.
Reorganization	The financial restructuring of enterprises, typically involving re-negotiation of debt amounts and terms.
Proposal	A proposal made to creditors for re-negotiation of debts, within the context of a Reorganization.
Insolvent/Insolvency	Describes an enterprise which either: <ul style="list-style-type: none"> ■ is unable to pay debts in a timely fashion; or ■ has liabilities which exceed its assets.
Secured Creditors	Creditors possessing some kind of purported ² collateral over the debtor's (real or personal) assets, for example a mortgage, lien or pledge.
Priority Creditors	Creditors, other than secured creditors, identified by law as having priority of repayment over others. Typically they are state and municipal taxes, employee claims, and social security claims.
General Creditors	Creditors who are neither Secured nor Priority.
Trustee	Independent person appointed for the purpose of supervising or managing the Bankruptcy proceedings (also sometimes known as Administrator or Liquidator).

¹ Many of the technical terms have specific (and different) meanings from country to country. This general glossary applies however, except where terms are specifically defined in the text.

² The word "purported" is used because such security rights are far from perfect either for the purpose of enforcement and sale or even for the purpose of enjoying priority of repayment out of the proceeds of sale of such assets in a Liquidation.

1. INTRODUCTION

1.1 Background

Bankruptcy law lies at the foundation of a market economy and, in the area of business activity³, has come to serve three principal functions:

- an exit mechanism for failed enterprises, terminating the non-productive use of business assets ("Liquidation");
- a mechanism for rehabilitating enterprises which, although at risk of failure, are worth more as a going concern than liquidated, and have the potential to recover where such rehabilitation involves or requires financial reorganization ("Reorganization");
- a final debt collection mechanism for creditors.

As the countries of Central and Eastern Europe transform their economies from centrally planned to market systems the role of Bankruptcy law in instilling financial discipline acquires a growing significance. Firstly, it is the market economy's way of regulating the rapidly emerging private sector. Secondly, a role for Bankruptcy law needs to be developed in relation to state owned enterprises. In fact, many have argued that Bankruptcy is a useful privatization tool, and that Bankruptcy-type procedures can contribute to the task of reorganizing, privatizing or closing loss-making SOE's, as appropriate.

At present, the CEE countries are seeking the appropriate balance between imposing financial discipline on loss-making enterprises and the immediate need to keep the number of Bankruptcy proceedings (particularly Liquidation) within reasonable limits. The virtual absence of established and functioning financial markets and the still developing legal and regulatory framework require great care in determining the role of Bankruptcy and its place in the sequence of transition.

In western market economies, Bankruptcy plays a marginal⁴ but permanent role. Is such a procedure best suited to deal with the systemic but temporary insolvency found in Central and Eastern Europe? Do countries in the Region have as much to learn from each other as from western experience? To date, most comparative studies have focused on western models. In this study we concentrate on intra-Regional comparison in an attempt to:

- identify and explain Regional trends;
- identify variations and commonalities and understand what drives them;
- highlight the lessons that can be learned from successes and failures in introducing Bankruptcy law and practice.

We hope that the results of our analysis will be of interest and use to a wide audience, including policy makers in CEE countries, their technical advisors, the international community of lending agencies and a wide range of legal and economic development associations. Enterprise restructuring is at the heart of the transformation process. The legal and regulatory framework for enabling it should command attention.

1.2 Regional Bankruptcy Project

This study is the first phase of a project which has five components:

- I. A survey to determine where along the transition continuum each country in the Region is in the process of developing and implementing Bankruptcy law/policies, culminating in this report (the "Initial Report").
- II. Educational in-country workshops in selected CEE countries to build and support a coalition of local experts to further each such country's Bankruptcy reform process. These workshops were conceived as a forum for discussing both specific country findings and also disseminating our broader findings with respect to the Region.
- III. Based on the findings contained in our Initial Report and the feedback received from in-country workshops, offer to two to four countries the design and then the implementation of appropriate assistance models.
- IV. Appropriate ad hoc assistance for certain countries, not selected in part III but with specific needs, identified by the survey, workshops or as a result of new legislative proposals or enactment, and who request assistance.
- V. On the basis of existing perceptions of the need to support the development of the judiciary in several, if not most, CEE countries the project also contains a judicial training element which can be mobilized where appropriate and requested.

The overall objective is to assist in the promotion of formal and informal Bankruptcy procedures in the Region which can serve as a useful mechanism for restructuring or closing financially troubled enterprises.

1.3 Methodology⁵

1.3.1 Collecting the information

In each country we took a three-pronged approach:

- we researched the political and economic background (including the banking system, privatization and the debt structure of SOE's where such information was readily available) through press and other material, and also by interview;

³ Although ultimately important, countries in the Region have not generally focused on personal (as opposed to corporate) bankruptcy and our study relates almost exclusively to the latter.

⁴ Applying only to a small percentage of economic entities.

⁵ As can be expected, problems were encountered in each stage and we detail these separately in Annex A.1 which describes the methodology in more detail.

- we analyzed the written laws on Bankruptcy and other related laws (Commercial Code, Privatization Law, etc.);
- we conducted interviews with local policy makers, practitioners (judges, trustees), and with other potential users of the Bankruptcy procedures (bankers, ministries, privatization agencies, etc.) to determine practice as opposed to theory.

Our team included Bankruptcy practitioners in each country, as well as western lawyers and accountants familiar with the Region.⁶

1.3.2 Organizing the information

In order to collect the information in a consistent manner that could be useful for analytical purposes, a questionnaire was designed consisting of 36 in-depth questions of procedure and practice in each of the countries. The questionnaire was designed by practitioners and is functionally based rather than abstract. A copy is attached as Annex A.2.

1.3.3 Analyzing the information

Two approaches were used in analyzing the information. Firstly, a report was prepared for each country, the Country Report, comprising the following three parts:

1. Executive Summary.
2. Completed Questionnaire.
3. Copies of Laws (translated into English).

The Country Reports provide an overview of each country and are intended to serve as a working document for experts and practitioners in-country. Each report discusses the background, development and approach to Bankruptcy law and policy as well as analyzing key features of the local law and practice.

Secondly, the information was analyzed on a comparative basis across the Region in an attempt to find commonalities and divergence in policy and practice. These establish key issues for policy makers and practitioners and identify what lessons can be learned from the results of decisions on those issues.

Although time consuming, the dual approaches complement each other in providing a rounded picture of each country and also a framework for its comparative standing in the Region. This report addresses the results of the comparative analysis.

2. COMPARATIVE ANALYSIS

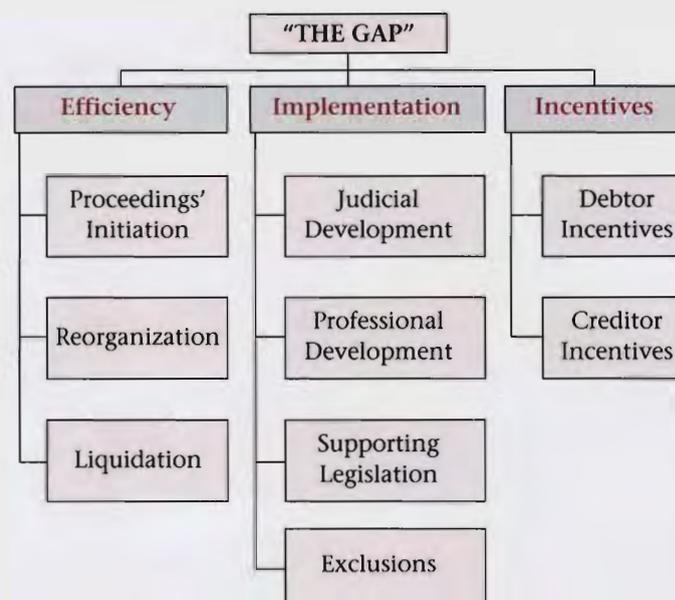
2.1 Analytic Framework

The first step in our comparative analysis was to devise a framework within which we could compare countries consistently. Based on our Country Reports we knew that:

- there were a large number of insolvent enterprises; yet
- there were relatively few attempts to start Bankruptcy proceedings; and
- there were even fewer proceedings actually started.

There appeared to be a need for Bankruptcy proceedings and Bankruptcy laws existed, but the number of proceedings was relatively low. There was a "Gap" between the need and the practice. We felt that the reasons for the Gap could be addressed under three main headings.

Reasons for the "Gap"



Efficiency of proceedings: This is the statutory analysis and examines whether or not the *written laws* provide a workable framework within which to initiate proceedings and carry out Reorganization or Liquidation, as appropriate. If the law is unworkable then it will not be used, hence the Gap. Our work on this area was mainly analysis of the law, backed up by interviews with local experts to validate our interpretation.

Implementation shortfalls: Although the written law provides a workable (or efficient) framework, Bankruptcy policy may still not be implemented in practice due to

⁶ This work was commenced in October 1994 and continued through to January 1995. The practical aspects were updated in the light of information gained during the in-country workshops during May, June and July 1995. We are not aware of any major legislative changes since the basic analysis was performed so that, as at the time of publication, the results generally can be considered as current. The exception is Romania where a new, and we understand much improved, law came into effect on 22 August 1995. All references to and comments on the Romanian law relate to the old version.

deliberate exclusions or infrastructural weakness. We conducted interviews to obtain information on the structure and development of the courts, of the judicial system and of related professions, particularly of trustees. We also examined any Bankruptcy-specific supporting legislation. Information on exclusions from the scope of Bankruptcy laws was obtained both by examination of the laws and by collection of anecdotal evidence.

Incentive problems: Even if a workable statutory framework and the necessary infrastructure are in place, the absence of appropriate incentives (or existence of inappropriate disincentives) may result in a situation where the intended "benefits" of Bankruptcy are perceived as unavailable so that no-one uses the procedures. To determine relative incentives for players to use the Bankruptcy laws, we examined the relative risks, degree of influence and relative benefits to various participants. In particular, we examined incentives and disincentives facing debtors and different groups of creditors.

The framework developed in this paper is not the only one for analyzing Bankruptcy law and practice, nor is it a standard one. We formulated this methodology with a view to developing an innovative approach that could encompass issues related to Bankruptcy law faced by the transforming economies. While we have made every attempt to be comprehensive and consistent, it would of course be impossible to include every feature of Bankruptcy law in each of these countries.⁷

2.2 Summary of Results

2.2.1 Efficiency of Proceedings

In this section we examined three areas:

1. The Ease of Proceedings' Initiation, be they Reorganization or Liquidation.
2. The Efficiency of Reorganization Proceedings.
3. The Efficiency of Liquidation Proceedings.

Ease of Proceedings' Initiation

One feature which emerged early in our statistical analysis was a substantial difference between the number of petitions filed and the number of cases actually commenced. In the Czech Republic, for example, the number of petitions filed exceeded the number of proceedings by a factor of ten. In FYROM during 1993 the five hundred or so enterprises for which cases were commenced had received two petitions on average, and sometimes as many as six or seven. Clearly it was difficult to get proceedings started, even when at least one party wanted to do so.

We observed three main factors limiting the ability to initiate proceedings:

- vague definitions of Insolvency or of the "grounds" for a petition;
- the lack of any obligation on the debtor (management) to start a proceeding when Insolvent, and/or the enforcement of any penalties for failure to file; and
- wide Court discretion in the decision whether or not to commence a Bankruptcy proceeding based upon the information contained in a petition.

We found wide divergence in the definition of Insolvency or the "grounds" for a petition. In Estonia, a creditor can initiate a Bankruptcy case if an overdue debt remains unpaid for more than 10 days. In Croatia, the time period for a debt to remain unpaid (for Insolvency to be established) is not defined in the law, but the Courts apply a limit of 60 days in practice. In Bulgaria, the existence of any overdue debt is grounds for a creditor petition, but the Courts must then make a determination as to whether the Insolvency is "temporary", which is not defined. Although not a sole determinant, we found a correlation between the clarity of the definition and the number of proceedings started.

We also observed that the Court plays a very significant role in Bankruptcy proceedings⁸ and this is especially true in proceedings' initiation. In many countries the Court has wide discretion as to whether to open Bankruptcy proceedings, notwithstanding that Insolvency or the "grounds" for a petition have been established.

For example:

Bulgaria	The Court may refuse to open proceedings if it determines that the Insolvency is temporary.
Latvia	The Court, if it "considers the debtor's or creditor's proposal for insolvency reasonable" begins its investigation, but does not necessarily commence a Bankruptcy case.
FYROM	A judge..., together with the debtor and the State Payments Office, will examine the possibility of a Compulsory Settlement (Reorganization) prior to granting a Bankruptcy petition.
Poland	Prior to the Court's entry of a Bankruptcy order, it can hold hearing(s) and request testimony from the debtor, creditors and other interested parties. Additionally, in the case of SOE's, the SOE's workers' council, founding Ministry and representatives of the State Treasury have a right to be heard prior to the commencement of a Bankruptcy.

⁷ While the actual scoring used in Section 2.2 is of no exact quantitative significance, it is a useful tool to suggest orders of magnitude and directional differences among the countries.

⁸ See Development of Judiciary at 2.2.2 below.

We observed that many judges feel a sense of responsibility to try and "save" the debtor and we were also told that Courts perceive a "political" risk in initiating proceedings. Such factors, when combined with wide Court discretion and a vague definition of Insolvency, or of the grounds for a petition, can severely impede proceedings' initiation.

The question of whether the law should impose an obligation⁹ on the debtor (usually management) to file for a Bankruptcy proceeding when it knows or ought to know that it is insolvent is one on which there are conflicting schools of thought:

- the first is that once an enterprise is insolvent, the owners' money has been lost and the enterprise should be managed for the benefit of creditors. Management is usually the first to realize this and should therefore be responsible for alerting creditors, by initiating proceedings;
- the second suggests that management's primary duty is to the enterprise and its owners and that it is unreasonable to expect them to act against that duty. Creditors should be obliged to protect their own interest provided they have remedies under the law.

For CEE policy-makers, the following observations from our work may be relevant:

- there is not yet an active creditor class in the Region which can be relied upon to commence proceedings against Insolvent debtors¹⁰;
- the obligation to file has no effect on behavior where it is not reinforced by enforceable (and enforced) sanctions for failing to fulfill that obligation; and
- where an obligation is imposed and enforced, it can dramatically affect the ease of proceedings' initiation. In the first year (1992) after the introduction of an Automatic Trigger in Hungary, there were over 4,000 debtor petitions for Bankruptcy proceedings compared to a few hundred the year before.

Efficiency of Reorganization Proceedings

The introduction of workable Reorganization procedures is one of the most important contributions Bankruptcy law reform can make in the Region. Many potentially viable enterprises have become financially overburdened during the early years of transition:

- with unmanageable debt levels, accumulated during periods of high inflation and interest rates;
- with losses accumulated during the period of transition, due to:
 - loss of eastern markets;
 - mounting tax liabilities charged on uncollectible receivables;
- where inflated or overvalued asset book values masks technical Insolvency.

There is a need for appropriate mechanisms to write off these accumulated liabilities write down assets and allow the enterprises to go forward with a clean sheet. The Reorganization objective is not new to CEE countries. Prior to World War II, procedures existed to allow a debtor to restructure debts if possible:

Poland	Arrangements Proceedings under the 1934 Act.
Czechoslovakia	Compositions under the former Czechoslovak Bankruptcy Act of 1931 and the Austro-Hungarian Bankruptcy Act of 1914.
Romania	Concordat Proceedings under the 1885 Commercial Code.
Bulgaria	Rehabilitation under the Commercial Code.

These laws were not used during the communist era. When reforming the legislation since 1989, CEE countries have had to introduce changes which modernize these laws and incorporate some of the features which have evolved in western models during the interim period. Because of the economic success of post-war Germany, many CEE countries have looked to the German model. Ironically, that model (which dated back to the 19th Century) is currently in the process of radical reform.

Although most of the laws in the Region contained some form of Reorganization procedures, these were, in fact, the least used with no more than a handful of Reorganization procedures occurring in practice in most countries. We examined whether the laws contained the requisite features to make Reorganizations work.

1. The ability to preserve going concern value during proceedings
Most laws provided that the management remain in control during Reorganization proceedings with power to carry on "normal" business, subject to varying degrees of supervision by the Court, a Trustee or a creditors' committee.

Not all countries allowed the debtor a Court-enforced moratorium on payments or stay of creditor proceedings against the debtor or its assets. Frequently, secured and priority creditors were allowed to continue enforcement proceedings, thus limiting the debtor's ability to survive.

The issue of financing business activities during Reorganization proceedings also received varying treatment. Some countries give specific priority of repayment to such "post-petition finance" (e.g., Estonia, Bulgaria). In others, we suspect that the ongoing business is financed informally through funds realized from pre-petition assets

⁹ Sometimes referred to as the "Automatic Trigger". For a more detailed account of the use of the Automatic Trigger in Hungary, see Annex B.2.

¹⁰ See Creditor Incentives at 2.2.3 below.

(e.g., receivables and inventory). In most cases, formalized sources of post-petition financing are unavailable to debtors in a Reorganization.

2. Adequate and timely information for decision-making

With the development of accounting standards still at an early stage, there is often inadequate financial and business information available to creditors or to the Court to form the basis of decision-making. We also found relatively few provisions governing the business and financial information to be provided in support of a statutory Reorganization Proposal.

Examples of the types of information which may be useful in evaluating a debtor's proposal include:

- a brief explanation of what caused the debtor to become Insolvent and how those causes will be avoided in the future;
- a description of each class of claims (including an estimate of the aggregate amount of claims in each class) and the distribution proposed to the creditors in each class;
- a comparison of how each class of creditors will fare under the Proposal, as compared to how that class would fare in a Liquidation;
- how the debtor or Proposal proponent intends to fund the distributions (if funding is to come from future operations, the Proposal should include financial projections for the period over which distributions are to be made);
- the identity of the person(s) who will be in charge of the debtor following approval of the Proposal, whether any of those persons are "related" to the debtor and, if so, the compensation paid to any such person.¹¹

The danger with existing legislation in the Region, is that debtor's Proposals can be unstructured in practice and not helpful to the Court or to the creditors in making a determination. The judges that we spoke to confirmed that this is often the case.

Creditors also need time to consider the Proposal before voting. Often this time is not allowed; in Hungary, for example, a first meeting of creditors is called within 15 days of filing the petition to make an "in principle" determination on whether to allow a Reorganization Proceeding to go ahead. Not surprisingly, practitioners in Hungary indicated that it was almost impossible to meet this deadline.

3. The scope for real debt forgiveness, not just a rescheduling of debt

One notable feature was a reluctance on the part of legislators in the Region to allow creditors to forgive any significant part of their debt.

- No debt forgiveness: Moratorium – Romania; Rehabilitation – Lithuania.
- Limited debt forgiveness: Compulsory Settlement – Croatia, FYROM and Slovenia; Concordat – Romania; Arrangement – Poland, Arrangement – Czech and Slovak Republics.¹²

There are also frequent restrictions on who may forgive debt. Usually, secured creditors are not required to forgive debt, unless they specifically agree. Priority creditors are also frequently excluded by the Bankruptcy law (e.g., Poland, FYR, Latvia). Even where permitted by the Bankruptcy law, forgiveness of state budget claims¹³ may require parliamentary approval.

The combined effect of these provisions is to limit the number of Proposals which can be realistically made. The danger is that a bona fide debtor either may not make a Proposal or may promise unrealistically high payments just to comply with the law.

4. Provisions to bind dissenting minorities.

Another feature which limits the chances of achieving a successful Reorganization is the level of creditor support required to approve the Proposal. Although countries which have reformed their legislation have moved towards the western norm of two thirds or a simple majority (sometimes distinguishing number and value), Romania requires 100% approval (Concordat), Latvia requires a two thirds vote (by number) representing three quarters of claims (in value) for approval of a "Peaceful Settlement". The Czech Republic requires a vote by the majority (in number) of creditors representing three quarters of all claims (in value) for Voluntary and Involuntary Compositions. These majorities, based on *all* creditors and/or claims, are hard to achieve.

There is a link between the policy on majorities and that on debt forgiveness (above). Sometimes this is made explicit, with higher levels of debt forgiveness requiring higher majority approval. In Estonia a two thirds creditor vote (both in number and in value) is required if a debtor's Proposal is to repay at least 50% of all unsecured claims. If the debtor's Proposal is to repay less than 50%, then a three quarters creditor vote (in number and in value) is required.

¹¹ This includes related legal (as well as natural) persons, although the concept of a "related company" is embryonic under most of the legal systems studied.

¹² The limitations are imposed by requiring the debtor to repay a certain minimum % to general creditors or by specifying a maximum time period within which the rescheduled debt must be repaid. In Croatia, for example, a debtor must propose a minimum of 50% if repayment is within one year; if repayment is within two years, then the minimum must be at least 80%; if repayment is over two years, then the full amount must be repaid and, in any event, the repayment period must not exceed three years.

¹³ E.g., debt claims for income taxes, VAT (or equivalent), customs duties, compulsory dividends for SOE's and other similar claims according to local legislation.

5. Safeguards for creditors against debtor abuse

Creditors are usually protected (at least on paper) during the period from the opening of a case until a Proposal is approved (or rejected) by way of supervision of the debtor by a Trustee or creditors' committee and by way of provisions to cancel proceedings if creditors' interests are being damaged. However, the period during implementation of a Reorganization plan is generally less well regulated.

Overall Summary – Reorganization

Notwithstanding the problems highlighted above, we found that several countries have Reorganization provisions which contain many of the required elements. Bulgaria, for example, has an excellent set of provisions reflecting a modern approach and Hungary made some significant improvements to its law in 1993.

Ironically, the number of applications for Reorganization in Hungary fell sharply shortly after these amendments. Key reasons for this appear to be:

- the "Automatic Trigger" mechanism was removed;
- the moratorium on payments, was no longer automatic; and
- the new proceedings are perceived as unnecessarily complicated.

In assessing the efficiency of Reorganization proceedings, it is worth taking into account that an effective Reorganization mechanism is comprised of a finely balanced set of procedures which has proved difficult to achieve in many western economies and remains the subject of considerable debate. Reorganizations are very sensitive to what might appear to be minor inefficiencies and slight legislative change can have a profound effect, as was demonstrated in Hungary.

In our view the most sensitive areas of the Reorganization process for CEE countries to focus on at this time include:

- the exclusion of certain significant claim categories from the scope of the Reorganization¹⁴ (e.g., taxes, secured and employee claims);
- restrictive provisions relating to minimum amounts which must be paid to General creditors, and the time limits within which such creditors must receive payment under a Proposal; and
- the high percentage creditor majorities required to approve a Reorganization Proposal.

Efficiency of Liquidation Proceedings

If Reorganization is not appropriate for a particular debtor, or does not work in an orderly and timely fashion, an efficient

law should provide the means for an effective and expeditious Liquidation. In western economies, Liquidation procedures serve a number of broad functions:

1. an orderly exit mechanism;
2. a transfer of business assets to new owners and management who may be able to use them more productively;
3. a cessation of use of business assets which have no further useful life;
4. the final stage of debt collection;
5. a distribution of the proceeds of asset sales among creditors, in accordance with the rules and priorities set down in the law; and
6. an investigation of the reasons for Insolvency and possible Bankruptcy offenses in order to recover improperly transferred assets and thereby increase the sums available for distribution to all creditors.¹⁵

By way of context, we would venture that the third function will be more frequently required in CEE countries than in western economies. We would also suggest that, in a commercial law environment which is not yet fully regulated and "policed", the sixth function is given an added importance. Certain features are required in order to discharge these functions effectively, allowing asset value to be maximized and realized, and allowing the creditors' claims to be quantified and paid expeditiously. We examined whether the laws contained the requisite features.

1. Ability to maximize asset value

While a piecemeal sale of assets is frequently the result of a Liquidation, there is always an opportunity for sale of all or part of the assets as a "going concern". As any liquidator will confirm, going concern value evaporates very quickly.

The somewhat formal procedures, combined with Court delays,¹⁶ make a quick sale impossible under most laws in the Region. Provisions which allow the liquidator to continue operations for a limited period and enforce executory contracts¹⁷ would help. Countries in the Region cover the full spectrum of possibilities, from Romania, where a cessation of business is automatic, to Hungary where there are no restrictions on business continuation.

The objective of a quick sale can also come into conflict with the wish to preserve the possibility of a Reorganization. Several laws allow for a Reorganization to be proposed during the course of a Liquidation, and some even prohibit the sale of assets until the time limit for proposing a Reorganization has expired.¹⁸

¹⁴ I.e., these excluded creditors are required to be paid in full under the Proposal.

¹⁵ This includes the avoidance and recovery of pre-Bankruptcy transfers of money and property which may have "unfairly" benefited some creditors or insiders of the debtor to the detriment of other creditors.

¹⁶ See section 2.2.2 below.

¹⁷ Contracts where at least one party has not yet fulfilled his obligations under the contract as at the effective time of commencement of the proceedings.

¹⁸ E.g., the countries of the Former Yugoslav Republic share this feature.

Another important set of provisions allowing asset value to be maximized relate to the avoidance of certain pre-Insolvency (or pre-petition) transactions which were prejudicial to creditors generally. There are two principal types:

- *Transactions for less than full value*; where the debtor has given away assets for little or insufficient consideration.
- *Preferences*; where the debtor has put one or more creditors into a better position than others, e.g., by payment, lien creation, etc.

Most CEE countries have such provisions in their laws, however they are rarely used and hardly ever used successfully. It seems that there are a number of contributing reasons:

- the circumstances which allow a transaction to be avoided or set aside are often not clearly defined;
- such cases can be quite complex and the burden of proof is substantial;¹⁹
- the debtor's and its transferee's books and records are not adequate to permit investigation and/or proof; and,
- the liquidator has insufficient estate assets available to fund such a case.²⁰

This is a relatively advanced area of law, and it may take additional legal reform, and some improvements in the Court system, before significant progress is made.

2. Ability to realize asset value

As any practicing liquidator will confirm, the greater the flexibility in methods of sale, the greater the chances of realizing full asset value. This is particularly true in the Region where sales are made harder by:

- surplus supply of many types of business assets for sale as a result of privatization and restructuring programs;
- obsolescence of many assets of liquidated enterprises; and
- lack of capital in the economy.

Unfortunately the provisions relating to sales by liquidators are often characterized by restrictions as to the method of sale, for example:

- imposing frequently unrealistic minimum prices based on a theoretical rather than a market value;
- requiring sale by formal Court auction;
- prohibiting non-cash consideration; and
- prohibiting sale to certain buyers (e.g., management).

While all these provisions are well intentioned, designed to ensure a transparent process and avoid sale at an undervalue, their combined effect is probably to reduce the prices achieved overall. In part, these provisions cover for other areas lacking regulation (e.g., Bankruptcy-related offenses) and for the fact that a profession of reliable and trusted liquidators has not yet emerged. As these develop, and with them the professions of auctioneer and appraisers, some greater flexibility in the sale process would improve creditors' prospects for repayment.

In some countries there is an emerging problem of what to do with assets which cannot be sold at any price. In Poland, for example, hundreds of Liquidations have remained open for this reason and the problem is growing. In some cases the assets may actually have a negative value due to environmental clean-up obligations.

Hungary, which has by far the most experience of Liquidations, allows for a distribution of assets in kind to creditors and permits other imaginative solutions where a straight cash purchaser cannot be found. It is perhaps no coincidence that Hungary also has a body of officially registered liquidators.

It is hard to see any solution for assets with *negative* value without state support however, either directly through the establishment of some kind of state-owned asset management body, or indirectly through grants or subsidies to purchasers. However, current budgetary constraints are likely to inhibit an early resolution of this problem.

3. Clear and detailed rules on claim determination

The concept of "claim" is of central importance in the Bankruptcy laws of the Region. Whether a creditor's claim in fact exists and when a claim arises often determines the extent to which a creditor can participate in a Bankruptcy and how much the creditor will recover. Yet, it appears that none of the Region's Bankruptcy laws clearly defines "claim" or deals with when a claim arises.

"Claim" can be defined in a variety of ways. It can be defined very narrowly, to include only matured, undisputed debts. On the other hand, it can be defined very broadly, to include any right to payment, regardless of whether that right is legal, equitable, reduced to judgment, matured, unmatured, disputed, undisputed, secured or unsecured. The advantage of a broad definition is that it enables a debtor to deal with many liabilities and obligations for which the amount may not have been determined as of the date of the commencement of the Bankruptcy, such as unmatured product liability or environmental claims relating to pre-Bankruptcy activities. If such items were excluded from the definition of "claims", a debtor could go through a successful Reorganization,

¹⁹ Some Western countries have addressed this problem by introducing "objective" rather than "subjective" standards, putting the burden of proof on the debtor where the counterpart to the transaction is in any way "related", which is variously defined, or if the transaction took place so soon before the formal Insolvency as to be particularly suspicious.

²⁰ The liquidator must frequently pay a high filing fee to commence such an asset recovery action. Under some laws, creditors may take the action themselves. They must fund it themselves, however, while the rewards of a successful suit are paid to the estate, for the benefit of all creditors generally.

for example, only to wind up in financial difficulty again as the debts relating to those items matured. To the extent the definition of "claims" is unclear, a final distribution in a Liquidation and a determination of which creditors are eligible to participate can be held up indefinitely.

In addition to a broad, explicit definition of "claim", it is also important that there be clear rules for determining the amount of a claim and when that claim arose. These issues are often of critical importance in a Bankruptcy proceeding. Since voting by creditors is usually on the basis of the relative amount of each creditor's claims, there must be some clear mechanism for determining the amount of each claim. Also, since the relative priority of a claim often depends upon whether the claim arose before or after commencement of the Bankruptcy proceeding (claims arising after commencement usually having a higher priority), there is a need for clear rules governing when a claim arises.

Examples of types of claims which present the greatest difficulty in the areas of quantification and timing, and for which express provision in the law should be considered, include:

- "Contingent" claims (claims the amount of which becomes fixed or determinable, and/or the obligation of which to pay only arises, upon the occurrence of some subsequent event);
- "Future" claims (claims arising after the commencement of the Bankruptcy proceeding but which relate to an event occurring before commencement of the Bankruptcy proceeding, such as environmental claims relating to contamination discovered after commencement but which occurred before commencement);
- Claims in foreign currency (due to fluctuations in exchange rates, the amount of these claims can vary significantly depending on the date they are valued); and
- Claims of guarantors and others with rights of subrogation (if the debt to the creditor holding the guaranty has not yet been paid in full, there is the possibility that the same debt could be "double-counted"; the creditor holding the guaranty would have a claim against the debtor and the guarantor would have a contingent claim against the debtor in the same amount).

Just as important as clear rules for determining the amount of a claim and when it arose is a speedy mechanism for making that determination. In the countries of the Region, that function is usually performed by the Courts or the Trustee/liquidator. This may take a great deal of time, particularly if the debtor's records are incomplete. In cases where there are thousand of relatively small claims, the time and money expended to verify the amount of a claim may be greater than the amount of the claim. One way to avoid this would be to have a filed claim presumed correct unless challenged by those with an incentive to do so, such as the

debtor, the Trustee, or another creditor or party in interest. In that way, the Court does not have to concern itself with the vast majority of claims, and can focus its energies on those relative few about which there is a real issue.

The consequence of unclear, or incomplete, rules can be plainly seen in some CEE countries: long delays in determining claims, frequent recourse to the Courts to make the determination, Court delays and subsequent appeals. In many cases, it is unclear what can constitute a claim in Bankruptcy, as opposed to, e.g., a claim of ownership or possession.

One of the best sets of provisions is to be found in the Region is in the Slovenian law which specifically addresses the different types of claims described above.

As well as the amount, the law must also clearly govern the priority afforded to each type of claim. This is generally done in the Region's laws but there needs to be greater care taken that all priority provisions can be found in one place or, if there are provisions in a different statute that are applicable in a Bankruptcy proceeding, that there is a reference to that other statute in the priority provision of the statute governing Bankruptcy proceedings.

For example, in Poland, in addition to the priorities listed in its Bankruptcy Act, there are provisions in its Civil Procedure Code granting priority over secured creditors to costs of execution, alimony claims, employee wage and benefit claims and bank claims (regardless of whether the bank claims are secured or unsecured).²¹

4. Provisions for distribution and closure

It is particularly important in countries with high inflation for the creditors to receive any repayments (dividends) as soon as possible. Generally, Bankruptcy proceedings are stated to be of an "expedited" nature although weaknesses in the Court infrastructure prevent the theory from becoming a reality.²²

Hungary imposed a two year time limit on all Liquidations, although we are not aware of any cases where this has been enforced against the Trustee. Hungary also imposes interim reporting requirements on the Trustee and allows him to draw remuneration only at these reporting points. This rule has had the effect of ensuring prompt reporting, and thereby enhancing the chances of interim distributions to creditors.

5. Insuring creditor involvement

As the Liquidation process is for the benefit of creditors, they have a role to play and this is most effectively done through elected committees. We observed a very low level of creditor involvement in the Region and this could in part be due to the lack of powers given to such committees, for example:

- the Court, rather than the body of creditors, appoint the committee;

²¹ For a discussion of claim priorities, see Section 2.2.3 on Priorities.

²² See Section 2.2.2 on Judicial Development.

- the powers (and duties) of the committee are not clearly established;
- the committee has a consultative, rather than a decision making, role.

The attitude of the legislators in Slovenia is instructive of the policy dilemma in this area. According to government sources, the legislature deliberately held back from significantly empowering the creditors' committee as they felt that, in a climate of general creditor passivity, one or two major creditors might dominate and steer the conduct of the Liquidation to their own advantage. There is clearly something of a "chicken and egg" situation here: by legislating for creditor passivity you risk reinforcing it.

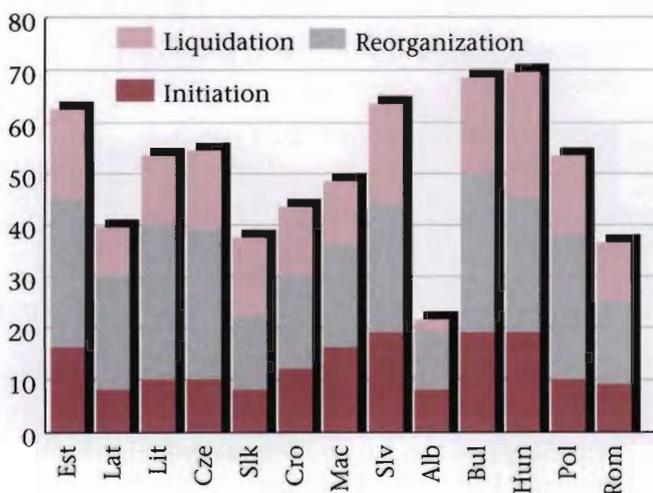
Overall Summary – Liquidation

We found the Liquidation provisions in the Region to be generally workable; the comments we have raised are directed towards making them optimal. If there is a key issue it is flexibility in the methods of sale. In our view, Hungary had the best provisions on methods of sale, mainly by virtue of such a flexibility. This is not surprising for a country which has conducted over 10,000 Liquidation proceedings.

Overall Summary – Efficiency

In order to apply a consistent comparative approach, we devised a simple scoring mechanism to reflect the way in which each country's law dealt with some of the key issues under the three main headings discussed above. Although undoubtedly flawed in some of its detail, we believe that the system and its results are "directionally correct"²³. The results are set out below. As benchmarks, the maximum possible score was 98 and we would expect laws such as those found in the United States and the parts of the European Union to score in the 80-90 range.

Overall Efficiency of Proceedings



It is not surprising that the two countries that have the lowest scores are those that have yet to reform their primary legislation.²⁴ At the other end of the spectrum is Hungary which has revised its law twice and has had the benefit of significant practical experience. It is also interesting to note the relative development of three sub-groups which started with the same or a similar base.

Firstly, the Baltic states which were all former Republics of the Soviet Union. Estonia has done the best job of drafting, followed by Lithuania. Latvia's law is the least efficient, resulting primarily from the unclear and confusing nature of its statute. It has multiple definitions of Insolvency and multiple and conflicting grounds for commencing a Bankruptcy. The legislation is generally vague, with the powers, rights and obligations of the various parties unclear.

Secondly, the Czech and the Slovak laws both were based upon the former Czechoslovak law. The difference in scores stems from the subsequent changes made in Slovakia which actually made their Bankruptcy proceedings *less* efficient.

Thirdly, of the countries of the Former Yugoslav Republic, Slovenia has devoted most effort to reform of its Bankruptcy law and with most success. *FYROM* and Croatia have almost identical laws, neither having made substantial amendments to the Former Yugoslav Republic law; the difference in scores relates to proceedings' initiation where *FYROM* has clearer definitions of Insolvency arising from new parallel legislation on financial operations.

It is notable that Bulgaria drafted an excellent Bankruptcy law in late 1994. It remains to be seen whether they will take advantage of it. Poland has not made substantial changes to its 1934 Laws although changes are currently under consideration; that it scores relatively highly is a tribute to those pre-World War II laws.

To conclude on efficiency, all countries that have gone through a reform process, with the exception of Slovakia and Latvia, have primary legislation that can be considered to be relatively efficient and this might be considered a surprising conclusion. Perhaps even more surprising is that, with the exception of Hungary, there is no obvious correlation between the efficiency of proceedings and the extent to which such laws are used. This may be explained by the relative newness of the laws.

While the laws can be improved, legislative reform should not be the main focus. Our conclusions cause us to look mainly to Infrastructure and Incentive problems to explain the "Gap".

2.2.2 Infrastructure for Implementation

Implementation of the written law can be impeded either by deliberate exclusions from the law's application or by an infrastructure insufficient to support Bankruptcy

²³ That is to say that they are sufficiently accurate to support the conclusions drawn.

²⁴ Based upon the status quo at the time the survey was conducted.

proceedings. The relevant infrastructure depends upon who controls and has a high degree of involvement in proceedings. Mainstream proceedings in the Region are Court-based and Trustees, as officers of the Court, implement the Court's orders. Unlike in the West, creditors play a rather passive role, without much power in practice. In addressing the infrastructure we therefore focused on four main areas:

1. Development of the judiciary;
2. Development of the professions;
3. Development of detailed procedural rules to apply the laws; and
4. Incidence of formal or informal exclusions from the application of the laws.

Development of the Judiciary

It is important for those used to western systems, especially the Anglo-Saxon models, to understand the particular judicial and legislative framework in CEE countries. Some main distinguishing features are:

- a body of law which is codified;
- legal provisions which can be of a general nature, allowing wide scope for interpretation by the Court in any given instance;
- limited concepts of binding precedent (a common law concept).

Bankruptcy proceedings are mainly Court-based and the Court exercises a "hands on", administrative role as well as that of dispute resolution. While the day-to-day management of the Bankruptcy case is delegated to Trustees, they are officers of Court.

Further, Courts in the Region frequently carry out administrative functions such as sending notices to creditors; the Court will also make key business decisions itself, in a pending Bankruptcy case, for example:

- whether to allow a business to continue;
- the minimum value at which assets can be sold;
- the method of sale; and
- voting rights in a Reorganization, in the first instance and not just on appeal.

Additionally, the level of judicial training, expertise and remuneration in the Region needs to be understood. Most countries have now distinguished between criminal, civil and commercial proceedings, whether by way of establishing separate courts or by allocating and training specific judges. In several countries in the Region, however, the distinction between civil and commercial is relatively new and the

amount of specialized training and experience which judges have received in purely commercial matters is often limited. This applies particularly in the area of Bankruptcy.

Latvia and Lithuania have made effective use of Courts that had been used to deal with commercial issues under the Socialist system. They both took the old "Arbitration" Courts and converted them to deal with Bankruptcy and other commercial law cases. This is a transitional measure while they develop their civil Courts to a sufficient degree, and retrain professionals that had been trained to do commercial cases under the Soviet regime to deal with these cases in a market economy.²⁵

Finally, the position of a judge, while highly responsible, does not always carry the prestige or remuneration associated with the office in Anglo-Saxon systems. While notable exceptions exist in all the countries studied, there is a danger that the best legal minds are attracted into private practice by the far greater financial rewards. We found also that, in addition to a shortage of qualified and experienced judges, the Courts lack material resources to discharge their functions effectively, for example:

- court clerks, registrars and related support staff to provide much needed administrative assistance to the severely overburdened judges;
- computerized systems for functions such as case management, registration and monitoring, correspondence and reporting;
- adequate accommodations both in terms of courtrooms and the supporting office facilities; and
- relevant public access to Court records and case information.

Against this background of limited resources and investment, the Courts are charged with significant responsibilities:

- dealing with a growing number of Bankruptcy proceedings;²⁶
- making commercial decisions, for which training has not prepared them; and
- operating in an area of great political sensitivity.

It is clear, therefore, that there is a significant need for investment in the further development of the Judiciary, both in human and material resources:

- training programs established by the relevant institutions in each country are emerging, but the demand far exceeds the supply at present, particularly in the areas of finance and business;

²⁵ Although the Lithuanian Court law is denominated a "Temporary" law, the Latvian law is part of a larger reform program.

²⁶ In Hungary the number of proceedings increased from a few hundred in 1991 to several thousand in 1992. Currently, the Bankruptcy judges in Budapest are handling some 500 cases each on average.

- while it is not necessary to have specialized Courts for Bankruptcy, it is important to develop and maintain a cadre of specialized judges who can deal with Bankruptcy issues;²⁷
- finally, a relatively modest investment in Court systems and procedures, not least the introduction of basic standard documentation and pleadings would assist the judges with their new and increasing responsibilities.

*Development of the Professions*²⁸

The burden of the Courts could be at least partially relieved by the development and more extensive use of supporting professionals, especially Trustees. It may be easier, in the short run, to mobilize private sector Trustees through market forces than to develop state institutions such as Courts.

The general perception in the Region, however, is that the quality and possibly even the integrity of Trustees is low. Romania presents a good example of the dilemma facing legislators as they consider whether to have the bulk of work under their new law conducted by "syndic" judges or by Trustees. The Romanians recognize that they have only a handful of judges with any experience or qualification for the role of syndic judge under the proposed law. Nonetheless, they feel that they would rather entrust the conduct of proceedings to persons who are inexperienced but of proven integrity, rather than sophisticated but unregulated Trustees.

The development of a respected profession is not an overnight task, but certain concrete steps can act as a catalyst. Estonia, for example, requires of its prospective Trustees that they take a two week training course and certification exams. Some three to five hundred Trustees have obtained certification in this way. Hungary has gone further, with licenses to act as Trustee bestowed by the Ministry of Finance once the applicants have proved that:

- they employ at least one lawyer, economist and financial expert;
- they or their staff have experience of Bankruptcy work; and
- they have capital of at least \$150,000 (or an insurance bond in that amount).

Hungary has two professional associations of Trustees; one of large companies and one representing the smaller practitioners. There is also an association of Bankruptcy lawyers. These associations meet regularly to discuss Bankruptcy-related issues and submitted comments to the Justice Ministry on the proposed changes to the law in 1993. Hungary has over 100 officially registered Trustees.

Another measure taken by Hungary to improve the quality of its Trustees and their work was to give them a reasonable rate of remuneration which, based on a percentage of realizations, rewards success and penalizes long drawn out proceedings. Poland, Hungary and Estonia have significantly developed their professions. This is to be expected in Poland and Hungary where there have been many Bankruptcies. Estonia is exceptional in that it has built up capacity ahead of needing to use it.

Development of Detailed Rules & Procedures

At this early stage in the use of Bankruptcy laws, the full complement of supporting legislation is not yet in place or harmonized. The two major problems which we observed were gaps in the supporting legislation and conflicts within it. These problems add to the already difficult task faced by a relatively underdeveloped judiciary.

We observed a lack of detailed Rules and Procedures governing issues such as:

- the form and content of pleadings;
- the various time periods within which certain actions are to be taken throughout the Bankruptcy process;
- claims quantification;
- voting at creditor's meetings (especially on Reorganization Proposals); and
- the powers and duties of Trustees.

Secondly, conflicts among laws are a common feature stemming primarily from the fact that the laws in the Region have not evolved naturally. It is not uncommon to find three conflicting bodies of laws in operation at the same time: pre-World War II era laws recently re-adopted, amended communist era laws and newly adopted market economy oriented commercial laws based on western models.

During the transition period, amendments and new laws have been enacted quickly with little time to harmonize their provisions with existing legislation. Bulgaria has a good example of these conflicts, in the procedure to be followed by the Court on receipt of a creditor's petition for Bankruptcy:

- The Bulgarian Bankruptcy law is modeled on modern Bankruptcy procedures of the type found in Germany or the United States, and therefore envisages that at the hearing to review the Bankruptcy petition and decide whether to commence a Bankruptcy case, the Court will hear evidence from only the petitioning creditor and the debtor, and then make an expedited decision. It is allowed 14 days to do this.

²⁷ It should be remembered that specialized Courts for bankruptcy are not a widespread feature even in the West.

²⁸ Our direct research was limited to Trustees, although it became apparent through our discussions in each country that development of the professions of accounting, law, investment banking, appraisers, auctioneers and real estate agents would also improve the implementation of Bankruptcy laws.

- In contrast, under the Bulgarian Civil Procedures Code, which was not amended at the time of enactment of the new Bankruptcy law, the Court is required to hear testimony from any party with an "interest" in the proceedings, which, in effect, brings in all other creditors, the owners and possibly the debtor's employees and certain State institutions, thereby unduly delaying what was intended to be an expedited process and leaving the judge with a dilemma as to which law to follow.

Thirdly, there is substantial evidence that the right to appeal almost any decision in Bankruptcy proceedings, a practice quite prevalent in the Region, impedes the expeditious conduct of those proceedings. This is further aggravated by the minimal costs of appeal and the absence of requirements for appellants to post financial security in order to launch an appeal. We were informed, for example, of instances of:

- unsuccessful bidders for assets appealing (without real basis) against Court ratification of the sale to the highest bidder, thus stalling the sale; and
- a creditor with a disputed claim ruled against by the Court appealing (without real basis) against confirmation of the Trustee's distribution schedule, then applying for removal of the Trustee, then of the judge – all in an effort to disrupt proceedings.

Both litigants were rejected on appeal but incurred little or no cost and substantially delayed key progress in the Liquidations concerned. Clear procedural rules are needed penalizing such abuses of the legal system and requiring those filing appeals to post financial assurances against harm to others participants in the Bankruptcy process.

Exclusions

Even if the infrastructure exists, outright exclusion from the application of the Bankruptcy law of certain enterprises, types of enterprises or sometimes entire sectors of the economy limit the practice of an efficient law. Exclusions arise either as a result of specific statutory provisions or in practice. Understandably, exclusions are most prevalent in the state enterprise sector.

Lithuania is a good example of "statutory" exclusion: "Special Purpose" SOE's may not be subjected to Bankruptcy proceedings. This may sound unremarkable, however the list of "Special Purpose" SOE's runs to twenty pages.²⁹

Elsewhere the exclusion is less direct. Bankers in Bulgaria told us that it can take from 6 to 9 months to file a Bankruptcy petition against an SOE due to additional formalities and consents with which they have to be comply. This more complex procedural process for SOE's is common in the

Region and means that financially troubled SOE's often do not enter Bankruptcy soon enough, making Reorganization more difficult, because of worsened financial condition during the delay.

FYROM, on the other hand is an example of exclusion in practice. In *FYROM*, the Payment Operations Service, which monitors credit and payment throughout enterprises, must file for Bankruptcy when an enterprise is insolvent (clearly defined). In 1993/4 this responsibility appears to have been exercised much more diligently in the private sector than for SOE's.³⁰

That such exclusions exist is not surprising. As postulated at the outset, some 60-70% of SOE's in the Region might qualify as Insolvent under a strict interpretation of that definition. Subjecting all these enterprises to Bankruptcy proceedings is not an option. As an alternative, most countries have designed and implemented special programs for restructuring large loss-making SOE's, discussed at Section 2.3 below.

Another exclusion is the so called "no asset" cases, where assets are insufficient to cover the costs of the proceeding. Typically, laws in the Region provide that the Court is not permitted to commence a Bankruptcy case unless the debtor enterprise has sufficient resources to fund the costs of the proceedings. A side-effect of this rule is that unscrupulous managers may strip an entity's assets completely prior to creditors filing a Bankruptcy petition, safe in the knowledge that no one will subsequently investigate their action. This is a regulatory weakness in the Region and has implications for governance of the newly emerging private sector. It is far too easy (and too common in practice) for unscrupulous entrepreneurs to start up limited liability companies, run up debts and then "silently" liquidate, leaving their companies with no assets.

Some western economies, and some of those in the Region, have developed funding mechanisms to process all insolvencies whether or not the assets of any particular case are sufficient to cover immediate costs so as to lessen this problem. For example, the Hungarian solution is to provide a fixed minimum remuneration to Trustees, whatever the assets of a particular case, thus enabling them to carry out their investigative functions. This minimum is paid out of a central fund. In order that the central fund not be a drain on the State Budget, it is funded by a 1% levy on realizations in all Liquidations, paid in by the respective Trustees.³¹

2.2.3 Incentives

Whatever the nature of the law and the infrastructure for its implementation, practice will be critically affected by the incentive structure facing potential parties to the proceedings.

²⁹ Since the time of our original research the list has been substantially reduced by the Legislature.

³⁰ In *FYROM* "enterprises with Social Capital".

³¹ The West provides other examples of solutions to the problem. In the U.S., legislation was enacted to create a system of "U.S. trustees" in all Federal judicial districts to supervise the conduct of Bankruptcy cases, and to serve as trustees in cases when private trustees are unwilling to serve. The UK subsidizes its "Official Receivers" service (which takes care of "no asset" cases) through a form of indirect levy on all cases.

The incentive structure derives from the law itself, from other relevant laws and regulations and from human and business behavior. In looking at incentives,³² we considered separately the debtor's and the creditor's perspective.

We also took account of the fact that, generally, a debtor can initiate either a Reorganization or a Liquidation while a creditor may only initiate a Liquidation.

Debtor Incentives

Debtors rarely have an incentive to commence Bankruptcy proceedings even in western economies; the possible stigma attached to Bankruptcy, the loss of business and the admission of failure act as strong general disincentives. Other factors we examined, and which can be affected by the law, include:

Incentives

- penalties levied and enforced against management for failure to commence a proceeding when the enterprise is Insolvent;
- relief from creditor pressure through a moratorium on payments and a stay of any legal proceedings against the debtor; and
- provisions allowing real debt relief and not just re-scheduling, and the ability to obtain creditor approval by majority (rather than supermajority or unanimous) vote.

Disincentives

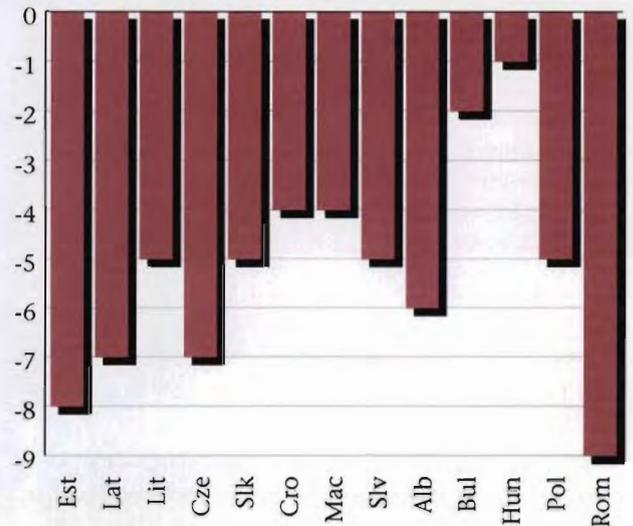
- the extent to which business is damaged or lost by starting proceedings; and
- the degree to which management loses control once a Bankruptcy proceeding has been commenced.

The strongest incentive is clearly the sanction for failure to file, although the sanction must be accompanied by penalties which are enforced in practice. The Hungarian experience in 1992/3 is ample evidence of this. On a more positive note, debtors may be attracted by the relief from creditors which a moratorium gives, or by a genuine hope of achieving a successful Reorganization if debt forgiveness is a real possibility.

Conversely, the damage to the business is a strong disincentive. This is especially true where proceedings tend to get delayed in Court and the opportunities to save the business are lost. This, combined with the loss of business control provide disincentives which far outweigh the incentives, as our scores show.

Debtors may have fewer disincentives for starting a Reorganization (as opposed to Liquidation) or for converting Liquidation to Reorganization; the cost is less in terms of

Overall Debtor Incentives



closure of business and losing control. However, it is the presence of vigilant creditors that incentivizes them to begin such proceedings in the West. The real risk to debtors in the West of loss of their assets outside of Bankruptcy, incentivizes them to file for bankruptcy to obtain the breathing space from aggressive creditors needed for them to attempt to formulate a Reorganization Proposal or at least allow for an orderly Liquidation. The lack of vigilant and active creditors in the Region, however, provides few debtor incentives until such time as creditor activity develops.

Creditor Incentives

The key determinants of creditor incentives which we examined, and their relative importance to each class of creditor, were:

- the speed and cost of realization;
- the existence or threat of intervening priorities;
- the creditor's degree of control or influence;
- tax policy; and
- the nature and effect of "political message".

Speed and Cost of Realization

In Bankruptcy proceedings, realization is slow and costs can be high for creditors. This is due to Court delays (implementation), restrictive provisions on realization of assets (efficiency) and uncertainties in the quantification of claims (efficiency). As a result, Bankruptcy is seen less as a method of debt collection and more as a measure of last resort or a punitive step against an enterprise which is not meeting its debts.

³² The term "incentives" includes disincentives to the respective participant.

We received comments throughout the Region that managers of SOE's may be less inclined to take this punitive measure against each other than when the private sector is involved. The same is true for state-owned banks. Against this general background, we can make the following observations about specific creditor classes:

Secured creditors: The behavior of secured creditors will depend upon the rules relating to the validity and enforcement of collateral, which are generally weak and may counter the above bias against Bankruptcy proceedings:

- while a creditor may be successful in passive enforcement (receiving the proceeds of sale in priority to other creditors in a Liquidation), active enforcement (taking individual action through the Court) is generally harder; and
- court fees for realization of liens on collateral can be prohibitive. In Poland, for example, a secured creditor had, until recently, to pay a Court fee of 10% of his aggregate claim, irrespective of the value of the collateral or of his actual recovery to commence an asset recovery action to enforce his lien. This figure has now been reduced to 5%.

We observed that Central Bank regulations can significantly affect their incentives to take action. Where reserves are not required until a borrower is in a formal proceeding, banks will be reluctant to start one. Stricter reserve requirements for non-performing loans push banks towards collection measures rather than taking a passive role. Additionally, the speed with which bank creditors take action is directly tied to the number of days after non-payment by a borrower, when a bank is required to create a loan-loss reserve under each country's banking regulations.

Priority Creditors: State institutions often have an expedited or low cost procedure outside of Bankruptcy for enforcing debts so that, although they have a priority in Liquidation,

they often take individual action rather than commencing a Bankruptcy. Additionally, since many priority creditors are state institutions, they may be more disposed towards preserving large loss-making state enterprises, rather than commencing Bankruptcy proceedings. Unless and until these state priority creditors perceive that addressing the financial problems of SOE's sooner rather than later is in the best interest of these SOE's – that is, that it will provide them with at least an opportunity to Reorganize before it is too late – they will have few incentives to utilize the Bankruptcy process.

General Creditors: General creditors rarely receive anything from a Liquidation, so they cannot reasonably be expected to initiate or participate in proceedings. This may be less true of Reorganization proceedings, but there they are hampered by a lack of knowledge and experience of the proceedings.

Intervening Priorities

We looked at the priorities of repayment in Liquidation for each of the countries studied. Priorities are principally an issue of local policy, however it is informative to observe the commonalities and variations in this important area. Distorted priorities can create strong creditor disincentives and critically affect behavior. We set out below a rough ranking of the principal creditor classes identified in each law. To get an overview, we also calculate an average for the Region.³³

Claims priorities have been structured so that, while secured creditors often have a relatively high priority (usually first or second), their claims are often subordinated or equal to tax, administration and/or employee claims, which are usually sufficiently large to seriously devalue the security. This can undermine the flow of credit from the banking sector to enterprises and sits uneasily with the expectation of many that banks will lead and be active in the Bankruptcy process.

If recouping moneys is such a risk for secured creditors, then it is a much greater risk for a general unsecured creditor, reinforcing the expectation that they will receive little or nothing from a Liquidation.

Claim Category	Est	Lat	Lit	Cze	Slk	Cro	Mac	Slv	Alb	Bul	Hun	Pol	Rom	Avg.
Court Fees	1	1	2	1	1	2	2	2	3	2	1	1	2	1.6
"Secured" Claims	2	6	1	1	1	1	1	1	1	1	2	2	1	1.6
Administration Costs	1	1	2	1	1	2	2	2	3	2	1	1	3	1.7
Employee Claims	3	2	1	1	2	2	2	2	4	3	1	1	4	2.2
State & Municipal Taxes	4	3	3	2	3	3	3	3	2	5	4	1	1	2.6
Post-petition Finance	1	7	2	1	2	2	2	2	2	6	5	3	6	3.2
Social Security	4	4	3	2	3	3	3	3	4	4	4	4	4	3.5
Environmental Claims	5	5	4	3	2	4	3	4	2	7	1	6	6	4.0
"Private" Debts	5	7	4	3	4	4	3	4	2	7	3	5	5	4.3
General Claims	5	7	4	3	4	4	3	4	2	7	5	6	6	4.6

³³ The table of priorities is in places grossly oversimplified in the interests of consistent presentation and to support the general conclusions. A fuller and more accurate description of priorities is available in Annex C and in the respective Country Reports.

In those countries where Court and trustee fees, administration costs and post bankruptcy finance claims are subordinated to or share a priority with other types of claims, it will be difficult to find Trustees to act (as in Bulgaria) and to administer an efficient process.

Degree of Control or Influence

As a general rule, most creditors have little or no control over the debtor once the proceedings have commenced. Although most laws provide for some type of creditors' committees, their powers (if any) are often ill-defined and their role is to watch rather than participate. Some specific powers which you might expect creditors and their committees to have would be:

- appointment and removal of the Trustee;
- fixing the remuneration of the Trustee (in the first instance);
- approval of continuation of business operations;
- approval of the compromise of debts; and
- approval of asset sale below book value or by a method other than auction.

Although Estonia grants all of these rights, most countries do not, or at most they are given in a way which is consultative rather than authoritative. That creditors are not given these powers is not always an oversight.

In Slovenia, for example, the legislators were concerned that a small number of major creditors (especially banks) might dominate such committees and distort the conduct of Liquidations in their own favor. The point is valid, but could be made in relation to any democratic institution.

Tax Policy

Tax policy in the Region also plays a significant role in creating creditor incentives (or disincentives) and must be coordinated with Bankruptcy policy.

Until recently, in many countries in the Region uncollectible receivables were taxed, creating large tax arrears, without any concomitant tax deduction provided for such losses. An example of a tax policy which might incentivize creditors, even general unsecured creditors, is one which permits losses from receivables to be used to reduce such creditor's tax liabilities from profitable operations only if the debtor is subject to Bankruptcy or other legal proceeding brought to recover such unpaid debt.

Banking regulations requiring banks to create loan loss provisions, to be effective, must be coordinated with tax policies which would allow the tax deductibility of loan loss provisions for such banks incentivizing them to deal with their problem loans and thereby reduce their overall tax liabilities from profitable operations. By creating a variety of tax incentives for creditors, tax policies can go a long way towards ending creditor passivity.

Political Message

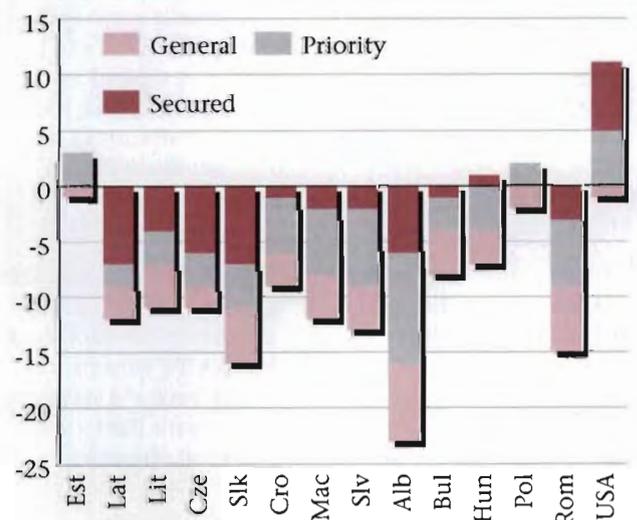
It is noticeable that countries where the government has given an indication that bankruptcies will be tolerated experienced a sharp increase in activity and vice versa. While this factor can be observed, it is difficult to measure.

For example, in Hungary, the 1992 legislation made filing compulsory for debtors who had debts more than 90 days past due. In addition to thousands of debtor filings, the number of creditor filings also increased dramatically, outnumbering those initiated by debtors. This must in part be due to a policy statement implied in the law that Bankruptcies would be tolerated. In Poland, the introduction of the 1993 legislation on Financial Restructuring of Enterprises and Banks ("FREB") gave a similar message with a concomitant increase in filings overall.

Conversely, in the Czech Republic the government has made it clear that it does not want large scale Bankruptcies such as Hungary experienced. Put in other words, it does not want to introduce this market economy mechanism until the market economy is well underway and reasonably stable. Although the Czech Bankruptcy law was enacted in 1991, it was subsequently amended twice, with the early amendment postponing the law's application until April, 1993. It is no coincidence, therefore, that despite the provisions of the Bankruptcy laws, the number of Bankruptcies in the Czech Republic can be measured in hundreds as opposed to tens of thousands in Hungary and that creditor passivity appears to be greater in the Czech Republic.

The creditor incentive scores are set out below.³⁴ It is immediately noticeable that there is wide divergence, suggesting that policy makers can make a significant impact on behavior by affecting the incentive structure.

Overall Incentives – Creditors



³⁴ Note that the scores are relative and not absolute, so that a total score of 0 (Bulgaria) does not imply indifference. In view of this we scored the U.S. system on the same basis to act as a benchmark.

It is also possible to see significant differences in the incentive structure facing secured creditors. They are relatively likely to use Bankruptcy proceedings in Hungary, Poland, Bulgaria and the Former Yugoslav countries. This may not necessarily mean that they have a strong position in these countries, only that the alternatives are worse. There is also a noticeable correlation between the countries with major disincentives and those that have not yet made significant amendments to their laws: Latvia, Slovakia, Albania and Romania.

2.3 State vs. Private Sector

We have observed the extent to which the state sector is often excluded, in law or in practice, from the strict application of the Bankruptcy laws. The emphasis in the state sector has been on restructuring, no doubt because of the social and political implications of widespread closure of large loss-making SOE's with many employees. Rather than use the Reorganization procedures contained in the Bankruptcy laws, governments have designed a variety of special alternative programs.

Because of the financial cost of restructuring, governments have often looked to the International Financial Institutions ("IFI's") for funding and the design process has, to a degree, been influenced by the IFI's and their western advisors. Partly for this reason, it is possible to see commonalities of approach across the Region. For the sake of comparison, we feel it is helpful to identify three basic types of approach:³⁵

1. **The Bad Loan "Carve Out":** Under this approach a primary objective is bank re-capitalization. There is typically a "carve out" of non-performing loans from the banks' portfolios into some central institution. A relatively soft approach is then taken to "working out" the loans with borrowers, usually large SOE's, thus allowing them the opportunity for restructuring.
2. **The Restructuring Agency:** This approach starts with the enterprises and typically selects specific SOE's to be restructured. The task of the Agency is to determine whether the SOE is potentially viable or not; if so, then restructuring will be undertaken under the control of the agency; if not, then Liquidation will be initiated. Ownership of the SOE's is not normally passed to the Agency.
3. **The Restructuring or Bank-Conciliation Program:** This approach is similar to that of the Restructuring Agency method, except that no special institution is established to implement the program. Again, specific enterprises are selected and given a procedure (by way of a statutory instrument) under which to negotiate with banks and other creditors to fulfill the restructuring objectives.

Although somewhat perilous, because of the risk of oversimplification, we attempted to identify whether there

were any observations we could make about the relative success of each of the types of program and the reasons for that success, or lack of it. To begin with, we set out our categorization of the various programs undertaken by the CEE countries.

Country	"Carve Out"	Restructuring Agency	Restructuring Program
Latvia	Bank Rehabilitation Agency (1995)		
Lithuania			Special Restructuring Program (1995)
Czech Republic	Consolidation Bank (1992)		
Slovak Republic	Consolidation Bank (1992)		Special Restructuring Program (1994)
Croatia	Bank Rehabilitation Agency (1995)		
FYROM			Special Restructuring Program (1995)
Slovenia	Bank Rehabilitation Agency (1993)	Development Fund (1992)	
Bulgaria			Bad Credits Act (1993)
Hungary	Loan Consolidation (1991 & 1992)		Debtor Consolidation (1993)
Poland			FREB (1993)
Romania		Restructuring Agency (1994)	

This table is illustrative, not exhaustive. That is to say that a "blank" box does not mean that there has been no such program. It does go to show, however, that in all of the countries covered (except Albania) there has been some kind of special program to address the issue of loss making SOE's.

³⁵ This is our own categorization, not that of the CEE governments nor of the IFI's, and we recognize that within the groups there are significant differences which reflect the particular needs of each country. Additionally, certain in-country approaches are a combination of one or more of these basic approaches.

It is noticeable that some countries have tried more than one approach, for different reasons. In Hungary, a Restructuring Program approach was adopted in 1993 because previous "Carve Out" programs had been unsuccessful. In Slovenia, the Bank Rehabilitation Agency (as creditors) and the Development Fund (as owners) are two complementary bodies which both address the enterprise restructuring need. It is not possible to say that one approach is more successful than others. Poland and Slovenia are widely seen as achieving positive results, using differing approaches. It is interesting, however, to compare different versions of the same approach:

- The Restructuring Agency in Romania does not have ownership of the SOE's, and has found it extremely difficult to implement restructuring plans. In Slovenia, by contrast, the Development Fund owns the enterprises, and has been much more successful.
- The Restructuring or Bank Conciliation Program (called Debtor Consolidation Program) in Hungary had very few detailed provisions in the enabling legislation with the result that the procedure was not fully, or even similarly, understood by the participants. On the other hand, in Poland, the law on Financial Restructuring of Enterprises and Banks (the "FREB") was a more thorough piece of legislation which was successfully implemented.³⁶
- The "Carve Out" solution can become repetitive. If it is not expressed, and believed, to be a one-time re-capitalization measure there is little incentive for the banks to prevent loan portfolios from again deteriorating. This is particularly evidenced in Hungary by repeated re-capitalization and, to a lesser extent, in the Czech and Slovak Republics where the Consolidation Bank continued to take over non-performing loans after the initial transfer. These issues are discussed in greater detail in the individual Country Reports.

While separately constructed, these programs can be related to our overall framework for analysis. They address incentives and exclusions by naming the enterprises, and typically try to address efficiency and infrastructural problems by taking the restructuring process out of existing Bankruptcy legislation and the Court system.

Although a practical temporary solution, bypassing the Court system has raised jurisdictional issues and is not viable long-term. The programs have a limited life and will have greatest effect if they are conducted concurrently with, and contribute to the development of, mainstream laws, the Courts and related professions.

For example, Poland's successful FREB is due to expire in March 1996 and the government has the option of retaining some of its benefits by either extending its life or incorporating some features into the mainstream Court-based Reorganization proceedings laws.

3. IMPLICATIONS

In conclusion, we assess some of the policy implications of our work.

We have found that the Bankruptcy laws in the Region are reasonably efficient and contain workable mechanisms to effect both Reorganizations and Liquidations. It follows that legal reform in this area is not *the* priority, yet many countries are currently planning such reform.³⁷ While these reforms will undoubtedly lead to improved laws, and in some of the countries are much needed, it is important to recognize that legislative reform alone is not enough.³⁸ Without substantial investment in the infrastructure, e.g., the Courts, judges and trustees, even the best laws will not be applied successfully in practice. It is important to keep infrastructural development in line with the improvements in laws. Further, much greater attention (and resources) should be given to the development of related professions such as lawyers, accountants, investment bankers, appraisers and auctioneers.

Three major areas of disincentives also need to be addressed. Firstly, the rules on claim priority strongly favor state-budget creditors and employees with a relegating effect on banks and general unsecured creditors. This hinders the flow of credit to enterprises and then leads to creditor passivity when an enterprise is in financial difficulty. Western models have evolved towards a sequence of priorities which broadly resembles:

- limited costs of the proceedings (court, trustee, post-petition finance) without impairing secured creditors;
- secured creditors;
- priority creditors (employee and tax-related claims) with monetary and time limitations; and
- other claims.

This may be a useful model for CEE countries considering reform in this area.

Secondly, the laws on debt enforcement generally and enforcement of collateral in particular are extremely unfavorable for creditors.³⁹ This again has the effect of inhibiting the flow of credit and creating a passive creditor class. From our results, it would appear that the area of collateral is a far higher priority for legal reform than the Bankruptcy laws themselves. The empowerment of the creditor class will do much to redress the incentive problems which we have identified, on both the debtor's and the creditor's side.

³⁶ A more detailed analysis of each of these two programs is attached as Annex B.1 and B.2.

³⁷ Croatia, Czech Republic, Estonia, Latvia, Lithuania, FYROM, Poland, Romania, Slovakia.

³⁸ Indeed the prospect of imminent legal reform can stall progress in institutional development, encouraging a postponement of activity until the introduction of the new legislative framework.

³⁹ In the words of a senior banker in FYROM "In the west, a company borrows money from a bank and then lives in fear of its life until the loan is repaid. In Macedonia, it is the banker who lives in fear."

Thirdly, tax policies must be coordinated with overall Bankruptcy policies so as to remove existing disincentives to creditors.

Although special programs have been devised to address the restructuring needs of large loss-making SOE's, these have generally been of limited success. Certainly, there have been few Liquidations of those large SOE's deemed not to be viable. This suggests that there is still much to do and many costs to be borne, both financial and social, in the transformation of the state sector. This observation corresponds with the current slowing of the privatization process in many CEE countries.

New sources and methods of funding post-Bankruptcy operations are also required if many cash-poor, but potentially viable SOE's are to be Reorganized.

Finally, it is clear that policy makers face a dilemma in the application of Bankruptcy law and practice to the state and private sectors respectively:

- on the one hand, the state sector may need the somewhat soft application of Bankruptcy laws in order to prevent widespread Bankruptcies during the transition period;
- on the other hand, this soft application disadvantages the private sector and may impede its development;
- simply extending the soft approach to the private sector carries its own risks: if private entrepreneurs are not constrained by the normal application of Bankruptcy laws then there is a risk of financial indiscipline which will harm private sector development as a whole through reduced confidence in credit, that is, it is important that there be a real threat of Liquidation, even though financial restructuring needs to be used more frequently in the Region.

The degree to which these competing needs are successfully balanced will be of critical significance to progress in enterprise restructuring, privatization and the growth of the new private sector in coming years.

⁴⁰ Detailed citations to country-specific legislation refer to "official" and unofficial English translations of the laws in question, not to the original language texts. As a result, errors in translation may have resulted in errors of interpretation. In connection with our legal analysis, without further inquiry, we have assumed that such translations were accurate and that they incorporated the latest amendments to such legislation, unless otherwise noted.

ANNEX A. METHODOLOGY

1. Information

Gathering the Information

This Initial Report is a working document, not an academic research project, and has been prepared as a tool for providing in-country assistance. The findings contained in the Initial Report, as illustrated in the various accompanying charts and tables, are not intended to be statements on macroeconomic impact in the Region. Differences among countries do not reflect value judgments on our part. Rather, the findings reflect differences in actual activity levels in each country.

The methodology used in preparing the Initial Report can be broadly grouped into three stages. Information was collected in the first, summarized in the second, and analyzed in the third stage.

Collecting the Information

In each country, we drew on multiple sources of information, as we found that no one source was complete alone. The team putting together the information included Bankruptcy practitioners in each country, as well as western lawyers and accountants familiar with the Region. With the use of an in-depth questionnaire (described below), the team surveyed the current situation in each country by using their own expertise on the country, reviewing the translated laws, and conducting interviews.

Those interviewed included policy makers, other donors, lawyers, judges, bankers and other business persons in the countries. These interviews were useful in understanding practice and also gave a flavor of recent amendments in some cases. In preparing the Initial Report, we have assumed the accuracy of the data provided to us in this manner.

In reviewing the laws, due to obvious constraints, original language texts were not reviewed. A realistic approach necessitated the use of the English translations without further inquiry⁴⁰. While some translation of Bankruptcy laws generally exist, related laws that affect debtor and creditor rights, in particular, each country's civil and procedural codes generally do not exist in English. We have focused in our research on primary Liquidation and Reorganization procedures.

Broad generalities were encountered in much of the legislation reviewed which provided for discretion in interpretation. Further, the terminology used was not homogenous across the countries. To present an overall view, we have used similar terms with the result that gradations of differences have been simplified.

Summarizing the Information

A detailed questionnaire was completed to summarize the information obtained through a review of the laws and interviews by the team surveyors in each country. The in-depth survey questionnaire was designed to obtain detailed legal and factual information on the state of Bankruptcy policy, laws, procedures and practices in each of the thirteen countries studied.

Questions were designed to determine whether some form of Bankruptcy law existed and, if so, to set out its source and scope; to determine the various Bankruptcy type procedures provided for, their principle objectives and characteristics; and to determine the existence, extent and effectiveness of any specific provisions designed to:

- allow for the Reorganization of potentially viable enterprises (or parts thereof);
- provide for efficient Liquidation of non-viable enterprises;
- protect the interests of creditors and shareholders generally and among classes;
- ensure that proceedings are conducted properly and expeditiously.

It was thought that this offer would homogenize the information across the different countries to the extent that it was possible.

Analyzing the Information

Two approaches were used in analyzing the information: a country-by-country approach and a comparative approach across countries. It was felt that the two approaches complemented each other in providing a complete picture of each country as well as its standing in the continuum of transition economies in the Region. The country analysis is contained in detailed Country Reports. The bulk of this Initial Report deals with the comparative analysis.

2. Questionnaire

No.	Question	Guidance Notes for Completion
1.	<p>Does the country have any form of Bankruptcy law, covering for example:</p> <ul style="list-style-type: none"> ■ voluntary arrangement or composition ■ reorganization or rehabilitation procedures ■ receivership or trusteeship ■ liquidation (solvent or insolvent) ■ dissolution 	<p><i>"Bankruptcy" includes any mechanism for a debtor to deal with his unpaid debts or for creditors to enforce those debts.</i></p> <p><i>Distinguish Court vs. Out-of-Court proceedings.</i></p> <p><i>Look for special provisions for "self-liquidation" of SOE's under laws on privatization or management of State-owned property.</i></p>
2.	<p>Is any such Bankruptcy law a separate law or part of another piece of legislation (e.g. Companies law, Commercial Code)? From when does it date? Does any other country's law serve as a model?</p>	<p><i>Look for inter-relationships between Bankruptcy law and other legislation e.g. privatization, employment, Court procedure.</i></p>
3.	<p>To whom does the Bankruptcy law apply? Are there any exclusions or special provisions covering, for example:</p> <ul style="list-style-type: none"> ■ certain specific types of entity or industrial sector ■ state and local government enterprises ■ co-operatives and trusts ■ banks and insurance companies ■ foreign firms and joint ventures ■ non-profit enterprises ■ partnerships ■ individuals 	<p><i>Exclusions may be of a temporary nature, and therefore not on the face of the Bankruptcy law. Look also for government decrees, special rules relating to privatization and for temporary programs such as regional development programs.</i></p> <p><i>Exclusions may arise in practice as well as in law. Follow this up under the interviews in F3. below.</i></p>
4.	<p>Is "insolvency" defined under the law? If so, how?</p>	<p><i>Give the exact definition [translated].</i></p>
5.	<p>What alternatives, if any, do creditors have to judicial bankruptcy proceedings?</p>	<p><i>Check any Out-of-Court remedies for debt enforcement.</i></p>
6.	<p>For each type of proceeding, establish:</p> <ul style="list-style-type: none"> ■ who may (or must) commence a proceeding ■ when may (or must) they be commenced ■ how are they commenced, implemented and resolved ■ summarize the key procedural aspects of the Bankruptcy process 	<p><i>For all proceedings identified in Q1.</i></p> <p><i>Give a bullet point (or flow-chart) summary of procedure.</i></p>
7.	<p>What specialized "players" are created or appointed as a result of proceeding having been commenced (e.g. liquidator, receiver, trustee, creditors' committee)? What are their respective powers, duties, obligations?</p>	<p><i>Note whether these "players" have to change on the transfer from Reorganization to Liquidation.</i></p> <p><i>How are they remunerated (by whom and on what basis)?</i></p>
8.	<p>What is the role of incumbent management vis a vis these players with respect to the management of the debtor during these proceedings?</p>	<p><i>Can creditors bring in new/additional management?</i></p>

No.	Question	Guidance Notes for Completion
9.	Does the law allow for debt forgiveness and, after the completion of proceedings, can creditors claim the unpaid part of their debts?	<i>Discharge means the complete forgiveness of all unpaid claims on completion of the Reorganization proceedings.</i>
10.	Does the Bankruptcy law distinguish between procedures aimed at Reorganization and those aimed at Liquidation? If so: <ul style="list-style-type: none"> <li data-bbox="209 506 767 533">■ are they mutually exclusive or are they linked? <li data-bbox="209 546 746 573">■ what are the decision criteria between them? <li data-bbox="209 586 834 645">■ who proposes and who decides which will prevail (are there appeal provisions)? 	<i>Does the debtor have to make a once and for all decision between Reorganization and Liquidation? If a Reorganization fails, is Liquidation automatic? If a creditor files for Liquidation, can the debtor file a protective suit (e.g. for Reorganization or a moratorium)?</i>
11.	What are the risks and benefits for debtors and creditors respectively between Reorganization proceedings, Liquidation proceedings and taking no action?	<i>Debtors – look at personal liability of officers/managers. Creditors – look at tax treatment, depletion of assets etc.</i>
12.	Does the law permit/restrict a debtor's ability to operate under Reorganization or Liquidation proceedings (e.g. new contracts, borrowing and collateral)?	
13.	Are the company and its assets protected from legal proceedings, seizure and execution? If so, at what point in the Bankruptcy process?	
14.	What is the procedure for and the persons who are responsible for identification and realization of assets? Are they given special powers, for example powers of compulsion and powers to obtain specialized assistance?	
15.	What types of pre-filing transactions or its affiliates may be challenged during proceedings? Who may challenge such transactions?	<i>Include relevant time limits. Consider impact of legislation on fraud.</i>
16.	What provisions govern or restrict the procedure for sale of assets? Consider: <ul style="list-style-type: none"> <li data-bbox="209 1413 871 1440">■ method of sale (auction, public tender, private contract) <li data-bbox="209 1453 424 1480">■ use of proceeds <li data-bbox="209 1494 794 1520">■ which parties have the authority to approve sales <li data-bbox="209 1534 775 1592">■ whether any persons are restricted from buying (related parties, officers, creditors) <li data-bbox="209 1606 611 1632">■ the rules on timing of the sale(s) 	
17.	What rules of distribution and claim priority are provided for? Consider in particular: <ul style="list-style-type: none"> <li data-bbox="209 1738 523 1765">■ pre vs. post-filing claims <li data-bbox="209 1778 823 1805">■ fees of any "special players" identified in Q7. above <li data-bbox="209 1818 834 1845">■ claims by government or local authorities (e.g. taxes) <li data-bbox="209 1859 440 1886">■ employee claims <li data-bbox="209 1899 440 1926">■ "secured claims" <li data-bbox="209 1939 496 1966">■ environmental claims 	<i>Are these rules the same in Reorganization Proceedings as in Liquidation? Are all classes of claim potentially subject to Reorganization proceedings, or are some excluded "ab initio".</i>

No.	Question	Guidance Notes for Completion
18.	Where (unsuccessful) Reorganization procedures can be followed by Liquidation, are there any rules governing claim priority of costs and liabilities incurred during the Reorganization period?	
19.	Are there provisions governing the quantification of claims? Consider: <ul style="list-style-type: none"> <li data-bbox="181 483 667 510">■ the date at which claims are established <li data-bbox="181 528 628 555">■ interest accrued (pre and post filing) <li data-bbox="181 573 368 600">■ set-off rights <li data-bbox="181 618 432 645">■ contingent claims <li data-bbox="181 663 520 689">■ claims in foreign currency <li data-bbox="181 707 405 734">■ disputed claims 	<i>See comment on Q17. above.</i> <i>Consider the position as regards voting (e.g. in a Reorganization) and payment.</i>
20.	What are the provisions regarding set-off of mutual claims?	<i>Establish whether set-off rights can be acquired after the start of proceedings.</i>
21.	What is the tax treatment of write downs under Reorganization procedures, both in the debtor and the creditor enterprise? Are they chargeable/allowable respectively?	<i>Consider carry forward/back of profits and losses.</i>
22.	May shares or creditors claims be bought, sold or transferred after an enterprise has become the subject of a bankruptcy proceeding?	<i>This question aims at the possibility of acquiring "control" of a business. Consider the potential for holders of claims to then swap claims for equity.</i>
23.	What is the effect of the initiation of proceedings on existing contracts such as employment and lease contracts? Does the liquidator/trustee have the power to disclaim onerous contracts?	<i>Different types of contract may be differently affected.</i>
24.	What are the roles (power and discretion) of the courts generally and the judges particularly in Bankruptcy proceedings (see also Q31.)?	<i>Do they make commercial, as well as legal, judgments?</i> <i>How much do they delegate to their officers?</i>
25.	What other parties have a role in proceedings? Consider in particular: <ul style="list-style-type: none"> <li data-bbox="181 1424 464 1451">■ government agencies <li data-bbox="181 1469 448 1496">■ local municipalities <li data-bbox="181 1514 312 1541">■ owners <li data-bbox="181 1559 472 1585">■ officers and managers <li data-bbox="181 1603 496 1630">■ employees/labor unions <li data-bbox="181 1648 296 1675">■ banks 	<i>Consider particular rules for State-owned enterprises.</i>
26.	What sort of publicity and records of the proceedings (procedural or financial) are required? Who has access to them?	<i>Including notification requirements.</i>
27.	What examinations and investigations of debtors and their officers are permitted and/or required? Who can require it? Who carries it out?	
28.	Are there any special licensing provisions for persons wishing to act as e.g. trustee, liquidator or supervisor of an insolvent enterprise?	<i>What sanctions (if any) exist under these licensing provisions?</i>

No.	Question	Guidance Notes for Completion
29.	Does any personal liability of officers/managers ever exist under the Bankruptcy laws? Do any criminal offenses arise from Bankruptcy or other related legislation?	
30.	Do the proceedings affect the taxation (e.g. income tax, VAT, social security deductions) status or reporting requirements of the debtor?	
31.	Are there separate civil, commercial and/or bankruptcy courts? If there are specialized Bankruptcy courts, are there separate rules or regulations governing their operation?	
32.	Is there a secured creditor (lien) law? How does it work? Consider in particular: <ul style="list-style-type: none"> ■ type(s) of property covered ■ registration requirements and facilities ■ enforcement procedures (in or out of Court) ■ effect of Bankruptcy proceedings on collateral rights 	<i>Summarize the main features.</i>
33.	How much privatization is occurring through the application of Bankruptcy procedures?	
Factual/Practical Issues		
F1.	How many proceedings have occurred in each country? What volume and capacity exists with respect to formal Court proceedings? Provide some analysis, where available, by: <ul style="list-style-type: none"> ■ type of proceeding ■ type of enterprise (and size) ■ state vs. private enterprises ■ duration and stage of completion of proceedings ■ petitioner (debtor vs. creditor; class of creditors) 	
F2.	What is the typical debt structure of insolvent companies? Analyze between: <ul style="list-style-type: none"> ■ Bank debt ■ State Budget debt (taxes, development loans etc.) ■ Social Security debt ■ Employee debt (including severance liabilities) ■ Inter-enterprise debt 	<i>If this is not available statistically, try to get an impression through interview under F3. below.</i>
F3.	Interview representative parties involved in actual Bankruptcy proceedings to develop a summary of the critical problems encountered in implementing the law.	<i>This would include reasons for not using the law.</i>

ANNEX B. ALTERNATIVE APPROACHES TO THE STATE SECTOR

1. "Bank conciliation" in Poland

A Reorganization option for SOE's (only) is contained in the Law on Financial Restructuring of Enterprises and Banks dated February 3, 1993 ("FREB").

According to banking sources, by July, 1993, the National Bank of Poland ("NBP") considered 32% of bank loans to commercial businesses (both private and state-owned) to be troubled or in default. These troubled enterprises were absorbing 40% of bank credit, that is, most new lending was being directed to loss-making firms, most probably for overdue interest. Further, at that time, banks were not instituting Bankruptcy or Reorganization proceedings using the then existing legal framework under the Bankruptcy and Arrangement Acts.

To deal with this situation, the government enacted FREB. The history of the FREB indicates that among the problems the law was intended to solve were: the restructuring of those SOE's which have a realistic prospect of functioning effectively in a market environment; the elimination of those SOE's that are financially and functionally Insolvent and have no realistic chance of independent existence; the speeding up of the privatization of the state sector; the re-capitalization of the state-owned banks; the preparation of the state-owned banks for privatization; and, generally, the strengthening of Poland's financial sector by resolving the bad loan portfolio problem in state-owned commercial banks.

FREB, broadly speaking, is comprised of two sets of provisions which regulate the conditions under which state-owned commercial banks may receive their re-capitalization; and the method by which state-owned commercial banks may restructure enterprises, i.e., the conciliation procedures. It applies only to debtors who are SOE's or commercialized SOE's in which the state has retained a greater than 50% equity interest, and to the Agricultural Property Agency. The FREB, at this time, has a limited life (3 years), since by its terms no conciliation proceedings may be commenced after March, 1996.

The FREB authorizes banks, that is state-owned banks (in which the state holds more than 50% of the equity) to conduct out-of-Court "conciliation" or Reorganization proceedings (with a limited role for the Courts) on behalf of all creditors. These out-of-Court conciliation proceedings can include the restructuring of a debtor's capital and interest payments, partial write-offs of accrued interest and/or principal and debt/equity swaps. The FREB also created a framework for the disposal and trading of bad debt, a new loan classification system for banks, and requirements for banks to establish workout departments and to place their bad loan portfolios within such department's responsibility.

According to a recent World Bank report, since early 1993, of the 7 state banks' loans classified as non-performing on December 31, 1991, 13% have been repaid in full, 19% have become current on principal and interest and approximately 25% have been partially serviced, arguably because of the incentives provided by the FREB. Additionally, since early 1993 these 7 state banks have negotiated 44 conciliation agreements which have involved debt/equity swaps. According to statistics provided at a recent OECD conference, more than 500 conciliation proceedings involving SOE's were commenced pursuant to the FREB since 1993, with some 200 having been completed.

2. "Consolidation" in Hungary

Background

Prior to 1989, Hungarian Bankruptcy law was incorporated in the Commercial Code of 1986 ("the 1986 Law"), which comprised a fairly workable set of Bankruptcy provisions, allowing both for Reorganization and Liquidation procedures. During the initial years of transition its provisions were little used although, in common with other former COMECON economies in transition, Hungarian enterprises suffered severe losses and many became technically Insolvent. These losses were partly absorbed by the banks which typically "rolled over" defaulting loans. The resulting pressure on bank liquidity was alleviated by the issuance of refinancing credits by the National Bank.

By 1991, the build up of pressure was intense and the Government of Hungary ("GOH") took steps to address the issues. It imposed much tougher accounting and provisioning standards on the banks in order to reveal the problem of bad loans and force the banks to deal with them. At the same time, it introduced (on January 1, 1992) a consolidating piece of Bankruptcy Legislation ("the 1992 Act").

Loan Consolidation - 1991

At around the same time the GOH orchestrated a buyout from the banks of their loans 13 major loss makers (known as the "dirty dozen") totaling some \$170m. These debts were rescheduled while the dirty dozen underwent operational restructuring. This buyout protected the banks from the effects on their balance sheets that additional provisions (under the new accounting laws) would have had and the rescheduling kept these strategic enterprises outside the teeth of the new Bankruptcy Law.

Bankruptcy Law Reform – 1992

The 1992 Act was basically well constructed but contained two particular provisions which were to have a significant effect:

- enterprises who had debts more than 90 days overdue were **required** to file for Bankruptcy proceedings (“Automatic Trigger”);
- on filing, the enterprises were **automatically** granted a payment moratorium of 90 days (capable of extension) during which they were to attempt to construct a plan of Reorganization and obtain creditor approval.

The combined effect of these provisions was to create a flood of debtor Bankruptcy filings (4,169) in 1992. In addition to those who filed because of the Automatic Trigger, many opportunistic debtors filed simply to take advantage of the payment moratorium. The harsh new climate was also reflected in the number of Liquidation filings in 1992 (9,891 of which 8,131 were creditor initiated).

Having pushed all these enterprises into Bankruptcy, the law did not, unfortunately, provide them with an efficient Reorganization procedure. Most significantly, 100% creditor agreement was required to approve a Proposal and any debt forgiveness. As a result, those few agreements that were reached (740 out of 4,169) were largely cosmetic in nature, promising full repayment in time and based on Reorganization plans that proved to be incapable of fulfillment.

Largely as a result of the new law unemployment rose from 1% to around 11% during 1992 and it was estimated that by the end of the year some 20% of the Hungarian economy was in some kind of formal proceeding. The effect on the banking sector was severe and the government announced a new bailout, known as the 1992 Loan Consolidation.

Loan Consolidation – 1992

Under this scheme, the GOH purchased around \$1,100m of bad loans from the banks in exchange for the issuance of Government Bonds. Responsibility for the collection and work out of these loans was passed to the Hungarian Bank for Investment and Development (“HBID”) a relatively small, state-owned, development bank. The intention had been that HBID would quickly develop expertise in debt recovery (with technical assistance) and become a vehicle for workout and enterprise restructuring. There was an implicit assumption that the Automatic Trigger had caused some potentially profitable enterprises to enter Bankruptcy proceedings, but which could now be Reorganized and (partly) saved. In the event, this proved a false hope for two principal reasons:

- a) Due to the (effective) discount at which the Government Bonds had been issued, the banks had offered only their very worst loans into the scheme. With borrowers who had some chance of recovery lending had often been split, with the “rump” of the loans given to HBID and the better part retained by the banks.
- b) HBID was unable to build up quickly the required expertise to cope with the huge volume of cases with which it was required to deal. Any remaining business value quickly slipped away and only a handful of serious Reorganization cases were attempted.

Bankruptcy Law Reform – 1993

By mid 1993 the extent of formal enterprise Bankruptcy had become one of many reasons for the GOH’s unpopularity and an election was less than a year away. Changes to the Bankruptcy law were proposed and in September a new Bankruptcy law came into force (“the Act”) which made a number of significant amendments:

- the Automatic Trigger was removed;
- the payment moratorium required creditors’ (majority) agreement
- a debtor’s Reorganization proposal could now be accepted by a majority of creditors binding the (dissenting) minority;
- Trustees’ remuneration was increased to encourage the development and improve the quality of the private sector Trustees; and,
- secured creditors’ control over their security in Bankruptcy proceedings was severely curtailed.

Debtor Consolidation – 1993

Despite the high volume of Bankruptcy filings in 1992 and (early) 1993 many large Insolvent SOE’s somehow avoided the provisions of the 1992 Act and were continuing to threaten the banks’ balance sheet and liquidity. Because of the discounts at which loans were bought under the 1992 Loan Consolidation scheme, these enterprises had not been included either because of the less dubious quality of the loans (although they were still non-performing) or because the banks believed that they might be the subject of Government assistance and support.

In 1993, the GOH devised another scheme known this time as the Debtor Consolidation which involved, initially, 55 large loss making SOE's ("fast track") and subsequently some 100 more smaller and less critical enterprises. Under this scheme, the enterprises prepared Reorganization plans for "in principle" approval by the SPA (as owners) and an oversight committee comprising representatives of the Ministry of Industry and Trade and other governmental institutions. Once approved (most were), enterprises conducted talks with their bank and the state budgetary authorities to renegotiate the debt structure to one which the Reorganization plan could support. The banks were given re-capitalization funds to compensate for the anticipated debt reductions and state budgetary institutions were specifically empowered to write off principal owing if, and to the extent that, the banks did so.

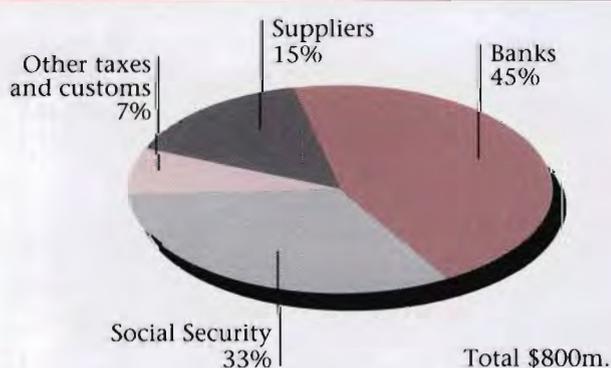
The scheme was not a success. By the time of the deadline for the "fast track" enterprises, only 3 out of 55 had obtained creditor agreement for a debt reduction package. This was due to fundamental flaws in the scheme's design and misconceptions in its implementation. The main design flaws, and therefore the major lessons to be learned, were:

- The banks received their re-capitalization funds in advance of, and without a specific link to, debt reductions. Having secured the funds, there was little or no incentive for them to negotiate with their borrowers.
- The debt negotiations involved only the banks and state budget creditors, both of whom are priority creditors in a Liquidation. Debt reductions by these parties would have enabled general (unsecured) creditors to be paid in full, a reversal of normal priorities which made no commercial sense in the absence of specific incentives to do so.
- The scheme expressly included an option for the SPA to buy out the banks' loans in the event that an agreement could not be reached. Although intended as an option of last resort, this provision had the effect of politicizing the process from the SPA's perspective and encouraged the banks to be intransigent in negotiations, relying on the buyout option.
- The form and content of Reorganization plans to be prepared by the enterprises was not adequately prescribed. As a result the plans were of variable quality and consistency, thus hampering the decision making process.

As regards implementation:

- a) The SPA allowed the banks to believe that it had more funds available (from privatization revenues) than was in fact the case, exacerbating the design flaw of the buyout option, and the intransigence of the banks.
- b) With only 6 months to go before a general election, the SPA was under pressure to apply the buyout option on political rather than economic grounds.
- c) State budget creditors did not formulate a coherent and consistent policy in debt negotiations and their representatives at meetings both lacked the authority to make decisions and were unclear as to what their department's policy would be.

Some figures are available on the debt structure of the 55 "fast track" enterprises, which are probably instructive as to where the balance of debt in Hungary's loss making SOE's lies:



ANNEX C. CLAIM PRIORITIES

1. General Categories of Prioritized Claims

Examination of the claims priority provisions of the Bankruptcy laws in the Region reveals the following broad categories of claims, the priority of which varies from country to country:

- A. Secured claims
- B. Administration costs (including Trustee/liquidator compensation)
- C. Employee-related claims (e.g., wages, compensation for injury)
- D. Taxes
- E. Social security
- F. "Budget" (governmental claims)
- G. Post-Bankruptcy claims
- H. Entitlement claims
- I. Alimony
- J. Claims re third party property in possession of debtor
- K. Environmental claims
- L. Unsecured claims
- M. Late-filed claims

2. General Claims Issues

A. Secured Claims

With the exception of Estonia and Hungary and, in the case of a Liquidation only, the Czech Republic, a secured creditor effectively has a first priority in the proceeds of such creditor's collateral, up to the amount of such creditor's claim. In many of these countries (e.g., Croatia, Latvia, Macedonia), this is accomplished by excluding the collateral and/or the secured claim from the debtor's Bankruptcy estate, and therefore from administration as part of the Bankruptcy proceeding (this is similar to the way secured claims are treated in a U.S. Chapter 7 liquidation proceeding). In other countries (e.g., Bulgaria), secured claims are expressly granted a first priority.

In Estonia, secured claims have a priority behind various post-Bankruptcy and administration cost claims. In a Liquidation proceeding in the Czech Republic, various post-Bankruptcy and administration cost claims, as well as "entitlement" claims, are required to be satisfied in full in order to complete the proceeding, thereby implicitly giving them a priority equal to secured claims (this is similar to the treatment of secured and administration claims in a U.S. Chapter 11 reorganization).

In Hungary, secured claims are subordinate to various post-Bankruptcy and administration cost claims, as well as environmental claims.

A special problem exists in Poland. While secured claims ostensibly have a first priority, they are subordinate to various "secret" liens securing certain tax and other governmental claims. No record notice of these liens is required. There also appears to be no time limit within which the government must assert these lien claims, thereby enabling them to assert the priority years after the amount was due. Note that while, in the U.S., claims secured by real estate are generally subordinate to real estate tax liens and all claims may be subordinate to various tax and other governmental liens, there is usually either some sort of record notice required before the lien attaches (e.g., federal tax liens) or the existence of the lien is easily discovered (e.g., real estate tax liens). Also, in the U.S., many of these governmental liens are subordinate to security interests perfected before the government lien attached.

B. Post-Bankruptcy Claims/Administration Costs

In most of the countries examined (e.g., Croatia, Latvia, Macedonia and Poland) administration costs have or share the highest priority among general unsecured claims. This high priority is deceptive, however, since in many cases there will be few, if any, unencumbered assets to fund these costs. In Hungary and Estonia, however, administration costs have a higher priority than secured claims.

In almost all of the countries where administration costs have a high priority, post-Bankruptcy claims (including claims related to post-Bankruptcy financing) either share that priority (e.g., Croatia, Lithuania) or have the priority immediately above (e.g., Estonia) or below (e.g., Croatia) that of administration costs. The one exception from this similar treatment is Bulgaria, where administration costs have the highest priority among unsecured claims but post-Bankruptcy claims have a priority behind secured claims, administration costs, employee wage and social security and tax claims.

A few of the countries (e.g., Albania, Latvia) do not mention post-Bankruptcy claims at all in the priority provisions of their Bankruptcy laws. The effect of this omission is not clear.

One of the problems with the relative priority given to post-Bankruptcy claims is the apparent lack of authority for granting post-Bankruptcy financing claims a "superpriority" over secured claims, similar to the authority under U.S. Bankruptcy Code, Section 364. This could inhibit financing for bankrupt businesses, particularly those whose assets are already fully encumbered.

C. Employee-Related Claims

Employee-related claims (e.g., wages) usually have a relatively high priority among unsecured claims. In several countries (e.g., Croatia, Lithuania, Macedonia, Hungary), employee-related claims share the highest priority with administration costs.

In certain countries (e.g., Bulgaria, Czech Republic, Slovakia (Reorganization only)), the priority is limited to wage claims arising within a certain period of time prior to the Bankruptcy (usually one to three years). This is significantly longer than the ninety day pre-Bankruptcy period during which wages have a priority in the U.S. In Slovenia, the priority is limited to a certain base level of wages; wages in excess of that level are treated as general unsecured claims. Again, this is somewhat similar to the treatment of wages in the U.S., where the priority claim is capped at \$4,000 per employee.

In addition to employee wages, some countries also give a relatively high priority to social security claims (e.g., Macedonia, Slovakia (Reorganization only), Czech Republic, Estonia) and/or employee personal injury claims (Croatia, Macedonia, Slovenia).

At the other end of the scale is Albania, where employee wage and social security claims share the lowest priority among prioritized claims, coming after secured, unsecured, bank and administration cost claims.

The relatively high priority given to wage claims in most of the examined countries may give employees a disproportionate influence in a Bankruptcy. This may result in certain businesses remaining in operation solely to keep people employed when, on a purely economic basis, those businesses should not continue in existence.

D. Government-Related Claims

Government-related claims (tax, "budget," etc.) often have a priority immediately below that of employee wage claims (e.g., Bulgaria, Croatia, Estonia). This is similar to the priority given to such claims in the U.S. The relatively large size of these claims, and the authority of a government to reduce the amount of such claims, however, often determines whether a debtor will choose Bankruptcy proceedings over some other type of restructuring.

E. Other Claims

1. "Third Party Property" Claims. These are either claims for return of property of the debtor in the possession of third parties or turnover by the debtor of property owned by third parties. While certain countries (e.g., Estonia, Slovakia) treat these claims in their priority scheme, they probably should not be viewed as "claims" but as matters relating to the composition of the Bankruptcy estate, and therefore outside of the "claim" system, much in the same way as most of these countries treat secured claims.

2. Alimony. A few countries (e.g., Czech Republic, Slovakia, Estonia, Romania) expressly mention alimony in their claims priorities. With the exception of Romania, all of those countries give it a relatively high priority among unsecured claims.

Alimony is not expressly mentioned in the claims priority provisions of the Bankruptcy laws of the other countries examined. This may mean that, in those countries, alimony is treated as a general unsecured claim. This is unlike the U.S., where alimony and child support are non-dischargeable debts, meaning that an individual cannot avoid those obligations by filing for Bankruptcy.

3. Environmental Claims. While environmental contamination is a serious problem throughout the CEE, only Latvia, Hungary and the Slovak Republic expressly mention environmental claims in their claim priority systems. Latvia gives it a fifth priority among unsecured claims, immediately above that of general unsecured claims. In Hungary, environmental claims share a first priority with other administration costs over secured claims. Additionally, as part of the Slovak Republic's May,

1993, amendment to its Bankruptcy law, environmental claims not appear to have an administrative priority as in Hungary, with any such unsatisfied liabilities being transferred to the State. It is not clear what the failure to mention environmental claims in the other countries means. It could mean that such claims are treated as general unsecured claims. It could also mean that those claims are dealt with outside of the Bankruptcy system or not at all.

4. Late-Filed Claims. Estonia and Latvia both expressly provide that claims filed after the filing deadline may be paid, but they are paid after timely-filed claims are paid in full. The other countries appear not to expressly provide for late-filed claims. The effect of this omission is not clear; it could mean that such claims cannot be paid at all.