ENTERPRISE INSOLVENCY AND CREDITOR PROTECTION

Arlene Elgart Mirsky*

I. STATEMENT OF THE PROBLEM

Introduction

There are large numbers of insolvent, loss-making enterprises in the Russian Federation, with ever increasing debts to banks, suppliers, employees, and the state. In 1996, relative to 1995, the share of enterprises reporting net losses increased from 23 to 43 %.[1] The magnitude of the overall enterprise insolvency problem in Russia is huge, given the size of the Russian Federation. However, even though the number of insolvency matters considered by the Russian *arbitrazh* courts has been increasing (see Box 1 below), these still account for less than one percent (0.5% in 1996) of all civil cases the *arbitrazh* courts have concluded.[2] Moreover, the most frequent use of these proceedings is as a tax collection device by the Russian Federal Service on Insolvency and Financial Rehabilitation.[3] In sharp contrast, bankruptcy proceedings have been used only infrequently for the financial restructuring of enterprises or the repayment of non-tax creditors.

Box 1: Bankruptcy Statistics

	1993	1994	1995	1996	1997
# of Proceedings	**100**	**240**	**1,108**	**2,618**	**2,200**

The number of debtors recognized insolvent (bankrupt) on a national level grew from 50 in 1993 to 1035 in 1996. In 1996, external management procedures were applied to 413 debtors and rehabilitation procedures were applied to 28 debtors. In 1997, of the 2,200 bankruptcy cases opened: 66% involved joint stock companies or limited liability partnerships as debtors; 10% banks; 12% state-owned enterprises (i.e., those entities with, at least, a 25% ownership interest held by the state); and, 12% miscellaneous type debtors (e.g., sole proprietorships and private farmers).

On a local level, the Moscow *Arbitrazh* Court has opened a total of 400 bankruptcy cases since 1993, with only 15-20 cases having been completed and closed to date. Approximately one-third of their cases are bank bankruptcies. External management procedures were applied in fewer than 10 cases. Other than bank bankruptcy cases, the majority of cases opened in Moscow were "no asset" cases.

Source: Supreme Arbitrazh Court and Moscow Arbitrazh Court

---

* Arlene Elgart Mirsky, Esq. is Partner, Hannoch Weisman, Counsellors at Law, New Jersey.

Additionally, severe and repeated payment blockages and the virtual explosion in the use of barter, bills of exchange and other debt instruments as a substitute for cash, may demonstrate that a significant proportion of Russian enterprises are unable to fulfill their financial obligations (see related papers in this volume). Moreover, these enterprises' need for working capital go unmet, because long-term, low-interest secured credit is not readily available. The failures, to date, of Russia's credit creation and enforcement regimes have contributed to these problems.

As Russia has adopted market reforms, conflicts have emerged among debtor enterprises and various claimants, including banks, suppliers, the government (as tax collector), and shareholders. The inadequacy or implementation failures of available tools for exercising creditor rights has become apparent. The information hazards of Russian credit markets remain formidable. Creditors have far too little leverage over enterprises due to weak protection of their rights as creditors in the event of default, even in the case of secured loans.

Role Of Insolvency Laws In Imposing Financial Discipline

Bankruptcy or insolvency laws lie at the foundation of a market economy and work to impose financial discipline on market participants. The terms "bankruptcy and insolvency laws" are used interchangeably in this note. They *include* (as appropriate) laws covering reorganization (also referred to as financial restructuring) *and* liquidation.

For business activity[4] these laws impose financial discipline by serving the following functions:

- an orderly exit mechanism for failed enterprises, terminating the non-productive use of business assets (liquidation);
- a mechanism for the financial restructuring of firms whose "going concern" value exceeds liquidation value (reorganization);
- a final debt collection mechanism for creditors; and,
- the promotion of the flow of credit by protecting creditors.

The term "enterprise restructuring," when used in the bankruptcy context, merits clarification (see Box 2 below). When such restructuring involves only operational changes within an enterprise, it is legitimately conducted by or on behalf of the enterprise's owners; when, however, the enterprise is unable to meet it legal obligations to creditors (either to pay them in full or to pay them on time) some kind of financial restructuring is also required. This financial restructuring requires a set of laws that govern the necessary terms and conditions to change or modify creditors' rights. Such financial restructuring rules are usually included in a country's bankruptcy laws.

Box 2: Financial & Operational Restructuring Compared

Operational restructuring involves changes and improvements in the way an enterprise carries on its business or operates with the objective to improve its profitability and competitiveness. Measures may include development of new products, exploiting new markets, increasing productivity, decreasing overhead costs, selling off non-core assets and others.
Financial Restructuring will be required, *in addition to operational restructuring*, where an enterprise's historic losses have caused the firm to accumulate large debts which they are unable to pay currently, thus hampering their recovery. While Operational Restructuring can take place without Financial Restructuring, Financial Restructuring should almost always be accompanied by an Operational Restructuring program. Enterprises which require Financial Restructuring either are, or are about to become, *insolvent*.

When an economic entity is unable to pay it's liabilities as they fall due, it is said to be insolvent on a *"cash basis"* that is, it is suffering from liquidity problems. If, on the other hand, the total value of an enterprise's liabilities exceed its assets, then it is said to be insolvent on a *"balance sheet"* basis. *What is the significance of this distinction?* When a debtor is insolvent on a "cash basis", it may be possible to address and remedy its insolvency simply by postponement or rescheduling of the (re)payment of outstanding debts. The overall surplus of assets means that, eventually, the liabilities can be repaid, either by selling the assets or by using them as collateral for refinancing. Where the enterprise is insolvent on a "balance sheet basis," however, *rescheduling will not be enough*. It is likely that creditors will have to agree to some *reduction* of the liabilities if the enterprise is to escape continuing insolvency and eventual liquidation.

The Financial Restructuring then comprises a compromise among the debtor and its creditors, either individually or collectively, as to the timing and/or amount of the repayment of the debts outstanding.

Source: Coates, Green & Mirsky, Handout for International Conference on Restructuring (1997)

Comparing The Role Of Insolvency Laws In The West And In Russia. In Russia, insolvency laws must deal with two different end-users: state-owned (or formerly state-owned) enterprises and the new private sector. Moreover, in Russia, insolvency laws must work for a very high percentage of enterprises in the economy (as compared to a small number in the West). As a consequence, Russia is seeking the appropriate balance between imposing financial discipline on loss-making enterprises and the immediate need to keep the number of liquidations within reasonable limits and thus preserve economic activity.

Role Of Non-Insolvency Debt Enforcement Regimes In Creditor Protection. There are alternative exit mechanisms to bankruptcy for firms in mature market economies. They include, e.g., voluntary dissolutions, friendly sales, or hostile takeovers. Moreover, many other laws, including secured credit, foreclosure, and corporate governance may affect the timing and method of exit of financially troubled enterprises. At this time in Russia, however, the implementation of these other laws may be even more underdeveloped than that of bankruptcy.

The state of secured creditor law determines whether clear mechanisms exist for establishing the priority of claims on assets, and the state of foreclosure law determines whether creditors can readily foreclose on bad debts by means other than bankruptcy. If secured credit and foreclosure laws provide more favorable priority, greater speed, or lower costs than bankruptcy, they may be a preferred creditor route. Moreover, in the event of nonpayment, lenders need a rapid and inexpensive way to recover and sell pledged and mortgaged assets. Although the number of bank collection actions has increased steadily in the last few years,[5] *significant problems remain to be solved with debt enforcement mechanisms.*[6]

II. THE ANALYTICAL FRAMEWORK FOR ASSESSING RUSSIA'S PRACTICES AS COMPARED TO OTHER COUNTRIES' EXPERIENCES.

Introduction

In most transition economies, as in Russia, there is a gap[7] between the need for fully functioning insolvency and creditor protection regimes and what occurs in practice. The reasons for the gap are analyzed under three main headings:

- *efficiency*: this is the statutory analysis and examines whether or not the *written laws* provide a workable framework for carrying our reorganization or liquidation under the insolvency laws;
- *implementation*: even if a particular country's written laws provide a workable framework, insolvency and creditor protection policy may still not be implemented in practice due to *infrastructural weaknesses*[8]; and,
- *incentives*: the absence of appropriate incentives (or the existence of inappropriate disincentives) may result in a situation where the intended "benefits" of insolvency and creditor protection laws are perceived as unavailable so that no one uses the procedures.

Efficiency Issues

In many transition economies it is difficult to get proceedings started, even when at least one party wants to do so. We observed the following factors in the written laws of several transition economies limiting the ability to initiate proceedings: vague definitions of insolvency or of the "grounds" for filing a petition; the lack of any obligation on the debtor (or management) to start a proceeding when insolvent, and/or the lack of 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, or otherwise.

The introduction of workable financial restructuring procedures is one of the most important contributions bankruptcy law reform can make in transition economies. Although most of the bankruptcy laws in Central & Eastern Europe contain some form of restructuring procedures, these are, in fact, the least used, with very few restructurings occurring in practice. To remedy the situation, we need to analyze a country's bankruptcy law to see whether it contains the requisite features to make restructuring work. *Efficient written mechanisms for restructuring* should provide an enterprise with: the ability to preserve its going concern value during the proceedings; adequate and timely information to creditors for decision-making; real debt forgiveness, not just a rescheduling of debt; and, should contain provisions to bind dissenting minorities.

If financial restructuring is not appropriate for a particular debtor, or does not work in a timely fashion, an efficient law should provide the means for an expedited liquidation. *Efficient written mechanisms for liquidation* should provide the liquidator with: the ability to maximize asset values; flexibility in methods of sale; clear and detailed rules on claim determination, distribution and closure; and, should ensure creditor involvement in the liquidation process.

For creditor protection outside of the insolvency laws, efficient written mechanisms should provide a timely and relatively inexpensive framework within which to: create security interests; determine priority; and, obtain collection and enforcement of a creditor's debt.

Implementation Issues

Infrastructure weaknesses in transition economies include:

Development of the Judiciary. Bankruptcy proceedings are mainly court-based. Moreover, in many transition economies the courts exercise a "hands on," administrative role as well as that of dispute resolution. Against this background we identified a number of specific issues to be addressed including: the need for judicial training in business and financial issues; the relatively low pay and prestige of judges in the region, leading to a shortage of qualified judges; and, the courts lack of material resources to discharge their functions effectively, e.g., the lack of court clerks and related support staff; lack of computerized systems for functions such as case management, registration, monitoring, correspondence and reporting; and the like.

Development of the Professions. The burden of the courts could be at least partially relieved by the development and more extensive use of supporting professionals, especially bankruptcy trustees and liquidators. It may be easier, in the short run, to mobilize private sector trustees and liquidators through market forces than to develop state institutions such as courts. The general perception in transition economies, however, is that the quality and possibly even the integrity of trustees and liquidators is low. Moreover, the development of the professions of lawyers, accountants, auctioneers, appraisers, and investment bankers, and the like, with experience in the bankruptcy process, would also improve the implementation of the bankruptcy laws.

Development of Detailed Rules & Procedures. At this early stage in the use of bankruptcy laws in transition economies, the full complement of supporting legislation is always in place or harmonized. The two major problems observed were gaps in the supporting legislation and conflicts within it. We observed, for example, the lack of detailed rules and procedures governing issues such as: the form and content of court pleadings; the various time periods within which certain actions are to be taken throughout the bankruptcy process; and, harmonization of new economic legislation.

Implementation issues specifically relevant to *debt creation and enforcement* include: development of pledge and mortgage registries; issues re speed and costs of court collection; costs incurred to create enforceable security interests; ability of creditors to use extra-judicial enforcement methods; and, poor or inadequate development of court enforcement branches and procedures.

Incentives (And Disincentives)

The incentive structure derives from the law itself, from other relevant laws and regulations and from human and business behavior. In looking at incentives in transition economies we consider separately the debtor's and the creditor's perspectives.

Debtor Incentives. Debtors rarely have an incentive to commence bankruptcy proceedings, even in Western economies. Factors we examine include: penalties levied and enforced against management for failure to commence a proceeding when the enterprise is insolvent (e.g., Hungary); relief from creditor pressure through a moratorium on payments and a stay of any legal proceedings against the debtor; provisions allowing for real debt relief and not just debt rescheduling, and, ability to win creditor approval by majority (not supermajority or unanimous) vote. *Debtor disincentives* include: the extent to which business is damaged or lost by starting proceedings; and, the degree to which management loses control once a proceeding has commenced.

Creditor Incentives include: the speed and cost of debt collection and enforcement; the existence or threat of intervening priorities; the creditor's degree of control or influence over the bankruptcy process; tax policy; and, the nature and effect of the "political message." An examination of behavior of both debtors and creditors in other transition economies suggests that policy makers can make a significant impact on behavior by affecting the incentive structure.

III. THE CURRENT SITUATION IN RUSSIA

The analysis that follows is based on fact-finding, review of English translations of relevant laws, and on interviews in the field.

Efficiency Issues

The New Russian Bankruptcy Law. Russia's most recent legislative achievement was the enactment of a new bankruptcy law which came into force on January 1, 1998.[9] As to business bankruptcies, the law applies to cases opened on or after March 1, 1998.[10] It replaced the 1992 Law on Insolvency (Bankruptcy) of Enterprises.[11] The New Bankruptcy Law contains 12 chapters and 189 articles and marks a significant step forward in the reform process.

Bankruptcy now applies to all forms of business entities, including individual entrepreneurs, “town-forming organizations,” credit organizations (e.g., banks, subject to the later enactment of a separate bank bankruptcy law), insurance companies, professional participants in the securities markets, agricultural entities, private individuals (personal consumer bankruptcies) and individual farmers. The Russian *arbitrazh* courts have exclusive jurisdiction to hear bankruptcy cases. *Bankruptcy cases may be initiated by the debtor, a creditor, the tax authority or the public prosecutor.* The definition of “creditor” has been expanded to include secured creditors, and secured creditors’ collateral is now part of the bankruptcy estate, a good step forward.

Among the inefficiencies in the Old Bankruptcy Law, was the requirement that the court itself undertake an independent valuation of the debtor’s assets and liabilities to determine if balance sheet insolvency existed. This was a time-consuming task, often resulting in a subjective valuation. Moreover, many regional courts refused to apply a cash flow insolvency test because of ambiguities in the law, thereby denying relief to creditors whose debts were not being paid. The New Bankruptcy Law, by contrast, employs a simplified cash flow test, thereby improving the ease of proceedings initiation.[12] Now, if a debtor fails to satisfy its monetary or tax obligations within three months of their coming due, it is subject to the insolvency laws.

The New Bankruptcy Law includes mechanisms for both financial restructuring and liquidation. The *three stages* of a bankruptcy proceeding are:

- *“observation proceedings”* (the interim period after a bankruptcy petition has been accepted by a court, but before restructuring or liquidation proceedings have begun; during this early period, pre-petition management stays in place, subject to certain restrictions and the supervision of an interim trustee, called the “interim manager”);
- *“external management”* (reorganization proceedings; the only way to write-off, write-down or otherwise modify creditors’ claims, with less than 100% creditor agreement, however, is for the parties to enter into an “*amicable agreement”***;** it is these latter provisions which resemble a U.S. Chapter 11 reorganization, with certain notable exceptions); and,
- *“competitive proceedings”* (liquidation).

Court Discretion to Overrule Creditors’ Decision to Liquidate the Debtor. As was the case in other transition economies, we observed that many judges feel a sense of responsibility to try and “save” the debtor and may even perceive a “political” risk in declaring a debtor bankrupt.

The New Bankruptcy Law may reinforce this behavior by permitting a court, *in its discretion,* to decide to institute external management proceedings, up to a period of eighteen months, if it determines that the debtor’s liquidation would “harm ...the majority of ... creditors and a realistic opportunity to restore the solvency of the debtor has been established...”[13] As a consequence, a court can overrule the creditors’ decision that the debtor be liquidated. It is contrary to imposing financial discipline for a court to have the power to allow long delays in the debtor's liquidation when creditors have decided otherwise.

Town-forming Organizations. The New Bankruptcy Law includes special provisions[14] on: insolvency of enterprises on which a *town is dependent* (defined as an enterprise whose employees and employee family members make up more than one half of a town's population); and, organizations of any type that employ more than 5,000.

The different treatment afforded these organizations, as compared to other firms, is with respect to external management. If not voted for by creditors, external management may nevertheless be instituted at the request of a federal, regional or local governmental body, provided there is a guaranty of the debtor's liabilities (in all probability given by the requesting party).

These provisions may be unfair to creditors, because they replace or supplement one debtor's credit with another's, without the accompanying requirement that the guarantor have the ability to fulfill the guaranty. Moreover, if the enterprise is to be liquidated, there must first be an attempt to sell to a buyer who agrees to preserve employment of at least 75% of the work force. This requirement will reduce the price paid for a debtor enterprise to the detriment of creditors. Most troublesome, however, is the possible broad scope for application of these procedures to any organization that employs more than 5000, not just to one-company town debtor enterprises, which do pose unique problems and may require special handling.

Secured Creditor Laws. Russian legislators remedied many of the inadequacies of secured transactions provisions in the old Soviet Civil Code by enacting two laws on the use of personal property security. One law, the Law on Pledge, is devoted entirely to the subject, and the newer Russian Civil Code contains a section on pledge among its provisions on contractual obligations.[15] These laws have the potential to improve the practice of securing obligations in Russia in a broad range of tangible and intangible property rights. Moreover, the laws explicitly permit the debtor to remain in possession of the collateral, thus recognizing "nonpossessory" security arrangements.

One problem with these laws, however, is that the Civil Code limits the mechanisms available to secured creditors to obtain the full value of their collateral following foreclosure -- that is, *it mandates that collateral be sold at public auction*. This limitation, while founded on European practice, is actually significantly more restrictive than Western European and U.S. rules and practices. For example, the provisions on pledge in the civil codes of the Netherlands, Germany, and France include explicit statutory language, narrowly construe the statutory language, or permit the use of certain techniques that mitigate the negative effects of their public auction restrictions. (See Box 3 below). In the U.S., Article 9 of the Uniform Commercial Code also provides a flexible mechanism for sale of collateral. The only limitation on sale is that "every aspect of the disposition, including the method, manner, time, place and terms, must be *commercially reasonable*."[16]

Box 3: International Experience in Realizing on Collateral after Foreclosure: Western Europe

The German, Dutch, and French Civil Codes all contain some provision initially mandating that, following foreclosure, the creditor utilize a public auction to sell its collateral. However, while the Russian Code stops here, the European codes continue and offer greater flexibility by retreating from the public auction limitation.

One important exception in the European codes is an allowance for sale by a broker when the collateral consists of property normally sold on a recognized market. The German Civil Code, for example, provides that if the collateral has an "exchange or a market price," the creditor may conduct the sale through a broker. The Dutch inserted a similar exception into their law in the case of publicly traded commodities and securities. For "commercial" pledges, the French Commercial Code also permits the sale of collateral by an agent more familiar with the specific goods involved.

A more significant exception that appears in both the German and Dutch Civil Codes allows the parties to deviate freely from the public auction requirement when they feel that a modified procedure would more likely lead to a greater return. After default has occurred, the parties may privately agree to sell the collateral in some other way, such as through private sale. Moreover, if either party feels that a method of sale, other than that prescribed by the law, more equitably protects its interests, that party may demand that the sale take place in that way. If the parties can't agree on an alternate method of sale, a court will decide which method to pursue.

European courts have further limited the negative effects of the public auction restrictions by

- narrowly construing the statutory language; and,
- permitting creditor techniques, such as retention of title devices, which eliminate the public auction restrictions entirely.

Source: Kilborn, "Securing Russia's Future: A Plea for Reform in Russian Secured Transactions Law" (1996)

The enactment and implementation of a new mortgage law covering security interests in real property, long overdue, should be made a high priority for the Russian Government as well. With minor modifications, the current draft mortgage law[17] appears to be ready for adoption and would be a significant step forward in improving secured creditor laws.

Implementation Issues

Developing the Profession of Bankruptcy Managers (Trustees & Liquidators). At present, more than 2,000 individuals have been trained as bankruptcy managers and approximately 1,300 have received their specialist's certificate in "crisis management" from the Federal Service. Under the New Bankruptcy Law, the professional requirements for these managers have been strengthened. By March 1, 1999, only licensed managers may be appointed in bankruptcy cases by the *arbitrazh* courts. During the interim period, managers who have received their crisis management certificates may be appointed and can register with the *arbitrazh* courts with whom they would prefer to work.

The most important change in the New Bankruptcy Law is the requirement that the manager be a *"disinterested"* party -- that is, someone unrelated to any of the participants in the bankruptcy case.[18] This new requirement will, if vigorously enforced, end the prior practice of court's appointing the debtor's manager as the party responsible for supervising the bankruptcy proceedings, "protecting" debtor's assets and "protecting" the creditors' interests.[19]

Need to Harmonize Conflicting Laws. Although great advances in lawmaking have occurred in Russia since 1991, much remains to be done to harmonize the complex bodies of conflicting laws, decrees, regulations and the like, on a Federal, regional and local level. The implementation problems are worsened further by the proliferation of legal acts issued by various levels of government.[20] These conflicting laws seriously hamper the effective implementation of insolvency and creditor protection laws.

We believe that the Supreme Arbitrazh Court will issue a detailed commentary on the New Bankruptcy Law shortly. Hopefully, this commentary will include an explanation of the relationship among the bankruptcy law and the complex mix of other Russian laws. This commentary is a crucial first step in the implementation process.

The Role of the Federal Service for Insolvency and Financial Rehabilitation. Commentators differ as to the original role of the Federal Service in the insolvency and creditor protection process - to set up the necessary infrastructure to implement the bankruptcy laws, including the training and certification of bankruptcy trustees and liquidators; or, to prevent mass liquidations; or to represent the state's interest as debtor or creditor, with a particular emphasis on tax collection, in bankruptcy proceedings.

No one will disagree, however, that they have been the primary movers in the bankruptcy process. (See Box 4 below). The Federal Service also played an important role in the development of the New Bankruptcy Law. It serves on the Supervisory Board of the Federal Debt Center,[21] as well. The Center is a newly-formed state agency to assist in the court enforcement process. This is an impressive record of accomplishments.

Box 4: Federal Service Activities

Since its formation through the first quarter of 1997, the Federal Service has filed 1,368 bankruptcy petitions, of which 936 were filed in 1996. This trend continued through 1997 and into 1998. Beginning in 1996 as well, its efforts, at least as they relate to tax collection, have been partly coordinated with the Temporary Extraordinary Commission for Improving Tax and Budgetary Discipline.[22] Measures employed by the Federal Service have included the seizure of property, forced privatizations (i.e., the sale of shares in satisfaction of tax arrears), and the seizure of bank accounts of enterprises with tax arrears, including the direct channeling of funds from these accounts to state budgets.

In 1994, the Federal Service, with the assistance of its territorial branches, reviewed the financial status of 15,638 state-owned enterprises (i.e., those enterprises in which the state had, at least, a 25% ownership interest). It found that 6,959 of these enterprises (24%), were unable to pay their debts. As to these 6,959 enterprises, the Federal Service liquidated 5% outside of bankruptcy; 22% were privatized; 28% "found money" and repaid their creditors; and in 6% of the cases the Federal Service sold the enterprises as "going concerns."
Source: Federal Service

The longer term goal of the Federal Service, however, should be to take itself out of all sides of the insolvency equation (i.e., as debtor, creditor and bankruptcy trustee). These multiple roles create an inherent conflict of interest.. The policy issues for the Government to consider, over the next several years, is how to simplify the Federal Service's structures and, eventually, reduce its role to that of infrastructure support -- providing trustee/liquidator training, certification and monitoring. Only then will market forces govern the enterprise exit, restructuring, and debt enforcement processes.

Enforcement of Arbitrazh Court Orders and Judgments. During the Soviet era, *arbitrazh* decisions resulted in moneys being shifted from one state firm to another. As a result, *arbitrazh* courts had little need for strong enforcement. That is not the case today. Nevertheless, the Russian legislature has been slow to develop new judicial enforcement mechanisms. Implementation of these mechanisms has been even slower. In 1995 only 50 percent of court rulings for recovery of money were implemented.[23]

Several step were taken during 1997 to resolve these problems. A law "On Court Officers"[24] was enacted which provides for the creation of a corps of Marshall's (*pristavy-ispolnitel'ny*) with responsibility for enforcing court decisions. The law is based, in part, on the British bailiffs' and U.S. Marshall's' systems. The corps will be part of the Ministry of Justice and was to have become operational by January 1, 1998, although it was not to be fully staffed until at least 1999. As of this time it is unclear whether funding has been made available to meet this schedule.

Responsibility for enforcing court decisions rests currently with poorly paid personnel attached to the general courts.[25] Some of these shortcomings may be improved by the creation of the new Federal Debt Center, a specialized body which will have responsibility for seizing and selling property as part of the court enforcement process. It is unclear from a review of the Center's regulations, however, how its functions will be coordinated with those of the Marshall corps and with the arbitrazh courts.

The law "On Enforcement Proceedings," also enacted in July 1997,[26] vests marshals with broad powers to compel compliance with court rulings. Since *arbitrazh* courts do not have criminal jurisdiction, however, they may not directly impose criminal contempt sanctions. Rather, offenders must be prosecuted in the general courts. Nevertheless, an *arbitrazh* court may directly impose civil monetary penalties in an amount up to two hundred times the monthly minimum wage. They may also impose a fine of up to fifty percent of the value of a judgment upon a bank that fails to heed a writ of execution. A bank that repeatedly fails to honor writs of execution risks losing its license.[27] *Although these new legislative enactments, once implemented, will add teeth to court rulings, enforcement problems are likely to persist.*

Fiscal Policy. The insolvency and creditor protection processes in Russia are currently hampered by: special features of fiscal policy; the size and prevalence of tax arrears; and, special enforcement powers given to the Federal Service and State Tax Service.

Firstly, there is a *"flow" problem* caused by punitive rates of taxation. As well as pushing a significant portion of economic activity into the "gray economy," this has also caused a build up of tax arrears as enterprises find themselves unable to pay, especially when they are not making profits. As most policy makers have agreed, this is an area for *fiscal reform.*

Secondly, there is a *"stock" problem* of arrears which have built up historically. Many firms will never be able to repay these tax arrears, but they cannot be written off, forgiven or restructured without a special tax restructuring program in place. This almost certainly prevents the survival of some potentially viable enterprises. Policy makers in other transition economies have used special programs to deal with the historic "stock" problem. These programs allowed the write-down and restructuring of tax arrears, including the forgiveness of penalties, subject to certain conditions, such as: a realistic plan for restoring viability in the future; and, payment of all current taxes on due dates.[28] Although there have been several previous attempts by the Russian government at tax restructuring programs[29], a newly-designed tax restructuring program, adopted on April 14, 1998, holds the best prospect of succeeding, particularly since it is specifically linked to the "amicable agreement" provisions of the New Bankruptcy Law.

Box 5: New Russian Tax Arrears Restructuring Program

Generally, the principal and unpaid interest on tax arrears can be restructured and repaid in installments over a 4-year period, with arrears on penalty payments repaid in installments over a 10-year period. Interest on these installment payments is set at one-fourth of the Central Bank's refinance rate. Installment payments must be made *in cash only* and the debtor must provide the government with *collateral* "sufficient to cover the arrears," either in the form of bank guaranties or as provided for in the Civil Code.

Debtors undergoing bankruptcy proceedings may take advantage of this tax restructuring program *so long as they "...enter into an amicable agreement with [their] competitive creditors on the terms and conditions which shall not give such creditors any privileges compared to the terms and conditions of [the tax] restructuring [program]..."*. Although it is unclear from a review of these regulations whether or not secured creditors are intended to be included in the group of "competitive creditors," assuming that they are not, it appears fair to provide no greater return to unsecured creditors than to the taxing authorities under a restructuring plan. The future interpretation and implementation of these somewhat vague provisions in the bankruptcy setting, however, need further clarification.

The Federal Service is responsible for approving or rejecting tax restructuring proposals, after receipt and review of various documents provided to it by the debtor, the State Tax Service, and, in the bankruptcy setting, the arbitration manager. Its decisions will take the form of a written opinion. Moreover, the regulations direct the Federal Service to initiate bankruptcy proceeded against any enterprise which has failed to restructure or repay its January 1, 1998 tax arrears by January 1, 1999.
Source: GOR Decree No. 395 "On the Procedure Governing Restructuring in 1998 of Legal Entities' Arrears to the Federal Budget," (April 14, 1998).

Thirdly, the Federal Service and the State Tax Service have *special powers of enforcement, including the right to sequester assets and seize cash held at debtors' banks*. These powers frequently prevent firms from operating normally and should be modified. In addition, there is some evidence that these powers are not applied even-handedly as between the state and private sector. This discrimination, if true, is likely to hamper the development of the private sector with consequences for the growth of the economy.

The filing of a bankruptcy petition should be the start of a collective procedure for the benefit of all creditors, rather than its use currently as a debt collection measure for the benefit of the taxing authorities. *Evidence from other countries shows that when tax rates are lowered, the powers of tax enforcement do not need to be so Draconian*.

Asset Recovery Mechanisms. The New Bankruptcy Law has fraudulent transfer and preference provisions which cover under-value and insider transactions and transactions which occurred within six months of bankruptcy. It also invalidates share redemptions occurring within six months of bankruptcy, i.e., payouts to shareholders in advance of bankruptcy, which diminish the debtor's estate and ultimate payout to creditors. Annex 4 provides a more detailed description of modern asset recovery mechanisms. These mechanisms are an important tool for bankruptcy managers to recover wrongfully transferred, hidden or stolen debtor asset and increase the ultimate payout to creditors. The implementation of these mechanisms in practice, however, will prove difficult. There is, therefore, great need for training creditors, bankruptcy managers, judges, lawyers, accountants and prosecutors in the financial forensic skills needed to trace assets.

Incentives (And Disincentives).

Personal Liability, in Certain Circumstances, for the Debtor's Management and Owners. An important change in the New Russian Bankruptcy Law is the requirement that debtor's management initiate a bankruptcy proceeding or face personal liability. The law provides that the debtor's officers, directors, managers and, it appears, related parties or affiliates, may have personal liability to creditors in a number of circumstances. Specifically, if a firm fails to file for bankruptcy when it is required to do under the law -- within one month after certain events occur -- the debtor's executive will have liability for obligations of the debtor that arise after the deadline for filing for bankruptcy passes.[30] In order for these penalty provisions to be effective, however, they must be enforced *vigorously* in practice.

Treatment of Secured Creditors; Creditor Priorities. The New Bankruptcy Law does not provide sufficient protection to secured creditors, which acts as a disincentive for secured creditors to initiate bankruptcy proceedings. Firstly, secured creditors do not have priority in the proceeds of their collateral; secondly, they do not have the ability to either obtain the release of their collateral or to receive compensation for its use during the pendency of the bankruptcy proceedings, even if such collateral's value is deteriorating.

Under Article 57 of the New Bankruptcy Law, all legal proceedings with respect to claims or execution against a debtor are suspended and consolidated in the bankruptcy proceeding (an "automatic" stay). The automatic stay is fundamental to the operation of modern bankruptcy laws and is a valuable new provision in the law. However, if a secured party and its collateral are made party to the proceedings and are subject to the stay, its interests should be protected. Consequently, the stay of secured creditors should be conditioned upon the arbitration manager or debtor providing "adequate protection" to the holder of the secured claim. By "adequate protection" we mean, generally, giving the secured creditor a replacement lien or an additional security interest in unencumbered debtor property, or compensating him for any likely deterioration or depreciation of the collateral. Such protection could take the form of regular cash payments to the secured creditor during the pendency of the bankruptcy proceedings, and the like.

As to *secured creditor priorities*, proceeds of their collateral are used first to pay: (i) all court costs, arbitration manager compensation, the debtor's or arbitration manager's post-filing operating expenses, claims that arose after the commencement of proceedings and other administrative expenses; (ii) personal injury claims; and, (iii) employee wage and severance claims. *This fourth*[31] *priority accorded secured creditors is a serious problem with the law*, although we are aware of the legal and political issues surrounding creditor priorities under the Civil Code.[32] The efforts of those who drafted the new law to protect secured creditors in other ways -- by requiring the secured creditor's consent as a condition to the approval of an amicable agreement (reorganization plan), and by permitting secured creditors to recover the value of their secured claims out of *all* of the debtor's assets, not just out of their original collateral--although steps in the right direction, do not provide secured creditors with the true economic equivalent of their contracts. In fact, the lender's initial collateral/credit analysis, performed at loan inception, is rendered meaningless.

If secured creditor claims are subordinate to those of personal injury claimants, employees and to the operational expenses of the continued activity of the debtor's business that can last up to eighteen months, or even longer in certain cases, there is a real risk that significant losses will be incurred. The last priority given to general unsecured creditors, after payment of government claims, is even more dire. The government's penalty claims share equally with them, rendering trade creditors, and others in this last class, unlikely to receive any distribution in the event of a liquidation. See Annex 5 for a description of the claim priorities experience of other transition economies.

Trustees' & Liquidators' (Arbitration Managers') Compensation. At present, most arbitration managers' compensation is based on a monthly salary, usually equal to the firm's director's salary. Such a compensation method acts as a disincentive for the speedy resolution of bankruptcy cases and, moreover, does not link compensation with performance. In order to attract suitably qualified persons to act in this capacity, compensation regulations should be designed to provide: a clear and predictable method of calculating compensation; is linked to the effectiveness of the manager's performance; and, is sufficient to make the profession a viable private business activity.

Disincentives to Credit Creation. Credit regimes, ideally, should permit the inexpensive creation of security interests for any person over any thing in order to facilitate the flow of credit to enterprises. For pledging (secured credit mechanisms) to work, lenders need an inexpensive and easy way to determine whether a prior security interest exists against the property offered as collateral, i.e., the need for publicly accessible pledge registries. At this time no central pledge registries exist in Russia.. The current situation, instead, provides a complex patchwork of overlapping filings, replete with information hazards for creditors. Moreover, existing legislation does not adequately address priorities among creditors or the rights of creditors that simply cannot register their liens.

Additional disincentives to securing a borrower's indebtedness by taking a mortgage on the borrower's rights in land, buildings and fixed structures, is that the mortgage must be notarized and the fee for that service is presently set at 1.5% of the value of the assets secured. The high cost of mortgage notarization makes this type of security unattractive.

Moreover, although a borrower's bank accounts may be pledged under existing law, it is unclear whether the existence of a pledge would prevent the current enforcement practices of satisfying tax and other government claims directly out of a debtor's bank account, ahead of secured creditors.

Social Services, Unemployment and Safety Net Issues. Among the *most significant disincentives* to enterprise liquidations and restructurings in Russia, are: fear of widespread unemployment and political unrest; the inadequacy of existing social safety net mechanisms; the importance of social services provided by large industrial firms; and, the unwillingness or inability of regional governments to assume responsibility for these functions. For these reasons, regional governments have come to the defense of their larger enterprises, often actively obstructing the functioning of the insolvency and creditor protections laws.

Banking Regulations. We have observed that central bank regulations in transition economies, as in the West, can significantly affect creditors' incentives to take action. Where reserves are not required until a borrower is in formal proceedings, 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. As a result, active implementation by the Russian Central Bank of its new loan loss reserve requirements,[33] can favorably incentivize creditor behavior.

Policy Recommendations

Create a fully functioning insolvency and creditor protection system by giving immediate attention to *implementation* issues and to the removal of significant *disincentives* to the use of these laws. Issues to be addressed include:

- Vigorous enforcement of the new "disinterested" standard for arbitration managers;
- Issuance by the Supreme *Arbitrazh* Court of a detailed commentary which would include an explanation of the relationship among the new bankruptcy law and other Russian laws;
- Reduction, over time, of the Federal Service's role in insolvency proceedings to that of infrastructure support;
- Training of all participants in the bankruptcy process on the New Bankruptcy Law, on business and financial issues, and in the financial forensic skills needed to trace assets (pilot bankruptcy projects would be of great assistance to this training process);
- Vigorous enforcement of the New Bankruptcy Law's penalties for non-filing against management of insolvent firms;
- Adoption of compensation standards for arbitration managers that provide: a clear and predictable method of calculating compensation; is linked to the effectiveness of the manager's performance; and, is sufficient to make the profession a viable private business activity; and,

- Vigorous enforcement, by the Russian Central Bank, of its loan loss reserve requirements.

***Improve the treatment of secured creditors generally*:**

- Amend the new bankruptcy law, and Civil Code if necessary, to provide sufficient protection to secured creditors;
    - if a secured party and its collateral are made party to bankruptcy proceedings and are subject to the stay, its interests should be protected; the stay should be conditioned upon the arbitration manager or debtor providing "adequate protection";
    - the fourth priority accorded secured creditors is a serious problem with the law; if secured creditor claims are subordinate to those of personal injury claimants, employees and to the operational expenses of the continued activity of the debtor's business that can last up to eighteen months, or even longer in certain cases, there is a real risk that significant losses will be incurred; and,
    - the last priority given to general unsecured creditors, after payment of government claims, is even more dire. The government's penalty claims share equally with them, rendering trade creditors, and others in this last class, unlikely to receive any distribution in the event of a liquidation.
- Adopt a new mortgage law covering security interests in real property;
- Create a central pledge registry;
- Change laws relating to pledges of collateral and enforcement to permit greater flexibility in methods of sale along the lines of Western European countries; and,
- Reduce the current high cost of mortgage notarization.

***Improve financial discipline*:**

- remove court discretion to overrule creditors' decisions to liquidate a debtor;
- limit town-forming organization provisions to firms on which a town is truly dependent; and,
- eliminate their application to *any* organization that employs more than 5000.

Provide immediate funding for the *Marshall's Corps* and coordination of its work with that of the *arbitrazh* courts and the new Federal Debt Center to ***improve court enforcement***; make implementation of the new enforcement laws a very high priority;

Modify tax enforcement powers which interfere with insolvency and creditor protection systems;

Initiate programs at all levels of government to deal with ***funding for social services and the redeployment of social assets*,** some of which cannot be dealt with at individual enterprise level; this is needed to remove this significant disincentive to the operation of the bankruptcy process; and,

Some of the more painful costs of liquidation and restructuring should be alleviated by ***social safety net initiatives.***

- Care should be taken so that the safety net protects individuals from poverty but *not* enterprises or industries from liquidation by market forces.
- Short-term priorities should include: monitoring the insolvency process to anticipate possible enterprise closures and mass layoffs; and, developing policy actions which can shorten and *ameliorate the impact of unemployment*.

ENDNOTES

[1] See OECD Economic Surveys: Russian Federation 1997.

[2] See Kathryn Hendley, "An Analysis of the Activities of Russian *Arbitrazh* Courts: 1992-96" (unpublished).

[3] Formerly known as the Federal Insolvency Agency, and referred to in this paper as the "Federal Service."

[4] Although the new Russian bankruptcy law includes provisions for consumer or personal bankruptcy, this paper focuses almost exclusively on enterprise bankruptcy issues.

[5] See Annex 1 for an analysis of bank-related cases in the Russian Federation.

[6] Problems in the enforcement of debt contracts remain an important reason why banks are reluctant to finance restructuring. A common perception among Russian banks is that block equity holdings represent the only potentially effective enforcement mechanism. Improving the effectiveness of traditional debt enforcement mechanisms might modify this behavior, an important goal, since the role of banks in equity ownership creates its own separate set of problems.

[7] See detailed discussion of the "gap," using this analytical framework, in Coates & Mirsky, "Restructuring and Bankruptcy in Central and Eastern Europe (1995). The foregoing comparative study, as well as a later bankruptcy study on Ukraine, were funded by the U.S. Agency for International Development. Both bankruptcy projects were the "brainchild" of Pat. R. Shapiro, Esq., General Counsel to USAID's Mission to the Russian Federation and former Director of the Office of Economic Restructuring at USAID's Mission to Ukraine, Belarus and Moldova.

[8] Deliberate *exclusions* from the laws, or, exclusions in practice, also create implementation shortfalls. See Annexes 2 and 3 for a description of programs that have dealt with exclusions in transition economies.

[9] RF Federal Law on Insolvency (Bankruptcy), No. 6-FZ, enacted by the State Duma, December 19, 1997, approved by the Federation Council, December 24, 1997, and signed into law by President Yeltsin on January 8, 1998 (the "New Bankruptcy Law").

[10] The provisions with respect to "citizens'" (i.e., individuals, not individual entrepreneurs, or what we call personal bankruptcy) will not go into effect until the necessary amendments to the Russian Civil Code have been enacted; the provisions dealing with the licensing of arbitration managers (i.e., trustees and liquidators) will not go into effect until March 1, 1999.

[11] RF Law No. 3929-1 of November 19, 1992 on Insolvency (Bankruptcy) of Enterprises (the "Old Bankruptcy Law").

[12] The requirements for the liquidation of an individual debtor, however, include a balance sheet test as well as a cash flow test.

[13] See Article 67(3) of the New Bankruptcy Law.

[14] See New Bankruptcy Law, Articles 132-138.

[15] RF Law "On Pledge" No. 2872-1 (May 29, 1992); Arts. 334-358 of RF Civil Code (1995, as amended).

[16] U.S. U.C.C. Section 9-504(3).

[17] RF Law on Mortgage (Pledge of Real Estate) (June 24, 1997 Draft).

[18] See New Bankruptcy Law Articles 18 & 19.

[19] Under the New Bankruptcy Law, bankruptcy managers are chosen by the creditors; if creditors fail to do so, then the *arbitrazh* court chooses; if they can't find a candidate, they may go to the Federal Service. .

[20] For example, decisions of the Federal Government may be embodied in any of the following types of legal acts which form only a loose hierarchy: Federal Constitution and Federal Constitutional Laws (amendments); Federal Laws (*zakon*) and Codes (*kodeks*); Duma or Federation Council decrees (*postanovlenie*); Presidential decrees (*ukaz*); Presidential orders (*rasporiazhenie*); Cabinet decrees (*postanovlenie*); Cabinet orders *(rasporiazhenie*); Administrative rules (*podzakonnye akty*); and so on.

[21] RF Government Resolution No. 6, "On the Federal Debt Center," (January 6, 1998).

[22] The VChK, as this Commission is known, is meant to be the coordinator of the efforts of the numerous agencies involved in tax collection, including the Tax Service, the Tax Police, the Treasury, the Customs Committee, the Federal Service, and so on.

[23] Source, Minister of Justice Valentin Kovalyov Press Conference, December 6, 1995.

[24] RF Law No. 118-FZ "On the Officers of Justice" (July 21, 1997).

[25] See discussion in Hendley, "Remaking an Institution: The Transition in Russia from State *Arbitrazh* to *Arbitrazh* Courts," to be published in the *American Journal of Comparative Law* (1998).

[26] RF Law No. 119-FZ "On the Executive Procedure" (July 21, 1997).

[27] RF 1995 Code of Arbitration Procedure, Articles 206.3; 206.1 & 206.2, respectively.

[28] See, e.g., Annex 3 for a discussion of the Polish Bank-Conciliation Procedures.

[29] See, e.g., GOR Decree No. 254 "On the Conditions and the Procedure for Restructuring the Indebtedness of Organizations in the Payments to the Federal Budget,"(April 22, 1997) and Draft Federal Law No. 2093-II "On Restructuring Organizations' Arrears on Mandatory Payments" (January 14, 1998).

[30] New Bankruptcy Law, art. 9(1).

[31] Although secured creditors rank third in priority (Art. 106(2)), as in the Civil Code, since administrative claims come ahead of all creditors (Article 106(1)), secured creditors have a fourth priority claim, followed by government claims, and general creditors.

[32] See Article 855(2) of the RF Civil Code (as amended on August 12, 1996); Decision #21-P of the RF Constitutional Court (December 23, 1997); and Resolution #2140-11 of the Duma (January 23, 1998).

[33] See RF Central Bank Regulation No. 101-U, "Directions On Implementing the Instruction On the Procedure of the Formation and Use of the Reserve Against Bad Loan Losses and On Taking into Account the Size of the Reserve Against Bad Loan Losses in Taxation" (December 25, 1997).

ANNEXES

Annex 1. Bank-Related Actions in the Russian Federation: 1993-1996

During the period 1992-96, bank debt has gradually become an important source of disputes for *arbitrazh* courts. For the most part, these cases did not exist during the Soviet period when banks were merely an arm of the state. Indeed, statistics were not collected until 1993. Because privatization was carried out in Russia through a distribution of a majority of the ownership interest to managers and workers, the process generated no capital. In order to maintain production and to build toward the future, enterprises sought capital from banks. Often these banks were ill-equipped to assess the credit-worthiness of applicants, and so loans were not repaid. The data suggest that banks have become increasingly aggressive in terms of their collection efforts.

In 1993, the first year for which information was collected, bank-related cases were few, both in actual number and as a percentage of total civil cases. With the exception of the Moscow City court, these disputes accounted for less than one percent of the civil cases resolved. In Moscow, they constituted 2.3 percent of the total civil cases. Given Moscow's status as the banking center of Russia, the considerably higher incidence of bank-related cases is not surprising. In the years from 1993-96, bank-related disputes increased astronomically. In many courts, the actual number multiplied ten times over. The importance of these cases is also visible as a percentage of total civil cases resolved. In Saratov, for example, they grew from 0.7 percent in 1993 to 16 percent in 1996. The national-level data only confirms the increasing importance of this category of dispute.

Bank-Related Cases: Number Resolved and Percentage of Total Civil Cases Resolved

Court:	**1993:** Number (%)	**1994:** Number (%)	**1995:** Number (%)	**1996:** Number (%)
Moscow City	559 (2.3)	653 (3.9)	1,676 (9.6)	4,778 (19)
Novosibirsk	21 (0.4)	89 (2.9)	560 (12.9)	538 (13.1)
St. Petersburg	134 (0.95)	225 (2.7)	606 (7.6)	1,171 (9.2)
Saratov	40 (0.7)	126 (2.1)	401 (10.5)	545 (16)
Sverdlovsk	45 (0.4)	320 (4.4)	592 (8.3)	506 (7.5)
Total for all *arbitrazh* courts	2,706 (1.0)	6,932 (3.6)	17,626 (8.2)	28,651 (11.7)

Source: Professor Kathryn Hendley, "An Analysis of the Activities of Russian Arbitrazh Courts: 1992-96," a report submitted to the National Council on Soviet and East European Research (unpublished).

Annex 2. Dealing with Exclusions - Special Programs for SOEs in Transition Economies

- ***The Bad Loan "Carve Out"***- under this approach a primary objective was bank re-capitalization. There was typically a "carve out" of non-performing loans from the banks' portfolios into some central institution. A relatively soft approach was then taken to "working out" the loans with borrowers, usually large SOEs, thus allowing them the opportunity for restructuring (e.g., Czech Republic);

- ***The Restructuring Agency*** - this approach started with the enterprises and typically selected specific SOEs to be restructured. The task of the Agency was to determine whether the SOE was potentially viable or not; and then to take the appropriate action (e.g., Romania); and,

- ***The Restructuring or Bank-Conciliation Program*** - this approach is similar to that of the Restructuring Agency except that no special institution is established to implement the program. Again, specific enterprises were selected and given a procedure, often by way of statutory instrument, under which to negotiate with banks and other creditors to fulfill restructuring objectives. Poland's and Hungary's programs are the most well-known examples of this approach. Both programs were enacted in connection with bank recapitalization programs and were an attempt to force banks to resolve problem loans expeditiously.

Commentators are not in agreement as to the efficacy of any of these programs, and, to the extent they undermined the developing judicial bankruptcy processes, these programs may even be said to have impaired their development. Moreover, many of these attempts at bank reform many not have paid sufficient attention to the dangers of negative incentives arising from recapitalization. A detailed description of the Polish and Hungarian programs is included in Annex 3.

Source: Richard D. Coates and Arlene Elgart Mirsky, Restructuring and Bankruptcy in Central and Eastern Europe (1995).

Annex 3. Dealing with Exclusions - Special Programs in Poland and Hungary

A. BANK CONCILIATION IN POLAND

A Reorganization option for SOE's (only) was 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, was comprised of two sets of provisions which regulated the conditions under which state-owned commercial banks could receive their re-capitalization; and the method by which state-owned commercial banks could restructure enterprises, i.e., the conciliation procedures. It applies only to debtors who were SOE's or commercialized SOE's in which the state had retained a greater than 50% equity interest, and to the Agricultural Property Agency. The FREB had a limited life (3 years).

The FREB authorized 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 could 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.

Comparison of Polish Arrangement Proceedings Act & the FREB

Arrangement Act	FREB
Permanent Law	Temporary Law (ended 3/96)
Court Proceeding	Out-of-Court Proceeding
Court-Led	Bank-Led
Available to All Types of Commercial Debtors, Both Private and State	Available Only to Debtors Who were SOEs or Commercialized SOEs in Which State Had Retained More Than 50% Equity

Excludes Compromise of Taxes, Secured and Other Priority Claims	Included Compromise of Taxes and Other Priority Claims and Mechanism for Secured Claims.
50% Creditor Quorum	No Creditor Quorum Requirements
50% in Number, 2/3 in Value Greater Than 40% Debt Reduction, Need 4/5 Vote	No Numerosity Requirement; 50% in Value Vote, Must Include Bank
No Ability to Deal With State Treasury Claims	If State Treasury Claims Given Treatment as Other Claims, Ministry of Finance Must Approve Plan
Secured Claims Excluded	If Secured Creditor Consents, Part of Proceedings, If He Doesn't Consent, At End of Proceeding Debtor May Transfer Collateral to Him in Complete Satisfaction of Secured Claim

B. <u>CONSOLIDATION IN HUNGARY</u>

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.

Source: Richard D. Coates and Arlene Elgart Mirsky Restructuring and Bankruptcy in Central and Eastern Europe (1995).

Annex 4. Modern Asset Recovery Mechanisms

Creditors everywhere are required to investigate and recover debtor assets which may have been wrongfully transferred, hidden or stolen by the debtor or its affiliates. This problem is particularly acute in Russia today. A number of different approaches to this problem have been developed internationally. In most modern commercial and bankruptcy laws, for example, the mechanisms used fall generally in one of two following categories:

Fraudulent Conveyance Law. Modern fraudulent conveyance law is derived from the Statute of Elizabeth (1570) and, in civil law countries, from the Roman law, which invalidated conveyances (transfers) made with the "end, purpose, and intent to delay, hinder or defraud creditors." In its original form, fraudulent conveyance law focused exclusively on transfers of a debtor's property where there was actual evidence of the debtor's intent to harm its creditors by hiding assets from imminent levy.

As the world of finance became more complicated, debtors were able to elude their creditors in subtle ways. In light of the resulting difficulty in producing evidence of actual fraudulent intent, judges developed a standard that brought transactions that carried "badges of fraud" within the purview of fraudulent conveyance law. The presence of suspicious circumstances -- such as the pendency or threat of litigation, secrecy or concealment, insolvency or a familial relationship between the parties--created a legal presumption of fraudulent intent.

Today the two strands of fraudulent conveyance law, in the U.S., are embodied in the Bankruptcy Code and in the state enactments of the Uniform Fraudulent Conveyance Act and the Uniform Fraudulent Transfer Act. With some differences in language and interpretive case law, each statute provides that two general types of transactions may be avoided (set aside) as fraudulent conveyances: (i) transfers made, or obligations incurred, with an *actual intent* to hinder, delay or defraud creditors of the transferor; and, (ii) *"constructive" fraudulent transfers* made, or obligations incurred, that are undertaken in exchange for inadequate consideration and occur when a company is insolvent or that render a company insolvent or too thinly capitalized to conduct its business. These two types of fraudulent conveyance laws exist in many other countries as well, including Russia (see discussion *infra*), covering both bankruptcy and non-bankruptcy situations.

Doctrine of Voidable Preferences. Like the doctrine of fraudulent transfers, the doctrine of voidable preferences, within the bankruptcy laws, is intended to protect a debtor's estate against depletion to the detriment of *all* creditors. Although the doctrines in some cases overlap, they are intended, under the U.S. Bankruptcy Code and other countries' laws, to deal with separate problem areas in which either may provide the sole protection for creditors. In the case of the doctrine of preferences, its special role is to achieve *equality of distribution* among creditors. Thus, a debtor's repayment of an antecedent debt in the statutory period preceding the bankruptcy filing (e.g., 90 days under U.S. law) may not constitute a fraudulent transfer because the debtor may have received "reasonably equivalent value" from the creditor. Though it may otherwise comply with the statutory requirements, it may nevertheless constitute a voidable preference because the payment to the preferred creditor would defeat the principle of equality of distribution among creditors of the same class.

Moreover, the greatly strengthened provisions of U.S. law dealing with voidable preferences to "insiders", a rather broadly defined term including, among others, the debtor's offices, directors, subsidiaries, partners and the like, render voidable, subject to certain limitations, a transfer of property or an *interest* in property (e.g., the granting of a mortgage) by an insolvent debtor for the benefit of a creditor that is an affiliate, or for an antecedent debt owed to an affiliate, if made within a 1-year period preceding the bankruptcy filing (similar longer preference periods for insiders, as compared to unrelated creditors, are provided for under several other countries' bankruptcy laws, e.g., U.K., new German law, and the new Russian law.)

Annex 5. Claim Priorities - Central and Eastern Europe on Bankruptcy Laws (1995)

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

The above table of priorities is in places grossly oversimplified in the interests of consistent presentation and to support the general conclusions. A fuller and more precise description of priority issues follows.

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 had 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 was 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 were expressly granted a first priority.

In Estonia, secured claims had 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, were 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 were subordinate to various post-Bankruptcy and administration cost claims, as well as environmental claims.

A special problem existed in Poland in 1995. While secured claims ostensibly had a first priority, they were subordinate to various "secret" liens securing certain tax and other governmental claims. No record notice of these liens was required. There also appears to have been no time limit within which the government was required to 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 had or shared 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 had a higher priority than secured claims.

In almost all of the countries where administration costs had a high priority, post-Bankruptcy claims (including claims related to post-Bankruptcy financing) either shared that priority (e.g., Croatia, Lithuania) or had the priority immediately above (e.g., Estonia) or below (e.g., Croatia) that of administration costs. The one exception from this similar treatment was Bulgaria, where administration costs had 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) did 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 was 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 Claim

Employee-related claims (e.g., wages) usually had 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 was 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 was limited to a certain base level of wages, wages in excess of that level are treated as general unsecured claims. Again, this was 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 gave 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 was Albania, where employee wage and social security claims shared 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 had 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 were 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 mentioned alimony in their claims priorities. With the exception of Romania, all of those countries give it a relatively high priority among unsecured claims.

Alimony was 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 mentioned environmental claims in their claim priority systems. Latvia gave it a fifth priority among unsecured claims, immediately above that of general unsecured claims. In Hungary, environmental claims shared 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 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 provided 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 appeared 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.

Source: Richard D. Coates and Arlene Elgart Mirsky, Restructuring and Bankruptcy in Central and Eastern Europe (1995).