Bankruptcy Law Reform in Eastern Europe

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Bankruptcy Law Reform in Eastern Europe

For the transition to a market economy, several countries in Eastern Europe, which formerly had centrally planned economies and decided in the past few years to adopt new economic systems, have enacted or are considering enacting new laws on bankruptcy. These new laws could facilitate the restructuring or liquidation of existing insolvent state enterprises, which are currently an important obstacle to structural reform of the economy, as well as provide for future needs.

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1. The need for bankruptcy laws in these countries is widely recognized. Writes one analyst:

Bankruptcy as practiced in market economies was unknown and unneeded in centrally planned ones. In Central and Eastern Europe, debtors and creditors were generally arms of the state or ultimately supported by the state, and thus inherent conflicts of interest that drive bankruptcy proceedings did not exist. . . . Measures in lieu of bankruptcy, including financial "rehabilitation" and "compulsory settlement" (i.e. pro-rate debt reduction) were relied upon to keep ailing firms alive and preserve employment.

. . . As the private sector grows, true conflicts of interest will emerge among debtors and various categories of claimants, including banks, suppliers, the government (as tax collector), and shareholders.

CHERYL W. GRAY, EVOLVING LEGAL FRAMEWORKS FOR PRIVATE SECTOR DEVELOPMENT IN CENTRAL AND EASTERN EUROPE 10-11 (World Bank Discussion Papers No. 209, 1993) [hereinafter GRAY, EVOLVING LEGAL FRAMEWORKS].
to deal with insolvencies in an effective and efficient manner. They also could enhance the prospects for privatization of restructured enterprises and enable banks to improve the quality of their assets by realizing some nonperforming assets. Consequently, the prospects for the restructuring and privatization of banks would also be improved. There is also scope for out-of-court settlements other than pursuant to a bankruptcy law, which are particularly appropriate when the debtor and significant creditors are owned by the state.

This article considers the bankruptcy laws of the Czech Republic, Hungary, and Poland, the three countries in Eastern Europe that have made the most progress towards transition to market economies. The laws' design and experience

2. Bankruptcy is one of the most contentious areas of legal reform in the CEE countries. This is in large part because of the conflict and confusion between two different sets of potential "users" of bankruptcy procedures. This first is the large group of state-owned enterprises in need of restructuring or liquidation. However, the social costs of widespread liquidation of these firms are often considered to be too high to let bankruptcy proceed unabated. The second group is the newly emerging private sector, whether enterprises or banks. For this group, bankruptcy law . . . increases the potential for debt collection and thus facilitates the flow of private credit in an economy. Such credit is essential for the success of new private business.

Id. at 11.

In Poland, liquidation of state-owned enterprises is conducted pursuant to the bankruptcy law and the Law on Privatization of State-Owned Enterprises Act of 12 July 1990, as amended [Ustawa z dnia 12 lipca 1990 r. o prywatyzacji przedsiębiorstw państwowych, z późniejszymi zmianami], Dziennik Ustaw [JOURNAL OF LAWS] [Dz.U.] No. 51, item 298 (1990). Under the privatization law, creditors are paid in full and this is not intended to address insolvency. See Jerzy Rajski, Privatization in Poland, in PRIVATIZATION IN CENTRAL AND EASTERN EUROPE 35, 48 (Peter Šarčević ed., 1992) (describing the process of liquidation of state-owned property); Eva & Wladyslaw Jermakowicz, Approaching Business Valuation in the Polish Privatization Programme, in VALUATION AND PRIVATIZATION 25, 29 (Enery Quiñones et al. eds., 1993); see also Pierre Guislain, Divestiture of State Enterprises 22 (World Bank Technical Paper No. 186, 1992) (discussing the liquidation or bankruptcy of state-owned enterprises).

3. The Czech Republic's bankruptcy act [hereinafter CL], which has been amended since its adoption in July 1991, is the Act on Bankruptcy and Settlements, No. 328/1991 Coll. of 11 July 1991. While the CL generally applies to insolvencies of individuals as well as enterprises, this article focuses on the application of the laws to business insolvencies.


Poland's bankruptcy act [hereinafter PL], originally a presidential order of 1934, was amended in 1990. Bankruptcy Act, Dz.U. No. 14, item 87 (1990) (Regulation by the President of the Republic of Poland of 24 October 1934, as amended). Thus, while the 1934 law provides the substance of this bankruptcy law, the fact that it was amended as part of the commercial law modernization in 1990 signifies legislative ratification of the prior rules. See Stephen Baister, Corporate Insolvency—Eastern Approaches, 5 INSOLVENCY L. & PRACTICE 109 (1989) (briefly describing the laws of Poland, Hungary, Yugoslavia, and the USSR). For an overview of the 1934 presidential order, see CHERYL
in implementation, both successful and unsuccessful, could be useful for other countries that contemplate adopting new bankruptcy laws.

The Czech law and to a lesser extent the Polish law appear to be inspired by the German insolvency laws (which will be superseded by a new law in 1999 that was recently approved by the legislature) perhaps because of a desire to emulate an important element of the commercial law system of an economically successful West Germany. Many provisions of these laws are identical to the German laws. In light of the special needs in Eastern and Central Europe (and in the former Soviet Union) for the restructuring of large, financially distressed, state enterprises, it is questionable whether the initial bankruptcy laws for these countries should have followed so faithfully the laws of a developed country. Indeed, the German laws will be replaced because of perceived deficiencies: the lack of practical application of the provisions for financial reorganization, as distinguished from liquidation, because of the limited impact of the laws on secured creditors. The German law also contains provisions that preclude an enterprise from conducting normal business operations while the restructuring is developed.

Certain other provisions of the prior German law also appear to be inappropriate for economies in transition. Since the volume of insolvent enterprises in economies in transition is great and disproportionate to the administrative capabilities

4. Konkursordnung, II B 50 (Dec. 1982), applicable in the former West Germany; see also Gesamtvollstreckungsordnung, BGB. I (June 1991), applicable in the former East Germany.

In Poland, the Law on the Procedure for Mutual Agreement, which was passed in 1934, also was modeled after a 1927 German statute. See THE CASE OF POLAND, supra note 3, at 23 n.28.

5. In April and July 1994, the German legislature approved a new bankruptcy law that will be in effect from January 1, 1999. The text of the law is expected to be published in the Bundesgestezblatt in November 1994. See Germany to Revise Insolvency Law, BUSINESS EUROPE, Nov. 29, 1991 (announcing the introduction of a bill with reorganization provisions).

6. A prominent member of the German bankruptcy bar has indicated that only about 1% of business bankruptcies are resolved by a judicial composition, which is the main law in Germany for restructuring of a debtor enterprise.

7. In Hungary, in part due to the mandatory filing requirement contained in the prior version of the recently amended bankruptcy law, the number of bankruptcies increased from 528 in 1991 to 14,300 (4,400 reorganizations and 9,900 liquidations) in 1992. Cheryl W. Gray, Bankruptcy Law and Enterprise Restructuring in Central Europe, 4 TRANSITION No. 5, June 1993, at 3 [hereinafter Gray, Central Europe]. ("Of the 14,300 cases filed in 1992, about 40 percent of the reorganization cases (approximately one-third of which ended in an approved reorganization plan) and a smaller percentage of liquidation cases had been concluded by the end of the year."); see Bankruptcies Partly to Blame for Declining Imports, MTI ECONEWS, May 6, 1993 (15,000 companies had filed for bankruptcy or liquidation since early 1992); East Europe's Bankruptcy Laws, INDUSTRY WEEK, Apr. 5, 1993 (10% of Hungary's enterprises declared bankruptcy in the first eight months of 1992 and experts feared that as many as 20% of the Czech Republic's companies might be liquidated once its law took effect April 20, 1993); Liquidations Predicted Instead of Bankruptcies, MTI ECONEWS, Apr. 9, 1992 (the number of company liquidations has doubled every year since 1988; in 1991,
both in the private and public sectors to resolve these situations, more expeditious and streamlined procedures are needed than in Western countries with a long tradition in bankruptcy matters and a manageable volume of cases.

1,268 liquidation procedures were initiated in Budapest alone); Bankruptcy Law—One Year On, MTI ECONeWS, Jan. 20, 1993 ("Hungarian courts handled almost a thousand bankruptcy cases" in 1992).


In the Czech Republic, according to the newspaper Cesky Denik:

[As] of February 1, 1994 as many as 1,592 bankruptcy petitions and 10 petitions regarding property settlement were filed with various regional judicial and commercial courts. However, only 82 actual bankruptcy proceedings and only one property settlement, were allowed to be initiated by the relevant authorities. In the remaining cases company managers have responded sufficiently so that petitions were either denied, dismissed, suspended, repealed, or delegated to another administrative authority.


8. In mid-1992, the Budapest court had approximately 4,000 cases but only eight judges handling them. Gray, Central Europe, supra note 7, at 3. Gray writes:

This surge in cases demonstrates the difficulty of applying the traditional solution—bankruptcy procedures—to the systemic problems of enterprise insolvency in CEE countries. It is highly improbable that any judicial system—much less one with relatively little exposure to economic matters—could handle such a surge in caseload efficiently and effectively. Not only are experienced judges in short supply, but so are qualified trustees. Especially in cases that involve large enterprises, liquidators have to act as corporate managers and financial managers in order to preserve the assets of the enterprise and, whenever viable, to encourage settlements between creditors and debtors. They also need to have legal expertise.

GRAY, EvOLVING LEGAL FRAMEWORKS, supra note 1, at 83-84 (footnotes omitted); see also THE CASE OF POLAND, supra note 3, at 24-25, 27-28 (discussing capabilities of receivers, judge-commissaries, judges, courts, and the judicial system in Poland to handle the increasing number of cases); Bankruptcy Law—One Year On, supra note 7 (noting lack of organizations with experience relevant for reorganizations).

The demand for western expertise in the fields of accounting, auditing, and business consulting has been increasing. See Price Waterhouse Ends Successful Fiscal Year in Hungary, MTI ECONEWS, Jan. 6, 1993.

9. Certain significant procedural steps under the German law appear to be excessively cumbersome for the Eastern and Central European context. Section 133(2) of the bankruptcy law provides that if a creditors’ committee has been appointed, its approval is required, inter alia, for the trustee to act on executory contracts, to recognize preferential claims, and to allow the redemption of pledges when the value of the object is more than three hundred German marks. Konkursordnung, II B 50 (Dec. 1982). These matters are all basic to the administration of a bankrupt’s estate, which a trustee with experience in bankruptcy proceedings should be authorized to decide, to provide for efficient disposition of the proceeding. Similarly, section 134 provides that the creditors’ committee, if appointed, or if not, the creditors’ assembly, must approve the action by a trustee to mortgage assets of the estate, to borrow on the account of the estate, or to purchase real estate. If these actions are in the ordinary course of business, the trustee should be able to decide these matters independently. If there is to be review, the bankruptcy court, rather than creditors’ representatives, would appear to be more qualified to decide on the appropriateness of the trustee’s proposed actions.

The time periods for steps in the bankruptcy proceeding stipulated in the German law also are not appropriate for countries with high inflation, which is prevalent in many economies in transition. Section 138 provides that the period for the submission of claims by creditors and their examination can be as long as five months. In this period of time, in countries with high inflation, absent special provisions, a claim can lose a significant portion of its value, if not become virtually worthless.

The German law also provides in section 146 that in some cases contested claims would not be
This article compares Czech, Hungarian, and Polish bankruptcy laws in seven aspects essential for the efficient and fair resolution of business insolvencies: the definition of insolvency that gives rise to the application of the law; the efficiency of administration of the insolvency proceeding; whether a proceeding under the insolvency law stays other debt collection proceedings against the debtor; the degree of finality of the resolution of claims against debtors; the possibility of rehabilitation of an enterprise as a realistic alternative to liquidation; the ability to rescind certain prebankruptcy payments and transfers; and the designation of priorities in distribution of assets to different types of creditors, including priority treatment for post-proceeding creditors.

To elaborate on the seven important features of the laws that the article evaluates: The definition of insolvency that triggers action under the law should be precise and negate attempts of debtors to conceal assets. The administrative procedures in a bankruptcy law should be practical and not too complex. They should strictly limit the number of opportunities for joint action by the trustee, a creditors' committee or assembly of creditors, a bankruptcy judge, and the bankruptcy court. The occasions for appellate jurisdiction should also be limited so as not to unduly encumber the process. Because the economies in transition lack a sophisticated bankruptcy bar and judiciary, a relatively large degree of discretion should be given to a qualified trustee if the system is to be workable. The judiciary is not likely to be sophisticated in financial matters for several years and even in the West expertise in commercial matters varies considerably among courts. A stay of collection actions against a debtor subject to insolvency proceedings is a desirable result of such proceedings because individual creditors pursuing individual remedies often decrease the aggregate value of assets available to creditors generally.

The insolvency law should include the realistic possibility for reorganization proceedings, whereby an insolvent company's finances are restructured, allowing the then presumably viable company to continue in business (relieved of some of its liabilities) and to pay some claims, after confirmation of the plan of rehabilitation, from future income. The insolvency law should include more than a general provision for settlement without requirements for the contents and procedure for approval of a plan of reorganization, which could relegate the bankruptcy proceeding to essentially a liquidation procedure. With respect to the resolution of claims against a debtor, as a collective creditor collection system, bankruptcy

heard by the court before which the bankruptcy proceeding was pending, but rather by another court. This provision also complicates the conduct of a bankruptcy proceeding. While it may be feasible in an industrialized country, it would severely test the resources of a country without significant recent experience in judicial proceedings on insolvency. Indeed, centrally planned economies experience no business insolvencies since the state pays state-owned enterprises' liabilities. Also under the German law, the bankruptcy proceeding did not finally settle claims not paid in the proceeding. Section 164(1) provides that "after termination of the bankruptcy proceedings, the bankrupt's creditors who have not obtained satisfaction may enforce their claims against the debtor without restriction."
proceedings should dispose of all creditors' claims, whether they all agree or not, provided that dissenting creditors receive at least as much as they would receive in a liquidation. Only in this way can the important benefit perceived in some countries in bankruptcy proceedings of providing the debtor with a fresh start be realized. Bankruptcy laws should implement the equitable principle that similarly situated creditors should be treated alike. Unfair advantages gained by some because of payments and transfers by the debtor before the bankruptcy filing, when the debtor may have already been insolvent, or which are gratuitous or represent a fraud on creditors, should be disregarded. Thus, the law should contain a broad provision for voiding certain payments and transfers made by the debtor before commencement of a bankruptcy proceeding.

The law should also clearly state the priorities for distribution of debtors' assets among several classes of creditors, in addition to the priority that should be accorded to secured claims to the extent of the proceeds of the collateral security. This information is important in that it enables potential creditors of enterprises to know where they would stand in the event of bankruptcy and to price their financing accordingly. The number of classes of priority creditors should also be limited so that similarly situated creditors are treated alike. If priority is given to claims for wages and benefits without limit and to governmental claims for taxes and social welfare payments, this preference may discourage commercial credit other than secured financing. However, one class of creditors that should be given preferential consideration is those who provide credit to a company after bankruptcy proceedings have been initiated like financial institutions or suppliers of goods. This type of credit is often vital for a business that has prospects for restructuring rather than liquidation, since it enables the business to continue in operation so it can retain suppliers and customers.

The following is an evaluation of the three countries' laws based on these factors.

I. Evaluation of the Laws Based upon the Seven Features

A. The Definition of Insolvency That Gives Rise to the Application of the Law

The definition of insolvency is key for the laws under consideration because it may act as a trigger to the application of the bankruptcy law. If the trigger is pulled too early, the action may have tragic effects for the debtor who is trying...
to save his business. If the trigger is pulled too late, the creditors' rights may be impaired because the debtor's assets may be depleted.

The Czech law rather imprecisely defines the insolvency that gives rise to a bankruptcy proceeding under section 1(2) generally as when a debtor is unable to meet obligations to a number of creditors for an extended period of time. Under section 4(2), if a debtor has ceased making payments, he is presumed unable to do so. Thus, this provision leaves room for interpretation at least as to what period of time is considered extended. Section 1(3) contains an alternative test for an individual entrepreneur or for enterprises, which can also be considered bankrupt if overburdened with debts. Thus, they are subject to an alternative test of balance-sheet insolvency, while for individuals who are not business persons the test is failure to meet obligations over a prolonged period of time. Since balance-sheet insolvency is often difficult to determine because assets are often overvalued, the inability of a debtor to meet obligations may become the more important test in practice.

The Polish law also contains two tests for insolvency. First, an economic entity is to be declared bankrupt when it "has ceased to pay debts." Second, state enterprises, cooperatives, limited liability companies, joint-stock companies, or other legal persons can be declared bankrupt "in cases where their assets do not suffice to satisfy their debts"—balance-sheet insolvency. In both cases, a "short-term suspension of debt payment due to temporary difficulties" does not give rise to grounds for declaring bankruptcy.

The Polish law provides a time limit within which a debtor must file a bankruptcy petition: "within no more than 14 days from ceasing to pay debts" or "within 14 days of the disclosure that the assets of the company do not suffice to satisfy the debts, unless the debtor has presented a petition for opening reorganization proceedings." If the debtor does not file within the time limit, the judge-

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(A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of—
(i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and
(ii) property that may be exempted from property of the [debtor's] estate.

Id. § 101(32).

11. In practice, it may be the period after which more than two creditors lose patience and decide to file a petition against the debtor.

12. "Entrepreneur" is defined in § 2(2) of the Czech Commercial Code as a person recorded in the Commercial Register; a person conducting business activity on the basis of an authorization; or a natural person engaged in farming and registered as such. Act No. 513/1991 Coll., as amended.

13. PL, supra note 3, art. 1, § 1; see Izabela Sewerynik, Some Problems Regarding Bankruptcy of Enterprises in the Polish Economy, 9 PUB. ENTERPRISE 168 (1989) (encouraging companies to make technical progress and adopt modern methods of management and financing in order to regain financial solvency and avoid bankruptcy).

14. PL, supra note 3, art. 1, § 2.

15. Id. art. 2.

16. Id. art. 5, §§ 1, 2.
commissioner is empowered on these grounds to refuse any reorganization plan proposed in the future and to impose civil or criminal penalties. A creditor may also initiate a proceeding at any time.

Previously, the Hungarian law contained a mandatory filing requirement; a businessman had to declare bankruptcy within eight days of when it would be impossible to pay a debt within 90 days of the debt becoming due. This provision was wisely removed from the law in July 1993. Under the current law, a debtor may voluntarily file for reorganization or liquidation, but a creditor may file a petition only for liquidation. The debtor will be found by the court to be insolvent if: (1) he fails to settle his debts within sixty days of the filing of the petition; (2) an execution proceeding against him is unsuccessful; or (3) he fails to fulfill a payment obligation pursuant to a reorganization plan.

For bankruptcy laws like those in the Czech Republic and Poland, which do not have adequate provisions to encourage financial reorganizations, the laws embody, in effect, a policy that promotes liquidations of enterprises because their liabilities exceed their assets, regardless of the degree of negative net worth and whether the situation may be remediable. Negative net worth to a small degree is something the enterprise should seek to correct, in the first instance, rather than cause the winding-up of an enterprise. Similarly, where laws presume insolvency when the debtor has suspended payments to creditors, as in the Czech Republic, the reason for the suspension of payments should be ascertained before a formal bankruptcy proceeding is initiated, which in these cases favors liquidation rather than restructuring of enterprises in financial difficulty.

B. THE EFFICIENCY OF ADMINISTRATION OF THE INSOLVENCY PROCEEDING

Another important element of a bankruptcy law is that it provide efficient methods for both liquidation and reorganization. The law should specify what court has jurisdiction and provide for specialized courts or divisions that will handle commercial matters, since modern corporate financial transactions that are often required in insolvency proceedings in a market economy were not before the courts in Eastern Europe in the recent past; define and allocate the roles and

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17. Id. arts. 5(3), 177(4).
19. The mandatory trigger was thought to have been a cause in the high number of cases (over 14,000) filed in Hungary in 1992. GRAY, EVOLVING LEGAL FRAMEWORKS, supra note 1, at 12. "Because the law came into effect January 1, 1992 and requires reporting after 90 days in default, there was a particular surge of 3500 filings in April alone—including 2200 reorganization filings and 1300 liquidation filings." Id. at 83; see Finance Ministry on Bankruptcies and Liquidations, MTI ECONews, June 12, 1992 (in the first four months of 1992 there were 3,045 bankruptcy declarations and 3,898 liquidation declarations).
20. HL, supra note 3, §§ 7, 22, 23(2).
21. Id. § 27(2).
22. See infra text part I.E.
powers of the court, judges, trustee, and creditors; and limit the number of decisions subject to appeal.

The Hungarian law sets up no specialized courts to deal with bankruptcy matters; rather the county court where the debtor has a registered office has jurisdiction. However, the statute provides a streamlined process for either reorganization or liquidation. A debtor may voluntarily enter reorganization proceedings. Alternatively, a debtor or creditor may initiate liquidation proceedings, which at the debtor's initiative may be terminated because of a compromise agreement.

The prior version of the Hungarian law attempted to create an efficient bankruptcy process by imposing a series of deadlines on such things as when the bankrupt must file, when the court must issue writs and decisions, and when a party may appeal. However, many of these deadlines were changed and the number of occasions for appeal were decreased. Moreover, the new version of the law requires, for the account of the debtor, the appointment of a trustee, whose role is clearly defined. Previously, the trustee was appointed only at the request of the creditors, who were required to pay the costs of the trustee. These improvements should make the process more efficient and the law more effective.

Under the Czech law, as under the Hungarian law, the regional or municipal court with jurisdiction over the debtor handles the case. The provisions on administrative procedures for the bankruptcy proceeding appear to be conducive to the efficient disposition of claims except where enterprises involved in privatization are concerned. The law does not appear to include too many excessive or inappropriate procedural measures.

Czech law article 12(1) is a model provision on giving the appropriate degree of discretion to the court in supervision of the trustee, and article 12(2) denies any right of appeal against the court's supervision of the proceeding. One peculiar aspect is the requirement in article 23(2) that creditors whose claims are opposed by other creditors file separate lawsuits to resolve such claims, rather than resolving them in the context of the bankruptcy proceeding in which the claim is at issue. In the case of a claim by the trustee against a creditor, such matter may be resolved in the bankruptcy proceeding or in another proceeding. These provisions would appear to cause unnecessary delay in the resolution of the bankruptcy in some cases.

23. HL, supra note 3, § 6(1). This court is referred to in the law as the "Court."
24. Id. § 7(1).
25. Id. §§ 22, 41-45.
28. HL, supra note 3, §§ 14-17.
29. Pre-amendment HL, supra note 3, § 14(1).
30. CL, supra note 3, art. 3(1).
31. Id. art. 24(1).
With respect to enterprises slated for privatization or in the process of privatization, recent amendments to the Czech law contain provisions that are complicated and may be impractical in many cases. The amendments do not appear to fully distinguish a sale of assets from a sale of an enterprise, how an impending bankruptcy proceeding would affect the prospective investors in a company to be privatized. A court may stay a request for initiation of a bankruptcy proceeding against a company involved in privatization for different periods of time, depending upon the stage of the privatization process.

The Polish law contains efficient procedures for the administration of proceedings. It contains straightforward provisions on where the debtor is to file his bankruptcy petition, what the petition is to contain, and the judicial procedure for a decision determining the bankruptcy of a debtor. Similarly, the liquidation provisions provide clear roles for the judge-commissioner and the official receiver, whom the court appointed when bankruptcy is declared. The reorganization provisions are more problematic, as discussed below, because they provide for too much court discretion in approving arrangements. The law allows appeals on the initial determination of bankruptcy and the final decision regarding a plan for reorganization.

C. Stay of Collection Proceedings against a Debtor

Once a debtor files for bankruptcy, some creditors' sole concern is to satisfy their claims against the debtor. The main purpose of an automatic stay is to

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32. PL, supra note 3, art. 8 provides:
§ 1. Proceedings for the declaration of bankruptcy shall be instituted in the district court within whose district lies the principal establishment of the debtor, and if the debtor has several establishments in districts of various courts, in one of those courts. If the debtor has no enterprise in Poland, the court of jurisdiction shall be the one in whose district the debtor has his place of residence or principal place of business, and where the debtor has no place of residence or business headquarters in Poland, the court in whose district the estate of the debtor is situated shall have jurisdiction over the case.
§ 2. The power to declare bankruptcy lies with the district court-economic court consisting of three professional judges.

See id. art. 9 (regarding contents of the bankruptcy petition), art. 10 (providing for hearings), art. 12 (injunctions to protect the estate), art. 13 (dismissal if debtor’s assets would not even satisfy the costs of the proceedings), art. 14 (contents of the declaration). One unusual provision allows the court to require a creditor, who files a bankruptcy petition, to advance the costs of the legal proceedings; otherwise, the court dismisses the petition. Id. art. 11.

33. See id. art. 14, § 1(3) (bankruptcy petition shall appoint the judge-commissioner and the official receiver), arts. 87-109. Id. art. 87 provides: "The judge-commissioner conducts the course of proceedings, inspects the acts administered by the official receiver and specifies the acts the official receiver must not perform without his special consent or the consent of the committee of creditors."

Id. art. 90 states: "The official receiver, by operation of law, takes possession of the bankruptcy estate, administers it and conducts its liquidation."

34. Id. arts. 171-201.
35. Id. arts. 17, 192.
36. Some creditors, like suppliers and employees, may also have a strong interest in seeing that an enterprise remains in business.
prevent a race by creditors to seize the debtor’s assets. A stay allows the debtor and a trustee time to consider alternatives to piecemeal liquidation and it protects pre-proceeding creditors from each other. It allows the debtor’s estate to remain intact for a period, for a greater value may be realized if the property of the debtor is sold in whole or in larger parts than would result from piecemeal sales as a consequence of individual creditors’ actions. The law should distinguish between actions that determine the validity or amount of a claim, which can be allowed to proceed, and those that execute on assets of a debtor, which should properly be stayed. The laws in question are not sufficiently precise on this point.

Under the Czech law, the initiation of a bankruptcy proceeding stays collection actions against the debtor. Similarly, according to the Polish law, a declaration of bankruptcy suspends actions by creditors against the debtor. When the court approves the decision determining bankruptcy, any such actions are discontinued by operation of law.

According to the Hungarian law, upon commencement of liquidation proceedings, creditors may submit their claims only to the liquidator. However, any proceedings that started before the announcement of the commencement of the liquidation proceedings may continue to be heard. In reorganization proceedings, a stay on the collection of claims does not automatically arise when the petition is filed. Previously, the Hungarian law provided that for ninety days after the court’s decision announcing the commencement of a reorganization case, a moratorium was imposed automatically on pecuniary claims against the debtor. Reorganization proceedings were to last less than ninety days; therefore, the moratorium was a stay on the collection of claims. However, the heavy caseload of the courts caused delay and in practice debtors were protected for a much longer period. Consequently, the law was amended and now a debtor must meet with creditors within fifteen days of filing for reorganization and a certain percentage of the creditors must agree to a moratorium. This provision obviously increases the pressure on a debtor, who within days of filing a petition

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37. In the United States, the stay arises automatically upon the filing of a voluntary, joint, or involuntary bankruptcy petition. 11 U.S.C. § 362 (1993) (also setting forth the scope of the stay, exceptions to the stay, the duration of the stay, and when a creditor may seek relief from a stay).
38. It may be more efficient to allow the conclusion of a lawsuit on such matters rather than to have the bankruptcy court consider these matters de novo.
39. CL, supra note 3, art. 14(1)(e).
40. PL, supra note 3, art. 62, § 1.
41. Id. & art. 57, § 1.
42. HL, supra note 3, § 38(2).
43. Pre-amendment HL, supra note 3, § 9. However, there was an expectation for wages, other benefits, and value added taxes that had to be paid. Id. § 12(2).
44. Smith, supra note 3, at 58.
45. More than half of the parties with claims that have matured by the initial date of bankruptcy and more than a quarter of the parties with unmatured claims must agree to the granting of a moratorium. HL, supra note 3, § 9(4). Furthermore, such claims must total at least two-thirds of the total creditors’ claims, except those to which the moratorium does not apply. Id.

WINTER 1994
must be able to convince creditors that the business can be reorganized. A debtor who files initially for liquidation would get the benefit of the stay and has the opportunity to reach a compromise agreement with his creditors.46

D. THE DEGREE OF FINALITY OF THE RESOLUTION OF CLAIMS AGAINST DEBTORS

One of the most important goals of bankruptcy in some countries, namely, in Anglo-Saxon countries, France, and under the new German law, is providing the debtor with an opportunity for a fresh start.47 According to this view, the bankruptcy procedure should settle all claims against the debtor, with limited exceptions. If the decision does not bind all creditors the value of the process is impaired from this perspective. In a market economy, entrepreneurial risk is to be encouraged because successful new business ventures benefit the economy and society. The penalty of failure should not be so great as to discourage risk-taking. If a business person will be barred for life from engaging in business or will never be free of business debts, risk-taking will be limited. In Eastern European countries, many businesses are in the form of unincorporated single proprietorships. In these countries involvement in bankruptcy proceedings has more consequences for future business activities than in countries in which limited liability corporate forms of business are more usual.

The Czech law provides that in compulsory settlements and in settlements satisfied by the debtor, the debtor is relieved of claims not required to be paid under the terms of the settlement.48 There is no provision, however, on the effect of a bankruptcy (liquidation) proceeding. In the case of an enterprise, it would usually be dissolved after a liquidation proceeding, so claims could not be pursued.49 In the case of a sole proprietorship or a partnership, however, the persons originally responsible for the debt would survive the bankruptcy proceeding, and

46. Id. §§ 41-45.
47. Several provisions of the U.S. bankruptcy code support this goal. Section 522 provides that certain property of the debtor is exempt from the bankruptcy proceedings. 11 U.S.C. § 522 (1993); see id. § 727 (stating when a court is to grant the debtor a discharge in liquidation cases); § 1141(d)(1) (providing that the effect of a confirmation of the reorganization is to discharge debts, unless otherwise provided in the reorganization plan); §§ 1141, 1328; see also id. § 523 (listing the exceptions to discharge), § 524 (describing the effect of a discharge). Furthermore, unless it is a case of fraud or willful injury to a person or property, state constitutions typically prohibit the imprisonment of debtors. DAVID G. EPSTEIN ET AL., DEBTORS AND CREDITORS 56 (1987). Some Eastern European nations, which are having problems with con artists who borrow money with the intention of declaring bankruptcy and then do so, are imposing strict restrictions or criminal sanctions upon a bankrupt. Pawel Wrabec, Bankruptcy: The Fall Artists, POLISH NEWS BULL., Aug. 13, 1993.
48. CL, supra note 3, arts. 42 & 63.
49. In the event that a corporate entity continues, the same ambiguity as with individuals regarding unsatisfied claims would result. Under U.S. law enterprises are not entitled to a discharge from unsatisfied debts in bankruptcy proceedings so as to discourage the purchase of bankrupt companies for their operating losses, which could offset corporate income tax liabilities of the acquiring company. See 11 U.S.C. § 727(a)(1) (1993).
the law should address whether unsatisfied claims against them could be pursued. To give a fresh start to unsuccessful business ventures, a final settlement of claims in the bankruptcy proceeding is desirable.

The prior version of the Hungarian law permitted a creditor who did not accept a reorganization plan to commence liquidation proceedings after ninety days of the publication of the court decision. Consequently, at least in a reorganization proceeding, the debtor was subject to further assault. This provision was amended, and now if a certain percentage of creditors approve the plan, all creditors are bound by it, as long as those not accepting the plan receive equal or better treatment compared to those creditors approving it. Thus, this standard of fair treatment for dissenting creditors is based upon treatment relative to other creditors. Under U.S. law, for comparison, dissenting creditors must receive at least as much as they would receive in a liquidation, which presents a more objective standard of fairness. The Hungarian statute does not expressly state that all claims against the debtor are discharged upon conclusion of the liquidation process.

In the Polish law, the liquidation proceedings do not finally settle all claims against the debtor. Claims not recognized in the bankruptcy action may be brought against the debtor after the bankruptcy proceedings terminate. Certain other claims may be brought after the bankruptcy proceedings; however, in certain circumstances, the debtor can file to have them quashed one year after the final decision by which a bankruptcy proceeding is completed or discontinued. A court-approved arrangement is binding on all creditors regardless of whether they submitted claims.

E. ENTERPRISE REHABILITATION

Among the laws under consideration, Hungary’s most strongly encourages financial reorganization of insolvent enterprises as a serious alternative to liquidation. The Hungarian statute’s preamble provides that liquidation proceedings

50. Pre-amendment HL, supra note 3, § 20.
51. HL, supra note 3, §§ 19(4), 19(5).
53. PL, supra note 3, art. 169.
54. ld. art. 170.
55. ld. art. 193.
56. The trend in the last 20 years in mature market economies has been toward reorganization in lieu of liquidation. The most extreme example is perhaps the United States, where Chapter 11 of the Federal Bankruptcy Code gives debtors extensive powers vis-à-vis creditors to design and implement reorganization plans and thus remain as going concerns. Germany, in contrast, uses its judicial bankruptcy proceedings almost exclusively for liquidations, leaving reorganization to pre-bankruptcy workout procedures. . . . At a minimum, to the extent reorganization is included as an option in the CEE countries, steps should be taken to reduce the power of company managers and strengthen the voice of creditors, perhaps by imposing strict time limits and/or allowing the submission of competing restructuring plans.
GRAY, EVOLVING LEGAL FRAMEWORKS, supra note 1, at 11-12 (footnotes omitted).
are to occur if reorganization is not possible. This preference for restructuring is supported by straightforward provisions on how to proceed. Unfortunately, one drawback to the statute is that creditors, who often know well the prospects of the business of the debtor, apparently can only file for liquidation of the debtor, though the debtor may propose a reorganization plan during the liquidation proceedings.

In Hungary, the reorganization procedure is as follows: after filing for reorganization, the debtor must hold a meeting of creditors at which time they vote on whether a stay on collection actions by creditors should be imposed; if the court approves and grants the stay, the debtor draws up a plan, which must contain certain specific information for restoring solvency. During the period of the stay, the debtor must hold compromise negotiations to which the creditors, who must have already received the plan, must be invited. Previously, a major fault of the statute was that all the creditors present at the negotiations had to approve the plan. However, the 1993 amendments cured this and now only a certain percentage of creditors need to approve the plan. Within three days before the expiration of the moratorium, the debtor must report the result of the reorganization negotiations, and if a plan has been prepared, he shall also attach the plan. If the plan corresponds with the requirements of the law, the bankruptcy proceeding is to be declared concluded by a court order.

57. Parliament, in order to reorganize insolvent business organizations through bankruptcy proceedings, and if this is not possible, through a liquidation procedure, to regulate the final settlement of solvent business organizations about to terminate their business activities, and to protect the interests of creditors, enacts the following law:

58. Only the largest suppliers eager to maintain their markets, and powerful banks which want to improve their portfolios, are actually prepared to help the companies survive, Istvan Racz, chairman of the Chamber of Liquidators and managing director of Concor-dat liquidating and consulting company, told Econews.

59. Pre-amendment HL, supra note 3, § 17(1). However, this requirement was not applicable to compromise agreements reached during the course of liquidation proceedings. For such agreements, at least half of the creditors with claims equal to at least two-thirds of the total claims must approve the agreement. Id. § 44. Thus, a reorganization plan could have been rejected during the reorganization stage but approved during the liquidation process.

60. HL, supra note 3, § 19(4); see supra note 45.
61. HL, supra note 3, § 21(1).
62. Id. § 21(3).
While the insolvency laws of the Czech Republic and Poland are too new to determine whether the discretion given to courts to reject settlements agreed to by the debtor and creditors will significantly limit the utility of reorganization provisions, this outcome is a possibility. Certainly, the arbitrary provisions in the law of the Czech Republic for a minimum payment of claims by the debtor to conclude a settlement will restrict the use of reorganizations as an alternative to liquidation. For example, if, in a reorganization, general unsecured creditors would receive 20 percent of their claims while in a liquidation they would receive 10 percent, the law should not arbitrarily require that a debtor pay half the amount of certain claims when the alternative is liquidation. The law should support creditor democracy—if creditors favor a plan of reorganization that appropriately treats secured creditors and is not patently unfair to other classes of creditors, the majority creditors' views should prevail.

Though the Polish law is more tailored towards liquidation proceedings, it contains a chapter on reorganization, titled "the bankrupt's arrangement with creditors." However, the fact that secured creditors are not involved in reorganizations diminishes the prospect for their success in many cases. It provides that after the schedule of debts is drawn up by the judge-commissioner, "the bankrupt may make an arrangement with the nonpreferential creditors." These are unsecured creditors, who must approve the plan "by a majority of the creditors voting who represent together not less than two-thirds of the value of debts," if there is no guarantee for the satisfaction of their claims. This initial process appears to be straightforward, but its utility may also be diminished by the other related provisions for approval by the court. The judge-commissioner, as distinguished from the court (as discussed below), must determine whether to approve the arrangement and apparently can reject it on only two narrow grounds: if it contains no arrangement proposals (which probably means that the plan is proposed to delay the liquidation proceedings and is not a realistic reorganization plan); or

63. PL, supra note 3, ch. VII, arts. 171-201; see id. art. 14, § 1(3) (providing for the appointment of the judge-commissioner and official receiver). Also, Poland’s Law on Financial Restructuring of Enterprises and Banks, supra note 3, has provisions whereby "creditor banks that initiate bankruptcy proceedings against a defaulting debtor are granted a special status to implement restructuring arrangements, including debt-for-equity swaps, even before full privatization. The Czech Bankruptcy Act grants creditor banks no such special status, and generally delays recapitalization until after privatization." Varanese & Westphal, supra note 7, at 11. These analysts note that the financial restructuring law is "a hybrid bankruptcy privatization tool: because the debt-for-equity swaps transfer state-owned shares to private hands, the twin goals of recapitalization and privatization are achieved with one stroke." Id.

64. PL, supra note 3, art. 171. In the case of state enterprises petitioning to make an arrangement with creditors, the petition may include a "demand to have the arrangement proceedings preceded by a public invitation for tenders as to the further running of the enterprise, its transformation or utilization of its productive capacity." Id. art. 175a.

65. Id. arts. 174, 185.
if the bankrupt is barred from entering into such an arrangement. The decision of the judge-commissioner to permit the bankrupt to make the arrangement is not subject to appeal.

According to the Polish law, once a plan is approved by the creditors, the court, in addition to the judge-commissioner, must also approve the arrangement, unless: (a) it contravenes the bankruptcy law; (b) the creditor's vote was somehow manipulated (for example, creditors were given inappropriate information regarding the future prospects of the reorganized business); (c) the arrangement "conflicts with decency or public order;" or (d) the "the conditions are too disadvantageous to the creditors who have voted against the plan." Any creditors objecting to the plan may complain at a hearing. These provisions introduce too much court discretion. A better approach would be to establish fair and objective confirmation rules, with the creditors having the power of decision. The court's decision is subject to appeal. Once the court's approval of the plan is final, in the future, the plan may be set aside on only two grounds: the conviction of the debtor for fraudulently hiding assets from creditors; or the debtor's failure to abide by the terms of the plan.

The law of the Czech Republic provides both for settlement and for compulsory settlement of creditors' claims, which could have the effect of establishing a reorganization. The procedure for settlement arises outside the context of a bankruptcy proceeding, whereby the debtor is protected from creditors' claims while the debtor continues its business activity with a view to restructuring its finances so that the business can continue. Relieved of some portion of its debts, the business gains a chance to prosper in the future. The possible involvement of a trustee in a settlement proceeding is unclear.

66. *Id.* art. 176. Certain bankrupts may not enter into an arrangement. These include: bankrupts who have declared bankruptcy within the last five years, bankrupts who have already been party to an arrangement, bankrupts who have not maintained books as required, bankrupts who have unconscientiously kept their books, bankrupts who did not file a bankruptcy petition within the prescribed time limit, and bankrupts who have refused to cooperate in establishing the financial condition of the bankruptcy estate. *Id.* art. 177.

67. *Id.* art. 178.

68. *Id.* arts. 189-192.

69. *Id.* art. 189.

70. *Id.* art. 192.

71. *Id.* arts. 197-201.

72. CL., supra note 3, arts. 34-43, 46-66. Two analysts of the Czech bankruptcy law noted:

Often debtors utilize the limited time available prior to the court's formal declaration of bankruptcy to directly negotiate with creditors a mutually acceptable financial restructuring. Prior to the court's formal declaration, the debtor may request and receive a protection period of three to six months or longer. The protection period has a special legislative purpose: to protect newly privatized companies during their birthing period. Within this protection period, the debtor has a reprieve from the formal declaration of bankruptcy proceedings that permits the negotiation of a financial restructuring package acceptable to both debtor and creditor.

Varanese & Westphal, supra note 7, at 9.
A settlement proceeding would arise before the court issues a bankruptcy order and is proposed by a debtor who would qualify for bankruptcy proceedings; that is, it meets one of the insolvency tests. For an entrepreneur the proposal for a settlement apparently must include a reorganization plan. The filing of a proposal by the debtor suspends the debtor's rights, inter alia, to transfer property, incur new debt, or otherwise impair the rights of creditors, so the conduct of business as usual is restricted. In a settlement, preference is given to governmental claims and employee claims, as in compulsory settlements. A court can accept or reject the proposal. However, the court must reject the proposal if it determines that the nonpriority creditors have not been offered at least 45 percent of their claims to be paid within two years of the filing of the proposal. The creditors are entitled to make proposals as to the terms of a settlement and creditors whose rights are impaired vote on whether to accept the settlement.

The criteria in the law for the court to determine whether a proposed settlement can go forward introduces some rigidity into the system with respect to priority claims and minimum payments for nonpriority claims, which is undesirable. The creditors as a whole should determine whether they would be better off in a settlement rather than in a prospective liquidation. While priority creditors would perhaps be better off in a liquidation if sufficient assets are available to satisfy their claims, the law should not implicitly favor liquidations if prospects are good for rehabilitation of a business. Thus, the court should not reject settlement proposals because they do not meet arbitrary guidelines.

Similarly, in regard to confirmation of settlements, a court may refuse to confirm settlements agreed by the creditor and debtor if in the opinion of the court "the advantages to the debtor... are at considerable variance with his recognized financial status" or if the settlement is too disadvantageous to the dissenting creditors. Again, the court should not substitute its judgment for that of the parties to the proceeding, especially on such indefinite criteria, since the alternative in many cases would be liquidation.

The Czech law provides that the debtor may propose a compulsory settlement after the court reviews the validity of claims, to conclude a bankruptcy proceeding. A majority of the creditors representing three-quarters of the claims must approve the proposal. Such settlement precludes the liquidation of assets in

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73. CL, supra note 3, art. 46(1). "Entrepreneur" is defined in § 2(2) of the Commercial Code.
74. Id. art. 46(3).
75. Id. art. 49(1).
76. Id. art. 54.
77. Id. art. 50.
78. Id. art. 58. While id. art. 58(b) stipulates which creditors are entitled to vote on a settlement proposal, the votes needed to accept the proposal are not stated. Presumably, the same rules apply as for compulsory settlements. Id. art. 38(1).
79. Id. art. 61(2)(a), (c).
80. Id. art. 34. The review hearings are described in arts. 20-25.
81. Id. art. 38(1).
the bankruptcy proceeding and therefore provides a method for a business to reorganize, albeit after the disruption caused by the intervention of a trustee and a cessation of normal business operations for some period of time. The court must reject a settlement proposal if it involuntarily impairs the rights of secured creditors.\textsuperscript{82} This provision is an important impediment to reorganizations, especially as secured credit becomes more widely used as the money and capital markets develop. As in the disappointing experience in Germany with concordats, if secured creditors' claims may not be deferred, there may be no practical alternative to liquidation in many cases in which reorganizations would otherwise be desirable. The law provides that the court shall reject a proposal for a compulsory settlement, inter alia, if the costs of administration or claims of employees are not paid in full\textsuperscript{83} or if at least one-third of nonpriority claims are not scheduled to be paid within one year.\textsuperscript{84} These are other arbitrary obstacles to reorganization and are not consistent with solutions to enterprise financial distress used in the West. The court must also consider whether such settlement would sanction the debtor's "dishonest or carefree management of his economic affairs" and if so, reject the settlement.\textsuperscript{85} The introduction of this value judgment also does not appear to be helpful.

Amendments to the Czech law enacted in April 1993 provide for a period of three to six months' protection for a debtor, after a creditor has requested the initiation of bankruptcy proceedings.\textsuperscript{86} During the period the court will not formally initiate bankruptcy proceedings. Within this protected period, the debtor must "make continuous efforts" to rehabilitate its affairs.\textsuperscript{87} and a settlement according to the provisions of the bankruptcy law could be proposed.\textsuperscript{88} Creditors during this period may not make claims on debtors, with the exception of employee claims and those in relation to tax and social and health insurance.\textsuperscript{89} It is unclear whether the debtor's business could be conducted to enhance the prospects for rehabilitation during this period. Article 5d(d) provides that "actions taken by the debtor which infringe on the interests of the creditors . . . are ineffective." The law should make explicit that actions in the ordinary course of business such as purchasing supplies and selling inventory are permissible, and that a creditor who extended any new credit to the debtor would have high priority in any liquidation. Otherwise, a debtor would find it difficult to implement a plan of rehabilitation other than through retrenchment.

\textsuperscript{82} Id. art. 36(a).
\textsuperscript{83} Id. art. 36(b).
\textsuperscript{84} Id. art. 40(1)(e).
\textsuperscript{85} Id. art. 40(1)(f).
\textsuperscript{86} Act No. 122/1993 Coll.
\textsuperscript{87} Id. art. 5d(e).
\textsuperscript{88} Id. art. 5d(f). If a statement is proposed by the debtor during the protection period, it will not end before the court decides on the proposal.
\textsuperscript{89} Id. art. 5d(b).
All the countries could strengthen their reorganization provisions in different degrees by adopting certain measures similar to those used in countries where enterprise reorganizations have had an extensive history, like France and the United States, to make reorganization a more meaningful alternative to liquidation. The law could provide for the expeditious consideration of whether the debtor may continue to conduct its business, pending determination of the feasibility of a reorganization plan.  

With regard to settlement proceedings commenced after bankruptcy proceedings have begun, the disruption to the business of the debtor may have irreparably harmed the prospects for rehabilitation because important suppliers and customers may be lost. The law could also contain a provision to enable widely held companies to organize committees of equity holders, in addition to creditors' committees, which would consider the advisability of the continued existence of a troubled enterprise.  

The law could empower both types of committees, or the court, to engage professionals like attorneys, accountants, and investment bankers to appraise the desirability of the continuance of certain facets if not all of the business of the debtor and formulate a plan of reorganization.

The law could also contain a list of possible specific elements of a plan of reorganization, to stimulate consideration of alternative means to restructure the finances of the debtor. This specificity would be particularly helpful in Eastern Europe, which is embarking on a new era of financial restructuring of enterprises for a market economy. Such measures could include: the modification of rights of holders of claims, both secured and unsecured; the sale of substantial parts of the debtor's assets; the merger or consolidation of the debtor with another enterprise; the issuance of securities of the debtor for cash, for existing securities, or in exchange for other claims; and the amendment to the debtor's charter to provide for new classes of voting securities with preferences with respect to ordinary dividends and liquidation distributions. The law should require that interested parties' acceptance or rejection of the plan be based on adequate information and that they receive a disclosure statement. To induce negotiations on the terms of a proposed reorganization plan in countries that have had no recent tradition in this area, the law could also provide for the submission of counteroffers at different time intervals. Such provisions should stimulate the creative efforts of interested parties and their advisors.

To favor the reorganization rather than a liquidation of an enterprise as a matter of policy, the law can remove some discretion from the interested parties with respect to a reorganization plan where they are deemed to be treated fairly. Thus,

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94. See id. § 1125(b).
the law could provide that creditors who dissent will be considered to have accepted a plan if they will receive or retain under the plan property of a value that is not less than they would receive or retain if the debtor were liquidated.\textsuperscript{95} Such value could be in the form of deferred cash payments over a period not exceeding a specified number of years, and to address inflation, the imputed rate of interest could be subject to indexation.

F. AVOIDANCE OF PRE-BANKRUPTCY TRANSFERS

As a matter of fairness to creditors and in order not to discourage them from extending credit, the law should provide that certain payments by a debtor to creditors during some period before the bankruptcy proceeding will be null and void.\textsuperscript{96} Transfers and payments other than in the ordinary course of business or in which there is a contemporaneous exchange for new value should be subject to avoidance. This provision would allow a debtor's business to receive supplies and to sell output. Certain other payments and transfers would become part of the debtor's estate, to be apportioned among all creditors, or to be used as assets in a reorganized business. As a general principle of equitable treatment of all creditors, debtors should not be able to choose who will get paid in full and who in part or not at all. Nor should creditors be able to exert undue pressure for payment from a financially distressed business.

None of the laws under consideration contain broad provisions that void unfair preferences given to creditors within a certain time period before bankruptcy. Some laws void transfers made gratuitously or to relatives, or security interests given, or payments by way of settlement, but no broad provision applies.

The Hungarian law contains a simple provision allowing a creditor or liquidator to challenge certain preliquidation contracts and transfers.\textsuperscript{97} Furthermore, in the hierarchy of claims, secured debts are given priority, unless the security was pledged less than six months before the starting of the liquidation process, in which case the claim is apparently included with unsecured claims.\textsuperscript{98}

The Polish law contains several provisions voiding pre-bankruptcy transfers.\textsuperscript{99} All "gratuitous acts" done within one year of the bankruptcy petition have "no effect upon the bankruptcy estate."\textsuperscript{100} Also, all pledges of security and payments

\textsuperscript{95} See id. § 1129(a)(7).


\textsuperscript{97} HL, supra note 3, § 40.

\textsuperscript{98} Id. § 57(1)(b).

\textsuperscript{99} PL, supra note 3, ch. IV (Ineffectiveness of and Action Against the Bankrupt's Acts), arts. 53-58.

\textsuperscript{100} Id. art. 53, § 1.
of debts that have not fallen due within two months of the petition are void.\textsuperscript{101} Moreover, creditors apparently have the power to file an appeal against the bankrupt’s acts that are prejudicial to them.\textsuperscript{102} The law also contains a provision whereby the debtor’s contracts with certain extended family members within six months preceding the presentation of the bankruptcy petition have no effect upon the bankruptcy estate.\textsuperscript{103}

Under the Czech law, security interests granted to creditors within two months before the date of the receipt by the court of the petition to initiate formal proceedings become void.\textsuperscript{104} In the case of a protective proceeding under Czech law article 5a, which can ordinarily last for up to six months, or nine months in the case of an agricultural production business,\textsuperscript{105} any preferences granted to some creditors during this period are subject to rescission. Collusive actions in the past three years by the debtor and third parties with the intention to impair the rights of creditors are also voidable.\textsuperscript{106} These partial provisions appear to be equitable, as they afford equal treatment to some similarly situated creditors. However, the law has no general provision in the law for treating similarly creditors who receive payments shortly before bankruptcy and those that do not.

G. PRIORITIES IN DISTRIBUTION OF ASSETS

To implement the basic precept of insolvency law that similarly situated creditors should be treated equally, an insolvency law should not contain too extensive a hierarchy of priority classes of claims in regard to the distribution of a debtor's assets in liquidation. The laws in question generally accord too many priorities to employee, tax, and social welfare payment claims. The legislatures appear to have assumed the existence of a law of equity as to which creditors should be paid preferentially. Yet in the transition to a market economy, where the extension of commercial credit is vital, especially in the absence of other significant sources of business finance, the law should not discourage general creditors, who are disadvantaged when several other classes of claimants are given priority.

Among unsecured claims, all the laws give priority of payment of claims from the proceeds of the estate to administrative expenses of the bankruptcy proceeding, which is appropriate. Indeed, if a trustee is not assured that costs and fees of the administration of the estate will be paid, the bankruptcy proceed-

\textsuperscript{101} Id. art. 53, § 2. A creditor, who was not aware of the existence of the grounds of bankruptcy, may request that the payment or security be declared valid. Id.
\textsuperscript{102} Id. art. 55.
\textsuperscript{103} Id. art. 54.
\textsuperscript{104} CL, supra note 3, art. 14(1)(f).
\textsuperscript{105} Id. art. 67c.
\textsuperscript{106} Id. art. 15(2). There are also provisions in Criminal Code § 256 for preferential transfers.
ing may not be responsibly administered. Employee and government claims are generally next in payment priority. Highest priority is accorded to secured claims in all countries except Hungary, where administrative costs take precedence. The claims with such priority are for the amount realized from the collateral security. Any remainder due becomes an unsecured claim.

Only the Czech law appears to give priority to those who provide credit after the commencement of a bankruptcy proceeding. Omission of this priority diminishes the prospects for restructuring of some enterprises because they will have to curtail business activities that depend on new credit. Few enterprises in bankruptcy will be able to give security for new credit, especially since in these countries, receivables are generally not used as a form of asset-based financing. The laws also have no limits on payment of claims for compensation to managerial or other highly compensated officers or employees of enterprises. This lacuna creates a moral hazard, and limits on payment of such claims could instill more managerial discipline that would prevent some insolvencies.

In Hungary, in compromise agreements, the creditors may agree on the order in which debts will be satisfied. As for liquidations, the statute provides a specific order for the payment of debts: liquidation costs (which include employee severance pay); certain secured debts, wages, and employee benefits; "claims by private persons deriving from noneconomic activities"; social security obligations and taxes; other claims; and finally, interest and penalties.

The Polish law provides the following priority for claims to be satisfied out of the bankruptcy estate: costs of the proceedings, which, curiously, include wages and pension payments owed by the debtor; claims incurred by the official receiver; taxes for a period of two years prior to the declaration of bankruptcy; social insurance payments for a period of one year prior to the declaration of bankruptcy; other claims plus interest for one year prior to the declaration of bankruptcy and contractual damages and related costs; other interest; penalties

107. The supremacy of secured creditors is important to the flow of credit in the economy.

In the new Hungarian law, these rules of priority are shifted to place the claims of workers for salaries and severance pay (considered here as liquidation costs) above that of secured creditors. This is likely to dampen the incentives of secured creditors to initiate bankruptcy, reduce the role of banks in enterprise restructuring, and ultimately constrain the development of secured credit as a financial instrument.

GRAY, EVOLVING LEGAL FRAMEWORKS, supra note 1, at 12.

108. However, the Polish law gives some preference, after administrative claims, to new credit that was provided in the context of a failed reorganization attempt, as "claims generated from the bankrupt's acts carried out with permission of the court supervisor or by the supervisor's acts in the course of arrangement proceedings, which were completed or discontinued within three months preceding the declaration of bankruptcy." PL, supra note 3, art. 203(1).

109. HL, supra note 3, § 43.

110. Id. § 57(2).

111. Id. § 57(1).
and fines; donations and bequests.\textsuperscript{112} The law also states that to the extent a secured creditor's debt is not satisfied by his mortgage or lien, that amount shall not be included in the list of claims to be satisfied out of the estate.\textsuperscript{113} Apparently, debts secured by mortgages and liens are given absolute priority, though this question is currently being debated in Poland.

In the Czech Republic, priority is accorded first to claims related to the administration of the estate, and then to employees' claims for three years prior to the bankruptcy (so-called first class claims).\textsuperscript{114} Next, are governmental claims for taxes, fees, duties, and social security contributions within three years prior to the bankruptcy and in the course of the bankruptcy, which are called second class claims.\textsuperscript{115} Other nonpriority claims are third class claims. Claims not recognized include interest on creditors' claims, both pre- and post-bankruptcy, and extra-contractual penalties.\textsuperscript{116} It appears that the priority accorded to disputed claims that are ultimately upheld is the priority they would have received had they not been contested. Funds are set aside to cover contingent claims.\textsuperscript{117} The Czech law in article 33(2) states that these claims will be paid according to a "new distribution schedule." With respect to the treatment of credit provided after the initiation of bankruptcy proceedings,\textsuperscript{118} claims with respect to post-proceeding credit are first class claims.\textsuperscript{119} Thus, reorganizations may be facilitated by the debtor's receiving new credit, since such creditors may be encouraged by the priority accorded to their claims.

\section*{II. Conclusion}

This article has shown the ways in which laws of three Eastern European countries deal with important aspects of insolvency legislation. The early experience with these laws shows that some provisions can predominate compared to others. In Hungary, the early experience shows that reorganizations have been undertaken to a significant degree. Similarly, the number both of reorganizations and liquidations in Poland is on the rise. In the Czech Republic, the very early experience is that the administrative framework is inadequate to resolve the volume of cases filed.

Since the state is still the owner of the vast majority of large enterprises and banks in these countries, the use of insolvency laws has been tempered by the

\begin{itemize}
\item \textsuperscript{112} PL, supra note 3, art. 203(2).
\item \textsuperscript{113} Id. art. 207.
\item \textsuperscript{114} A recent amendment to the law provides in art. 67a that claims of management personnel shall have priority only up to the amount of \textcurrency k\textcurrencys 10,000 per month; any excess will be treated as a nonpriority claim.
\item \textsuperscript{115} CL, supra note 3, art. 32.
\item \textsuperscript{116} Id. art. 33(1).
\item \textsuperscript{117} Id. art. 33(2).
\item \textsuperscript{118} See id. art. 52(2) regarding restrictions on creating new liabilities in a settlement proceeding.
\item \textsuperscript{119} Id. arts. 31(2), 32(1).
\end{itemize}
natural reluctance of governments to cause disruption in employment. When more private interests obtain ownership of enterprises, the new adversarial relationships will undoubtedly cause an increase in the number of involuntary initiations of insolvency proceedings. As these bankruptcies proceed, the bankruptcy courts and private sector professionals will develop more expertise to improve the efficiency of the process. The laws may be amended to remedy provisions and procedures that have proven impractical. Then, in the countries whose laws provide a fair opportunity, the prospects for successful reorganizations may improve.