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Examination of Pre-insolvency Procedures in Central Europe

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Abstract:
The opening of the insolvency proceedings, i.e. declaring bankruptcy, is stigmatic and shunned throughout Europe (and elsewhere). Insolvency procedures are often reduced to liquidation procedures; much too rare do they involve restructuring with an operating business as an outcome. Additionally, they are known to be costly and inefficient. Pre-insolvency, “hybrid” procedures were introduced in order to avoid this. They enable application of insolvency regulations without actually declaring insolvency. This paper aims to analyse and compare such procedures in Central and Eastern Europe.

JEL Classification:
G33, K22, K49, O57

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Pre-insolvency, compulsory proceedings, hybrid proceedings

Conference Topic:
Law and business

1. Introduction

The stress of multi-year recession in Europe produced incentives\textsuperscript{26} to reshape insolvency systems with the aim of conserving and protecting value; not only tangible assets of commercial companies, but also not so noticeable inputs made by the society throughout the many years of propping up and sustaining these economic entities. Paradigm of a company as a synergy of inputs is now commonly accepted – most often it is more valuable as a going concern than the sum of its separate assets.

Protecting the debtor from a hasty liquidation boils down to restructuring; not only his debt, but the business as well. Restructuring can be worked out when the debtor is already insolvent, or before the insolvency is triggered. Usually, the restructuring prior to opening insolvency procedure is more effective (Brouwer, 2006), as time dissipates options for restructuring, for as the bankruptcy approaches the best assets and employees tend to disperse.

\textsuperscript{26} Analysis of a new framework for business restructuring in Europe can be found at Eidenmüller (2013), McCromack (2014), and elsewhere.
Furthermore, restructuring can be performed in and out of court, but ultimately it must be approved by the court (Arons, 2014:62).

Bearing in mind the need for a timely solution for a distressed company, together with the introduction of a pre-insolvency procedure in Croatia in 2012\(^{27}\) (extensively redesigned in 2015\(^{28}\)), the aim of this paper is to examine and compare legislation and practice of out of court\(^{29}\) restructuring of non-financial\(^{30}\) companies before the opening of the insolvency proceedings.

The non-liquidation, pre-insolvency compulsory proceedings scrutinized in this paper are also labelled as hybrid\(^{31}\) proceedings (Garcimartin, 2011; European Commission, 2012; Moravec, 2014; etc.). They fill a gap between the out-of-the court restructurings and formal insolvency proceedings. Hybrid proceedings are performed under the supervision of an administrative authority or a court and provide debtor with an opportunity to restructure while avoiding classic insolvency proceedings. They combine the advantages of informal debt rearrangements and formal, traditional proceedings. Typical difference between hybrid proceedings and out-of-court restructuring is that it can be performed against the will of the minority of creditors. Even though classic insolvency procedure has not commenced the insolvency rules apply\(^{32}\). In 2012 there were 15 EU Member States that had pre-insolvency or hybrid proceedings; these were: Austria, Belgium, Estonia, France, Germany, Greece, Italy, Latvia, Malta, Netherlands, Poland, Romania, Spain, Sweden and UK\(^{33}\).

The motivation for this paper stems from the fact that the commencement (i.e. the opening) of the insolvency proceedings, which de facto means declaring bankruptcy, is stigmatic and unpopular in Croatia (and elsewhere). As a result business owners and management seek to postpone and defer it as long as they can\(^{34}\). Consequently, when the typical Croatian bankruptcy case eventually does get opened the company is usually already stripped of its assets and there is nothing left to restructure. Insolvency procedures are most often liquidation procedures; rarely do they involve restructuring with an operating business as an outcome. Additionally, insolvency procedures are known to be costly and inefficient everywhere (e.g. Djankov et al., 2008). In order to avoid this, and with the aim of promoting timely restructurings, pre-insolvency settlement procedure was introduced in Croatia in 2012, but it needed transformation as certain errors in practice became evident\(^{35}\). The redesign of the system in 2015 is only recently enacted; therefore it is too soon to examine its adequacy and appropriateness. In this context we are seeking for best practices across comparable legislations.

2. Review of Literature

Western European countries are more frequently researched regarding insolvency procedures than their Central and Eastern European neighbours. That could be ascribed to the fact that they were more developed and globally integrated than those behind the “iron

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28 The Insolvency Act, Official Gazette 71/2015
29 They are usually achieved out of court, but (as stated before) ultimately they have to be brought before a court in order to be approved.
30 Different rules apply for financial and non-financial companies, whereas private financial companies much too often get bailed out with public resources. In this paper we will focus on non-financial companies.
31 They aren’t either out of court voluntary rearrangement of debts, neither traditional, classic insolvency procedures, but position themselves somewhere in between. Hence the term hybrid.
32 Consensus of the majority (in insolvency) vs. individual consent of every single participant (otherwise).
33 European Commission (2012:5-6).
34 Aided by the fact that management and previous owners get ousted from the bankrupt company.
35 Mostly regarding debtors’ recognition of creditors’ claims and appeals.
curtain”, which rendered them more suitable for this kind of research. There are many examples of comparative analysis of western insolvency regimes, and here only a few will be mentioned. Brouwer (2006) examined US bankruptcy procedures and compared them with legislation in the UK, the Netherlands, France and Germany. Davydenko and Franks (2008) analysed small and medium enterprises that defaulted on their debt in France, Germany, and the UK. Gutiérrez et al. (2012) researched the effect of the bankruptcy law on firms’ performance in Germany, Spain, the United States, France and the UK.

Djankov et al. (2008) expanded the scope significantly and included in their research a total of 88 countries, where they evaluated efficiency of procedures when dealing with a typical insolvency case. Blazy et al. (2008) studied correlation between bankruptcy law and the overall system of firm’s governance in 39 countries around the world. Arons (2014) asks whether public authorities are able to enforce restructuring of claims issued in foreign jurisdictions, and provides a brief overview of the debt restructuring powers available in the Netherlands, Germany, France and the UK, both for financial and non-financial companies. Crhová and Paseková (2013) made a general comparison of insolvency proceedings in France, Germany and Slovakia.

There are papers that inspect individual countries which deal with pre-insolvency procedures, such as Cafritz et al. (2005) for France, Wibier (2008) for Netherlands, Scarso (2009) for Italy, Laitinen (2011) for Finland, Potamitis and Rokas (2012) for Greece, Leyman (2012) for Belgium, Tomas Žiković et al. (2014) for Croatia, etc. However, none of the mentioned papers dealt in particular with comparative international analysis of pre-insolvency procedures within Central and Eastern Europe. This particular research aims to fill that void.

3. Methodology and data sources

The object of this paper is pre-insolvency procedures specifics in the following seven Central and Eastern European countries: Bulgaria, Croatia, Poland, Serbia, Slovakia and Slovenia. The selection was focused on countries with similar historical and economic heritage.

For the purpose of this paper pre-insolvency proceedings are defined as public, non-liquidation, compulsory hybrid proceedings. These procedures aim at maintaining the going concern, avoiding liquidation, and getting around formally declaring bankruptcy. Even though many debtors are often ripe to be named bankrupt or insolvent, among them there are those whose business is still viable, at least in part. Formally declaring bankruptcy habitually diminishes the possibilities of sustaining the going concern and brings forward inefficient, costly and lengthy classic insolvency procedures. Therefore, hybrid pre-insolvency practices are a route of bypassing the inefficient outcomes of classic procedures, but still invoking special rules found within insolvency (i.e. outvoting minority interests). The debtor’s management preserves control (full or partial) over the business, but falls under control or supervision by a court or an appointed insolvency practitioner. So, instead of combating and/or weakening the insolvency stigma, avoiding it became the chosen path for many jurisdictions.

The data used for compilation, comparison and analysis of pre-insolvency procedures in the observed countries is taken from seven databases which contain countrywide insolvency information (in chronological order, by the time of publishing):

1. Restructuring and Insolvency in 52 Jurisdictions Worldwide,

36 Debtor remains in possession of the company’s business, but pre-insolvency proceedings are not “debtor in possession” proceedings in the common, typical sense (INSOL 2014:21).
3. A Guide to European Restructuring and Insolvency Procedures\textsuperscript{39},
4. Global Restructuring & Insolvency Guide\textsuperscript{40},
5. Study on a new approach to business failure and insolvency\textsuperscript{41},
6. Corporate insolvencies in Europe 2014/2015\textsuperscript{42},
7. Insolvency Survey: Central and Eastern Europe 2015/2016\textsuperscript{43}.

For each observed country the following questions were asked:
1. Does the national law contain pre-insolvency proceedings?
2. Who can start the procedure?
3. What are the pre-requisites for the commencement?
4. Are there any sanctions for not applying for the procedure in proper time?
5. Are the debts temporarily suspended from enforcement during proceedings?
6. Does the debtor remain in possession of the business?
7. Can debt restructuring be approved in spite of disapproval of certain (minority) of creditors?\textsuperscript{44} What is the majority needed for this?
8. If new financing can be obtained during proceedings, do new creditors acquire priority over the preceding?
9. What are the usual expenses of the proceedings?
10. How long can the procedure take? Are there any time limits for completion?
11. Are there publicly available statistics on the number of pre-insolvency procedures? If so, how many of them usually get performed?

The answers to questions 2 – 11 are given conditional upon the answer to the question 1. The following chapter summarizes the responses.

4. Analysis

1. **Does the national law contain pre-insolvency proceedings?**
   - Bulgaria: No
   - Croatia: Yes (Predstečajni postupak)
   - Poland: Yes (Postepowaniennaprawcze)
   - Romania: Yes (Concordat preventiv). However, the procedure is not public, but confidential.
   - Serbia: No
   - Slovakia: No
   - Slovenia: No

2. **Who can start the procedure?**
   - Croatia: Only the debtor.
   - Poland: Only the debtor.
   - Romania: Only the debtor.

3. **What are the prerequisites for the commencement?**

\textsuperscript{38} Universities of Heidelberg and Vienna (2013).
\textsuperscript{39} Clifford Chance LLP (2014).
\textsuperscript{40} Baker & McKenzie Inc. (2015).
\textsuperscript{41} INSOL Europe (2014).
\textsuperscript{42} Creditreform (2015).
\textsuperscript{43} BNT Attorneys-at-law (2015).
\textsuperscript{44} I. e. "cram down"
Croatia: Imminent insolvency, which is defined as the debtor currently not being insolvent, but has not fulfilled some of his due obligations, or is more than 30 days late in paying worker’s salaries.

Poland: Reasonable estimation based on debtor’s economic condition where it is evident that soon he will be insolvent, even if he correctly performs his obligations at the present moment.

Romania: Financial difficulties; “decreasing economic and managerial viability”.

4. Are there any sanctions for not applying for the procedure in proper time?

Croatia: No. The pre-insolvency procedure is not mandatory.

Poland: The debtor who anticipates its insolvency in the future but still remains solvent has the right (but not a duty) to commence the proceedings.

Romania: No. There are no incentives to promote filing for pre-insolvency proceedings.

5. Are the debts temporarily suspended from enforcement during proceedings?

Croatia: After the commencement of the proceedings the debtor is entitled to demand temporary stay of enforcements.

Poland: Stay of individual enforcement can be imposed by the court if executing such enforcement compromises the possibility to reach the restructuring agreement. Secured claims cannot be stayed.

Romania: Yes, if the judge determines that the composition is feasible.

6. Does the debtor remain in possession of the business?

Croatia: Yes, but he cannot make any payments other than those required for ordinary business, and may not sell his assets or take new mortgages.

Poland: Yes. The scope of the possession depends on the initiator of the proceedings. However, if found necessary, the court can appoint the compulsory administrator who can take over the management of the debtor’s business.

Romania: Yes, but his activities are supervised by the insolvency practitioner that is appointed as a conciliator.

7. Can debt restructuring be approved in spite of disapproval of certain (minority) of creditors? What is the majority needed for this?

Croatia: The creditors can be divided into groups according to their profile (secured/non-secured, with or without ownership interest, or other common interest). The restructuring can be approved if the majority of all the creditors has voted for it, and if within every group at least 66% of the creditors has voted for it.

Poland: Yes. If the voting if is attended by at least half of the creditors jointly entitled to 75% of all undisputed claims, the majority required for the acceptance is 66%.

Romania: The preventive composition, as a contractual arrangement, can be approved if it is signed by the debtor and the creditors who own at least 80% of all undisputed claims. Additionally, the total value of undisputed claims must amount to at least 80% of overall total claims.

8. If new financing can be obtained during proceedings, do new creditors acquire priority over the preceding?

Croatia: Only with preceding creditors’ consent.

Poland: Only with preceding creditors’ consent.

Romania: Only with preceding creditors’ consent.

9. What are the usual expenses of the proceedings?

Croatia: The costs of the procedure consist of administrative costs, rewards and expenses of the compulsory administrator. The usual expenses range from approx. 750 €

45 I. e. "cram down"
upwards, depending on the size of the debtor and the length of the procedure. Lawyer’s fees should also be added.

Poland: The court fee is 230€. Out of court expenses vary from 1000€ upwards, depending on the complexity of the case.

Romania: The court fees are rather inexpensive (below 100 €). The lawyer’s fees are flexible.

10. How long can the procedure take? Are there any time limits for completion?

Croatia: The procedure should be completed within the 120 days after its commencement. With the permission of the Court prolongation is possible for additional 90 days.

Poland: According to the Law the procedure must be completed in 2 months. However, in practice it can take up to 6 months. On average the procedure takes approximately 3 months.

Romania: The limit for the negotiations is 60 days.

11. Are there publicly available statistics on the number of pre-insolvency procedures? If so, how many of them usually get performed?

Croatia: The data is available upon request from Financial Agency (FINA). By the end of October 2015, out of the total of 8478 initiated procedures 2244 agreements were performed and approved by the Courts.

Poland: National statistics are published by the Ministry of Justice.

Romania: The procedure is rarely practiced. There is not enough statistical data.

5. Conclusions

Pre-insolvency proceedings in Europe are performed in a wide array of varieties; they can be public or confidential, in- or out of court, compulsory or optional, they can optionally lead to full (classic) insolvency procedures, and they have other similarities and diversities. Comprehensive harmonization processes within the European Union will most probably narrow down national discrepancies. However, they all encompass the notion that the liquidation is the least preferable option when dealing with insolvent debtor. In this manner more effort should be given to providing means (expertise, education, financing, and other policy arrangements) for substantial restructuring, for only it can only deliver sustainable basis for a going concern, rather than postpone the inevitable.

In Central and Eastern Europe pre-insolvency proceedings are very similar in their basic traits. The debtor is the only person eligible for starting the procedure. Financial difficulties (but not insolvency) are the prerequisites for the procedure, which itself is not obligatory. The debts are suspended from enforcement, and the debtor remains in possession. New financing does not get priority over the preceding creditors.

The future researchers could expand the scope of this study and include into observation Western jurisdictions and exhibit comparable case studies.

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