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## Death or survival. Post-communist bankruptcy law in action. A survey

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Death or Survival. Post Communist  
Bankruptcy Law in Action. A Survey

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### Abstract

The paper discusses some major lessons to be learnt from the application of bankruptcy law in a post-communist environment. Its focus is on East Central Europe because elsewhere bankruptcy law is of rather limited practical relevance. The incentives and the selection of trustees turn out to be key issues if the loss of value typically occurring during bankruptcy procedures is to be contained within reasonable limits. Reorganization is a realistic option only if management has sufficient incentives to file bankruptcy in time. Post-communist legislation has tried to achieve this mostly by threat of punishment. This approach has proved inefficient. The paper also criticizes the tendency of post-communist legislation to deemphasize individual remedies against defaulting debtors.

JEL-classification: P37, P52, K49

Key words: trustee, execution, fraudulent conveyance, reorganization, going concern sale

### Zusammenfassung

*„Untergang oder neues Leben. Konkursordnung und lebendes Recht im Postkommunismus. Ergebnisse eines Ländervergleichs“*

Der Aufsatz analysiert Erfahrungen mit der Anwendung eines Konkursrechts in postkommunistischen Wirtschaftsordnungen. Der Schwerpunkt der Untersuchung liegt in Ostmitteleuropa, weil in den weiter östlich gelegenen postkommunistischen Ländern die praktische Bedeutung des Konkursrechts sehr begrenzt ist. Die Anreize, die der Konkursverwalter hat, und das Verfahren, nach dem er eingesetzt und gegebenenfalls seines Amtes enthoben wird, erweisen sich als wichtige Erfolgsfaktoren, insbesondere beeinflussen sie die Ausmaße, die der für Konkurse typische Werteverfall annimmt. Eine Unternehmenssanierung kommt meistens nur dann in Frage, wenn das Management ausreichend starke Anreize hat, den Konkurs nicht zu verschleppen. Postkommunistische Rechtsordnungen haben dies vor allem durch Strafandrohung zu gewährleisten versucht, dieser Ansatz war wenig erfolgreich. Als problematisch erweist sich auch die Neigung postkommunistischer Gesetzgeber, die Gesamtvollstreckung zulasten der Einzelvollstreckung zu favorisieren.

JEL-Klassifikation: P 37, P52, K49

Schlagworte: Konkursverwalter, Einzelvollstreckung, Vollstreckungsvereitelung, Konkursplan, übertragende Sanierung.

## **Death or Survival. Post-Communist Bankruptcy Law in Action. A Survey**

In surveying post-communist countries it is appropriate to draw a distinction between cases in which bankruptcy law is of major relevance for the decision what to do with a failed company and those in which it largely remains a dead letter. Countries of the latter type will be ignored in this survey. In such countries the choice between death and survival also has to be made somehow, but this decision is not guided by bankruptcy law. This distinction between relevant and irrelevant cases is closely related to that between governments which respect judicial independence and those which do not. In general, respect of judicial independence is of minor importance if the bankrupt company happens to be small, for example if a restaurant goes bankrupt. Such small bankruptcies are not likely to become much of a political issue anywhere, but usually they do not offer much of an opportunity for investment and restructuring either. All over the world small businesses mostly vanish after going bust. Survival is not much of an issue, and, thus, these are not the kind of bankruptcies which this paper seeks to study. It rather focuses on bankruptcies of medium-sized and large companies. In countries in which the rule of law is well established such companies or at least major parts of them more often than not survive bankruptcy. Nevertheless, such bankruptcies often become a political issue.

Political interference into such trials turns out to be the rule rather than the exception, if one takes a closer look at the large number of post-communist countries whose governments do not respect judicial independence. E.g. there is a study of bankruptcies in Russia which documents that Russian bankruptcy law is typically abused as an instrument to collect taxes, intimidate political adversaries and enrich political allies and friends<sup>1</sup>. In 2002 Russia witnessed efforts to reform both its judicial system and bankruptcy law. Curbing blatant abuses such as those mentioned before has been among the purported goals of these efforts. However, it remains to be seen whether this goal can be achieved under a government which is not committed to respecting judicial independence. Or to mention an even more clearcut example: Serbia during the Milosević era witnessed quite a number of bankruptcy procedure but most of them served political purposes<sup>2</sup>.

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<sup>1</sup> See Sonin and Zhuravskaya (2000).

<sup>2</sup> This argument does not claim that law and courts are irrelevant in Serbia or Russia. Indeed they are much more relevant than most observers tend to believe. The argument presented here only claims that law is of little relevance when it comes to handling major bankruptcies. For a demonstration that law plays an important role in Russia, China and other countries frequently thought of as „lawless“, see Murrell (2001).

Relevant for this paper is the experience of East Central European countries and the Baltics while Bulgaria is a borderline-case because judicial independence in Bulgaria is undermined by pervasive corruption. Bulgarian judges often are susceptible to political pressures because they have reasons to fear an investigation. Croatia joined the group of relevant cases after the change of government which occurred in 2000, since then Croatian governments have respected judicial independence. Even after Milošević's fall Serbia continues to be out of the group of experiences relevant for our conference and this is first, because Serbia is in an early stage of transition, and second because there is no clearcut commitment of the Serbian leadership to judicial independence<sup>3</sup>.

The basic reason why the bankruptcy experience of countries which lack an independent judiciary is of little concern for our discussion, is that in those countries problems of insolvency are foremost dealt with by discretionary political decisions, while we are interested in the problems arising if insolvency is dealt with by applying general rules. These two approaches, political discretion and general rules have so little in common, that a discussion which ignores this difference is unlikely to take us very far.

Among the rather small group of post-communist countries which seek to stick to general rules the Baltics are ignored in this paper. This is for the plain reason that its author is not familiar with Baltic languages and nobody else has undertaken a serious attempt to study their bankruptcy experience and present his findings in a non-Baltic language. As a result, the propositions presented have their basis only in a careful study of Czech and Slovak experience, a much less intensive study of Croatian and Bulgarian experience and a cursory review of Hungary, Poland and East Germany<sup>4</sup>.

In the remainder of this paper six propositions will be discussed. They will first be stated, subsequently they will be explained in more detail.

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<sup>3</sup> For recent evidence supporting this view see Predsednik (2002) which reports about a court making a U-turn after talking to the presidential „kabinet“ and president Koštunica. As *Ekonomist* magazin notes such interference into judicial decision making would be less noteworthy if it had been Đinđić. However, it was Koštunica and thus a politician who is particularly keen on styling himself as a „legalist“. For a more systematic discussion which ends up on a similar note see Trkulja (2001).

<sup>4</sup> See Schönfelder (2000), (2001) and (2003) and the sources quoted below.

1. Proposition: Whether a bankruptcy procedure is the route to liquidation or a chance for new investment depends to a large extent on the skills of trustees. All post-communist countries suffer both from a shortage of capable and honest trustees and from an excess supply of mediocre or inept trustees some of whom are of dubious character. There is indication that empowering creditors to interfere and replace trustees whom they do not trust is an effective instrument to improve matters. Probably it is the most effective instrument available. The current state of trusteeship may be largely due to the hesistance of most post-communist countries to empower creditors.
2. Proposition: The second key factor is whether bankruptcy is filed in time. The prototype post-communist bankruptcy features a much belated petition followed by a long lag between petition and opening. When the trustee finally takes over stewardship it is often too late, because little is left which could catch the interest of an investor. Value has been dissipated in the course of eve-of-bankruptcy transactions. Nevertheless, fraudulent conveyance suits are infrequent neither is management likely to be punished. The solution to this problem is presumably not found in bankruptcy law at all, it rather is the problem of putting individual remedies to life. The most effective threat to an insolvent enterprise presumably is a creditor holding an enforceable title provided that this title can in actual fact be enforced within a short time by a skilfull and reliable bailiff. Such threat is likely to force the company into declaring bankruptcy in time. Unfortunately, most post-communist countries have paid little interest to the effectiveness of execution.
3. Proposition: Even if the two aforementioned problems happen to be solved investment into bankrupt companies will remain a rare event if the country is unable or unready to provide a friendly and stable environment for domestic start-ups as well as foreign investors. So this is the third condition.
4. Proposition: Tinkering with bankruptcy law cannot yield a good substitute for the three aforementioned conditions. Attempts at post-communist remakes of US chapter 11 reorganizations have not been very successful and have in quite a number of cases even proved counterproductive, rendering reorganization actually less likely than under a more traditional approach. Those four countries which opted for a rather traditional type of bankruptcy procedure allowing reorganization only if a number of restrictive conditions are met, namely the Czech republic, Croatia, Poland and Slovakia, do witness unceasing quests for a reform which would redirect most if not all of the bankrupt companies into a mollified reorganization chapter. Such quests are also endorsed by some international institutions, in particular the World Bank. However, post-communist experience provides



little support for the claim that increasing the practical relevance of the reorganization chapter actually increases the likelihood of a successful reorganization.

5. Proposition: Provided that the conditions spelled out in proposition one to three are met bankrupt companies which are worth the effort are usually taken over by an investor. This proposition is corroborated both by Czech and Slovak post 1997-experience. This presumably did not hold in early transition but early transition is long over in most of Eastern Europe.
6. Proposition: In some post-communist countries as e.g. the Czech republic there is a growing tendency to emulate German labor law including rules which render labor shedding in a liquidating reorganization (sale as a going-concern) prohibitively expensive. In some others like e.g. Bulgaria it has always been that way. If such rules were adopted everywhere reorganization as well as liquidating reorganization would become largely counterproductive.
7. Proposition: Post-communist public opinion tends to believe that the success of restructuring efforts in post-communist countries crucially depends on the details of the bankruptcy statute and that many problems can be solved by amending it. As a result the average frequency of amendments is about one per year and per country. The expectation that this approach is likely to do any good is a grand illusion, frequently it creates more problems than it solves.

### **Proposition number one**

This section elaborates on the first proposition. The crucial role of trustees is fairly obvious. It takes a very unusual person and unusual talents to make for a good trustee. In addition to legal expertise the ideal trustee should possess the skills of a crisis manager and even those of a detective who manages to uncover and prevent sophisticated fraudulent conveyance schemes, moreover he must be able to recognize the hidden values inside the bankrupt company and solicit potential investors who are able to appreciate these values. And all of this must be done quickly and discreetly. A trustee does not necessarily need to possess all of these capabilities himself, he can substitute some of them by unusual talent in leading and motivating a team of persons. Nevertheless, it is fairly obvious, that in early transition the supply of suitable persons was about equal to zero. Unfortunately, in many post-communist countries this situation has since then improved only very slowly. Referring to the Czech republic Bautzová (2002a) identifies the trustee as the weakest link in post-communist bankruptcies. As of now,

the Czech republic can muster about a dozen first-rated trustees, in Hungary there might be some more, most other post-communist countries have less.

In 1991 the shortage of good trustees was unavoidable, its persistence in 2002 however, is to a significant extent a self-imposed hardship. There are severe obstacles to the growth of the profession. One is the lack of clarity about the goals of bankruptcy procedures. This is likely to hinder the working of the selection process which otherwise would gradually improve the supply of capable trustees. Similar to other selection processes efficient selection among a population of trustees requires the existence of a selection criterion which renders it possible to distinguish success and failure. If instead the trustee is confronted with a variety of conflicting objectives he can always be charged to have failed on one of them. The prevalence of conflicting objectives is particularly obvious in the Bulgarian code which obliges the trustee to be good to the creditors, to the debtor and to his employees. If it is the judge who effectively decides on the appointment of the trustee, as it is the case in most post-communist countries, conflicting objectives cause obvious problems for the judge: whom should he choose, a trustee who has a reputation of doing well for employees or one who has a reputation of doing well for the creditors ? Experience suggests that this lack of clear performance criteria does not prevent the rise of a few stars of the profession who manage to come up with solutions which impress most observers. A negative impact is however strongly felt when it comes to the rank and file of the profession.

This problem is serious enough in itself, but it is further exacerbated by the persistent distrust of the post-communist public in most if not all public institutions and the ensuing abuse of this distrust for political purposes<sup>5</sup>. If the trustee is essentially holding some sort of a public office and is conceived of as an agent of the court rather than of the creditors, the lack of confidence in courts naturally extends to trustees. It is not difficult to find press reports and political statements in which even some of the best-reputed trustees of the Czech republic or Slovakia are suspected of corruption or greediness even though the absurdity of such claims should have been close to obvious<sup>6</sup>. Such rumours maybe have little impact on the actual behavior of the stars, but they are much more likely to impress the rank and file who will feel prompted to act more cautiously and stick to formalities. This reduces the chances to find an investor within a relatively short time, however such speed is often decisive for the survival

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<sup>5</sup> This distrust is a heritage of the communist system, in particular of Soviet type communism which was always characterized by a deep chasm between government and society. This chasm was less pronounced in Yugoslav communism.

<sup>6</sup> Two examples in which wild suspicions were raised against impeccable trustees were the cases of Devin Banka (Bratislava) and the shoe industry in Zlin formerly known as the Bata company. Both occurred in 2002.

of a bankrupt company. Distrust in trustees has in some countries like Bulgaria led to proposals such as requiring trustees to sell the bankrupt company only through a highly formalized auction, a requirement, which greatly reduces the likelihood of a sale as a going concern. The fact that even reputable Czech trustees have been suspected of embezzlement is particularly illuminating because it happened even though the Czech judiciary and supporting institutions are considered as one of the least corrupt parts of Czech government<sup>7</sup> and one of the least corrupt judicial systems in the post-communist camp.

Pervasive fears of embezzlement and corruption, consequently, provide an additional argument why creditors should be in control during bankruptcy. Creditors, particularly large creditors, whose receivables are not fully secured by collateral have a strong interest in appointing competent and reliable trustees. Such creditors will display the frequently deplored creditor passivity only if they are either under political pressure or if the bankruptcy procedure is such that their efforts are likely to be frustrated. Unfortunately, most post-communist countries adopted bankruptcy codes which severely limit creditor's rights during the procedure.

To conclude the discussion of proposition 1, it seems worth pointing out that in the absence of creditor involvement the selection of trustees done by courts often tends to proceed on rather formal grounds. Courts have lists of trustees who fulfill certain formal criteria and they take somebody from the list. If trustees can make good money the list is likely to be long. If they cannot it likely to star novices, losers and dubious characters. In the Czech republic successful trustees are highly rewarded. As a result the Czech list enumerates about five thousand trustees, a truly astronomic figure as Czech commentators point out. Matters are worse if trusteeship is unrewarding, this actually increases the probability that the choice of trustee occurs on the basis of personal connections and favors. Such mischoices of trustees are likely to derail all efforts to reorganize a bankrupt company.

In Czechoslovakia the concept of the trustee as a *komisař*, as the Czech call it in a rather particular reinterpretation of the old office of a „*commissarius*“ i. e. as an agent of the court and not as an agent of creditors, has its roots in legislation of the 1930s. Moreover, both in Czechoslovakia and in other post-communist countries the inclination to conceive the trustee as an agent of the court rests on the presumption that this increases chances to reorganize a bankrupt company. However, this view lacks a theoretic foundation, neither is it supported by evidence from Western Europe. France presumably makes for a good example be-

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<sup>7</sup> See the opinion poll published in *Ekonom* č. 18 (2.5.2002), p. 13.

cause in accordance with a taxonomy popular in the theory of finance its financial system is usually classified as relational finance and thus somewhat similar to post-communist financial systems. The concept of the trustee as an agent of the court was endorsed by the French bankruptcy reform of 1986. However, this reform has not been much of success. The share of ultimately successful reorganizations in French bankruptcies is somewhere in the range between two to three per cent, which is less than impressive<sup>89</sup>.

Slovakia reformed its bankruptcy law in 2000 breaking away from the inherited concept of the trustee as an agent of the court and empowered creditors to change the trustee with relatively little fuss and within a relatively short time. This produced visible changes. Until 2000 distrust of trustees was wide-spread and some journalists even claimed the existence of a trustee mafia. After 2000 the behaviour of trustees changed notably and their reputation improved (see Schönfelder 2003).

### **Proposition number two**

Most post-communist countries have attempted to solve the problem of delayed filings and eve-of-bankruptcy transactions („tunneling“) by instruments such as tort law and criminal law – holding managers liable for damages caused to creditors and threatening them with punishment. In addition they have been beefing up fraudulent conveyance law. Clarifying the concept of insolvency in much detail and broadening it has been another method employed to solve the problem. While all of these efforts have some justification, the progress achieved along these lines typically has been disappointing. This has been for a great variety of reasons. A much-publicized case currently tried in Czech courts illustrates the potential as well as the limits both of criminal procedure and civil procedure based on fraudulent conveyance

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<sup>8</sup> Barely 10 per cent of all bankrupt companies are admitted into „redressement judiciaire“ i.e. the reorganization procedure of French law. Out of these 10 per cent about half end up being sold or closed down rather than reorganized. According to Kremer (1994) only 4,6 per cent of all bankrupt companies are considered reorganized when leaving the bankruptcy court. However, many of these reorganized companies reenter bankruptcy within a few years after their reorganization. This is a common incident under the redressement judiciaire reducing the success rate to the aforementioned two to three per cent. For more detailed figures the reader may consult Blazy (2000, p. 135).

<sup>9</sup> Referring to French rather than to US experience may be justified on the grounds of the following argument: In the finance literature it is sometimes argued that the US financial system is characterized by arm's-length finance in contrast to the relational finance characteristic for continental Europe. The argument continues by claiming that relational finance offers some sort of insurance to distressed companies which is unavailable in an arm's-length finance environment. According to some views this lack of insurance justifies the recourse to a reorganization à la chapter 11. This view suggests that redressement judiciaire represents a transplant of a concept suited to US financial markets into an environment where it lacks such justification. Since post-communist countries feature relational finance this criticism if true should similarly apply to them.

and tort law. This concerns a former big whig of Czech business named Lubomír Soudek<sup>10</sup>, a man who became well-known in the nineties because he was owner and CEO of Škoda Plzeň, a company which is not to be confused with the automobile manufacturer Škoda automobilová. He is now being tried, multiple charges are raised against him among which fraudulent conveyance plays a prominent role. According to Bautzová (2002b) he might be sentenced for twenty years. This may be considered a triumph of law but it is a rather exceptional case in the post-communist world and came after a long gestation lag. The Czech prosecutor started to become interested in Soudek as early as 1997 when reputable financial journals were still celebrating him as Czech manager of the year.

Turning to definitions of insolvency, it is worth noting that broadening the concept of insolvency is of limited usefulness and may even backfire in an environment which continues to be characterized by shallow asset markets and a credit granting policy which has little else than reputation to build on. Post-communist banks of course do collateralize their credits, but in most countries collateralization is still likely to turn out an illusion as soon as debtors decide that they prefer not to service their debt. As long as collateralization remains an unreliable security instrument lending business is likely to remain stuck in a boom-and-bust cycle and the current lending boom observed in Croatia as well as other post-communist countries may easily collapse into another credit crunch. As a result the signalling properties of insolvency are compromised. Whenever the credit cycle reaches its bust phase insolvency turns into a noisy and misleading signal for the actual quality of a company. Various post-communist countries have at times resorted to a rather broad definition of insolvency and later narrowed it down again, Hungary being the most famous example for this sort of behaviour. While the ensuing problems have usually been discussed as the „too many to fail-problem“ there is a deeper and more important issue behind it which has been largely neglected. This issue concerns the host of problems caused by the notorious unreliability and unenforceability of all or nearly all security agreements witnessed in most post-communist countries throughout the nineties. As a result most assets are difficult to market most of the time and, consequently, valuation of assets often amounts to guessing. A particularly striking example for the enormous insecurity about asset values is provided by the (liquidated) Czech bank IPB which was evaluated by three different auditors all of whom were affiliated with very repu-

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<sup>10</sup> Since it is fashionable to blame the Klaus-government for everything that went wrong in the Czech republic it might be worth mentioning that the great career of Soudek was largely due to the backing of the trade unions while Klaus remained rather sceptical.

table companies. The highest and the lowest estimate of its networth differed by some 190 billion Kč ( $\approx$  6,3 billion Euro)<sup>11</sup>. This happened in 2002.

It is worth pointing out one of the resulting problems. This the potential abuse of bankruptcy in order to expropriate owners. This potential was strikingly revealed by a recent Czech scandal when the manager of a large Czech company (Tchecomalt) which according to some observers was neither insolvent nor overindebted filed for bankruptcy presumably in order to expropriate the owner and got away with that in court<sup>12</sup>. Of course, the trustee was easily able to find an investor for Tchecomalt because its prospects were good. Nevertheless, this (liquidating) reorganization of Tchecomalt probably should be considered a failure rather than a success of bankruptcy law.

This problem as well as others were surely exacerbated by a misconception shared by most post-communist countries. They have typically tended to emphasize collective procedures of debt-collection such as bankruptcy or composition while deemphasizing individual remedies. Presumably the emphasis on collective procedures has been due to the fear that usage of individual remedies might cause a premature liquidation of companies which are capable of restructuring. Even in East Central Europe most countries made efficient instruments of individual collection available only in 2000/01, in Eastern Europe they are unavailable to this very day. Making them available earlier would have forced quite a number of managers to file for bankruptcy when their companies had not yet declined into empty shells. This point is most clearly demonstrated by the Slovak example because Slovakia provided efficient instruments of execution earlier than the other post-communist countries (see Schönfelder 2003). In Slovakia this happened already in 1995. Since then bankruptcies have frequently been filed in order to keep the bailiff away. This is because similar to most other post-communist countries Slovak law puts a stay on creditors at the very moment the bankruptcy procedure is opened. The prospect of this stay makes filing for bankruptcy quite advantageous provided that the bailiff service is up to his duties and creditors holding a lien are able to enforce this lien in a short time.

To sum up, definitions of insolvency and overindebtedness become meaningful and reliable guides for action only if individual remedies are workable and if a broad range of reliable security agreements is available. This is because only the availability of such machinery gives rise to a flow of credit which is large enough to support thick asset markets and thick asset markets are required to make sense of the concept of insolvency.

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<sup>11</sup> The first was by HSBC, the latter by CAIB. See *Ekonom* č. 24 (13.6.2002) p. 36.

### **Proposition number three**

According to a well-known theorem of auction theory the outcome of an auction depends crucially on the number of participants (see Klemperer 2002). This holds in particular if the number of participants is small as usually is the case if a bankrupt company is on sale. Increasing the number of participants from let's say two to three is likely to make a dramatic difference for the price achieved. Although the sale of a bankrupt company rarely takes the form of an auction proper, this basic insight of auction theory still holds. It follows, that in bankruptcy procedures which focus on selling bankrupt companies these companies have a decent chance of survival if and only if the number of potential investors is larger than one and if their investment is not subject to a large political risk. In the absence of these prerequisites the price offered for the bankrupt company is likely to be less than the value of its assets and resultantly closing it down often will be the preferred choice. Only a procedure stressing reorganization at the costs of creditors such as the French „redressement judiciaire“ would then offer a reasonable chance of survival. It follows that under any procedure which respects creditors' interests the overall environment which the country offers to investors and entrepreneurship turns out to be crucial for the survival chances of bankrupt companies: They are good only if the country offers a friendly environment both to foreign investors and domestic small and medium sized companies i.e. if the latter have a reasonable chance to grow. This is the main reason why a large-scale implementation of a creditor-oriented bankruptcy law in early transition is unlikely to do any good: The environment is not yet clearly defined, foreign investors simply cannot know whether it is going to be friendly or not and domestic entrepreneurship is still in its infancy. However, already five to ten years into transition matters become quite different. The environment for investors still might be less than friendly, but this should be no longer used to argue against a creditor-oriented bankruptcy procedure. Rather government should seek to improve the environment rapidly.

The gist of this argument recently has been formalized in a paper by Cargill and Parker (2002). They deal with bankruptcies in Japanese type economics but the basic issues are quite similar. An unfriendly environment for start-ups and foreign investors combined with soft bankruptcy procedures make for a no-entry no-exit economy. The long-term growth potential of such an economy is poor because a large part of its resources is wasted by inefficient firms. Switching to a free-entry, free-exit economy greatly improves the long term growth potential. The main contribution of Cargill's and Parker's paper is a discussion of the

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<sup>12</sup> For a critical report suggesting this view see Szirmai (2002).

optimal switching period. In their model it turns out to be five years. While the precise figure depends on the details of the numerical specification, the more basic message does not. A cold-turkey approach which tries to do the switch in one to two years is very costly, but the same holds for a go-slow policy which drags matters out for decades.

#### **Proposition number four**

In financial theory it has become commonplace to use Hart's (1995) distinction between two basic types of bankruptcy procedures which he refers to as cash-auction and structured bargaining. In the cash-auction the insolvent company is sold either as a whole or piecemeal while in structured bargaining creditors are asked to write down their claims in order to restore solvency. Historically the prototype bargaining procedure was composition, but nowadays chapter 11 of the US bankruptcy commonly known as reorganization is often viewed as the leading case of a structured bargaining. Cash-auction type procedures are frequently referred to as liquidation even though they do not necessarily lead to the liquidation of the company. Instead it might be sold as a going concern. White (1989) labeled this a liquidating reorganization, a terminology consistently employed in this paper. For the sake of simplicity those parts of bankruptcy law which regulate cash-auction will be referred to as the liquidation chapter, while the sections covering the structured bargaining will be referred to as the reorganization chapter.

Most bankruptcy law systems of this world have both a liquidation and a reorganization chapter, but they differ with regard to the conditions under which an insolvent company is allowed to enter the reorganization chapter. We can identify a group of countries whose bankruptcy law is usually referred to as creditor-oriented because in their systems cash-auctions are conceived of as the fundamental procedure while a structured bargaining can take place only if a number of rather restrictive conditions are met which are meant to safeguard creditor's interests. In other countries insolvent companies are much more frequently allowed to enter the reorganization chapter. If conditions are lenient enough, insolvent companies tend to go into the reorganization chapter first and are transferred to the liquidation chapter only later if reorganization fails for some reason. These types of procedures are frequently referred to as debtor-oriented because in a large number of cases the reorganization chapter only amounts to buying time for the debtor whose liquidation is only deferred but not prevented. During this time the value of the company tends to dwindle and when liquidation ultimately occurs even secured creditors often find out that little value is left over.



Among the post-communist bankruptcy codes four may be characterized as of the first type i.e. fundamentally creditor-oriented, this is the Czech, the Croatian, Polish and the Slovak. Slovakia temporarily broke away from the club, this was in 1994, but reentered in 1997.

Turning to Poland, it is worth noting that Poland never formally abolished its old bankruptcy and composition law which was enacted in 1935. This law is rather similar to the old German law which applied in West Germany until 1999. In Poland this old law regained practical relevance in 1990 and survived the nineties with relatively little change. Only in 2002 preparations for a major reform started to gain momentum. Simplifying a good deal it might be said that Croatia applies German post 1999 law while Poland applies German pre 1999 law<sup>13</sup>.

As mentioned before, both the Polish and the Slovak law essentially belong to the creditor oriented class but this orientation was compromised in Poland and after 1996 also in Slovakia by factual circumstances and tax law i.e. circumstances outside the realm of bankruptcy law proper. Both in Poland and in Slovakia claims of the fisc effectively enjoyed a superpriority which puts the fisc ahead of virtually all other creditors be they secured or not. Throughout much of the nineties the Polish fisc was ready to tolerate substantial tax arrears if the insolvent company was thought of as important. In essence such companies received large subsidies, because they got away without paying taxes and social security contributions and went into bankruptcy only if in spite of these subsidies they were no longer able to pay suppliers. As a result, the creditor orientation of bankruptcy law tended to degenerate into a fiscal orientation, in bankruptcy remaining assets were auctioned off and the proceeds mostly went to the fisc, other creditors including secured creditors frequently received little or nothing. Studies done in the midnineties found few exceptions to this rule<sup>14</sup>, but matters have improved since then. In contrast, in Slovakia, insolvent companies up to 1996 typically survived on soft bank loans but had to pay most of their taxes, the fisc turned into a generous creditor only after 1996.

Let's next turn to the group of countries which adopted a bankruptcy law falling under the creditor-oriented label. This club comprises Hungary, Bulgaria, Slovakia 1994-97 and presumably also Slovenia, but Slovenia will be neglected here because the author of this paper has a hard time with Slovenian. Czech social democrats are currently undertaking an effort to transfer the Czech republic to this club.

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<sup>13</sup> Paintner (2003) reports about the development of Polish bankruptcy law up to Oct 2002.

<sup>14</sup> See Holle (1998).

Hungary was the first Soviet bloc country which adopted a bankruptcy law, this was in 1986, but this law remained of minimal practical relevance. This changed after a major amendment which went into effect in 1992. The bankruptcy spree which followed in 1992 and 1993 attracted a great lot of scholarly attention, and in terms of public relations abroad it was a smash hit for Hungary. It however wasn't for creditors who typically were shortchanged by trustees. As a result trustees acquired a bad reputation. Ever since 1992, the Hungarian bankruptcy statute has allowed insolvent company in a rather broad range of circumstances to go into the reorganization chapter first. It is transferred to the liquidation chapter only if reorganization is for some reason considered as failed or evidently impossible. This basic scheme has survived a great lot of amendments. Some like to view this as an adaptation of US chapter 11 even though a closer look quickly reveals that the differences to US law are significant. It is worth noting, that in spite of this seemingly reorganization-friendly blueprint Hungarian observers to this very day complain about the low success rates of actual attempts at reorganization. Already in its 1992 version the Hungarian reorganization chapter seemed to provide creditors with enough leverage to prevent reorganization schemes which were overly detrimental to their interests. However, as was shown by Gray et alii (1996) these creditors' rights largely remained a dead letter. In some sense, the primary function of the 1992-93 bankruptcy spree was to serve as an elegant way to legalize Hungarian-type privatization by theft also referred to as spontaneous privatization. After 1993 there were a number of amendments seeking to align the interests of the trustee with those of creditors and to provide creditors with additional leverage. This reduced the popularity of the reorganization chapter which largely fell out of use in the course of the nineties. Creditors nevertheless remained convinced that their rights are weakly protected as is evidenced by the extremely conservative lending behaviour of most Hungarian banks throughout the nineties. Reluctance to grant credit has also been due to the fact that until 2000 individual remedies for Hungarian creditors have remained highly ineffective. This was (see Munnell and Toth 2001) the main reason for a large number of bankruptcy petitions, creditors filed bankruptcy suits against solvent debtors because they did not know of any other way to pressurize them into discharging their contractual duties. Summarizing, even though Hungary in terms of bankruptcy statistics appears to have been the leading post-communist nation this creates a misleading impression because much of this activity did not serve the purposes which bankruptcies are mainly supposed to serve.

Let's turn to Bulgaria. As early as 1989 Bulgaria enacted a bankruptcy law. Bulgarian bankruptcy is a two-stage procedure with the first stage being an attempt at reorganization.

Until recently this stage could not be skipped. This basic concept has survived many amendments, and has come under more forceful attack only lately. However, to the knowledge of the author Bulgaria has not yet witnessed a single case in which a bankrupt company passed through a successful reorganization. While this lack of success is due to a great lot of reasons it is worth noting that the compulsory reorganization stage clearly has not been of much help. A Bulgarian attempt at reorganization which is likely to be of some interest for Croatians is the case of the shipyard at Varna. It entered the bankruptcy court in 1998, and stayed in the reorganization chapter of the Bulgarian statute for no less than four years. Nevertheless production of new ships came to a nearly complete halt already in 1998 with two major ships left unfinished until today. The number of employees was reduced from 5000 to 600, the remaining workers are repairing ships which is the only line of business continued after entering the courtroom. The trustee searched for years for an investor which might want to take over, but he found only one, a British shipyard, which however bankrupted itself before the take-over was effected. In 2002 it was decided that the reorganization effort had been in vain, but instead of transferring the company to the liquidation chapter government decided that the state owned ocean shipping company is to acquire the ship-yard. Since this shipping company is in great difficulties itself, it is definitely unable to restructure the ship-yard, and as of now is still searching for a genuine investor which might be ready to take over. In summary, the alleged reorganization as well as what followed after reorganization has been little more than an attempt to buy time, but this time served no useful purpose. It did not help to preserve any firm-specific assets, after four years of inactivity such assets are likely to have lost most of their value. This case demonstrates that a reorganization chapter is no panacea, it helps very little if a number of other requisites are missing.

Last but not least, the aforementioned Slovak amendment to Czechoslovak bankruptcy law which was introduced in 1994 and abolished in 1997 also provided for a compulsory phase of reorganization which had to be completed before an insolvent company could enter standard bankruptcy procedure. The author of this paper undertook a search for Slovak companies which were restructured successfully as a result of this reorganization phase. One and only one case was found. Irrespective of this compulsory reorganization phase, successful restructuring of bankrupt companies has been rare up to 1997, this changed only in 1998. By 1997, there was broad agreement that the 1994 amendment had been failure.

### **Proposition number five**

Schönfelder (2003) reports about an empirical investigation of Slovak bankruptcies occurring between 1997 and spring 2002. The results are in line with a more casual and less complete review of Czech bankruptcies which focused on the same period. One of the issues to be checked were the survival chances of medium- and large-sized companies in bankruptcy. For this purpose individual histories of bankrupt companies were spotted. This required a lot of work because there are no centralized data, histories rather had to be reconstructed from hundreds of press reports. After collecting reports for years most if not all major bankruptcies occurring in Slovakia during the period were covered. As mentioned before Slovak and Czech bankruptcy law is in principle pro-creditor, basically it is a simplified version of the bankruptcy law from the first Czechoslovak republic which largely adhered to the legal traditions inherited from the Habsburg empire. According to a popular view these types of bankruptcy laws suffer from a liquidation bias, they promote premature liquidation. So, one of the issues considered was whether this conjecture is confirmed. It was not. The sample contains 80 major bankruptcies. This may appear as little considering that during the time some 2200 bankruptcy procedures were opened. However, all or nearly all bankruptcies which are not covered in the sample concerned small companies. Out of the 80 major bankruptcies covered 42 survived bankruptcy, usually they went through a liquidating reorganization. 42 should be considered a good result considering that among the 38 non-survivors there was a group of financial companies which engaged in little else but fraudulent business as well as a group of hopeless cases which should have been closed down long ago. After 1998 government mostly took sort of a *laissez faire* attitude, among the procedures covered in the sample only one witnessed a full-blown rescue package arranged by government, this concerned the shipyard at Komarno but it has not been working too well.

### **Proposition number six**

In candidate countries for EU membership one frequently encounters calls for the adoption of European standards of labor law. While this wording is misleading because such standards can hardly be said to exist, it is true that several European countries including Germany do have a labor law which can render labor shedding extremely difficult and costly both in reorganization and liquidating reorganization. The relevant paragraph of the German civil law code (§ 613a BGB) was due to a social democrat government which ruled Germany in the

seventies. Such legislation makes reorganization unattractive from the investors' as well as from a social welfare point of view. The high costs of labor shedding must be born by somebody and this will be either creditors or taxpayers or more likely both. Imposing these costs on creditors and tax payers may be helpful for a limited number of bankrupt companies but it will harm a much larger number of solvent companies which as a consequence will suffer from a more cautious approach of creditors and a higher tax burden. So, debating reorganization while such labor law is in place makes little economic sense, it only serves the interests of organized labor. The situation in French and Italian is sort of similar to Germany and this has encouraged organized labor in post-communist countries to demand a corresponding legislation in the name of European standards. At the moment post-communist countries however differ considerably in this regard. Poland and Bulgaria kept much of the inherited socialist labor law in place. However, Poland has learnt from experience and a liberalizing reform of labor law was implemented in 2002. Its impact on the prospects of reorganization have not yet been studied. Czechoslovakia has been sort of the opposite. Czechoslovak labor law went through a significant liberalization in 1991, but recently in both successor states it has become more rigid again, this tendency has been comparatively more pronounced in the Czech republic. So there is considerable diversity.

### **Proposition number seven**

The illusion which the proposition is referring to is widespread among non-jurists, legal scholars are not prone to it. Legal scholars are usually well aware of the fact that an unstable legislation which is amended every year is unlikely to serve any useful purpose. Nevertheless virtually all post-communist countries suffer from this kind of legal instability, this is presumably due to the lack of influence of legal scholars. Similarly, legal scholars nowadays usually accept the proposition that every functioning legal system is to a large extent based on judge made law and that law-making by parliaments is bound to be a very imperfect process which should not be overused. However, outside the camp of legal scholarship the Communist concept of law which denies the lawmaking role of judges is still lingering even though it is no longer official doctrine. Summarizing it seems that misconceptions inherited from the communist past are to be blamed for much of the maze of amendments which characterizes post-communist law making. In addition, those countries which are preparing for EU membership in 2004 currently seem to be suffering from it. In order to qualify for EU membership

they have been enacting a real flood of hastily prepared statutes. This process is unlikely to strengthen the respect for law.

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