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**The Development of Insolvency Procedures
in Transition Economies: a Comparative Analysis**

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Abstract

In the past ten years all transition economies have adopted modern bankruptcy legislation as part of their institution building efforts. But their approach to insolvency and their determination to use the insolvency process as a selection mechanism have varied widely. The aim of the paper is two fold. Firstly, we identify the role of insolvency procedures in TEs, particularly in the orderly handling of financial distress and restructuring. Secondly, we analyse the recent developments in insolvency legislation in Bulgaria, Croatia, Czech Republic, Hungary, Poland and Romania, emphasising their inherent features and their impact on the restructuring process.

1. Introduction

It is now well recognised that one of the main causes of the slow process of transition in former socialist countries is the low level of development of some of the basic institutions of the market economy. One of the most fundamental changes witnessed in these countries was the introduction of a new legal framework, based on private property and its supporting institutions, which was designed to encourage, facilitate, protect and regulate the operation of the new system. However, in many areas the change has been slow and the relevant institutions remain undeveloped, acting as major barriers to the further development of the market system. The bankruptcy law, which is a basic and inseparable element of the private law system, is one of these undeveloped areas with strong ramification for the transformation process.

A major feature of a market system is its dynamic selection mechanism whereby the strong and efficient units replace weaker and less efficient ones, and new processes and products replace older ones. Some entrepreneurs and firms are unable to withstand the competitive pressure and exit the market, enabling their resources to move to more efficient employment. The Schumpeterian concept of *creative destruction* encapsulates this dynamism. The establishment of the new system in transition countries accentuated the selection process and gave it more prominence than in mature market economies. The inherited economic structure was unsuitable to a market system and had to undergo a dramatic change, requiring the closure of many enterprises and changes to the operation of many others. The extensive private sector development in the early transition period, and the high rate of entry and exit of new firms also highlighted the operation of the selection mechanism.

The aim of the bankruptcy law (or the insolvency proceedings) is to regulate the selection mechanism. It establishes the procedures for the orderly exit of failed enterprises and the re-entry of their assets and other resources into new firms and new activities. Moreover, the insolvency procedures provide a legal assurance for potential investors and creditors that even in the case of financial distress and business failure, there will be legal processes at work to prevent a rush on the assets of the distressed firm and to regulate the distribution of the estate of the bankrupt firm amongst its creditors.

The systemic transformation in CEE countries is closely bound with changes in the behaviour of enterprises and their managers and the creation of an environment conducive to new investment (by domestic and foreign investors). For this reason, the insolvency procedures play an even more important role than in established market economies. The greater uncertainty, the lack of experience with market mechanism, and the greater information asymmetry put shareholders, financiers and creditors at a serious disadvantage in comparison to the managers of distressed firms. Furthermore, the opportunity for fraudulent behaviour, which is greater in early transition than in an established economy, discourages individuals and companies from developing

relationships with new firms. A well functioning insolvency law provides a reasonable guarantee for financiers, creditors and suppliers of such firms.

In transition economies, the insolvency process is closely linked to two other fundamental processes of early transition: restructuring and privatisation. Restructuring requires the former state owned enterprises to change into market oriented firms by altering their behaviour from a passive administrative unit in the planning apparatus to an active independent agent making value maximising decisions for their own.¹ There was also a need for the radical change of the government's approach to state-owned companies in order to make them market oriented and not government protected at the expense of taxpayers. The restructuring process, invariably, involved financial distress and potential or actual insolvency and the exit of resources (reductions in the output of unwanted products and the resources employed in those activities, downsizing or closure of plants or enterprises, etc.). The bankruptcy law would facilitate the restructuring process.²

The privatisation process (which is also of fundamental importance to the systemic transformation), on the other hand, highlighted the plight of heavily indebted firms which could not be privatised as going concerns. The bankruptcy law provided the opportunity to deal with past debts and insolvency in order to speed up the privatisation of – in fact- bankrupt firms (for example, the so-called “liquidation” route in Poland). The opportunity was of course not utilised in all countries.³

Apart from the above, bankruptcy laws play an important role in the transformation process itself: they provide credibility for the regime change by signalling to the enterprises that if they cannot withstand the competitive process on their own, they will not survive (and that the previous soft budget constraint regime which made their survival possible has come to a definite end). Only then will enterprise managers change their expectation and become subject to the bankruptcy constraint. However if the bankruptcy laws are deficient or the administrative capacity is underdeveloped, there will be much room for fraudulent behaviour by managers and other stakeholders and the insolvency process will be used for the purpose of fraud.

This paper focuses on the development of bankruptcy laws and accompanying institutions in selected transition economies and compares them with the provisions in mature market economies.⁴ The paper presents the deficiencies of insolvency procedures and institutions and

¹ At macroeconomic level, many old sectors had to shrink and create room for new sectors (especially light industry and services).

² The exit of resources during the systemic transformation processes may take place through the classical exit processes such as bankruptcy and reorganisation or through non-classical methods such as restructuring, downsizing, informal arrangements, etc. Despite being very important in all transition economies, the latter forms of exit are conducted under general civil or commercial laws of these countries. The classical exit processes, however, are regulated by special laws coming under “the insolvency procedures”. For details see the introductory chapter in Balcerowicz, Gray and Hoshi, 1998 hereafter referred to as BGH, 1998.

³ In the Czech Republic, e.g., enterprises in the voucher privatisation programme were exempted from the application of the bankruptcy law while in Romania, the bankruptcy law excluded SOEs altogether. For details see BGH (1998).

⁴ For a detailed analysis of the insolvency laws in transition economies, see BGH (1998); Mitchell (1997); Završak and Lowitzsch (2003); Lowitzsch and Bormann (2002); Kallies and Lowitzsch (2002); Bormann and Lowitzsch (2001); Lowitzsch and Pacherova (2003); Lowitzsch and Neidenowa (2003); Lowitzsch and Khaibaljev (2003) Lowitzsch and

their impact on the behaviour of companies and their managers, and the security of creditors' interests. It will also assess the mechanisms designed to reduce the cost of managerial opportunism, prevent fraud, and improve corporate governance.

In the first section, we will discuss the economic importance of the bankruptcy laws. The second section presents the coverage of insolvency laws in the countries under consideration, highlighting the attempts by some government to limit the applicability of the law for political reasons. Section III discusses the importance of the obligation by, and incentives of, the debtor company to initiate the insolvency proceedings. Section IV analyses the insolvency process once it is initiated. Section V reviews the rules governing the disposal of the assets in bankruptcy. Section VI considers some institutional aspects of the insolvency proceedings and Section VII concludes.

2. Insolvency laws and corporate governance

In any market economy, mature or emerging, entrepreneurship and private enterprise is associated with risk and the possibility of failure. An important dimension of the legal system of private property is the allocation of obligations and responsibilities of different agents in the event of financial distress. Furthermore, with uncertainty and information asymmetry, it is not always possible to identify the cause of business failure. Given the separation of ownership and control, these conditions give rise to the possibility of managerial opportunism. The bankruptcy law is one of the important legal institutions of a market system, designed to ameliorate the adverse effect of information asymmetry and to punish fraudulent behaviour by company managers.

The separation of ownership and control associated with *corporations (limited liability and joint stock companies)*, especially in the chaos of early transition allowed the managers of these companies a privileged position from which they could engage in self-enriching activities. There was very little, if any, knowledge and experience of this type of company and the role and responsibilities of its managers. Economists in mature market economies, of course, have been aware of the potential for conflict of interest and misuse of the managerial position at least since the publication in 1932 of Berle and Means's *The Modern Corporation and Private Property*. In the presence of information asymmetry and uncertainty, the relation between managers and shareholders and financiers is a classic "agency problem" (Fama, 1980; Fama and Jensen, 1983) which can have adverse effect on resource allocation within these firms. The resulting misallocation of resources can be alleviated by the formulation of appropriate contracts and incentive packages, and the imposition of clearly defined rules and regulations. The bankruptcy laws in mature market economies have evolved over a long period of time so as to minimise the

Neusel (1999). For the development of insolvency laws in mature market economies, see Ziegel (1994); Berglof and Rosenthal (2000).

agency cost, prevent and penalise managerial opportunism, and provide protection for creditors and financiers. In order for the private property system to function and prosper.⁵

In mature market economies, the economic and legal mechanisms of *corporate governance* have evolved to ensure that the interests of owners and managers are aligned, that an appropriate level of oversight is exercised by the representatives of owners and creditors,⁶ and that any managerial opportunism is detected and penalised by both the market mechanism and the legal framework.⁷ Of course, when firms experience financial distress and are likely to enter the bankruptcy process, the normal rules of behaviour may be affected: managers may be tempted to hide the truth from shareholders and creditors as long as possible in order to prolong their own tenure; they may engage in excessive risk taking as a last resort to save the firm and their jobs; and they may embark on transactions favouring some creditors or owners which would not have been possible if facts were known to all stakeholders. Bankruptcy procedures are extensions of the legal framework, which come into effect when companies suffer from financial distress. Their aims are to protect the interest of investors as well as shareholders from scrupulous managers on the one hand, and to prevent further indebtedness of the firm on the other.

3. Government and insolvency procedures

Although governments in almost all transition economies have adopted modern bankruptcy laws (very similar to those in mature market economies), they have not always been fully committed to the underlying principle and logic of these laws. After ten to thirteen years of experience, many of these governments have still not accepted the fact that not all pre-transition enterprises can survive in the new market system either because the structure of demand has changed dramatically or because they are structurally inefficient. Instead of allowing these white elephants of socialism to go bankrupt and make room for the re-entry of much of their assets under new ownership, governments in a number of transition countries have excluded these companies from the operation of bankruptcy laws and wasted scarce financial resources on their unsuccessful subsidisation. In most cases, the real motives behind this policy have been political and electoral, rather than economic.⁸

⁵ It was precisely the absence of a legal framework, together with duties and responsibilities of managers in the early phase of the development of capitalism in former socialist countries, that led to the widely used descriptions such as “wild west” and “primitive accumulation”.

⁶ It is well recognised that excessive intrusion in the work of management will interfere with their ability to make effective decisions and their risk assessment. Excessive monitoring by large block-holders (made possible by the concentration of shareholding in few hands) may indeed impair the work of management and lower the performance of the firm (see e.g., Holmstrom and Tirole (1993), Cremer (1995), Aghion and Tirole (1997), Bukhart et al. (1997), and Allen and Gale (2000).

⁷ For a survey of literature on corporate governance, see Shleifer and Vishny (1997).

⁸ However, it has to be pointed out that even in mature market economies, governments are sometimes engaged in rescuing large firms from bankruptcy through subsidies, restriction of competition, etc. But these interventions are exceptional and, even then, in most cases they often do not work.

The repeated write-off of debts, exemption from bankruptcy laws while in the process of privatisation, and the exclusion of SOEs from bankruptcy laws are examples of such attempts. In some countries, Albania and Romania, for example, the so-called ‘strategic enterprises’ were transferred to a restructuring agency in order to return them to financial health. They were excluded from the operation of the insolvency procedures and also not included in the privatisation programmes. The experience has been largely negative: state subsidies were used to delay the closure and ultimate bankruptcy of these enterprises.

The lesson from advanced transition economies (Hungary for example) and the experience of those who have dragged their feet most (Romania for example), is that the universal application of the insolvency process is essential in order to: (a) signal the commitment of the government to the systemic change; (b) force enterprise managers to change their behaviour and engage in serious restructuring; and (c) speed up the reallocation of resources from insolvent old firms in old sectors to private new firms in new sectors.

Table 1 (see it below) presents the coverage of the insolvency procedures in selected transition economies. It shows that, while none of the transition countries has so far tackled the problem of consumer insolvency, in some countries, the state allocates itself additional powers and imposes a variety of exclusions, exceptions and extra-procedural measures. These measures, as the experience of Romania and other countries trying to protect some sectors or companies from bankruptcy show, are counter-productive. The treatment of insolvency is basically an issue for private law and all subjects should be treated equally. The state’s interests are of course represented in the insolvency process treated equally. The state’s interests are of course represented in the insolvency process in the normal manner – either as a creditor or as the owner of the enterprise in distress. As such it can introduce special measures such as delayed repayment of debt or write-off of old debts, etc. There is no need for additional intervention power, which could only be used for political reasons.⁹

⁹ The state intervention here can be done through an agency such as the German Treuhandanstalt or the Hungarian Privatisation Agency in the mid 1990ties. These agencies were mainly interested in fast privatisation by sales and therefore they sold most of the companies free of public debt with the sales price covering only the cost of debt alleviation.

Table 1. The Coverage of Insolvency Procedures in Selected Transition Economies and Germany

Country	Physical persons	Legal entities : exemptions and special rules
Bulgaria	Only merchants	Some sectors (e.g. non-commercial legal persons) are subject to special rules.
Croatia	Only merchants	Legal entities in the military and defence sector are exempt unless with the approval of the Ministry of Defence; Farmers and private pension funds are exempt
Czech Republic	Only merchants	Political parties during elections and units in the agricultural sector from April to September are exempt
Germany	Consumer Insolvency/ Minor Proceedings	None
Hungary	Not foreseen	Private pension funds are exempt
Poland	Only merchants; Entrepreneurs not subject to registration (mainly farmers) are exempt	Sickness funds, and institutions and organisations created by Parliamentary laws are exempt; 6 state owned companies are exempt unless with the consent of the state
Romania	Only merchants	Numerous exemptions (e.g. enterprises undergoing privatisation, enterprises in the <i>regies autonomies</i>);
Slovakia	Only merchants	Units in the agricultural sector from April to September and “strategic” supplier companies are exempt

Source: See footnote 4.

One of the frequently heard arguments for state intervention in insolvency procedures is the danger of mass bankruptcies and mass unemployment, the so-called “domino effect” that may occur if there is no “potential brake” on the automatic application of the procedures. The experience of countries like Hungary shows, that despite of the avalanche of filings for bankruptcy at the time of the introduction of the new bankruptcy law, the recession in Hungary was not deeper or very much different from that in other transition economies (more on this later). On the contrary, the massive wave of bankruptcies contributed to the acceleration of the restructuring process.

4. The initiation of the insolvency proceedings

The insolvency law should ensure that this process is embarked upon systematically, efficiently, fairly, and quickly. In this sense, the insolvency procedure complements both Company Law and Contract Law. A sound insolvency procedure provides the investors and lenders with the guarantee that, in the event of financial distress, appropriate provisions are in place to, firstly, raise the alarm about the situation (i.e., inform the interested parties) and, secondly, deal with their claims in an equitable and orderly fashion. Thus, potential investors will be concerned with two main issues: the trigger mechanisms, and the responsibility for the declaration of the insolvency status.

4.1 The trigger mechanism

In order to be efficient, the insolvency procedure has to be triggered by a clear, specific and verifiable criteria in order to enable those in charge to improve the survival chance of distressed enterprises and protect the interests of creditors. Three different criteria have been used in transition economies for this purpose and, as we shall see below, they all produce somewhat ambiguous results:

- (1) The cash flow, or ‘illiquidity’ notion, i.e., when the firm is unable to pay its due debts;
- (2) The balance sheet, or ‘over-indebtedness’ notion, i.e., when a firm’s assets fall short of its liabilities;
- (3) The notion of ‘impending’ or ‘imminent insolvency’.

The most common criterion is the first one, i.e. the inability to pay due debts. However except for Hungary, other countries under examination employ the first two or even all three criteria – though the latter are usually of less importance (see Table 2).

Table 2. Insolvency Trigger Criteria in Selected Transition Countries and Germany

Country	Illiquidity	Over-indebtedness	Imminent Illiquidity
Bulgaria	Yes	Yes	No
Croatia	Yes	Yes	No
Czech Republic	Yes	Yes	Yes
Germany	Yes	Yes	Yes
Hungary	Yes	No	No
Poland	Yes	Yes	No
Romania	Yes	No	Yes, since 2002
Slovakia	Yes	Yes	No

Source: See footnote 4.

Illiquidity. The traditional cash flow based definition used in all of the countries under consideration, is a convenient indicator and can be observed more easily.¹⁰

Over-indebtedness. While this balance sheet notion is theoretically a better reflection of the financial situation of a company overburdened by debt, in practice, given the inaccuracies of estimating the value of assets especially in transition economies, it cannot provide a satisfactory basis for insolvency. The valuation of the company in financial distress requires a special “over-indebtedness” balance sheet¹¹, identifying the assets of the company with their current open market value and their respective liquidation value.

In West European countries, the difficulties of deciding the status of insolvency on the basis of an inventory of assets alone has led to a combined “Two-Tier Method”:

- (1) An arithmetic rule for insolvency in respect to balance sheet and the liquidation value of assets;

¹⁰ Naturally, the practice of ‘late payment’ of bills should not be confused with the ‘inability to pay’ of a debtor.

¹¹The continuous judicial involvement of the German Supreme Court illustrates the complexity of the issue.

- (2) The correction of the liquidation value in case of a positive “survival and return” forecast on the “going concern” basis.

Table 3 shows the use of the “over-indebtedness” criterion and whether this is combined with the “two-tier method” in countries under consideration.

Table 3. The Use of “Over-indebtedness” Criterion in Selected Transition Countries and Germany

Country	Use of over-indebtedness	Combined two-tier method
Bulgaria	For commercial companies	Not foreseen
Croatia	For legal entities	Yes
Czech Republic	For legal and physical persons	Yes
Germany	For legal entities	Yes
Poland	For legal entities	Not foreseen
Slovakia	For legal entities	Not foreseen

Source: See footnote 4.

Note: “Over-indebtedness” is not applied as a criterion in Hungary and Romania.

The calculation of the going concern value of the firm, based on its expected survival, is subject to greater uncertainty in transition countries. To measure and compare the possible future survival and return chances of enterprises suffering from financial distress in the new market economies proves to be extremely difficult. On the one hand, there are an insufficient number of trained personnel in enterprises, courts, ministries and banks, who can undertake this task. On the other hand, the available data on assets of enterprises (whether deliberately or because of poor management) are unreliable both in their methodology and value in many of these countries. Furthermore, the presence of uncertainty and asymmetric information means that the accurate estimation of the two sets of values is extremely problematic and doubtful. Thus - especially in not advanced transition countries - the successful implementation of the “Two Tier Method” in the near future remains doubtful and over-indebtedness remains a problematic insolvency trigger.

Imminent illiquidity. This relatively new insolvency trigger aims at an early start of the insolvency procedure by encouraging the managers to provide information to market participants. Being the only party with access to the relevant information, the debtor may be the only party able to declare this state. But this trigger is effective only if appropriate incentives are provided for the managers of the debtor company (e.g., the discharge of residual debt or the ability of managers to stay in power, as in the recent German legislation). However, perverse incentives (such as the desire to gain shelter from the claims of a single creditor and personal management may also encourage firms to “escape into bankruptcy” (Kirchner 1997). As Table 4 shows, the “imminent illiquidity” criterion has been applied in 2 transition countries, even though there are no precise measures for assessing imminent illiquidity and also there are no economic incentives for the managers to declare the state of imminent illiquidity. Therefore it is reasonable to expect that this trigger mechanism is likely to remain idle.

Table 4. Imminent Illiquidity Criterion in Selected Transition Countries and Germany

Country	Criteria	Economic Incentives
Croatia	No criteria	None
Germany	No precise criteria concerning the length of the forecast period; min. ½ year	Discharge of residual debt; management remaining in charge
Romania	No criteria	None

Source: See footnote 4.

Note: “Imminent Illiquidity” is not applied as a criterion in Bulgaria, the Czech Republic, Hungary, Poland and Slovakia.

4.2 Declaration mechanism

The triggering of the insolvency process is one of the important points at which the information asymmetry between the debtor and others may generate serious perverse incentives and inefficient outcomes. It is essential that all stakeholders are made aware of its possible invocation as soon as possible. Even in mature market economies with developed financial markets and institutions, it is recognised that a firm’s financial distress may not always be picked up sufficiently early by the financial press and markets. Managers are in the unique position of knowing the affairs of a company and the potential imminent distress. They may embark on opportunistic behaviour aimed at benefiting themselves, by for example engaging in highly risky undertakings in order to prolong their position and possibly save the company. Thus although as a rule the insolvency procedure may be triggered by either the debtor itself or by a *bone fida* creditor, it has been argued that the managers should be required by law to declare their insolvency within a short period of realising that their company may default on its debt. In the UK and Germany, for example, the managers of a defaulting company are required to file a petition in court within three weeks of a default.¹² Table 5 summarises the rules governing the triggering of insolvency proceedings in selected transition countries and Germany.

¹² In the UK, the obligation is even stricter as the managers are also required to file this petition if they ‘should have reasonably known’ that the company is insolvent. Furthermore, the existence of over a thousand prosecutions for violation of this rule in the U.K. confirms that some managers will continue to have this tendency (see Franks and Torous, 1992). For a more detailed analysis of the personal liability of managers, see Sealy (1994). The managers’ obligation to declare the insolvency situation was only recently added to the Romanian legislation through Ordinance 38/2002.

Table 5. Triggering the Insolvency Proceedings in Selected Transition Countries and Germany

Country	Right to initiate the process	Managers' obligation to initiate the process	Legal sanctions
Bulgaria	Debtor, Creditor, Liquidator	Within 15 days	Liable for damages
Croatia	Debtor, Creditor	Within 21 days	Liable for damages
Czech Republic	Debtor, Creditor	No specified period but obligation to file without delay	Liable for damages,
Germany	Debtor, Creditor	Within 21 days	Civil and criminal liability for damages
Hungary	Debtor, Creditor, Commercial Register Court, (in case of Reorganisation, only Debtor)	None / no period (the original obligation was lifted in 1993)	Liable for damages,
Poland	Debtor, Creditor	Within 14 days	Civil and criminal liability for damages
Romania	Debtor, Creditor, Commercial Chamber	Within 30 days (since 2002)	Liable for damages
Slovakia	Debtor, Creditor Liquidator	Within 60 days	Liable for damages

Source: See footnote 4.

A brief review of different experience of the advanced transition economies gained in the early transition may highlight the importance of the declaration rule, and especially the obligation of the managers. In Hungary, where at the very beginning of the operation of the bankruptcy law managers were required to declare insolvency if a company had arrears over ninety days, there were some 3500 reorganisation and nearly 10,000 liquidation declarations in April 1992 alone (the total number reached some 22000 filing by the end of 1993).¹³ The “automatic trigger” was removed in September 1993, but by this time the accumulation of debt arrears had effectively stopped, payment discipline was strengthened, and creditors had become more active in filing. However, after removing the declaration obligation of managers, debt started to accumulate again, especially to the least rigorous debt collector: the state. This tendency was brought to a halt only after the behaviour of budgetary organisations changed and became more strict against notorious debtors in 1995 (Mitchell, 1997).

In the Czech Republic, in contrast, there were only 350 filings for bankruptcy in 1992 (and 1098 in 1993).¹⁴ The massive difference between the two countries was at this time largely due to the legal obligation of the managers to file for bankruptcy in case of default. Following much debate, the Czech Republic amended this aspect of the bankruptcy law in 1996 and placed the burden of declaration on the management (creditors retained their right to petition the court), though without a time limit.

¹³ The 1991 Bankruptcy Law came to effect in Hungary in January 1992 and the wave of declarations started on 1 April, after the expiry of the 90-day period. For details, see BGH (1998), Chapter 7.

¹⁴ The liquidation process in the Czech Republic applies to solvent firms and, therefore, is not comparable to the situation in Hungary where firms in default have to file for either reorganisation or liquidation. For details see BGH (1998), Chapter 5.

In Poland, too, the number of declarations was relatively low (as compared with the total number of enterprises), especially in the first two years of transition (1990, 1991).¹⁵ From 1992 there was a sharp increase in number of filings for bankruptcy (to the peak of 5249 in 1993). In the second half of the 1990s the number of insolvency declaration dropped significantly and stayed in the range of 2300-4400 filings a year. Here, the problem has been not the absence of the obligation by managers to declare insolvency but the poor enforcement of the law. Despite a clear legal requirement for a declaration within 14 days of default, the managers ignored these obligations and no prosecution was initiated to stop this behaviour. As a result of the delay in the publication of information, the financial position of enterprises deteriorated further and a big portion of petitions every year was rejected by courts at the start of, or during the insolvency procedure due to the insufficient assets of the debtor to cover the costs of the procedure alone. Only in 1997 a new provision was introduced into the Polish Bankruptcy Law allowing the imposition of two kinds of penalties on managers for not declaring insolvency of a company in time.¹⁶

5. The insolvency process

Once a petition to embark on insolvency procedure is placed by a debtor or creditor(s), and a court agrees to hear the case¹⁷, the debtor faces two fundamental options: liquidation or reorganisation, though here different terminologies are used to describe the process in individual countries.¹⁸ The debtor and creditors put forward their views and, generally, the court makes the final decision on which option is pursued.¹⁹ In either case, it is necessary to stop all claims against the debtor in order to provide conditions for the court or the court appointed trustee to conduct her/his duties. In the case of liquidation option, the reason for stopping individual creditors from exercising their rights is to ensure that all creditors receive equal treatment depending on their place in the priority list and that there is an orderly winding up of the company. But in the case of

¹⁵ It is worth adding that Poland was in the privileged position of having a Bankruptcy Law available at the start up of reforms in 1990. The Law, originally adopted in 1934, was never abolished during the communist economic regime.

¹⁶ Firstly, managers are liable for any damage caused to creditors and may be sued by them. Secondly, the manager will be deprived of the right to run another economic activity on his own (sole entrepreneurship) or manage another company, unless he proves that he is not guilty of not declaring insolvency within the obligatory time limit (The latter penalty was declared unconstitutional though by jurisdiction of the Supreme Court of 4.7.2002 (Dz. U. 113, Pos. 990).

¹⁷ It is important to point out that in many cases and in many countries, the court may refuse to hear the case if the assets of the debtor company are insufficient to cover the cost of the insolvency proceedings. This is a serious problem in Poland, where every year a substantial portion of bankruptcy filings are rejected for that reason alone. This fact may be well commented with the opinion that petitions are too late and this probably proves that penalties envisaged for imprudent managers are not regularly enforced as they should. Therefore it is reasonable to have a provision, as in the U.K., that the cost of insolvency proceeding is covered by public funds if the assets of the insolvent firm are insufficient.

¹⁸ The procedures may be referred to as bankruptcy, liquidation, administration, arrangement, receivership, official or judicial management or reorganisation/restructuring.

¹⁹ In some developed market economies a debtor is entitled to opt for reorganisation and, while the managers remain in office, it prepares a reorganisation plan to be submitted to the creditors and the court within a specified time limit (the case of the USA and chapter 11). In other countries (e.g. the UK), the court appoints an official (administrator or trustee) who investigates the possibility of preparing a reorganisation (or settlement), which would still have to be submitted to creditors and the court for approval. Even when the reorganisation option is chosen, the reorganisation plan may not be approved by the creditors and the firm would have to go to liquidation. For details, see BGH (1998), Chapter 2.

reorganisation, the issue of relief from creditors has a different function and needs careful consideration.

5.1 Relief from creditors

The automatic relief from creditors alleviates the pressure on the debtor and gives it a chance to negotiate with creditors to formulate a reorganisation plan. However, automatic relief also enables opportunist managers to embark on the reorganisation option in order to prolong their tenure. Such managers may well know that the chances of a successful reorganisation are small but will try to utilise this route for their own interests. The crucial point is whether the relief from creditors is automatic or a possibility that has to be approved by a court or by creditors. In the U.S., there is a ninety days automatic stay of claims for firms filing for a Chapter 11 bankruptcy – a point that has been much criticised by some legal scholars and economists. In the United Kingdom, however, firms may enter the reorganisation option (known there as *administration*) with the support of creditors and the approval of the court only. Once an *administrator* is appointed, there is a stay of claims against the company for a period of ninety days in order to give the administrator a chance to prepare a reorganisation plan.

The experience of transition economies has been varied in this respect. In Hungary, initially, the Bankruptcy Law made the 90-day relief from creditors automatic but since the September 1993 amendments, it has been subject to the discretionary vote of creditors. This change was made in response to the criticism by creditors that the managers had abused the relief provision. In all cases, the managers of the debtor companies prepare the reorganisation plan.

In the Czech Republic, since the 1993 amendments, the Court offers the debtor a 90-day protection during which it can produce a '*settlement plan*', which has to meet certain conditions and has to be approved by the Court. During the protection plan there is a stay of claims against the firm (except for the claims of employees and the state arising from current operations). This provision was particularly aimed at helping the newly privatised Czech firms (many of whom suffered heavily from the burden of past debts) to negotiate with their creditors and find a solution if at all possible. Under special circumstances, the protection period could also be extended by another ninety days. By 1996, however, it was felt that the post-privatisation urgency of supporting privatised firms had diminished. The protection period was then restricted to firms with more than 50 employees.²⁰

On this point, the Polish insolvency law is very much creditor oriented. A debtor, who opts for reorganisation, may place a petition with a court for a settlement plan with his creditors. A syndic

²⁰ The Czech bankruptcy procedure also allows for a '*compulsory settlement*' after a trustee has been appointed to wind up the company. During this period, the debtor may present a '*compulsory settlement*' plan to the court. This plan is subject to the approval of creditors and the court and must meet a number of stringent conditions, including the ascertaining of the '*honest intention*' of the bankrupt firm by the court. For details, see Hoshi, Mladek and Sinclair (1998).

judge may reject this petition if there is any evidence of misconduct by the debtor.²¹ Only if a syndic judge accepts the petition, will it be subject to the creditors' decision exercised through voting at the creditors' assembly. A stay of claims is possible if the satisfaction of secured creditors is provided for in the settlement.

The experience of other countries indicates that there is a general suspicion that the managers of financially distressed firms may abuse the automatic relief. Instead, firms should have the possibility of benefiting from a period of 'relief from debt' subject to the approval of courts or creditors in order to ensure that they do genuinely search for a solution. There is also much criticism of the long period of relief - usually 90 days, which may be extended by another 90 days. There is no genuine reason why the preparation of a reorganisation plan should take so long. It may be more effective if the basic period is shortened but its extension is made subject to the approval of creditors, or with the creditors having the right to end the period immediately if they so prefer.

5.2 The annulment of the debtor's transactions prior to insolvency

Bankruptcy laws usually contain provisions that give the creditor and court-appointed officials the power to annul the debtor's property transactions prior to insolvency if they were inconsistent with the principle of equal treatment of all creditors (*actio pauliana*), or were fraudulent.²² As a rule this concerns transfers of the debtor's property made within a specified period before the bankruptcy filing, which were made to insiders or favoured a particular creditor and enabled him to receive more than he would have received in an orderly liquidation.

Of course it is not always easy for creditors to prove the debtor's intention to prejudice them and, therefore it is necessary to establish clear rules under which creditors can examine past transactions. In limited number of circumstances, the burden of proof may even be shifted and the debtor may be required to prove that the disputed transactions were made in good faith. Similarly, the period in which transactions can be disputed should be fairly short – in general less than a year. Table 6 summarises the rules governing disputed pre-insolvency declaration transactions and the burden of proof in selected countries.

²¹ A petition for restructuring of debts may be rejected by a court if a debtor: a) was already declared bankrupt in the last five years, b) had already a court conciliation agreement in the past, c) had falsified the books (failed to prepare the accounts properly), or d) refused to assist in establishing the value of debtors' estate.

²² For a detailed discussion of the provisions in the UK law, see Fletcher (1994).

Table 6. Annulment of Pre-petition Transactions in Selected Transition Countries and Germany

Country	Regulation to annul/invalidate transactions	Valid period before insolvency for <i>Actio Pauliana</i>	Burden of proof for fraud/ <i>mala fide</i>
Bulgaria	Invalidity Suit	1-3 years, depending on motive	Creditor, Insolvency Administrator
Croatia	Rescissory Action	3 months to 10 years depending on motive	Rebuttable presumption of law, thus reversal of burden of proof
Czech Republic	Rescissory Action, Invalidity Suit	3 years	Creditor, Insolvency Administrator
Germany	Rescissory Action	3 months to 10 years, depending on motive	Rebuttable presumption of law, thus reversal of burden of proof
Hungary	Rescissory Action, nullification	1 year	Rebuttable presumption of law for nullification
Poland	Invalidity Suit	1 year or 5 years	Rebuttable presumption of law for invalidity
Romania	Rescissory Action,	3 years	Rebuttable presumption of law for relatives
Slovakia	Rescissory Action	1-3 years, depending on motive	Creditor, Insolvency Administrator

Source: See footnote 4.

5.3 Liquidation versus reorganisation?

Once it is established that a firm is insolvent, it is important that the procedure retains the widest possible range of actions for the agents involved (primarily the creditors of course). A well-designed insolvency law prevents the reduction in the value of assets during the insolvency and maximises debt recovery for creditors either through liquidation or through reorganisation. Although liquidation is quicker, it will not necessarily be the optimal solution for all parties involved. The reorganisation option on the other hand provides the possibility of revitalisation of the company and, if successful, will produce better results. In many mature market economies, this alternative is strongly enshrined in the law (e.g., the Chapter 11 option under the U.S. bankruptcy laws).²³ Of course an efficient insolvency law should prevent premature liquidation, but it should also speed up the winding up non-viable firms.

The reorganisation option has been of even greater importance in transition economies where, for many companies, the causes of financial distress often lay outside the firm itself (be it state owned or private). State owned firms faced financial distress because the systemic change

²³ Even in countries like the United Kingdom, where reorganisations were rather exceptional, a change is taking place. Until recently, the large majority of insolvencies (about 90%) resulted in liquidation. Receivership was the next most used options while the administration option applied to only a small fraction of cases (about 1%) – see BGH (1998), Chapter 2. In March 2002, the British government introduced an Enterprise Bill to the Parliament, in which it has taken measures to make ‘administration’, and not ‘receivership’, the normal route in insolvency, trying to encourage the reorganisation of insolvent firms.

affected their input and output markets adversely. When there was a large volume of inter-enterprise debt, some firms faced financial difficulty not because of their own operations but because other firms had not paid their invoices. Private firms, especially SMEs, were often linked to the state sector and financial distress was transmitted to them via their many linkages with the SOEs. Attempts to push these enterprises to bankruptcy would have been, in many cases, premature. Many of these enterprises were able to resolve their problems and operate in a market economy successfully. Additionally, in the early stages of transition, when a large number of enterprises remained state owned awaiting privatisation, care should have been taken to avoid premature liquidation, i.e., to distinguish between viable and non-viable enterprises.²⁴

The reorganisation option, however, should be utilised prudently and not as an excuse to prolong the reign of incompetent managers. Oversight by outside agents, for example the representative of creditors or a court-appointed trustee, would be a reasonable compromise. Moreover, within this option, the possibility of other forms of work out should be provided for. Examples of such actions are: debt forgiveness, reduction in interest payment, debt for equity swap, and similar measures in return for commitments by managers such as changes in the composition of the boards, changes in production lines, investment plans and asset structure.

The advanced transition economies have had a variety of experiences, which are very instructive for to countries with less developed insolvency proceedings. In Hungary, with massive insolvency declarations at the early operation of the bankruptcy law (discussed above) and a strong emphasis on reorganisation, the fear of a large-scale closure of firms was unfounded. As many as 67% of the firms that applied for reorganisation in 1992 succeeded in completing a reorganisation plan.²⁵

In the Czech Republic, however, the law created inherent obstacles to reorganisation. Indeed, the 'ordinary settlement' and 'compulsory settlement' options within the law involved meeting extremely difficult conditions.²⁶ Furthermore, in the Czech bankruptcy law, the creditors were unable to propose a 'settlement plan'. Consequently, only one in 1000 of bankruptcy filings succeeded in completing a reorganisation plan in the first two years of the application of the bankruptcy law.

In Poland, too, there has not been much room for the debtor's restructuring within the insolvency procedure, as the *court conciliation (or settlement)* option is a rather inflexible process when compared with reorganisation processes in mature market economies. As a result, the

²⁴ This is linked to the problem of the 'positive survival and return forecast' discussed in the context of the insolvency triggers.

²⁵ For details see Szanyi (1996). Furthermore, in Hungary, a 'debtor consolidation' form of restructuring was introduced in order to encourage some of the firms in financial distress to reach 'out of court' settlement with their creditors (and achieve the same outcome as the 'reorganisation') but in a simpler manner.

²⁶ These include acceptable arrangements for the satisfaction of 45% of the non-priority claims in two years (under ordinary settlement) and 33% of non-priority claims in one year (under compulsory settlement). Given the very high inter-enterprise debt at the early stages of transition, it was almost impossible to get a reorganisation plan through the court. On top of this, the debtor had to establish her/his '*honest intentions*', another subjective barrier. The outcome was a rate of 1 in one thousand filing referred to above. For details, see BGH (1998), Chapter 5.

number of 'settlements' in the 13 years of transition has been very low. In order to prevent premature closures in the early transition period, the government introduced the Enterprise-Bank Financial Restructuring Programme in 1993 to speed up the restructuring of state-owned commercial banks and their heavily indebted state enterprise clients.²⁷ The Programme was a success, mainly due to its untypical pattern: instead of centralisation of bad debts in a special new institution, the Programme required banks and their indebted clients to work out a solution during a limited time, reduce the indebtedness of both and make them of value to potential private investors²⁸. It should be mentioned here that in the last couple of years intensive work has been going on in Poland to prepare a new Bankruptcy Law, which will be more reorganisation oriented than the present one.

To facilitate the reorganisation option, it is also necessary to avoid opportunistic behaviour amongst creditors. While it is essential to retain the agreement of creditors for a reorganisation plan, it is essential that some creditors are not treated more favourably than others (for example the small number of large creditors against the often-large number of small creditors) are. With the exception of secured creditors who should retain seniority over the mortgaged assets, all classes of creditors should be involved in the reorganisation plan and a majority of them should accept the plan.

²⁷ For details, see Gray and Holle (1998) and Balcerowicz and Bratkowski (2001). In mature market economies too, there are arrangements outside the bankruptcy procedures which are often employed to speed up the process. In the United States, the 1978 Bankruptcy Reform Act (and its supplementary legislation in 1994), provide for a formal, but privately arranged 'workout' as an option for financially distressed firms. Workouts involve negotiations between debtors and creditors over a reorganisation plan which is agreeable to creditors but would also avoid lengthy court-based litigation. This type of agreement is obviously cheaper and speedier but it cannot benefit from court protection, stay of claims, tax advantages and bank borrowing on favourable terms, benefits that are available to firms in court-based reorganisation. This path is particularly beneficial if firms have fewer creditors, the main creditors are banks and financial institutions and when firms have more intangible assets (whose value may be lost during a long drawn out procedure). For details of a study of eighty financially distressed firms engaged in private workouts, see Gilson, John, and Lange (1990), and for a comparison of the performance of workouts and reorganisations in a sample of 82 firms, see Franks and Torous (1994). In the U.K. large firms in financial distress often embark on an informal procedure known as the 'London approach', originally devised by the Bank of England in the 1970s. This procedure, which is not a part of the Insolvency Act, seeks to restructure the firm's finances with the unanimous agreement of creditors, and without publicity (which may damage the firm's position in the market).

²⁸ In addition to these special mechanisms, general procedures such as court conciliation agreement, civil conciliation agreement, bankruptcy procedure, and liquidation procedure were also applied in the Programme.

Table 7. Features of Reorganisation Options in Selected Transition Countries and Germany

Country	Options	Time limit for submitting proposal	Reorganisation period	Approval condition
Bulgaria	Reorganisation	30 days	Trade Sale within 30 days	Simple majority and ½ of volume of claims
Croatia	Reorganisation, Trade Sale	No later than final distribution meeting,	Trade Sale within 30 days	Simple majority of each group and ½ of volume of claims
Czech Republic	Continuation, compulsory settlement, settlement	90 days (with 90 days extension possible)	Not foreseen	Compulsory settlement simple majority and ¾ of volume of claims; settlement - the same rule but prohibition to obstruct
Germany	Reorganisation	No later than final distribution meeting	Not foreseen	Simple majority of each group and ½ of volume of claims with prohibition to obstruct
Hungary	Moratorium, Settlement	90 days and 60 days extension possible	Not foreseen	Simple majority and 2/3 of volume of claims
Poland	Continuation, Trade Sale, Compulsory Settlement	Compulsory Settlement within 30 days from court decision	Not foreseen	Compulsory Settlement - majority vote of 2/3 of value of claims, Continuation - simple majority of creditors committee
Romania	Plan, Reorganisation	Plan within 30 days after Verification Meeting,	Reorganisation within 3 years	2 of 6 debtor categories approve by majority vote of 2/3 of value of claims, none is treated worse than in liquidation
Slovakia	Continuation, Priority of Trade Sale, Auction	Proposal within 15 days before Debtors Assembly	Not foreseen	Majority vote of 2/3 of value of claims

Source: See footnote 4.

Although the approval percentage varies in different countries (and in practice it has often been relaxed when it has been too restrictive), a reasonable majority (of for example two thirds) seems to be the common threshold in countries which are sympathetic to reorganisation. A high approval percentage gives disproportionate power to small creditors (and disadvantages large creditors) and a small approval percentage it may disenfranchise too many creditors.

In any case, the reorganisation period must be time-limited and the creditors must always have the option of revoking their initial agreement and convert the process to liquidation. An increase in the role of creditors in the insolvency process provides greater assurance for creditors and encourages the credit market – something, which is fundamental in any attempt to get out of financial distress. Table 7 summarises the characteristics of the reorganisation option in the countries under consideration.

5.4 Replacement of managers

Once the reorganisation option is selected, a decision has to be made on whether the existing managers should remain in charge of the firm or not. On the one hand, there is the argument that

the managers know the firm's potential as well as its problems better than an outsider (a court appointed trustee) who enters the company cold. Moreover, if managers know that their position will not be undermined, they would be more willing to file for bankruptcy early, as soon as they become aware of signs of the potential insolvency²⁹. This would allow them time to prepare a rescue plan before the financial distress gets out of control. This is the procedure followed in many market economies such as the United States and transition economies such as Poland and Hungary³⁰.

On the other hand, there is the argument that managers may opt for imprudent policies and embark on desperate measures to try to reverse the firm's fortunes and consequently harm the creditors. For this reason in many countries the managers are deprived of their posts once the firm enters the insolvency process. In the U.K., the declaration of default leads immediately to the appointment of a liquidator (to wind up the company), a receiver (to recoup the assets of a secured creditor) or an administrator (to prepare a reorganisation plan) by the court. In Germany and the Czech Republic, too, the courts appoint a court official to oversee the fate of an insolvent firm (whether it is liquidation or reorganisation). Given the importance of protecting creditors from opportunistic behaviour, which is common in transition economies, there may be an argument for ensuring that an outsider (appointed by creditors) is in overall supervision of the firm.

6. Disposal of assets

If the insolvent firm opts for the liquidation, or if the managers or administrator (trustee) are unable to prepare a reorganisation plan acceptable to creditors and the court, resulting in the conversion of the process to liquidation, the assets of the debtor have to be sold and the proceeds distributed amongst the creditors in a particular order of priority established by law. The disposal of assets involves a court appointed official (liquidator) and various degrees of court involvement. An efficient liquidation process should maximise the proceeds of asset disposal in as short a time period as possible – and this requires of an appropriate incentive package for the liquidator (more on this later). Two issues need to be discussed in some detail here.

Firstly, the position of secured creditors is relevant as it influences the decision on whether or not to reorganise as well as the asset disposal process and, by definition, the level of satisfaction of creditors. Secondly, given that the asset disposal process plays a particularly important role in transition economies – facilitating new entry and reallocating assets to new and more profitable activities – its organisation deserves special attention.

²⁹ This may be achieved by providing incentives for managers to declare insolvency as early as possible, as it has been done in Germany (see Table 4).

³⁰ The Czech bankruptcy law includes one option under which the management remains in charge during the protection period and prepares a reorganisation plan. In the first ninety days of protection, the managers may propose an 'ordinary settlement' plan to the court. Provided the plan meets various conditions and is approved by the court, a 'settlement administrator' is appointed by the court to oversee the process.

6.1 The position of secured creditors

While bankruptcy is a system for *terminating* the debt collection process, replacing other penalties imposed on defaulting debtors, secured lending is a system for *facilitating* debt collection. The latter works by improving security and information so that borrowers can more easily prove their creditworthiness, and lenders can make loans with less risk and collect those loans more easily. Even though bankruptcy and secured lending serve different ends, they are closely inter-linked: when bankruptcy terminates the debt collection process, it may also terminate or curtail the collection of secured loans (Fleisig 2000).

Although in Western economies much credit is unsecured, the widespread insistence on security in transition economies indicates that credit extension is not simply a function of price. In many cases a prospective borrower who is unable to furnish collateral, will simply be refused credit altogether rather than being charged a higher rate.³¹

Given the role and importance of secured credit, the legal systems in mature market economies almost always give secured creditors priority over other creditors and also allow them to claim their security outside the bankruptcy process.³² However, some systems of bankruptcy (for example in Hungary and Poland) have deviated from this principle by delaying the claims of secured lenders, subsuming them to other claims with less seniority prior to bankruptcy, giving some types of unsecured claims priority over the claims of the secured lender, or even setting them aside. Thus, in the worst case, the collateral securing a loan can be sold and the proceeds used to satisfy other claims (such as debt to the state, unpaid wages of workers, attorney's fees and costs of the bankruptcy court) before those of the secured creditor. These practices undermine the legal system of security, increase the risk and cost of capital, reduce the total amount of credit and the related social benefits of increased economic activity.

The rights of secured creditors may be in conflict with preserving the value of the firm, as the latter must nearly always require a stay of execution of the secured creditors' rights and a risk that they will be diminished in the course of the reorganisation proceedings. The individual interest of a particular creditor who has bargained for security is in conflict with that of unsecured creditors when it comes to the withdrawal of assets essential to the running of the business and for its reorganisation. The conflict is exacerbated when the procedure aims at reorganising a company or disposing of its business on terms more favourable than that secured by liquidation. In this situation even for the most ardent exponents of the principle that bankruptcy law should respect

³¹ See Debtor Creditor Rights Working Group (1999). According to the World Bank, for a loan secured by real estate, a borrower could expect to obtain a loan more than eight times larger, repayable over a period of time more than ten times longer, at an interest rate about 50% lower than the borrower offering no collateral. For a loan secured by movable property, the loan terms for the same borrower would fall somewhere in between those of unsecured loans and those of loans secured by real estate (Fleisig, 2000).

³² One exception being the U.K. Insolvency Proceedings which allow the seizing of secured assets only if this does not stop the operation of the debtor altogether. But even here, the secured creditor has the right to appoint a 'receiver' to speed up the process of orderly liquidation in order to dispose of the said security in the interest of the lien holder.

pre-bankruptcy entitlements it would be difficult not to recognise that some sacrifices have to be made by secured creditors in order to help to maximise benefits for the creditors as a whole.

One solution to balance the competing interests is to recognise the secured creditor's rights but to restrict their execution for a given short period. But if the period is substantially long, the secured creditor's rights will be undermined. Another possible solution is to provide for arrangements under which secured creditors could be compelled to accept a change of status or a diminution of priority in the interests of the general body of creditors.³³ If rehabilitation rules are to be effective, they must be flexible in their approach and must provide procedures for preventing a sensible plan being substantially delayed by a dissenting minority and allow the plan to be imposed on that minority (albeit with suitable safeguards) for the benefit of the interested parties as a whole.³⁴

Table 8 (see it below) presents the position of secured creditors and identifies the restrictions on their rights in selected group of countries.

6.2 Efficiency of the reallocation of assets of insolvent firms

A further important economic function of bankruptcy is the efficient allocation of assets from non-viable to viable use. Transition economies are particular from this respect too, since they inherited from the previous regime not only debt but also capacities (assets) that were created to meet the logic of central planning rather than the market. These assets needed to be either reorganised within the same company, sold to a new owner, or scrapped. While the reorganisation option may facilitate the restructuring debtor's company, the liquidation option leads either to assets restructuring carried out by a new owner, or to the partial or total elimination of physical assets.

³³ The issue is part of a wider debate on the extent to which bankruptcy law should have a redistributive role which goes beyond the avoidance of suspect transactions and the conferment of super-priority to certain types of debt; compare Debtor Creditor Rights Working Group (1999).

³⁴ Under the "cram down" procedure of Chapter 11 of the American Bankruptcy Code the court can impose on any class of creditors, including secured creditors, a plan which varies their rights (e.g. by extension of the period of payment) so long as the plan is fair and equitable.

Table 8. Position of Secured Creditors in Selected Transition Countries and Germany

Country	Priority of secured creditors	Priority of unsecured over secured claims	Interference of reorganisation with rights of secured creditors
Bulgaria	Absolute priority	Debts to the state	Stay of execution and change of status possible ^a
Croatia	Absolute priority	Debts to the state	Stay of execution possible, change of status if sale as going concern
Czech Republic	Relative priority, 70% directly, 30% as unsecured claims	Debts to the state	Stay of execution possible
Germany	Absolute priority	None	Stay of execution possible, compensation for use
Hungary	Relative priority, 50% directly, 50% as unsecured claims	Debts to the state	Stay of execution possible
Poland	Relative priority, 50% direct, 50% as unsecured claims	Debts to the state, 50% before secured creditors	Stay of execution possible
Romania	Relative priority after budgetary debts	Debts to the state	Stay of execution and change of status possible
Slovakia	Relative priority, 30% may be subtracted in case of pauperism	Debts to the state (from subtracted 30%)	Stay of execution possible

Note: (a) Stay of execution refers to preventing secured creditors from seizing their security and 'change of status' refers to altering the priority of secured creditors.

Source: See footnote 4.

At the early stage of transition the governments of course were concerned with the fate of the inherited assets of state enterprises. There was a widespread belief, that restructuring or elimination of companies' assets would contribute to large-scale unemployment, the disruption of co-operation networks, and recession. In a number of countries special measures were introduced to prevent or delay the initiation of the insolvency proceedings in SOEs or companies in privatisation schemes.³⁵ Countries with strong trade union movements also had serious difficulties with the extension of the effect of bankruptcy laws to large loss-making SOEs.³⁶

The restructuring and sale of assets was initially undertaken by companies themselves, writing off the non-viable parts of their portfolio and their loss making activities in order to improve their financial position. Downsizing was carried out by managers exactly for the purpose of avoiding insolvency.³⁷ However downsizing took place even in countries without an effective insolvency system.

³⁵ In the Czech Republic and Slovakia for example firms participating in the voucher privatisation scheme were exempt from the bankruptcy law. In Romania, SOEs were, and still are, exempt too.

³⁶ This was particularly the case in Poland, but there were similar examples in other transition economies too.

³⁷ The magnitude of the process was estimated at a 20-40 % reduction in employment and production in Poland, Czech Republic and Hungary. The different bankruptcy regimes of the three countries affected mainly the sequencing and timing of social costs occurring with market exit. For details see, BGH (1998), Chapter 4.

An analysis of the Hungarian reorganisation plans showed that their contents were mainly financial relief. Debt rescheduling, write-off of penalties, interest reduction and immediate cash payment to small creditors were the most common items of the plans. The plans also contained longer-term proposals for the restructuring of activities. The initial step in this direction was usually the sale of redundant assets (especially real estates).³⁸ Revenues from asset sale were usually used for debt repayment and not for the creation of new capacities or the purchase of new assets. New loans were extended only sporadically (Gray, Schlorke and Szanyi, 1996).

From a wider perspective it is also important to know how the assets sold in bankruptcy are used in the hands of new owners. Hungarian experience shows that firms sold as going concerns or complete sets of assets were sold most efficiently.³⁹ Real estates were also sold quickly, after environmental clean up, and used for new and different activities such as office space (and less frequently as workshop or other production premises). Machinery and equipment, which were not part of a going concern, were usually scrapped. Furthermore, a comparison of bankruptcy-related asset sale with ordinary asset transfers (Szanyi, 2001) indicated no major difference in the efficiency of the use by new owners. This means that assets sold in bankruptcy procedure were used in similar patterns by new owners as if it was purchased outside the bankruptcy process. The efficiency of the usage did not depend on the procedural background of the asset. It mainly depended on the quality of new owners.⁴⁰ The successful restructuring of bankrupt firms' assets depended very much on the presence of strong foreign investors. Going concerns were also sold at better conditions. A bigger part of their activity was maintained or recreated, and sales prices were also substantially higher. No strong evidence was found for the impact of the bankrupt firm's quality (e.g. the level of indebtedness) on the efficiency of the asset use.

7. The institutional framework

The effectiveness of the insolvency procedure is closely related to the development of the legal institutions of a market economy, in particular the processing capacity of the legal system. The insolvency proceedings rely heavily on the ability of the bankruptcy courts to process insolvency petitions and this, in turn, depends on the quantity and quality of the judicial personnel involved in the proceedings – most importantly, the insolvency judges and the court appointed insolvency practitioners. In this section we discuss some of the institutional obstacles to the operation of an insolvency law.

³⁸ In many cases, however, major pieces of assets were sold already prior to the bankruptcy procedure. The revenues from asset sale were usually used for further financing daily activities. Many "drifting companies" lost much of their asset value this way.

³⁹ This experience seems to be reflected in some of the most recent amendments to bankruptcy laws e.g. in Poland, Croatia and Bulgaria, where the sale as a going concern (trade sale) is favoured to other methods.

⁴⁰ Large and properly capitalised foreign companies were most efficient.

7.1 Involvement of courts

Unlike East Germany, where the systemic transformation was marked by a “permanent replacement of the Eastern elite by the Western elite” with a long-standing experience of the market system, the CEE countries at the start of transition were characterised by a shortage of court personnel, specialised chambers and competent administrators organised in professional associations. Also in the course of transition the administrative capacity was not developed at a sufficiently fast pace to cope with the rapid growth of court cases resulting from the operation of the market system and the increased role of the judiciary in new economy. Another, still existing, problem is poor (traditional) system of legal education, which produces judges with insufficient knowledge of economic and financial issues.

These limitations lead us to the conclusion that, in transition economies in general, the involvement of courts in insolvency proceedings has to be kept to the minimum. Otherwise insolvency cases will not be dealt with in reasonable time limits. The role of the court (and the insolvency judge) should be to start the process and to appoint an insolvency practitioner. Also the court should be involved at important points of the proceedings such as the approval of any reorganisation plan and its extension and at the end when the case is being completed.

The experience of transition countries, though different in this respect, strongly supports the conclusion reached above. In some countries, like the Czech Republic, the level of court involvement has indeed been one of the major causes of the slowness of the system – for every decision affecting creditors, the court-appointed trustee has to seek the approval of the judge overseeing the case. In the case of a sale other than by auctions this includes even the prices at which the bankrupt firm’s assets are being sold for.⁴¹ In Poland, where the court takes a limited number of crucial decisions in insolvency cases, leaving other tasks to the court appointed trustee, the processing of individual bankruptcies still takes much time and courts are considered to be slow. In short this inefficiency may be explained by the still-underdeveloped administrative capacity of courts burdened by the fast growing number of economic cases and still poor knowledge of economic issues by judges. Of course, it should be pointed out here that, in most of the countries under consideration, the level of court involvement has been only one of the factors behind the slowness and inefficiency of the insolvency system.

The insolvency practitioners, who are not in short supply like the judges, can take charge of the process once appointed and be legally responsible for the implementation of the proceedings. If so, they may be held accountable for their actions, as they are in mature market economies. It is therefore important that the insolvency procedure include legal sanctions and appropriate rewards and penalties for the court-appointed officials. This issue will be discussed in the following subsection.

⁴¹ See Hoshi, Mladek and Sinclair (1998) for a detailed discussion of the law in the Czech Republic.

7.2 Remuneration of insolvency practitioners and their accountability

The insolvency practitioners (administrators and liquidators)⁴² appointed by courts have significant discretion over the assets of a debtor enterprise, especially when it comes to the disposal of these assets. The insolvency practitioners should be expected to be: competent, able to act impartially, be insured or bonded against loss through fraud or other malpractice. They should be able to assess risk, and conduct an insolvency case in a cost-effective way.

The presence of uncertainty and asymmetric information, and the difficulty of monitoring the insolvency practitioners, creates a classic 'principal-agent' problem and adverse implications for the completion of the bankruptcy process. The method of remuneration of these practitioners is one way of bringing their interest into line with those of creditors and owners. A proper incentive structure will tie the remuneration of insolvency practitioners to the level of proceeds earned upon the disposal of assets, or the nature of recovery of the company upon successful reorganisation.

The experience of transition economies provides us with many negative lessons. In the Czech Republic, until June 1996, the administrators' fees, as set by Law, were based on a fixed schedule subject to a maximum, which was generally regarded as very low, and was not paid until the end of the procedure. The administrators' incentive to maximise the recovered value of assets was therefore weak. On the one hand, not many good and honest lawyers were prepared to become administrators and, on the other hand, the low pay created conditions for misconduct and misuse of the position of trust.⁴³

However, the remuneration of administrators and liquidators may affect the outcomes of procedures. If they are rewarded for keeping firms in operation and maintaining them as going concerns, they may prefer this option even against the interest of creditors. This was the case in Hungary, where the strong position of liquidators enabled them to perform reorganisation of debtors even if they had filed for liquidation. Hence, considerable share of liquidation filings ended with workouts and the sale of going concerns (Szanyi, 2000).

While the remuneration of insolvency practitioners is crucial in creating the right incentive for them to maximise the value of recovered assets or creditor satisfaction, they must also be held accountable for their actions and be subject to maintaining appropriate professional standards of quality. Therefore first of all it is essential, that insolvency practitioners have proper qualifications; their knowledge and practical understanding should be tested by impartial examination. It needs to be underlined that insolvency proceeding is a very complex and indeed interdisciplinary process and, therefore, general qualifications will not provide the required breadth and depth of technical knowledge and practical understanding. Furthermore, experience, particularly in countries where insolvency and insolvency legislation is relative new, are in fact limited.

⁴² In individual countries they are variously referred to as trustee, liquidator, administrator, supervisor, receiver or receiver and manager, curator, official or judicial manager.

⁴³ The report on the new legislation in the Czech Republic speaks of administrators acting as estate agents completing lucrative deals in their own interest. The method of remuneration of administrators improved significantly after the June 1996 amendments. See *Prague Business Journal*, May 13-19, 2002.

In order to ensure that insolvency practitioners have appropriate training and are subject to some form of professional monitoring, it is necessary to officially register the insolvency practitioners with a professional organisation.⁴⁴ The professional association may also help members with the provision of a collective insurance policy. Given that members are legally responsible for their actions and can be sued for taking wrong decisions on asset disposal or for having inflicted losses on third parties, and that the fear of such legal responsibility may distort their decisions, the insurance provided by their professional association would reduce the burden of potential losses significantly. Table 9 (below) summarises the present position of insolvency practitioners in the countries under consideration.

Table 9. The Position of Insolvency Practitioners in Selected Transition Countries and Germany

Country	Qualifications required	Remuneration	Liability
Bulgaria	Only physical persons – 3 years relevant experience – public list	Flexible, determined by Creditors Assembly	Exclusion from the list, fines and liable for damage
Croatia	Licence system, special exams, public list	Progressive fee scale acc. to asset value, Covering fund for pauperism	Exclusion from the list, liable for damage
Czech Republic	Court chooses from public list of experts with “suitable competence”	Determined by Court; official progressive fee scale acc. to asset value	Exclusion from the list, liable for damage, administrative penalty
Germany	Court chooses suitable expert with technical competence (fully qualified lawyers as a rule)	Determined by Court, official progressive fee scale acc. to asset value	Liable for damage
Hungary	Public auctions to enter the list, professional profile regulated	Covering fund for pauperism, Liquidation: 5% of revenues, reorganisation: 1,5% of book value	Exclusion from the list, liable for damage
Poland	Since 1998, university graduates with knowledge of accounting and management, and with 5 years of experience in management positions; public list run by regional courts	Since 1998 max 5% of asset value, the court decides the exact pay, pre-payment possible	Exclusion from the list; liable for damage; penal liable
Romania	Certified accountants or degree in economics, law, engineering and 5 years of practice; public list run by regional courts	Flexible, determined by majority of Creditors Assembly	Exclusion from the list, liable for damage
Slovakia	Professional profile regulated: only physical persons with relevant experience; public list	Determined by Court, official progressive fee scale according to asset value	Exclusion from the list, liable for damage

Source: See footnote 4.

⁴⁴ In the Czech Republic, the commission preparing a new Bankruptcy Law intends to introduce a compulsory membership of the association of insolvency practitioners on court administrators in order to prevent unscrupulous administrators from continuing to practice in another district even when they are found guilty of misconduct in one district. Naturally, the administrators, are strongly opposed to this compulsory membership. See *Prague Business Journal*, May 13-19, 2002.

8. Summary and conclusions

In the early stage of transition to a market system, the former socialist countries inherited a large number of inefficient state owned enterprises, with many of them suffering from insolvency. Different governments responded to the problem differently, and brought about different results. In some countries (like Romania for example) subsequent governments protected the big enterprises from bankruptcy (by taking them out of the insolvency law) and spent huge amounts of public money to keep them afloat. However, for a variety of reasons, governmental restructuring programmes turned out to be a total failure, but the government continued to inject money and write off the debts of these enterprises. The main reason for these actions was the short-sighted political interests of parties in power. In other countries, however, the opposite approach was chosen. The original 1992 bankruptcy law in Hungary introduced an automatic trigger mechanism, which resulted in massive bankruptcy filings at the early stage of transition. The Hungarian approach turned out to be more effective than the Romanian: massive restructuring was forced on insolvent enterprises, while Romania still faces the problem of “white elephants” inherited from communist times.

The lesson of these experiences is that the insolvency law can speed up the all important selection process in transition economies and should be applied universally. Exemptions are harmful to enterprises and sectors involved, as they only delay the necessary restructuring. From the macroeconomic point of view they are not only expensive, but also slow down the reallocation of resources and growth of the economy.

There are two types of deficiency that can be identified in the insolvency systems of transition economies developed over the past 10-13 years: the shortcomings of the insolvency laws themselves, and deficiencies in the execution of insolvency laws. The second group can be mostly explained by the underdevelopment of institutions that are necessary for the law to operate.

As far as the first group of deficiencies is concerned, in addition to the limited coverage of insolvency laws, there are problems relating to how the law regulates the triggering of the insolvency procedure, and the rules governing the obligation of a manager to file for bankruptcy once the insolvency criterion is met. If the responsibility of managers is not backed by strong incentives (as in the Czech Republic at the early stage of transition), then the number of filings would be very low and the insolvent companies would prolong their activities at the growing risk of creditors. The second important issue concerns the range of options available once the insolvency procedure is initiated, and specifically the room for reorganisation of the debtor company. The reorganisation option has been of even greater importance in transition economies than it has been in mature market economies as, for many companies in post socialist countries, the causes of financial distress often lay outside the firm itself, be it state owned or private. However the approach differed in individual countries. While the Hungarian law was very reorganisation oriented, in Poland the Bankruptcy Law inherited from pre-war times and applied for the whole transition period leaves very little room for the reorganisation of the debtor company. Therefore in

order to prevent premature closures in the early transition period, the special financial restructuring programme was introduced in 1993 to speed up the restructuring of state-owned commercial banks and their heavily indebted state enterprise clients. In the past couple of years, work has been going on to introduce a new bankruptcy law which will be definitely more pro-reorganisation.

While insolvency laws have been subject to numerous amendments in transition countries in order to deal with their obvious deficiencies, the shortcomings of the legal institutions necessary for the efficient operation of insolvency laws have been much more difficult and time consuming to resolve. At the start of transition, CEE countries were characterised by a shortage of court personnel, specialised chambers and competent administrators organised in professional associations. Also in the course of transition the administrative capacity was not developed at a sufficiently fast pace to cope with the rapid growth of court cases resulting from the operation of the market system and the increased role of the judiciary in the new economy. A continuing problem is the poor system of legal education, which produces judges with insufficient knowledge of economic and financial matters. These limitations lead us to the conclusion that, in transition economies in general; the involvement of courts in insolvency proceedings has to be kept to the minimum. Otherwise insolvency cases will not be dealt with in reasonable time limits. The role of the court should be to start the process and to appoint an insolvency practitioner. Also the court should be involved at the important points of the proceedings such as the approval of any reorganisation plan and its extension and at the end when the case is being completed. The insolvency practitioners, who are not in short supply like the judges, can take charge of the process once appointed and be legally responsible for the implementation of the proceedings. If so, they may be held accountable for their actions as they are in mature market economies. It is therefore important that the insolvency procedure includes legal sanctions and appropriate rewards and penalties for the court-appointed officials.

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