

Law in transition *online*

October 2014



Insolvency systems to the rescue

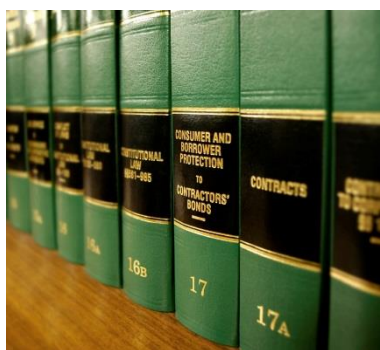
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Legal reform is a unique dimension of the EBRD's work. Legal reform activities focus on the development of the legal rules, institutions and culture on which a vibrant market-oriented economy depends. Published twice a year by the Legal Transition Programme, *Law in transition online* covers legal developments in the region, and by sharing lessons learned, aims to stimulate debate on legal reform in transition economies.

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Foreword

Law in transition – an especially appropriate title for this year's issue, dedicated to restructuring and insolvency. Efficient restructuring and insolvency regimes have proven their importance during the recent global financial downturn and European market turmoil. As the articles in this issue testify, effective legal systems, carefully considered legislative action, seasoned restructuring and turnaround expertise are critical to helping firms and countries successfully navigate financial crises. But as businesses across Europe and around the world adopt an ever-increasing cross-border focus, there is a growing need for consistency across jurisdictions and for commercial laws that address matters implicating multiple jurisdictions. Some countries have yet to adopt legislation that provides for the efficient restructuring of distressed businesses, and far too few have adopted legislation that establishes a framework for addressing cross-border and multinational issues.

As this issue describes, many countries in Europe have begun to re-examine their restructuring and insolvency laws in light of recent financial crises and closer ties to the global economy. These reform efforts mirror others around the world. There are many opportunities to improve restructuring law and practice, and recent experience as well as an international focus should guide any reform initiative. In this context, much useful work is being done at the national level by international organisations such as the European Bank for Reconstruction and Development (EBRD), the World Bank Group and the International Monetary Fund, to promote considered reforms and improvements to insolvency legislation and practice.

One important initiative is the effort being led by INSOL International Fellows for a wider adoption of the UNCITRAL Model Law on Cross-Border Insolvency (Model Law). The global business environment demands a coordinated approach to multinational insolvency and restructuring matters. In the absence of true regulatory convergence, it is crucial to establish a legal framework (like the Model Law) that coordinates proceedings across jurisdictions, recognises foreign laws and judicial decisions, and provides for the resolution of transnational differences. INSOL Fellows – a group of over 70 professionals from 20 countries, all graduates of INSOL's Global Insolvency Practice Course – are well positioned to help advance the Model Law's adoption. While it has not yet been adopted by the European Union or a majority of its Member States, many countries, including the United States, have already incorporated the Model Law into their legal regimes. With so many countries in Europe and elsewhere focusing on potential insolvency and restructuring reforms, now is the perfect time for a wider adoption of the Model Law.

As you read the articles that follow, you will see how important insolvency and restructuring laws are in times of turmoil and transition. As global forces and international issues become increasingly important to businesses (and all of us), consider the impact that more efficient coordination across jurisdictions could have on future restructurings.

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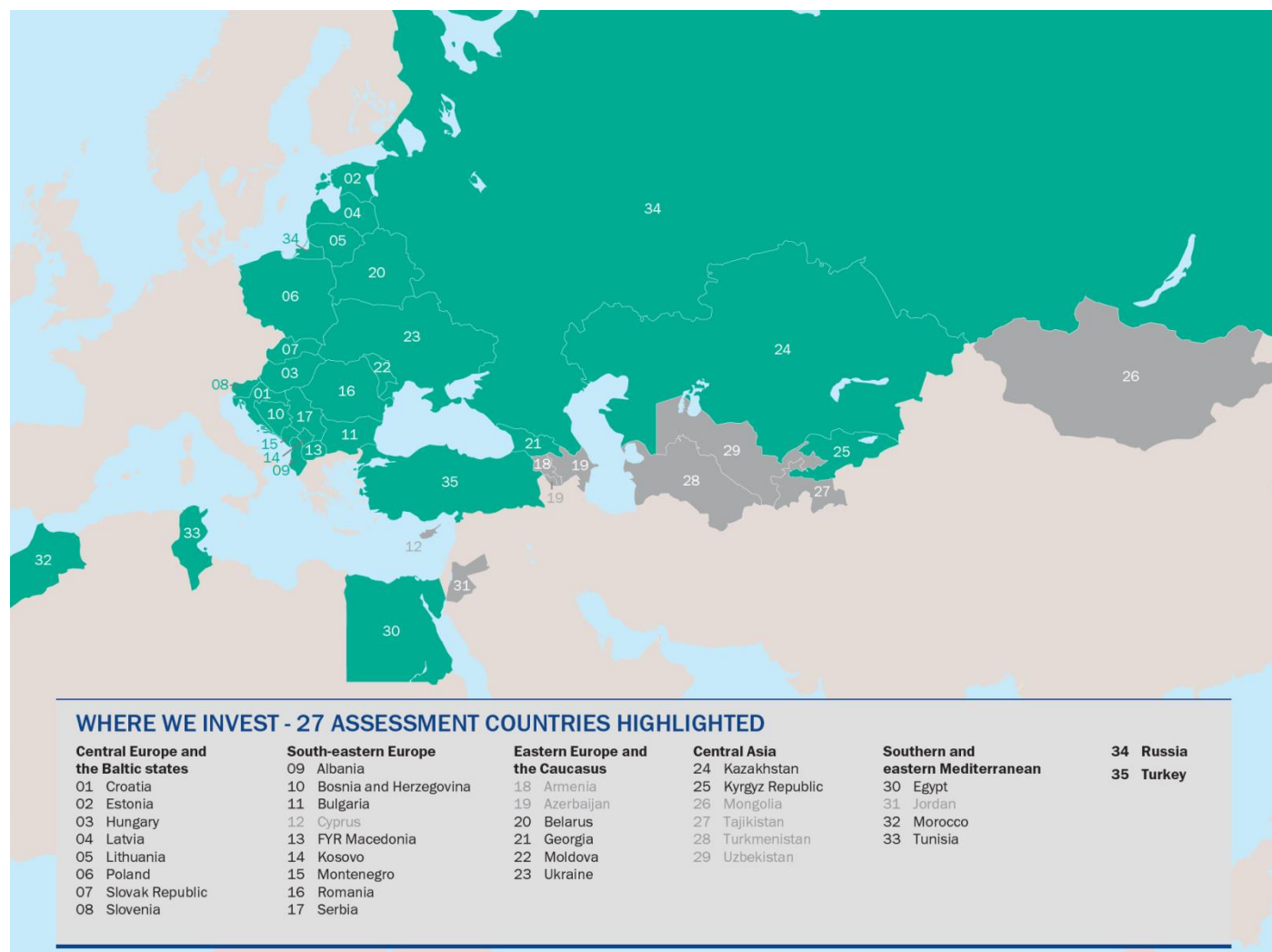
Insolvency office holders: a new study by the EBRD provides insight into creditors' rights in insolvency¹

Catherine Bridge

The EBRD has recently completed a detailed assessment of the insolvency office holder profession that evaluates the profession's state of development and performance in the Bank's region. The results of the assessment reveal important information not only about insolvency office holders, but also about the insolvency systems in which they operate and the dynamics of the relationship between office holders, creditors and the court. This article discusses a number of critical issues for creditors arising from the EBRD's assessment of the insolvency office holder profession.

Background to the Assessment

Known variously as administrators, managers, liquidators or trustees, insolvency office holders (IOHs) are central figures in collective insolvency proceedings. These proceedings often require the total or partial divestment of the debtor's management and the appointment of an IOH to administer or liquidate the assets of the debtor.² The centrality of the IOH to the insolvency process was well articulated by one Moldovan respondent, who commented, "An insolvency process cannot be imagined without the involvement of an insolvency administrator – the link between the court, creditors and the debtor." Notwithstanding the importance of IOHs, little comparative research had been done on the profession until recently.³ In 2012 the EBRD embarked on a study (Assessment) of the IOH profession in 27 countries⁴ to discover more about the profession and to identify any shortcomings that need to be addressed within the existing statutory framework for IOHs.



The Assessment was first piloted in 2012 in seven countries (Bosnia and Herzegovina, Latvia, Poland, Romania, Russia, Serbia and Tunisia), before being rolled out to a further 20 countries in 2013 and 2014. The Assessment involved the collection of information by means of questionnaires from selected stakeholder groups, which included IOHs, regulatory bodies (including government ministries), legal professionals and creditors (predominantly banks). One of the largest respondent groups across all jurisdictions was creditors.

The EBRD Assessment set the following seven “benchmarks” for the IOH profession (the Benchmarks), by which information on the profession was collected and assessed:

- Licensing and registration:** IOHs should hold some form of official authorisation to act.
- Regulation, supervision and discipline:** Given the nature of their work and responsibilities, IOHs should be subject to a regulatory framework with supervisory, monitoring and disciplinary features.
- Qualification and training:** IOH candidates should meet relevant qualification and practical training standards. Qualified IOHs should keep their professional skills updated with regular continuing training.
- Appointment system:** There should be a clear system for the appointment of IOHs, which reflects debtor and creditor preferences and encourages the appointment of an appropriate IOH candidate.
- Work standards and ethics:** The work of IOHs should be guided by a set of specific work standards and ethics for the profession.
- Legal powers and duties:** IOHs should have sufficient legal powers to carry out their duties, including powers aimed at recovery of assets belonging to the debtor’s estate.

IOHs should be subject to a duty to keep all stakeholders regularly informed of the progress of the insolvency case.

- (g) *Remuneration*: A statutory framework for IOH remuneration should exist to regulate the payment of IOH fees and protect stakeholders. The framework should provide ample incentives for IOHs to perform well and protection for IOH fees in liquidation.

Given the broad nature of the Assessment, this article aims to address key issues from a creditor's perspective across the jurisdictions surveyed in respect of two benchmarks: the appointment system and remuneration of IOHs. The article explores what these two benchmarks reveal about creditor rights and their influence over the insolvency process itself. Lastly, it considers the legal powers and duties of IOHs, with specific reference to the role of creditors and the court in overseeing the activities of IOHs.⁵

Insolvency office holders in transition countries

The Assessment reveals that office holders are predominantly natural persons, in other words, individuals (in 26 out of 27 countries). In a few countries, IOHs can also be a partnership or association of natural persons – for example, in Romania IOHs can be limited liability professional associations. In nine of the Assessment countries legal persons are entitled to act as IOHs. Hungary is the only country surveyed where IOHs can only be legal persons (either a private limited company or a private company limited by shares).

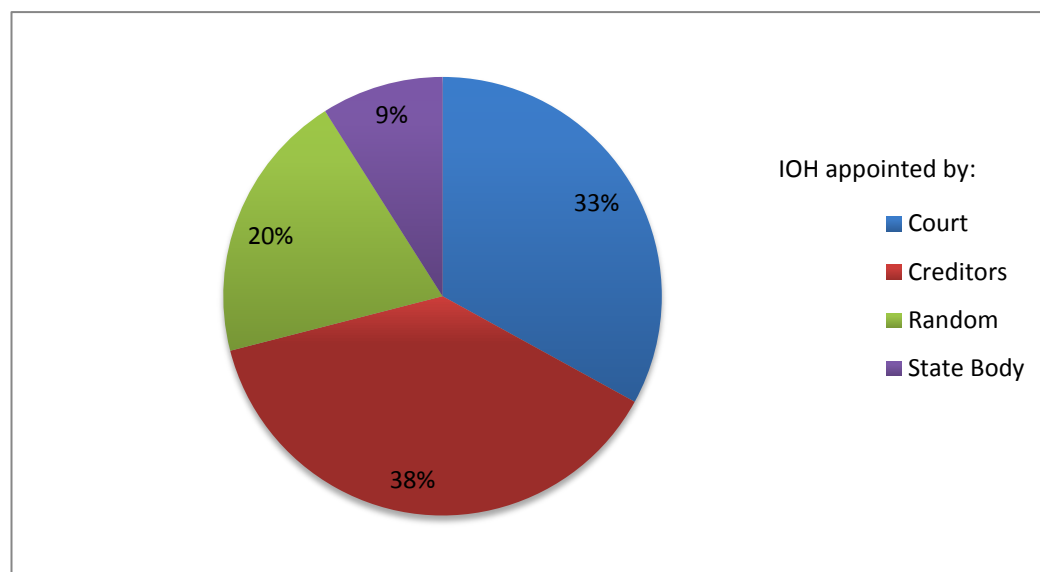
In most Assessment countries, there appear to be strong links between IOHs and other professionals, notably lawyers, although in some countries there are also links with accountants. IOHs often undertake other professional activities outside of insolvency proceedings. Serbia, however, imposes professional “exclusivity” requirements – since 2012 IOHs have been prohibited by law from carrying out other forms of employment. None of the representatives of major accounting firms appear to take appointments as IOHs in any of the surveyed countries, in contrast to the United Kingdom. This may be due to a number of factors, including low remuneration levels and/or high professional liability risks. In many countries, including Serbia and Slovenia, the most common type of IOH is the sole practitioner, rather than the IOH acting as part of a firm or partnership. The profile of the IOH gives an important indication of the nature of the profession and potentially also the market and demand for insolvency services.

Appointment of insolvency office holders

The IOH appointed to an insolvency case may have a decisive impact on the way in which the case is managed and on any recoveries by creditors. Notwithstanding the financial risks for creditors if the debtor's estate or business is poorly administered (and the fact that most creditors of an insolvent debtor will never recover in full), creditors are frequently denied any real or effective involvement in the appointment of an IOH. This may prevent creditors from undertaking any effective “contingency planning” for an insolvency filing. It may also diminish the bargaining power of creditors in relation to any threats by the debtor's management to file for insolvency.

As evidenced in Chart 1 below, creditors can nominate or directly select the IOH in over one-third of the countries surveyed. Such right may, nonetheless, be limited to the nomination or selection of the permanent IOH to be appointed following the appointment by the court of an initial or temporary IOH at the outset of the proceedings. In other Assessment countries, creditors have no or limited influence over the IOH's appointment and such appointment remains at the court's discretion or is determined by either an appointment system based on random selection or by the involvement of a state agency.

Chart 1: Insolvency office holder appointment system in transition countries



Note: This pie chart indicates the number of countries surveyed in which the key determining factor in the selection and nomination of insolvency office holders is either the court, creditors, a random/electronic appointment system or a state body. Where there is more than one determining factor in a particular country, that country's participation is reflected in each relevant category.

Source: 2012-14 EBRD Insolvency Office Holder Assessment.

Only a small number of Assessment countries' insolvency systems allow creditors (or the debtor for that matter) to recommend or select an IOH candidate when the insolvency petition is first presented. These include Bulgaria, FYR Macedonia, Moldova,⁶ Romania⁷ and Russia. In Romania, where both creditors and the debtor are entitled to propose an initial IOH, new insolvency legislation has clarified that a creditor's request shall prevail over a competing request by the debtor.⁸ In Latvia the court will only appoint the debtor's chosen IOH in legal protection (reorganisation) proceedings if such candidate has the majority support of creditors. However, in insolvency (liquidation) proceedings the IOH is selected by the Latvian Insolvency Administration⁹ and creditors are not given any opportunity to influence the appointment. In Belarus creditors and other stakeholders, including the debtor, can make representations to the court at the outset of the proceedings, but the court is not bound to follow these.

Those insolvency systems that permit creditors to participate in the selection of the permanent IOH typically only allow such participation at a post-filing stage, either at the first creditors' meeting or assembly following the opening of insolvency proceedings. This is the case in Croatia (in respect of bankruptcy proceedings only) and Estonia. In these countries the court, acting at its own discretion, will appoint an initial or temporary IOH and creditors will subsequently be requested to elect a permanent IOH. It is unclear how many court-appointed IOHs are, in practice, replaced by creditors. The risk is that the insolvency proceedings may be quite advanced by the time creditors have the opportunity to replace the IOH and important decisions relating to the course of the proceedings may already have been taken.

Under pre-2012 German insolvency legislation, the court appointed a temporary administrator and creditors were able to appoint a new administrator by majority vote at the first creditors' meeting. The administrator was rarely replaced by creditors in practice because of the resulting delay and additional cost. However, in 2012, German insolvency legislation was amended to enable a preliminary creditors' committee to be established by law for debtors of a certain size. This committee may select the insolvency administrator at the beginning of the insolvency proceedings and the court may only choose not to appoint such candidate if the person proposed is not suited to taking office.¹⁰ The relative merits of creditor involvement in the selection of the interim IOH were not covered by the Assessment, but the German reform is perceived by many within the business community as being fairer to creditors, as well as more efficient and predictable in terms of outcome.

This raises the question of whether Assessment countries might wish to adopt a similar reform to their IOH appointment system to enable creditors to participate from the outset in the selection of the interim IOH.

In a number of countries (Belarus, Bosnia and Herzegovina, Egypt, Morocco and Tunisia) the court is the sole body empowered to select and appoint the IOH. In these jurisdictions creditors have limited rights to request a replacement IOH. Grounds for replacement are typically limited to IOH misconduct or breach of duty. In Belarus creditors must first establish careless or improper performance of the IOH's duties or commission of an offence, among other matters, in order for the court to consider replacing the IOH. In Morocco and Tunisia, creditors may complain to the court and request the IOH's dismissal, but any decision to replace the IOH is entirely at the court's discretion. Unlike creditors, however, the court has no financial stake in the insolvency proceedings and their outcome.

In four countries (Croatia, Kazakhstan, Kyrgyz Republic and Latvia) a state body plays a leading role in determining the appointment of the IOH. In Croatia the selection of the pre-bankruptcy trustee in pre-bankruptcy settlement proceedings is assumed by FINA, a government financial agency. In Kazakhstan the Tax Committee appoints IOHs from a list; in the Kyrgyz Republic such appointment is made by the Department of Bankruptcy Affairs, although creditors may propose an IOH candidate to the department. In Latvia the Insolvency Administration makes recommendations to the court for the appointment of the IOH in insolvency proceedings.

Other insolvency law frameworks (FYR Macedonia, Hungary, Serbia, Slovak Republic, Slovenia and Ukraine) have introduced an automatic randomised IOH appointment system. Although this system may be superficially fair, it is something of a lottery and may lead to "random" results. In addition to not matching the IOH to the insolvency case, the randomised IOH appointment system can remove the incentive for IOHs to perform to a high level since future appointments are not dependent on performance. In systems where IOHs are appointed on the basis of reputation and merit, it is likely that they will work hard to maintain their reputation and perform to the best of their abilities. Exemptions introduced by Slovenia to the automatic system for medium and large-sized enterprises suggest that it may not be appropriate for companies of higher economic importance.

Interestingly, lack of creditor participation in the appointment of the IOH (either as a result of the court's leading role in appointing IOHs or the automatic randomised appointment system) does not necessarily result in a perception of weak creditor oversight of IOH activities by Assessment respondents. As demonstrated in Chart 2 below, respondents from Belarus, which has a court-controlled system of IOH appointment, unanimously report strong creditor oversight of IOH activities. However, in Egypt and Morocco, where the court plays a determining role in the appointment of the IOH, there appears to be a correlation between the court-based appointment system and a perception of weaker creditor control and oversight of the activities of IOHs. Respondents in Hungary, Slovak Republic, Slovenia and Ukraine, where an automatic randomised IOH appointment system operates, perceived creditors to exercise strong oversight.

Greater involvement of creditors in appointing IOHs should not mean that the IOH behaves in a manner that is partial to creditors. As recognised by the EBRD Core Principles for an Insolvency Law Regime, "The liquidation or restructuring of an insolvent corporation impacts the debtor, the creditors, the employees, the state and the community." An IOH should act as an impartial third party.¹¹ However, opening up the system of appointment to those stakeholders (creditors) which stand to lose most financially from the insolvency may encourage greater competition and better performance from those within the profession.

Remuneration of IOHs

In liquidation IOH remuneration is generally paid from the funds available in the debtor's estate, in priority to unsecured creditors and also sometimes preferential and secured creditors. It is therefore particularly important for creditors that they receive "value for money" for an IOH's services since they may be paying for these services from proceeds which would otherwise be available for distribution to creditors. At the same time a

competitive level of remuneration or professional compensation is essential for the development of the IOH profession. It provides an incentive to satisfy often burdensome, as well as costly, admission requirements for the profession, including specialised study and training. Remuneration is also a potential tool by which the higher performers within a profession may be rewarded for their efforts, or the specialist sector skill or experience held by certain professionals is reflected.

The statutory framework for IOH remuneration frequently differs according to the type of insolvency procedure and whether this is aimed at liquidation or reorganisation. Very few of the Assessment countries allow IOH remuneration to be freely determined between the IOH and creditors in liquidation. This appears only to be the case in Bulgaria, Georgia and Lithuania, where, exceptionally, there is no detailed legal framework for remuneration. In Bulgaria creditors are able to set the level of remuneration of the permanent IOH in both liquidation and reorganisation, nonetheless creditors are required to pay a monthly fee to the IOH for the work performed and may pay an additional final remuneration amount (as a percentage of the property of the bankruptcy estate or any property which has been liquidated). In Georgia and Lithuania, private IOH fees are determined by private contract between creditors and the IOH.

The remuneration system of some countries contains a flexible element, which enables the IOH to receive an optional performance-related “additional fee”. Additional remuneration is not, however, necessarily decided by creditors. In Russia the creditors’ meeting may decide to increase the fixed fee to be paid to the IOH, but its decision is subject to approval by the court. In Montenegro the performance-related fee is awarded by the court. In other jurisdictions, such as FYR Macedonia and Serbia, IOH remuneration may be increased in certain circumstances, such as when the case is particularly complex or there is a higher satisfaction of creditors’ claims. In Albania and Hungary higher remuneration is linked with continuation of the debtor’s business, which in the case of Hungary requires the conclusion of a settlement agreement between the debtor and its creditors.

In most Assessment countries, remuneration is set by the court and creditors have limited rights to participate in setting IOH fees. This is often the result of a strict tariff system, which guides the court in establishing the level of IOH remuneration, typically as a fixed fee and/or an amount determined by a sliding scale or range of values. In many countries creditors also have limited rights to review or challenge IOH remuneration. In Slovenia, for example, creditors wishing to challenge the court’s resolution on IOH remuneration must file an appeal in accordance with the general rules of insolvency proceedings. This may be a lengthy process.

The ability for creditors to influence the level of IOH remuneration is desirable. Nevertheless, given the nature of the IOH’s work and the fact that the IOH is generally paid from the debtor’s estate, it is important for there to be a statutory framework for IOH remuneration. A tariff system may be transparent and “appear to be fair”, but it can also be rather inflexible. It may either not sufficiently reward the IOH for high performance, or risk over-rewarding in cases where the IOH has not worked to maximise recoveries for creditors from the debtor’s estate. Fortunately the tariff system for IOH remuneration in some countries is moderated by a flexible element, which enables the IOH to receive an optional performance-based fee. Payment of the performance-based fee is often decided by the court, rather than creditors. Determination of performance-based fees is one key aspect of IOH remuneration where creditors could arguably play a greater role.

Court control and oversight of insolvency proceedings

The limited role of creditors in the appointment of the IOH and the determination of IOH remuneration in a number of countries surveyed brings into question the role played by creditors in overseeing the work of the IOH in insolvency proceedings. It also raises questions about the interaction between creditors and the court. In most of the countries surveyed, insolvency proceedings take place “in court”. Insolvency office holders therefore operate for the most part within a system, where prior notification to the court and sometimes court approval is needed at various stages of the insolvency proceedings. As discussed below, creditor oversight of IOH activities is typically shared with the court responsible for conducting the insolvency case.

In a minority of countries, including Croatia, Kyrgyz Republic, Slovenia and Turkey, certain insolvency proceedings have an out-of-court element. In Croatia the preliminary administrative stage of the pre-bankruptcy settlement procedure¹² is conducted before a non-court body, FINA, while in the Kyrgyz Republic, the debtor may elect for special administration and rehabilitation procedures under the Bankruptcy Law¹³ to take place extra-judicially, subject to the agreement of creditors. In both Croatia and the Kyrgyz Republic, an IOH is nonetheless appointed to the insolvency case. Exceptionally in these countries there may therefore be a lack of court control and oversight of IOH activities (in certain proceedings). It is interesting to note that in some countries with pre- or early insolvency procedures, the person or entity appointed to assist the debtor may not necessarily need to be a licensed or registered IOH. In Romania, similar to France, IOHs may, but are not required to be appointed in either *mandat ad hoc* or composition procedures.¹⁴ In contrast, under Croatian pre-bankruptcy settlement proceedings, the pre-bankruptcy trustee must be chosen from a list of certified IOHs.

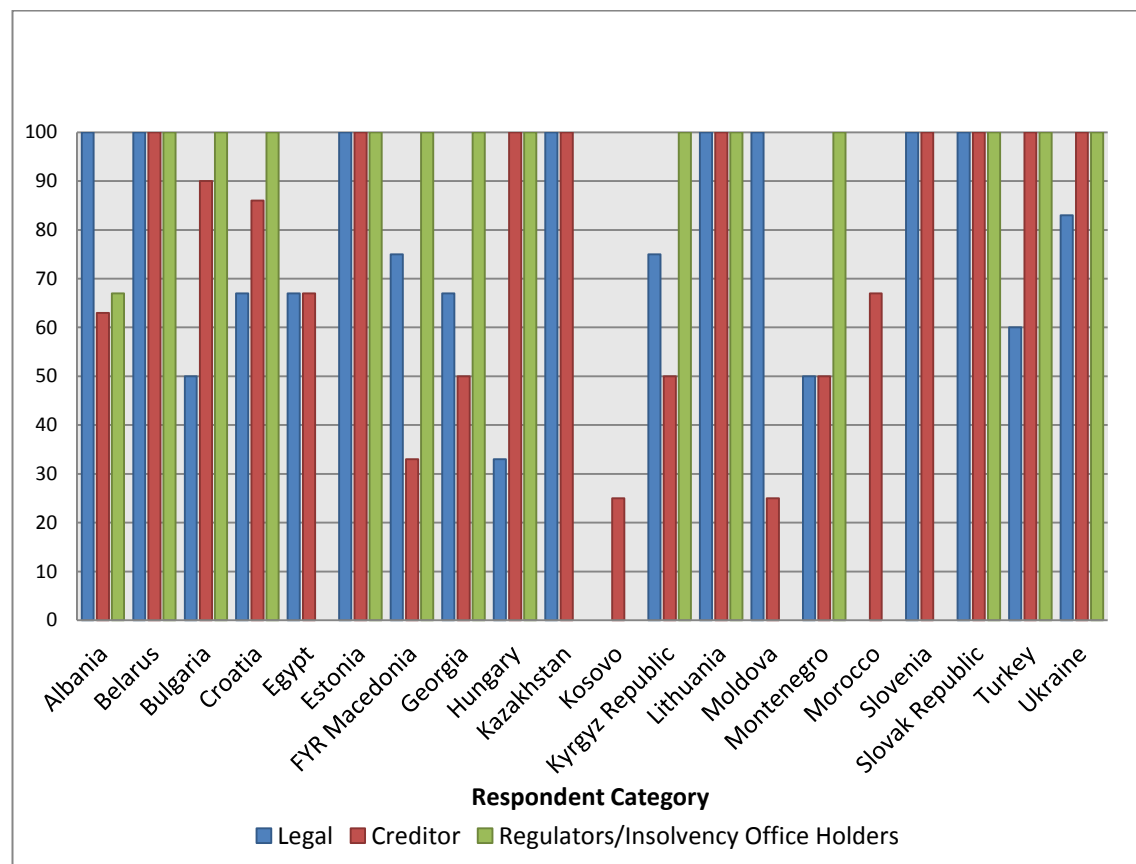
Overall, the extent of court involvement in judicial insolvency proceedings is likely to vary on a case-by-case basis. It may depend on the individual judge(s) and also on the competence of the IOH. Respondents consider the court to play a strong role in monitoring IOH activities in Bulgaria, Egypt, Lithuania, Slovenia and Turkey, but a relatively weak role in Georgia, Kazakhstan, Lithuania and Moldova. In Slovenia a large number of decisions relating to the debtor’s estate require prior court approval, which may explain the perceived strength of the court. A few Slovenian creditors suggested, however, that the court’s oversight was limited to matters of form, rather than substance. Importantly, in those countries¹⁵ with reportedly weak court control, creditors appear to fill the gap left by the court and are considered by local respondents to play a strong role in overseeing the work of IOHs.

Creditor control and oversight of insolvency office holders

Responses to the Assessment questionnaires suggest that creditors play a strong role in overseeing the activities of IOHs in most jurisdictions. A total of 77 per cent of respondents across all respondent categories and jurisdictions confirmed that IOHs are subject to strong creditor oversight in the exercise of their powers and duties (in some cases with reservations).¹⁶ Nevertheless, there are some differences of opinion among the different respondents, particularly in FYR Macedonia, where the regulator respondent believed that a strong degree of creditor oversight existed and only a minority (33 per cent) of creditors were of the same opinion (see Chart 2).

In Kosovo the majority of creditor respondents and all legal professional respondents did not consider creditors to play an important role in overseeing the exercise of powers and duties by IOHs. This may, in part, be due to a lack of practice. There have been few insolvency cases in Kosovo to date. In Morocco the relatively high perception of weak creditor control and oversight of IOH activities may be explained by the marginal role of creditors in the insolvency process. Although the court in Morocco may appoint a number of creditors to act as controllers or observers of the insolvency case, creditors do not participate in the appointment of the IOH or vote either as a general assembly or as a committee of creditors at any of the key points during the insolvency process. Creditor oversight is also weak in Egypt and Tunisia where, similar to Morocco, creditors may only be appointed as “controllers” (in Egypt this appears to happen rarely in practice).

Chart 2: Overall perception of strong creditor oversight of insolvency office holder powers and activities in transition countries



Note: This chart presents the percentage of respondents agreeing (Yes or Yes with reservations) to the question: "Are IOHs subject to strong creditor (including creditors' committee) oversight in the exercise of their powers and duties?" Answers were collected from respondent groups (legal, creditors, regulators/insolvency office holders) in the roll-out of the Assessment to the 20 countries cited above. Positive responses are presented on an aggregate basis per respondent category and are expressed as a percentage with 100 per cent indicating a unanimously positive response. Where there is no response from a respondent category, this is due either to the fact that all legal professionals responded in the negative (Kosovo, Morocco) or the regulators/insolvency office holders responded in the negative (Egypt, Kazakhstan, Kosovo, Moldova, Morocco and Slovenia).

Source: 2012-14 EBRD Insolvency Office Holder Assessment.

In many Assessment countries, creditors exercise strong powers in relation to the sale of the debtor's unencumbered property by the IOH in liquidation, although the nature of these powers varies from jurisdiction to jurisdiction. Creditor control may take the form of either prior creditor approval for the sale of all (or certain) assets or joint creditor and court approval. In some jurisdictions, such as Hungary, no direct approval is needed from the creditors for sales by the IOH.

In Albania the IOH's powers to sell any assets of the debtor are, as a rule, subject to prior creditors' committee approval, while in Belarus, the IOH is required to submit the liquidation plan to the wider assembly of creditors for approval. In Poland the consent of creditors is not directly solicited, other than in respect of private sales. Creditor oversight is also more limited in Serbia, where prior creditor approval is only required for sales by direct agreement and sales of the debtor as a legal entity. In some countries there are general restrictions on the method of sale. In the Slovak Republic, if the IOH wishes to sell debtor property, which is not a sale of all or a substantial part of the business, such a sale is required to take place by public auction.

Creditor control of any sale of the debtor's assets is, in some cases, shared with the court. In Bulgaria the meeting of creditors determines the procedure and the method of liquidating the debtor's property, including any property evaluation, but any sale of the

bankruptcy estate requires the prior permission of the court. In other countries such as Egypt, Morocco, Tunisia and Turkey only court (and not creditor) approval is needed for the sale of assets by the IOH. In each of these countries, there is no creditors' committee, although as noted above the court may appoint creditors to act as "controllers". Although the Turkish system does not give creditors the power to approve the sale of assets by the IOH, creditors participate in the nomination and shortlisting of candidates to be appointed as insolvency office holders in bankruptcy, and vote on any reorganisation or restructuring plan (unlike Egypt, Morocco and Tunisia). Turkey is therefore an example of a country where creditors appear to play a more substantive role in some, although not all, key aspects of the insolvency case.

Unlike sales of assets in liquidation, IOHs tend to be subject to fewer creditor (and court) controls in the exercise of management powers. There may, nonetheless, be statutory restrictions on an IOH's ability to exercise "higher value" decision-making. In Serbia actions of "special importance", including taking a loan and acquiring items of high value, require prior notification to the court and the consent of the creditors' committee. This is in contrast to the United Kingdom, which gives insolvency office holders (administrators) wide-ranging statutory powers to enter into a number of transactions, including the "Power to raise or borrow money and grant security therefor over the property of the company."¹⁷ IOH management powers may, in some cases, be shared with the court. In Montenegro, for example, IOHs cannot decide to enter into transactions such as taking a loan and procuring high-value equipment, without obtaining the judge's prior consent.

In reorganisation-type proceedings, where the debtor remains "in possession", the IOH's management powers are often limited to the supervision of existing management. Over half of the Assessment countries have a form of debtor-in-possession reorganisation procedure in which the IOH does not take over the management of the debtor's business, but monitors the actions of existing directors or managers. In such cases, creditors correspondingly have fewer powers of formal oversight of IOH activities.

Insolvency office holder reporting obligations

It is interesting to note the reporting duties of IOHs towards creditors. In the majority of countries, IOHs are required to report regularly to both creditors and the court. Reports facilitate the oversight by creditors and other stakeholders of the management of the insolvency case and provide them with the information to intervene and, if necessary, raise any issues or complaints in connection with the IOH's administration of the case. Nevertheless in certain countries, including Egypt, Kosovo, Moldova, Tunisia and Turkey, the court appears to be the sole addressee of the IOH's reports and information is not easily accessible by stakeholders. Creditors may, however, be entitled to consult the reports submitted by the IOH to the court. This is the case in Kosovo and Moldova.

Frequency of reporting is also important in allowing stakeholders to follow, influence and, if necessary, challenge actions by the IOH. Across the countries surveyed, reporting is often on a quarterly basis. Certain countries, including Belarus, Bulgaria (liquidation only), FYR Macedonia, Kazakhstan (rehabilitation only), Kosovo, Kyrgyz Republic, Romania (judicial administration) and Ukraine (liquidation only) set monthly reporting requirements. This may, in practice, create a relatively high administrative burden on the IOH. However, it is not possible to assess from the results of the Assessment the overall usefulness of monthly and other periodic IOH reports for stakeholders.¹⁸

Weak reporting obligations towards creditors risks marginalising creditors in the insolvency process and may prevent them from playing an effective role in overseeing the activities of IOHs. While the reporting obligations by IOHs appear, at first glance, to be satisfactory in many of the countries surveyed, some countries' reporting systems in insolvency proceedings would benefit from improvement to increase transparency for creditors and other stakeholders. It is interesting that in all of the countries with creditor-led IOH appointment systems, creditors have the right to receive regular reports from the IOH regarding the status of the insolvency case. Overall in such countries, creditors appear to have greater rights in insolvency.

Conclusion

In many Assessment countries creditors have limited rights in certain important areas of insolvency proceedings. Areas highlighted by this article include the right to determine the appointment of an IOH and to participate in decision-making regarding IOH remuneration. These areas are of fundamental importance to the issue of IOH performance and how to ensure insolvency stakeholders receive the best value for money from IOHs. A competitive appointment system is likely to encourage IOHs to carry out their activities to the best of their abilities. At the same time, a more flexible remuneration framework with input from creditors may provide an incentive for better performance by IOHs.

In those countries where creditors have a determining role in the appointment of the IOH, it has been seen that creditors typically have greater rights to influence certain IOH activities, including the sale of debtor's assets, and to receive regular reports in insolvency. The active involvement of creditors in the insolvency process should be encouraged. Creditors are important stakeholders in insolvency and may, together with the court and insolvency office holders, play an essential role in administration of the insolvency estate. In many jurisdictions surveyed creditors appear to be active in monitoring IOH activities and approving sales of assets from the debtor's estate.

It is clear from the Assessment that further capacity-building for the IOH profession, greater supervision of IOH performance and adherence to ethical norms for the IOH profession are needed. Nevertheless, responses to the Assessment questionnaire indicate that, at least on an aggregated basis, creditors believe that IOHs as a whole perform their professional tasks and duties well with some reservations.¹⁹

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² See the definition of “liquidator” in Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings, Article 2(b).

³ One recent research project conducted by Leiden University and commissioned by INSOL Europe has examined European principles and best practices for insolvency office holders in 11 European countries, with a view to developing a common set of principles and best practices for the profession in Europe.

⁴ Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Egypt, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, Latvia, Lithuania, Moldova, Montenegro, Morocco, Poland, Romania, Russia, Serbia, Slovak Republic, Slovenia, Tunisia, Turkey and Ukraine.

⁵ It should be noted that respondents in all countries were asked an identical set of questions tailored for their respondent category and the information gathered over the course of the Assessment was deliberately selective given the Assessment's cross-jurisdictional application. Certain limitations to the Assessment are noted in this article, where applicable.

⁶ In Moldova the debtor may also propose the IOH if it petitions for insolvency however, creditors are entitled to propose the replacement of the debtor's candidate.

⁷ Creditors may now request that the judge appoints their proposed IOH by joining the debtor's insolvency petition.

⁸ Romanian Law no. 85/2014 regarding preventative insolvency proceedings and insolvency proceedings, effective from 28 June 2014.

⁹ This body, which certifies and regulates IOHs, is under the control of the Latvian Ministry of Justice.

¹⁰ See Section 56a of the German Insolvency Statute of 5 October 1994 (Federal Law Gazette I, page 2866), as last amended by Article 19 of the Act of 20 December 2011 (Federal Law Gazette I, page 2854).

¹¹ See Principle 9: www.ebrd.com/downloads/legal/insolvency/principle.pdf (last accessed 3 September 2014).

¹² Act on Financial Operations and Pre-Bankruptcy Settlement Proceedings. Official Gazette Nos. 108/2012, 144/2012, 81/2013, 112/2013.

¹³ Law of the Kyrgyz Republic on Bankruptcy no. 74 dated 15 October 1997 (as amended).

¹⁴ In France, a *mandataire ad hoc* or a conciliator does not need to be a registered insolvency office holder.

¹⁵ Georgia, Kazakhstan, Lithuania and Moldova.

¹⁶ Respondents from Albania, Belarus, Bulgaria, Croatia, Egypt, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, Lithuania, Moldova, Montenegro, Morocco, Slovak Republic, Slovenia, Turkey and Ukraine were each asked in their respective questionnaires: "Are IOHs subject to strong creditor (including creditors' committee) oversight in the exercise of their powers and duties?"

¹⁷ See Schedule 1 of the Insolvency Act 1986, paragraph 3.

¹⁸ The usefulness of IOH reporting was not directly covered in the Assessment questionnaires.

¹⁹ Respondents from Albania, Belarus, Bulgaria, Croatia, Egypt, Estonia, FYR Macedonia, Georgia, Hungary, Kazakhstan, Kosovo, Kyrgyz Republic, Lithuania, Moldova, Montenegro, Morocco, Slovak Republic, Slovenia, Turkey and Ukraine. This question was not covered in the pilot Assessment.



Promoting greater cooperation among insolvency regulators

Rosemary Winter-Scott OBE

The International Association of Insolvency Regulators (IAIR) provides a range of support to regulators of insolvency practice in its member countries. These include Romania, Russia and Serbia where the EBRD invests. The changing nature of debt coupled with a sharp rise in consumer debt, a tighter financial climate and less money available from the public purse to fund insolvency proceedings has led many countries to revisit their legislation and insolvency products. Developing such new systems is a daunting task but considerably helped by the IAIR community.

The IAIR is an international body that brings together the collective experiences and expertise of government insolvency regulators from jurisdictions around the world. IAIR members have a unique perspective given the role that they play in insolvency systems. Why re-invent the wheel if another country has already found a solution that works? IAIR seeks to facilitate that sharing of experience and provides exactly what its name suggests – an association or collective group of regulators. In doing so, IAIR works closely with international organisations such as the European Bank for Reconstruction and Development (EBRD), INSOL International¹ and the World Bank in the dissemination of best practice.

The objectives of IAIR are to:

- promote liaison, cooperation and discussion among government insolvency regulators
- be recognised as an international body with the knowledge and credibility to promote fair, effective and efficient systems for the administration of insolvencies.

IAIR membership

IAIR is open to representatives from government departments, ministries, agencies and public authorities, which have responsibility in their country for one or more of the following functions:

- insolvency policy and legislation
- insolvency practice and administration
- insolvency regulation.

Hence IAIR members are normally government officials or representatives of the court. IAIR currently has around 30 active member countries and is keen to increase its representation across the full range of countries involved in delivering corporate and/or personal (consumer) bankruptcy systems.

Main activities

IAIR's main activity is an annual conference (and AGM), which is its principle forum through which liaison, cooperation and discussion are promoted.

IAIR held its first annual conference and meeting in November 1995 on the back of the INSOL conference in Hong Kong. Since then, IAIR's annual conference has been hosted by one of its member countries in a wide range of cities around the world; most recently in Edinburgh, Scotland in 2013 and in Washington D.C., United States in 2014.

Each conference has a theme and provides topical inputs (keynote speeches, panel debates and workshops) on subjects of relevance to its members. Rotating the hosting of the conference around the world allows different member countries to invite speakers on important issues affecting their insolvency regime. It also provides participants with an opportunity to learn more about the insolvency system in that country through "field trip" visits to the parliament or bankruptcy court and so on.

Attendance at the conference is only open to official delegates from IAIR member countries (or countries eligible for membership). As such, the conference attracts a relatively small group (around 50) which makes for a friendly atmosphere where it is easy to network and get to know colleagues in other jurisdictions.

Recent IAIR initiatives

IAIR seeks to use its network to undertake project work and produce reports on topics of interest affecting its members.

Recent initiatives have included a project on the Financial Education and Counselling in Personal Insolvency (led by Canada in 2012) and a study into the range of no asset procedures (NAPs)² being adopted by member countries (led by Jersey in 2013), which examines the impact of these procedures on an individual's circumstances and ability to manage his or her finances in the future. Other IAIR member studies have included the regulation of Phoenix companies led by Ireland in 2004, the mutual recognition of sanctions report in relation to both personal and corporate bankruptcies led by Ireland in 2008 and the development of insolvency professional standards led by Serbia and Canada in 2010.

In 2014 Scotland is leading an IAIR project to compare the fee-charging regimes that operate in each of the member countries. Member countries will be able to use the summary report to inform best practice for future policy development.

All these reports and a wealth of additional information are provided for IAIR members on the website www.insolvencyreg.org. This gives members easy access to contact details, national bankruptcy registers and a range of summary and technical information on fellow member countries – facilitating the exchange of insolvency information across borders.

In summary, for the past 20 years IAIR has been providing its worldwide members with a range of support and information. Effectively run by its members, with the support of a secretariat function, it strives to facilitate the more effective and efficient development of insolvency regimes around the world. Insolvency practice and policy remain in a considerable state of flux in many countries. IAIR welcomes the recent assessment by the EBRD into the insolvency office holder profession (in many jurisdictions known as trustees, administrators, receivers, liquidators) across 27 of the countries where the EBRD works. The assessment reveals much about the state of insolvency regulation in these countries and highlights the importance of insolvency regulators and regulation in maintaining high standards of professional conduct among insolvency office holders.

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¹ INSOL International is a worldwide federation of national associations for accountants and lawyers who specialise in turnaround and insolvency. See www.insol.org (last accessed 1 August 2014).

² NAP is an insolvency process under which an individual debtor who is insolvent and who has no, or very limited, assets is able to access a formal debt relief mechanism, which provides for the cancellation of outstanding debts after a specified period.



Turnaround management in south-eastern Europe

Hugh Larratt-Smith

In the summer of 1931 a Swiss newspaper reported that a prominent German bank was on the verge of collapse. On 6 July 1931 Germany's third largest bank, the Danatbank, denied it was having any financial difficulties but two days later conceded that it could no longer meet its liabilities. Danatbank closed its doors on 13 July 1931, only two months after the May 1931 bailout of Creditanstalt, the largest bank in Austria.

By 14 July 1931 the great banking house of Lazard Frères was in serious difficulties. A rogue trader made a wild bet on the collapse of the French franc and lost almost twice the bank's capital. The Bank of England agreed to bail out Lazard, as well as two other leading British investment banks – Schroders and Kleinworts.

That same year, Andrew Mellon, United States Secretary of the Treasury, advocated weeding out weak banks as a harsh but necessary means to the recovery of the US banking system. This “weeding out” was accomplished through refusing to lend cash to banks and by refusing to put more cash in circulation.

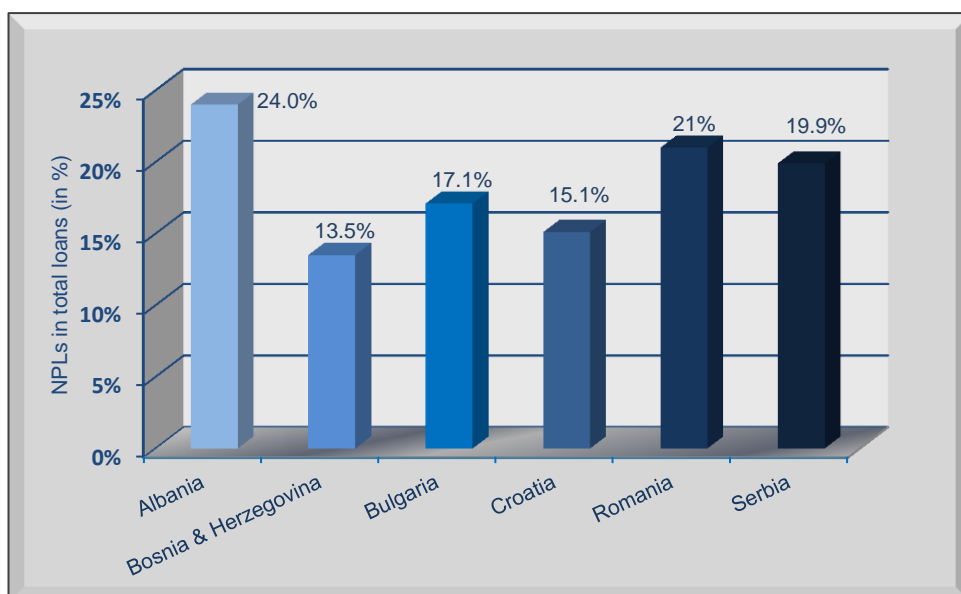
Fast forward to 2008 when fears about the collapse of Europe's banks dominated newspaper headlines. Heavy exposure to emerging eastern and southern European countries by banks nearly led to an unravelling of the European Union, as EU members fought over who should bail out the banks.

Today, in the aftermath of the financial firestorm that swept through Europe, banks are faced with weak loan demand, high levels of non-performing loans (NPLs), and the threat of deflation. Given this uncertain outlook, many foreign banks are rationing capital into south-eastern Europe (SEE), and instead allocating more capital to other higher-growth areas of Europe.

The banking problems besetting SEE countries will not be easily solved by sales of NPL portfolios. Unlike Ireland and Italy, many NPL portfolios in the SEE region are too fragmented to attract large-scale buyers like KKR, Apollo, Lone Star and Oaktree. And there are vast differences in NPL standards within SEE countries for loan documentation and sector concentration. According to Andi Ballta, Office Head for Western Balkans and Greece at NCH Capital, a US\$ 3 billion fund, “The NPL issue is a big concern. In most Western Balkans countries the banks are not acting – they are simply waiting and praying for better days, and paralysing their banking system. At this pace, it will take them another five to seven years to improve the NPL situation.”

Chart 1 illustrates NPLs as a percentage of total loans, according to the CESEE Bank Lending Survey, conducted by the European Investment Bank (EIB) in December 2013.

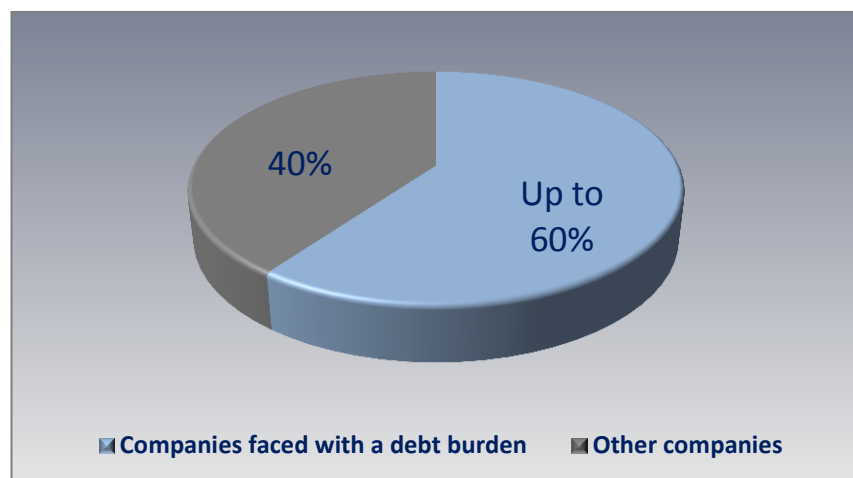
Chart 1: Non-performing loans as a percentage of total loans (as of Q2 2013) in south-eastern Europe



Source: CESEE Bank Lending Survey, EIB, December 2013.

According to the EBRD's May 2014 Working Paper¹, in Slovenia, "between 10,000 and 13,000 out of 23,000 companies (that is, between 44 and 60 per cent of all companies) are faced with a debt burden that will require some sort of debt restructuring" (see Chart 2).

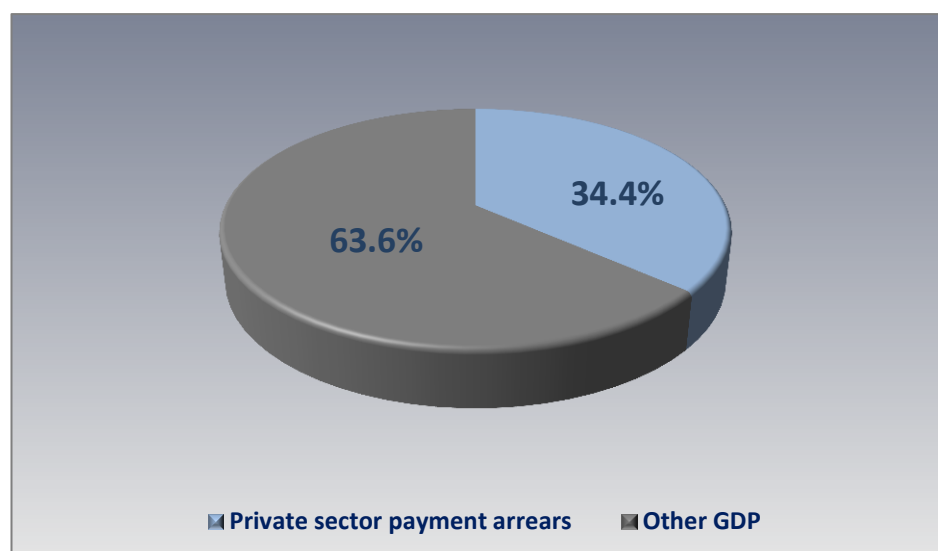
Chart 2: Companies in Slovenia faced with a debt burden requiring restructuring



Source: EBRD Working Paper No. 168, May 2014.

In addition, a recent World Bank report² found that, "private sector payment arrears (including non-performing loans, blocked bank accounts of private and legal entities, tax and related arrears to the government), amounted to 34.4 per cent of the GDP" in Montenegro, in the fourth quarter of 2012 (see Chart 3).

Chart 3: Private sector payment arrears as a percentage of Montenegro's GDP



Source: World Bank, Finance and Private Sector Development, June 2014

Many companies in south-eastern Europe are facing severe banking or liquidity constraints, which have hampered investments in new products, factories, supply chains and people. Companies have experienced blocked bank accounts, and some are barely surviving in the twilight zone of insolvency.

The chief structural impediments to the quick resolution of the NPL problem are:

- chronic inability to reduce the grip of existing owners on their companies
- unwillingness of creditors to provide new loans to owners/management who were at the helm when the business ran into financial difficulties
- mistrust of the quality of the debtor's financial statements
- holdout creditors that try to extort money
- lack of cooperation and trust among creditors
- work-out processes that are still prone to political interference.

Some owners are unwilling to give up control because they are convinced that the political environment which allowed them to amass their wealth will never exist again. On the other hand, bankers view owners as inexperienced with economic downturns, and are not confident that they possess the skills and experience required to deal with adversity. In their opinion, many oligarchs do not build their empire on hard work, focus and perseverance but through political privilege, and therefore lack the true grit to survive downturns. For example, many privatisations are the result of management buy-outs by managers who had no real external experience and had not taken significant financial risks.

One banker in Zagreb recently observed that consensual work-out is possible when two to three banks are involved, but impossible when there are more than three banks. Many companies have granted security and cross-guarantees that militate against a smooth work-out. Some owners deliberately set up complex banking arrangements on the basis that the complexity could create obstacles for banks to move against the company – such complexity then prevents banks from providing new cash to mitigate a liquidity crisis.

The issue of holdout creditors is severe in many parts of SEE. The behaviour is partially due to a lack of restructuring and a “first past the post” mentality, which favours enforcement or liquidation over work-out procedures.

Many countries have labour laws which prohibit rapid downsizing, and companies are burdened with heavy worker costs in the form of taxes and red tape. Political pressure has been an impediment to labour reform in many countries. Yet, globalisation continues its steady march and takes its toll on inflexible companies as production shifts rapidly to low-

cost areas. One boat manufacturer in Slovenia commented that his costs were 25 per cent higher than competitors in Florida, and his market share was slipping rapidly.

The laws in transition

Since the crisis, enormous attention has been placed on the adoption of new, less formal, consensual resolution procedures and the use of pre-packaged plans to help accelerate NPL resolution, while trying to place more control into the hands of the real stakeholders. Insolvency procedures have been significantly improved in some SEE countries, but continue to take time and are prone to heightened regulatory risks and unpredictable outcomes.

Croatia, Montenegro, Serbia and Slovenia have pressed forward with legal reform. Montenegro has recently recognised the imperative of NPL resolution and smoother restructurings. This year, in cooperation with the World Bank, the Central Bank of Montenegro embarked on “The Podgorica Approach”, which is focused on facilitating out-of-court restructurings. Montenegro’s new draft law on voluntary financial restructuring (similar to Serbia’s Consensual Financial Restructuring Law) establishes a framework, which encourages and supports the restructuring of economically viable companies.

Since 2011 pre-packaged plans have been commonplace under Serbia’s bankruptcy law, with a “cramdown” by majority creditors on dissenting minority creditors permitted within each class. However, the process does not allow for wider cramdown across classes, as it does in the United States, and is not subject to close court scrutiny for fairness (in an economic sense). The bankruptcy judge’s input is largely limited to ensuring proper procedures are followed. According to Luka Andric, Attorney at Law at Andric & Partners in Belgrade, “With the surge in pre-packaged restructurings over the past five years, no real efforts were invested by banks or incumbent owners into setting up feasible and sustainable restructuring solutions. Instead, most of these simply represented ‘kicking the can down the road’, which in turn over the period resulted in too many restructurings eventually failing. At this point, banks overwhelmingly do not genuinely believe in successful restructuring in 90 per cent of the cases.”

In Croatia the new pre-bankruptcy legislation of 2012 was designed to encourage companies in the early stages of insolvency to file for protection against creditor actions in order to develop and negotiate a plan of reorganisation with creditors. During this time creditors can reject the plan and present a competing plan of reorganisation. However, if the debtors and creditors do not reach a settlement, then the company is forced into bankruptcy proceedings.

Oleg Uskokovic, Attorney at Law at Uskokovic & Partners in Zagreb, said that the new legislation helped to highlight the real financial position of many Croatian companies, “since all the creditors’ claims (even potential or conditional claims) are identified and included in financial restructuring plans. This is regardless of the fact that many of those plans are not realistic and often include future revenues from the assets that are to be foreclosed by the mortgagees, who are not even participating in the financial restructuring plan.” On the other hand, the new legislation gives current owners too much leverage as it enables them “to blackmail their creditors with non-realistic restructuring plans.” Uskokovic adds, “Once pre-bankruptcy settlement proceedings have been initiated by the current owner, such proceedings can end only by settlement with the creditors or bankruptcy. Knowing that the average percentage of collected receivables by the creditors through bankruptcy in Croatia is around 10 per cent, creditors are rather voting for a non-realistic restructuring plan that enables them to keep their receivables at 30 to 40 per cent of their face value for some time, rather than writing them off to 10 per cent or zero immediately.”

In Slovenia, the compulsory settlement procedure is such that:

- any debtor that enters compulsory settlement is more or less forced to offer a debt/equity swap to creditors (the rule is a debt/equity must be offered if assets are valued at higher than liquidation value on the books of the debtor, which is usually always the case)

- creditors have greater powers in forcing a debt/equity swap (and wipe-out of existing equity occurs under the same rule as described above)
- creditors have increased powers to replace management (in large or medium-sized companies)
- creditors can initiate compulsory settlement (for large and medium-sized companies).

According to Grega Peljhan, Senior Partner at Rojs, Peljhan, Prelesnik & Partners in Ljubljana, “With the new compulsory settlement procedure creditors have finally gained more power, and are now even able to initiate the procedure. In principle, legacy equity should be subordinated to the claims of creditors who should have the right to decide by themselves to execute debt to equity swaps and thus eliminate the interests of former owners. In some cases, there are still holes in the legislation which can be exploited by the current owners, and which are prolonging or preventing actions of the creditors for several months.”

Uros Ilic, Managing Partner at ODI Law Firm in Ljubljana adds that, “The concept of absolute priority is now included in the new legislation (not only in the bankruptcy chapter but also in the chapter on compulsory settlement), so there is more balance between the shareholders and creditors than before.”

“Banking legislation in Albania is more advanced than in some other countries,” notes Andi Ballta from NCH. “And there is a different concentration in Albanian NPLs compared with the rest of SEE that comes from differences in (i) the legal framework relating to consumer loans; (ii) the attitude of courts in dealing with bailiff/pre-bailiff procedures; and (iii) policy decisions at the holding level of the foreign banks. In certain Western Balkans countries, it is not possible to sell consumer debt to non-banks; in other countries, the courts are notoriously and openly favouring the borrower. Very few foreign banks in the Western Balkans have made a decision to ‘clean’ the balance sheet (and even less have acted), while most banks have decided to either do nothing or create sub-bad banks which have very little impact on reducing the overall level of NPLs.”

The role of operational turnaround firms and private equity is the solution

In the years following the financial crisis, many companies restructured but they generally focused on re-profiling debts and reducing interest rates. Operational restructuring was not common. As a result, there were very few restructuring cases in the SEE region where new money was injected.

SEE has competitive advantages: low labour costs, a multilingual educated workforce and geographic proximity to 170 million consumers. Countries such as Albania, Romania and Serbia, with low labour costs and local currencies, can become the workshop of southern Europe by manufacturing products for high-cost countries like Austria, Germany and Italy, whereas Croatia and Slovenia have the potential to become knowledge economies.

But these transformations require financial capital, expertise in operational restructuring and the adoption of best practices. After the break-up of the former Yugoslavia, many sectors such as telecommunications, energy, transport, textiles and agribusiness became very fragmented, and in most cases, lost access to best practices as well as top tier technologies. Globalisation and EU competition are now creating the imperative of sector consolidation and vertical integration.

In the past two decades in eastern Europe, private equity (PE) funds have provided much of the capital to finance these transitions. PE firms now want to capitalise on the cycle lag between eastern Europe (which started its transition period during the early 1990s) and SEE, which is transitioning now. PE firms are awash with liquidity and are searching for yield, and as SEE countries de-leverage and transition, PE firms will play a vital role.

In many countries operational turnaround firms work closely with rescue capital PE funds on restructurings. For example, KKR and Alvarez & Marsal are cooperating on a number of Italian NPL transactions. But many PE funds need to get comfortable with SEE, and operational turnaround firms can help with this process. To invest in a turnaround, rescue

capital PE firms want a clear turnaround plan to positive cash flow, and they usually want a chief restructuring officer (CRO) to execute the turnaround plan.

Many businesses can be saved if the corporate turnaround plan is developed and implemented as soon as warning signs appear. Financial restructuring needs to follow operational restructuring. The right side of the balance sheet cannot be properly restructured before the left side of the balance sheet is addressed. As a company shows signs of early decline, an Independent Business Review is the most common first step, to describe and map the problems. The next critical stage is to develop granular, achievable action plans in order to implement the turnaround. A turnaround needs a path to profitability that clearly eliminates unprofitable products, lines of business, facilities, customers or products. The CRO needs to identify all unprofitable activities that can be eliminated from the company over a reasonable period of time.

SEE countries have a limited number of operational turnaround professionals who can restructure companies' operations by implementing robust operational recovery plans. One obstacle to finding CRO consultants in the region is the scarcity of experienced local managers with a restructuring background. This is due to the historic economic and market circumstances of the region (centrally planned economies).

What lies ahead?

Governments in SEE countries need to intensify the implementation of robust, creditor-friendly, legal frameworks that facilitate consensual plans of reorganisation leading to restructuring and/or sale of businesses. If a consensus cannot be reached, mechanisms to facilitate competing reorganisation plans need to be implemented. Labour laws in many countries need to reform in order to expedite corporate rightsizing.

According to Danijela Vukajlovic-Grba, a World Bank consultant in Montenegro, "In light of an increased availability of PE capital on the global markets and its increased propensity to invest in SEE, central banks of SEE countries should be using this momentum to sharpen their policies aimed at downsizing NPLs in banks through loan restructuring, with a view to supporting viable companies. With their measured policies central banks have saved many banks from losses and consequent capital increase in times when capital was scarce. However, financial stability becomes less of an issue compared with the struggling economic growth. Nowadays, when capital is becoming more available, banks would need to be better motivated by the central banks to initiate loan restructuring. Loan restructuring would help promote the survival of viable debtors and consequent credit and economic growth, support of which, in prudent terms, represents one of the main tasks of the central banks, along with preservation of financial stability."

The continuing process of privatisation needs to be vigilantly managed to ensure that valuation expectations reflect market conditions. While millions have been poured into state-owned companies over the past two decades in the hope of creating national or regional champions, the market may not see eye to eye with governments on valuations of these companies.

Governments can facilitate the entry of private equity into the restructuring market in ways other than reform of insolvency and labour legislation. For example, the Croatian Bank for Reconstruction and Development has played a vital role in encouraging the development of private equity in Croatia by offering to match funds for the capital raised from limited partners. International financial institutions such as the EBRD, the International Finance Corporation and the EIB can continue to provide support to rescue capital funds such as EMSA Capital and ADM CEECAT Recovery Fund, which are focused on turnaround financing. Operational restructuring expertise will develop during the course of this economic downturn.

The three new Turnaround Management Association (TMA) chapters in Croatia, Serbia and Slovenia, and the existing Romanian chapter will help foster operational turnaround skills and expertise, and will increase investor awareness of opportunities in the region. The TMA provides an important "clearing house" function for distressed investing and lending. The 2014 Annual Conference of TMA Europe showcased alternative capital providers across the credit spectrum, and TMA's NextGen education programmes will provide practical

restructuring education for young emerging professionals, which may be quite valuable in the long term.

Although considered a financial genius by his peers, Andrew Mellon will go down in history as the financial policy-maker who exacerbated the Great Depression in the 1930s. His famous phrase “squeeze them (the banks) until the pips squeak” epitomised his monetary doctrine.

Having studied the mistakes of the 1930s, central bankers have flooded today’s global money markets with liquidity. As this liquidity filters into SEE, coupled with robust restructuring efforts, the region that saw unprecedented growth in the early 2000s can begin to regain its footing. The SEE region may be one economic transition cycle behind Czech Republic, Hungary, Poland and Slovak Republic, but with rigorous turnaround practices, further legal reform and fresh capital, the uplift in shareholder value of SEE companies can replicate the success of those countries.

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¹ J.P. Damijan (2014), “Corporate financial soundness and its impact on firm performance: Implications for corporate debt restructuring in Slovenia.” [EBRD Working Paper No. 168](#) (last accessed 1 August 2014).

² “Public and Private Sector Payment Arrears in Montenegro: Size, Composition and Policy Options for Addressing Them”, World Bank, Finance and Private Sector Development, June 2014.



Restructuring law: recommendations from the European Commission

Kristin van Zwieten

In March 2014, the European Commission published its “Recommendation on a new approach to business failure and insolvency” (the Recommendation).¹ The Recommendation is addressed to European Union (EU) Member States, 11 of which are countries where the EBRD invests.² The primary subject of the Recommendation is the legal treatment of distressed but viable businesses. Its main objective is to ensure that all Member States have in place a procedure that enables such businesses to “restructure at an early stage with a view to preventing their insolvency”.³ With the exception of one section (which is concerned with personal bankruptcy law),⁴ the Recommendation is devoted to setting out what the Commission describes as “minimum standards” for these restructuring procedures in Member States. This article focuses on the restructuring components of the Recommendation.

The Commission defines restructuring as a process by which the “composition, conditions, or structure” of a debtor’s assets and liabilities are changed, “with the objective of enabling the continuation, in whole or in part” of its business activities.⁵ As noted below,⁶ the Commission has expressed concern at reports that distressed but viable businesses are being channelled into liquidation proceedings in some Member States. The result may be the break-up of business assets to be sold on a piecemeal basis, even though the business is worth more to creditors (and to other classes of stakeholders, such as employees) when preserved on a going concern basis. A restructuring is one way to preserve the value of such a business. A restructuring of liabilities (for example, through the write-down of debt or, in the case of a company, the conversion of debt to equity) could be used to restore the debtor to solvency so that it can continue to trade. Achieving this will require negotiation with affected creditors to procure their consent to compromise or otherwise alter their rights against the debtor. A restructuring procedure provided by law can, however, offer tools to facilitate reaching agreement – for example, by providing that in certain circumstances the decision of a prescribed majority of creditors to accept a restructuring plan can also bind dissenting creditors to the plan. Such tools can be provided within an insolvency code (for example, as part of a corporate rescue or reorganisation procedure),⁷ or outside it – as in the case of the English scheme of arrangement.⁸

The Commission’s Recommendation is primarily focused on this type of restructuring tool – that provided *by law* to facilitate the negotiation of a binding restructuring agreement. It should be emphasised at the outset that it is perfectly possible to achieve such an agreement without recourse to a restructuring or insolvency procedure provided by law. Creditors can negotiate informally with a debtor to achieve a restructuring by consensus. Creditors with sufficiently similar interests and incentives (such as banks) may also develop their own restructuring processes, for use where a debtor with exposure to multiple creditors of that class becomes distressed.⁹ More formally, creditors or classes of

creditors (such as bondholders) may commit themselves, before distress, to a restructuring process in a contract. These solutions may be more desirable than recourse to a formal procedure provided by law, not least because they may be less costly to achieve – recourse to formal restructuring or insolvency procedures can involve significant direct and indirect costs.¹⁰ Achieving such a solution may, however, be easier in the presence of a legal procedure that parties can “bargain in the shadow of”,¹¹ knowing that if they fail to cooperate, formal (public and costly) proceedings may have to be commenced. In addition, there will be some circumstances in which informal, industry or contractual solutions to distress are inappropriate (for example, because creditor interests and incentives are too diverse to permit effective coordination), and then the presence of a restructuring procedure provided by law may be of direct utility to stakeholders.

There is one other point that should also be emphasised at the outset, which is that a restructuring is not the only means of achieving the Commission’s objective of preserving the value of a distressed but viable business. Another route to preserving the value of such a business, that need not necessarily involve restructuring, is the sale of the business on a going concern basis.¹² Such a sale may be achieved outside or within a formal insolvency or receivership procedure.¹³ There is also a hybrid approach, in which a sale is negotiated in anticipation of an insolvency procedure and takes effect immediately on its commencement, with the proceeds of sale distributed to creditors in accordance with the priority rules provided by insolvency law. Such an approach (a “pre-packaged” sale) can avoid some of the loss to business goodwill that is associated with the commencement of formal insolvency proceedings.¹⁴ Whichever approach is used, a sale on a going concern basis may be the most effective way of maximising the value of a distressed debtor’s business. By comparison, a restructuring may be more costly to achieve, since it requires bargaining with creditors to procure their consent¹⁵ to alter or compromise the debtor’s liabilities.¹⁶ There may however be some cases where value can only be maximised by keeping the business with the debtor (for example, because its assets are not transferable or not readily transferable),¹⁷ and then a restructuring of the kind envisaged by the Commission may be necessary.

The background to the release of the Recommendation

Interest by European policy-makers in the subject of business rescue and restructuring is not new – the rise of a “rescue culture” in Europe over the last two decades has been well documented. It is clear, however, that the global financial crisis (and an associated rise in business insolvencies) has sharpened the focus of policy-makers on the subject. In late 2011, the European Parliament adopted a resolution on insolvency proceedings.¹⁸ The resolution exhorted the value of insolvency laws as a “tool for the rescue of companies at Union level”.¹⁹ It identified a trend towards greater convergence in the domestic insolvency laws of Member States, and urged further harmonisation of domestic law in several areas – including some aspects of the design of restructuring procedures.²⁰ Differences in domestic laws across states were identified as a potential barrier to restructuring in cross-border insolvency cases, and a desire was expressed to ensure a “level playing field” across the EU.²¹

The European Commission was tasked with considering Parliament’s recommendations, and submitting proposals for law reform. The reform agenda was ambitious, not least because the Parliament’s recommendations were directed not only to the harmonisation of aspects of domestic insolvency and bankruptcy laws, but also to the topic of cross-border insolvency in the EU (including the revision of the European Insolvency Regulation).²² Since 2011, the Commission has done a considerable amount of work on business insolvency at both the domestic and cross-border level. This has included commissioning multiple studies (including an in-depth study of restructuring mechanisms currently available to distressed businesses in Member States),²³ the release of Commission communications²⁴ and public consultations. Some of the themes that emerge from this body of work include: (i) a stated desire to enable the survival of viable businesses and a conviction that law has a role to play in facilitating this;²⁵ (ii) concern that differences in the laws of Member States mean that some businesses have a better chance than others of restructuring at an early stage;²⁶ and, relatedly (iii) concern that some restructuring procedures are so costly or otherwise unworkable that they cannot be used to resolve financial distress, with the result that some viable but distressed debtors

are unnecessarily wound up.²⁷ The overall conclusion of the Commission is that “many European restructuring frameworks are still inflexible, costly and value destructive”.²⁸ The Recommendation is the Commission’s response.

The core features of the Recommendation

Although the recent work of the Commission in the field of business rescue has been extraordinarily wide-ranging, the Recommendation has a much narrower scope. It focuses primarily on restructuring, and particularly on the design of procedures provided by law for the early restructuring of distressed business debtors. The Recommendation aims to “ensure that viable enterprises in financial difficulties, wherever they are located in the Union, have access to national insolvency frameworks which enable them to restructure at an early stage with a view to preventing their insolvency, and therefore maximise the total value to creditors, employees, owners and the economy as a whole”.²⁹ The Recommendation seeks to achieve this by encouraging the availability of a “preventative restructuring framework” in all Member States, and by setting out “minimum standards” for what this framework ought to offer distressed enterprises. By promoting adherence to these standards across the EU, the Commission hopes to improve existing means for resolving distress in viable enterprises, and through this to improve access to finance for businesses *ex ante* (that is, in the period before any distress) as creditors adjust to the availability of improved tools for resolving financial distress that avoid the need for recourse to value-destructive insolvency procedures.³⁰

There are six core principles emphasised in the Commission’s recommendations for a “preventative restructuring framework” in each Member State. These principles are complementary and as such should be analysed together, rather than in isolation. The six principles are:

- 1) *Early recourse*: the Commission recommends that a debtor be able to have recourse to the restructuring framework at an early stage, before factual insolvency.³¹ In Member States where restructuring tools are presently contained within insolvency procedures that can only be commenced after a debtor is insolvent,³² adherence to this principle would require a change in the law to make such tools available earlier, without recourse to the full insolvency procedure. The Commission does not, however, recommend unrestricted access to its restructuring framework. To prevent misuse of the procedure by solvent companies (for example, as a device to coerce a compromise where the debtor is fully capable of fulfilling its existing obligations), the Commission recommends restricting the availability of the framework to debtors already in “financial difficulties”, such that there is a “likelihood of insolvency”.³³
- 2) *Minimised court involvement*: the Commission recommends permitting a debtor to have recourse to the restructuring framework without the need to formally open court proceedings.³⁴ More generally, it emphasises the need for a swift and inexpensive procedure, and as such recommends restricting court involvement to circumstances where necessary and proportionate to safeguard the rights of creditors and others affected by a proposed restructuring plan³⁵ (see principle 5 below). The Commission does contemplate the involvement of a court in some other limited circumstances (including where the debtor seeks a stay of creditor enforcement action; see principle 4 below), but its overall emphasis is on minimising the need to have recourse to a court. Conformity with this principle could require significant change in jurisdictions that presently require courts to undertake a wider range of tasks in a restructuring process (for example, holding meetings for creditors to vote on a plan).³⁶
- 3) *Debtor-in-possession*: the Commission recommends that the debtor “keep control over the day-to-day operation of its business” while the restructuring framework is used.³⁷ This principle is designed to ensure that the business can continue to be run while the possibility of restructuring is explored, with minimal disruption to ordinary operations.³⁸ Leaving the debtor in control of the business may also help to incentivise early entry into the framework,³⁹ consistent with principle 1. The principle of leaving managers in control might be regarded as controversial in jurisdictions that presently require the relinquishing of control in insolvency processes, but there is no necessary inconsistency. The Recommendation focuses on legal tools to enable restructuring, and not on the broader question of the design of insolvency procedures (which

typically involve a much wider range of activities, such as investigations into managerial conduct, and the avoidance of pre-insolvency transactions).⁴⁰

- 4) *Court-ordered stay*: the Commission recommends that the debtor be empowered to seek a stay of individual creditor enforcement action (including by secured creditors), by application to a court.⁴¹ The stay is designed to enable the assets of the business to be kept together, preventing their piecemeal dismemberment by creditors. Since a stay impinges on the ordinary rights of creditors to enforce on default, its availability might in some circumstances be predicted to increase rather than decrease the cost of credit *ex ante*. For this reason,⁴² the Commission recommends a series of safeguards, including time limits (initial stay of up to four months, subject to renewal up to a maximum duration of 12 months),⁴³ and an obligation to lift the stay when no longer necessary to facilitate the adoption of a restructuring plan.⁴⁴ The Commission also contemplates Member States imposing other conditions on the availability of the stay. States might, for example, require evidence of the viability of a debtor's business, so as to exclude use of the procedure by non-viable businesses (that is, those whose assets are not worth more kept together than broken up in a piecemeal sale). The Commission does however recommend that the stay be granted where creditors with a "significant" amount of claims support the negotiation of a restructuring plan, and the plan has a reasonable prospect of being implemented and of preventing the debtor's insolvency.⁴⁵
- 5) *Ability to bind dissenting creditors to a restructuring plan*: the Commission recommends that the restructuring framework provide for a plan to be negotiated between debtor and creditors (secured or unsecured), and – where approved by the requisite majority⁴⁶ of creditors in affected classes – sanctioned by a court, with the effect that dissenting creditors are bound by it.⁴⁷ The Commission also recommends power to sanction a plan approved by some classes but not others, with the result that it would be possible for a majority of classes to bind dissenting classes (that is, for those classes to be "crammed down").⁴⁸ Various safeguards are called for, including a requirement that the plan does not reduce the rights of dissenting creditors below that which they might reasonably be expected to have received if the debtor's business had instead been liquidated or sold on a going concern basis, as the case may be.⁴⁹ Procedural requirements are also stipulated to ensure creditors are notified of the plan, can object to it, and can appeal against it.⁵⁰ As others have noted,⁵¹ aspects of the Commission's proposals for restructuring plans appear to borrow from the English scheme of arrangement procedure, which enables a court to sanction a binding scheme that has the consent of the prescribed majority of creditors (or of creditors in an affected class), subject to a range of substantive and procedural safeguards. It is important to acknowledge that the administration of this scheme procedure with due safeguards has required significant judicial input and expertise (for example, to develop principles for the proper constitution of classes).⁵²
- 6) *Protection for new finance*: the Commission recommends that those who provide new finance to a debtor in accordance with the terms of a court-sanctioned restructuring plan be shielded from the operation of avoidance provisions in insolvency law,⁵³ and from "civil and criminal liability relating to the restructuring process",⁵⁴ except in the case of fraud.⁵⁵

While developing its Recommendation, the Commission has also been working on the reform of the European Insolvency Regulation. The connection between these two projects should be briefly noted. One of the proposed amendments to the European Insolvency Regulation is the widening of its scope, to include certain debtor-in-possession and pre-insolvency procedures.⁵⁶ If this amendment is made, then the kind of restructuring procedure contemplated in the Commission's Recommendation could potentially come within the scope of the European Insolvency Regulation.⁵⁷ This would mean that the rules of the Regulation governing jurisdiction to open proceedings, and the effect of proceedings once opened (including obligations of recognition and cooperation by other Member States), could apply to these restructuring procedures. The cumulative impact of domestic reforms to give effect to the Recommendation, and the amendment of the European Insolvency Regulation, could therefore be highly significant.

Next steps

The Recommendation is not binding, but the Commission invites Member States to implement its core principles within 12 months (that is, by 12 March 2015).⁵⁸ The Commission proposes to conduct an overall assessment of compliance with the Recommendation after 18 months (in September 2015).⁵⁹ At the same time, the Commission also invites Member States to collect “reliable annual statistics on the number of preventative restructuring procedures opened, the length of procedures and information about the size of the debtors involved and the outcome of the procedures opened”, and to communicate this annually to the Commission (beginning in March 2015).⁶⁰ This invitation reflects the paucity of reliable information in many Member States (and in many other jurisdictions around the world) about the rate of recourse to formal restructuring and insolvency procedures, and the cost, duration and outcome of such proceedings once opened. As such, the Commission’s invitation to improve data collection and reporting is a positive step.

The Commission’s 12 month timetable for reforms to ensure compliance with its core restructuring principles is extremely short. There may be good reason for a Member State to proceed somewhat more cautiously, so as to better ensure the efficacy of reforms. The swift introduction of a new restructuring procedure might appear attractive but be ultimately counterproductive – for example, because it does not include adequate safeguards to ensure that viable businesses are filtered from non-viable businesses and that only the former are eligible to have recourse to the procedure. Such a result could actually add to the costs associated with enterprise distress, and as a consequence could have a negative impact on the cost and availability of credit *ex ante* – contrary to the Commission’s overarching objectives.

In many cases, it will be more sensible to begin by gathering much more detailed information at country level on what works, and what does not work, in existing law. This should include data of the kind called for by the Commission (that is, information on the use of any existing restructuring procedures), but is clearly not limited to this. Some important research has already been done (including in the studies commissioned by the European Commission), and other research is ongoing (such as the study commissioned by the European Law Institute).⁶¹ However, these studies should be complemented by further research and stakeholder consultation at country level in those jurisdictions contemplating reform. Given the discussion in the introduction to this article, some questions that might usefully be explored in these jurisdictions include:

- What kind of business enterprises might need to have recourse to a restructuring procedure provided by law, and what are their typical features (such as their capital structure)?
- Where such procedures are already provided by law, what are their deficiencies, not only in the law “on the books”, but also as it is interpreted and applied in practice?
- Are there legal or other institutional barriers to the use of informal, industry or contractual restructuring solutions to distress, and if so should more be done to dismantle these?
- Are there legal or other institutional barriers to achieving the sale of a business on a going concern basis (as a possible alternative to restructuring), and if so should more be done to dismantle these?

Exploring the first two questions should enable a tailoring of reform to meet stakeholder demand, and help to reduce the risk that any new procedure will be rendered too costly or otherwise unworkable by the same implementation problems that have impaired existing procedures. The latter two questions go beyond the scope of the Commission’s Recommendation, but are clearly complementary to it. If there are other less costly means of achieving a restructuring, or if there are other (non-restructuring) means of preserving the value of a distressed debtor’s business, then these should be explored, if the objective of maximising value *ex post* to improve the cost and availability of capital *ex ante* is to be taken seriously.

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¹ 12 March 2014, C (2014) 1500.

² Bulgaria, Croatia, Cyprus, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovak Republic, Slovenia.

³ Recommendation (n 1) Recital (1).

⁴ *Ibid.* Part IV, which recommends a discharge from debts for bankrupt but “honest” entrepreneurs after no more than three years.

⁵ *Ibid.* Article 5(b).

⁶ See text to n 27.

⁷ Though this does not mean that the debtor must necessarily be factually insolvent to use the procedure. Different jurisdictions take different approaches to this question.

⁸ Which appears in the English company law code (the Companies Act 2006, Pt 26), and may be used by a solvent or insolvent company: for an overview, see J. Payne (2014), *Schemes of Arrangement: Theory, Structure and Operation*, Cambridge University Press, Chapter 1.

⁹ Such processes have been developed in many jurisdictions for commercial banks, often under the leadership of central banks. Many have been modelled on the “London Approach”, as to which see J. Armour and S. Deakin (2001), “Norms in private insolvency: The ‘London Approach’ to the resolution of financial distress”, *Journal of Corporate Law Studies*, pp. 21-51.

¹⁰ See M.J. White (1989), “The Corporate Bankruptcy Decision”, *Journal of Economic Perspectives*, Vol. 3(2), pp. 129-151 see pp. 146-147. See also J.M. Garrido (2012), *Out-of-Court Debt Restructuring*, World Bank, Washington, D.C., Section 4.

¹¹ See further Garrido *ibid.* 24-25.

¹² These two routes to preserving value are not necessarily mutually exclusive – a restructuring could be carried out with a view to effecting a sale of the business on a going concern basis. See Payne (n 8) pp. 187-191.

¹³ Provided, in the case of receivership procedures, that the secured creditor has security over the whole or substantially the whole of the debtor’s assets, so as to be able to effect a sale of the business on a going concern basis. See S. Djankov, O. Hart, C. McLiesh and A. Shleifer (2008), “Debt Enforcement Around the World”, *Journal of Political Economy*, Vol. 116(6), pp. 1105-1149; J. Armour, A.P. Menezes, M. Uttamchandani, and K. van Zwieten, “How do Creditor Rights Matter for Debt Finance? A Review of Empirical Evidence”, *Research Handbook on Secured Financing of Commercial Transactions*, Frederique Dahan (ed), (provisional title) (forthcoming, Edward Elgar, London, 2015).

¹⁴ See further J. Armour (2012), “The Rise of the Pre-Pack: Corporate Restructuring in the UK and Proposals for Reform”, *Restructuring Companies in Troubled Times: Director and Creditor Perspectives*, in R.P. Austin and F.J.G. Aoun (eds) (Ross Parsons Centre of Commercial, Corporate and Taxation Law).

¹⁵ Or at least the consent of the requisite majority, as prescribed (in the case of a formal restructuring procedure) by law.

¹⁶ D. Baird (1986), “The Uneasy Case for Corporate Reorganizations”, *Journal of Legal Studies*, Vol. 15, pp. 127-147.

¹⁷ See further *ibid.* Part IV.

¹⁸ “European Parliament resolution of 15 November 2011 with recommendations to the Commission on insolvency proceedings in the context of EU company law” (2011), P7_TA 0484.

¹⁹ *Ibid.* Recital J.

²⁰ *Ibid.* Recitals D and C. The specific proposals for harmonisation are set out in the Annex to the Resolution. They were developed with reference to a report commissioned by the Legal

Affairs Committee of the European Parliament and produced by INSOL Europe. See Directorate General for Internal Policies, Policy Department C, Legal Affairs, “Harmonisation of Insolvency Law at EU Level” (2010), PE 419.633.

²¹ Resolution (n 18) Recital A. This recital also raises the issue of “forum shopping”, a phenomenon which European policy-makers have long been interested in.

²² Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings. The Regulation provides rules on the opening, recognition and effect of insolvency proceedings throughout Member States, where a debtor has its centre of main interests in a Member State (Recital 14). It was scheduled for review by 1 June 2012 (see Article 46 of the Regulation).

²³ “Study on a new approach to business failure and insolvency – Comparative legal analysis of the Member States’ relevant provisions and practices” (2014), INSOL Europe, available at http://ec.europa.eu/justice/civil/files/insol_europe_report_2014_en.pdf (last accessed 11 August 2014).

²⁴ Including “Communication from the Commission to the European Parliament, the Council and the European Economic and Social Committee: A new European approach to business failure and insolvency” (12 December 2012), COM 742.

²⁵ *Ibid.* Section 1.

²⁶ *Ibid.* Section 3.3.

²⁷ *Ibid.* Section 3.6. See also “Impact Assessment accompanying the document Commission Recommendation on a New Approach to Business Failure and Insolvency” (12 March 2014), European Commission, SWD 61, p. 2 and Section 3.2.

²⁸ Impact Assessment *ibid.* p. 2.

²⁹ Recommendation (n 1) Recital (1).

³⁰ *Ibid.* Part I. See also Recitals (4), (8) and (11).

³¹ *Ibid.* Article 6(a).

³² For jurisdictional examples, see Impact Assessment (n 27) 11-12.

³³ Recommendation (n 1) Article 6(a), and the definition of “debtor” in Article 5(a). See also Impact Assessment (n 27) Section 7.2.1.

³⁴ Recommendation (n 1) Article 8.

³⁵ *Ibid.* Article 7. See also Impact Assessment (n 27) Section 7.2.6.

³⁶ See further Impact Assessment (n 27) 14-15.

³⁷ Recommendation (n 1) Article 6(b). The Recommendation does however contemplate the appointment by a court of a “supervisor” to oversee debtor activity and safeguard creditor interests: Article 9(b).

³⁸ Impact Assessment (n 27) Section 7.2.3.

³⁹ See S. Franken (2004) “Creditor- and Debtor-Oriented Corporate Bankruptcy Regimes Revisited”, *European Business Organisation Law Review*, Vol. 5, pp. 645-676, see 654-655 explaining the trade-offs involved.

⁴⁰ See further Payne (n 8) [5.6.2.1] “A scheme is not an insolvency procedure”.

⁴¹ Recommendation (n 1) Articles 5(c), 6(c) and 10.

⁴² See Impact Assessment (n 27) Section 7.2.2.

⁴³ Recommendation (n 1) Article 13.

⁴⁴ *Ibid.* Article 14.

⁴⁵ *Ibid.* Article 11.

⁴⁶ As prescribed by national law. *ibid.* Article 18.

⁴⁷ *Ibid.* Articles 6(d), 16, 17 (providing for secured creditors to be treated as a separate class to unsecured creditors), 20-21, 26. Article 25 provides that a plan adopted unanimously by affected creditors should be binding on them, which appears to provide support for out-of-court contractual restructurings (discussed in the introduction to this article).

⁴⁸ *Ibid.* Article 18. For further discussion of the class cramdown tool, see Payne (n 8), Chapter 5, particularly pp. 239-242.

⁴⁹ *Ibid.* Article 22(c).

⁵⁰ *Ibid.* Article 24, except that an appeal should “not in principle suspend the implementation of the restructuring plan”.

⁵¹ S. Madaus (2014), “The EU Recommendation on Business Rescue – Only Another Statement or a Cause for Legislative Action Across Europe?”, *Insolvency Intelligence*, Vol. 27(6), pp. 81-85, see p. 84.

⁵² See further Payne (n 8) Section 5.5.2.1.

⁵³ Recommendation (n 1) Articles 6(e) and 27.

⁵⁴ *Ibid.* Article 28.

⁵⁵ *Ibid.* Article 29.

⁵⁶ See revised Article 1 of the Council of the European Union’s “Proposal for a Regulation amending Council Regulation 1346/2000 on insolvency proceedings”, 3 June 2014, Brussels.

⁵⁷ As is explicitly acknowledged in the Impact Assessment that accompanies the Recommendation (n 27) Section 2.5.

⁵⁸ Recommendation (n 1) Article 34.

⁵⁹ *Ibid.* Article 36.

⁶⁰ *Ibid.* Article 35.

⁶¹ “Rescue of Business in Insolvency Law” (2013-2016), described at <http://www.europeanlawinstitute.eu/projects/current-projects-contd/article/instrument-on-rescue-of-business-in-insolvency-law> (last accessed 11 August 2014).



Trends in corporate restructuring – Croatia and Serbia examined and contrasted

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Croatia and Serbia are among a number of countries where the EBRD invests that have recently adopted new statutory regimes with an extra judicial element to encourage business restructuring. In Croatia new legislation is in effect, forcing certain businesses facing financial difficulties to apply for the first stage of pre-bankruptcy settlement proceedings with one of the country's financial agencies. The initial “procedural” stage is conducted before the Croatian Financial Agency (FINA) and the court plays a subsequent role in confirming the final settlement agreement. In Serbia it is possible to present a pre-packaged reorganisation plan under the Bankruptcy Act, during which prior negotiations with creditors and a creditors' vote are conducted out of court (with the plan being confirmed by the bankruptcy judge following a formal creditors' vote before the judge). For businesses with liquidity problems, or at risk of insolvency, there is a new mediation-based and completely voluntary consensual financial restructuring (CFR) procedure, which takes place in the offices of the Serbian Chamber of Commerce and Industry (CCIS). This article provides in-depth analysis by practitioners and experts on the challenges and impacts of the new Croatian and Serbian legislation.

The Croatian Financial Operations and Pre-Bankruptcy Settlement Act

The Financial Operations and Pre-Bankruptcy Settlement Act (the Act) was introduced in October 2012 to address the widespread illiquidity of many Croatian legal entities, which had been exacerbated by the financial crisis. Bankruptcy proceedings conducted before the commercial courts were, at times, excessively long and protracted. In creating the Act, one of the principal aims of the Croatian government and legislature was to fast-track the reorganisation of businesses facing financial difficulties and improve their prospects of recovery.

The objectives of the Act are to return an entrepreneur to liquidity/solvency through a financial restructuring and to enable creditors to satisfy their claims more favourably than within ordinary bankruptcy proceedings. The Act's most significant introduction is the pre-bankruptcy procedure for entrepreneurs (legal entities and traders), which aims to facilitate a rapid financial restructuring of the debtor with majority creditor support. The Act also regulates the financial operations of entrepreneurs, the performance of their monetary obligations and the financial supervision of corporate legal entities.

Overview of the new pre-bankruptcy procedure

The focus of the pre-bankruptcy procedure is to reach a pre-bankruptcy settlement agreement between the debtor and its majority creditors. The procedure is intended to be a first resort for most businesses in the early stages of illiquidity and insolvency, with formal bankruptcy proceedings reserved for those who fail to reach an agreement with their creditors. It involves a preliminary administrative phase conducted before the Croatian Financial Agency (FINA),¹ followed by a judicial phase before the court, where the settlement agreement (or financial restructuring plan) is approved.

The preliminary administrative phase is overseen by a FINA “settlement committee”, which consists of three members appointed by the Ministry of Finance. These members are, in turn, responsible for appointing a pre-bankruptcy trustee from a list of certified bankruptcy administrators to co-manage the debtor and, most importantly, supervise any of its disbursements. The settlement committee’s decision can only be appealed before the Ministry of Finance and, if rejected, can only progress further as an administrative claim before a competent administrative court (the final level of appeal).

Only the debtor can initiate pre-bankruptcy proceedings. The debtor must start the procedure within 60 days of illiquidity or 21 days of insolvency (as defined under the Act). Failure to file for pre-bankruptcy within the statutory period can result in fines ranging from 1,000 to 1,000,000 kuna (approximately €130 to €130,000) payable by the debtor. No additional (personal) liabilities are envisaged by the Act. Nevertheless, the debtor is not obliged to initiate the procedure if it does not own any assets or if the assets are of insignificant value and it does not have any employees. As the pre-bankruptcy procedure aims to expedite the financial restructuring of the debtor, it must be completed within 120 days of its official commencement. As soon as the proceeding is initiated, the competent settlement committee will publish a decision on the opening of the settlement procedure on FINA’s website.

Once the decision is published, creditors have 30 days to file their claims. There is no obligation to provide creditors with any other notice. During the procedure, the debtor is required to prepare and present the restructuring plan to its creditors (an initial draft of which is submitted with the debtor’s request to begin proceedings). The plan must provide an overview of acknowledged and disputed claims, a debt repayment plan and/or a proposal to convert the creditors’ claims into equity in the debtor. For the purpose of voting on the plan, creditors are divided into three groups – state and majority state-owned companies, financial institutions and other creditors. If creditors representing more than half of all acknowledged claims disagree with the proposed plan, they can present a competing plan. If the debtor accepts the competing plan, FINA will schedule a vote by creditors on the plan. Votes by creditors are conducted in writing.

The prescribed creditor majority for adopting the restructuring plan is at least half of each class by value or, alternatively, creditors representing two-thirds by value of the total amount of creditors’ claims across all classes acknowledged by the plan. To date, most plans have been adopted with the approval of the latter because the majority of claims are from financial institutions such as banks. This means that banks can, in practice, out-vote other types of creditors. Unlike the Serbian pre-packaged reorganisation plan below, a plan in pre-bankruptcy proceedings could, in theory, be adopted with the consent of only one class of creditors, provided the class’s claim exceeds more than two-thirds of all acknowledged claims.

If the restructuring plan is approved by the majority of creditors, the debtor must then file a request before the competent commercial court to confirm the plan. The commercial court verifies that all procedural requirements set out in the Act during the preliminary FINA phase have been satisfied but is not required to examine the overall “fairness” of the plan. The commercial court’s decision on confirmation of the pre-bankruptcy settlement plan brings the pre-bankruptcy procedure to an end. Parties may, nonetheless, appeal against the commercial court’s decision before the high commercial court. So far appeals have been decided relatively quickly and, in most cases, were rejected. This is presumably due to the narrow competence of the commercial courts in the pre-bankruptcy procedure.

Implementation issues

When the Act was introduced in 2012 by “Sabor”, the Croatian parliament, part of the jurisdiction of the commercial courts over insolvency matters was indirectly transferred to a state administrative body – FINA. The Act received – and continues to receive – substantial negative criticism from legal theorists and commercial court judges. Questions have been raised about the constitutionality of the Act² and its compliance with the European Convention on Human Rights,³ which states that, in the determination of his or her civil rights, “everyone is entitled to a fair and public hearing within a reasonable time by an independent and impartial tribunal established by law”. Another concern is the lack of proper governance over the admission of claims in the new procedure. Under the current Act the debtor is the only person or entity authorised to completely or partially acknowledge or refute a claim in cases where the creditor does not have an enforceable act pursuant to Croatian law (for example, in the form of a final judicial decision or deed of enforcement).

A dishonest debtor could therefore, in theory, ask a related party to file a false claim before FINA and to acknowledge that related claim. If the amount of the claim were significant, it could enable the related party to out-vote other (real) creditors voting on the pre-bankruptcy settlement plan. While creditors may appeal any FINA decision before the Ministry of Finance, they are not authorised to dispute other creditors’ (existing or non-existing) claims. If the settlement agreement were confirmed by the court, the debtor would be legally obliged to make payments to all creditors pursuant to the terms of the settlement plan, including the creditor with the falsified claim, since an appeal would not postpone the enforcement of the court’s decision. Alternatively, if the debtor were to dispute a creditor’s valid claim, the creditor would be left to continue and/or initiate litigation against the debtor for recognition and payment of its claim. Such litigation might not be resolved before confirmation of the settlement agreement.

The Act has been amended three times so far to deal with a number of ambiguities and inconsistencies with the Bankruptcy Act. A further amendment is currently under consideration. It remains to be seen whether it will address the remaining loopholes in the legislation and in particular the existing claims verification process.

Impact of the pre-bankruptcy procedure

The Croatian government’s intention when it introduced the Act was to save businesses in the early stages of insolvency and their employees’ jobs. While the Act has most certainly extended the lifetime of a considerable number of entrepreneurs and businesses in Croatia, the full extent of its long-term benefits and effects remain to be seen.

Since 2012 debtors have initiated 6,890 pre-bankruptcy proceedings, of which only 1,269 pre-bankruptcy settlements have been successfully confirmed.⁴ Although the debtor may initiate the procedure, it still requires significant creditor support for a successful restructuring plan. In most cases restructuring plans grant an initial grace period for the debtor to repay its debts, accompanied by a rescheduling of debts over one to five years (or possibly longer). Assuming that the debtor is able to meet its payment obligations under the new plan, it may be expected to successfully avoid insolvency and save jobs. However, the Act may also have unintended negative consequences for small business creditors forced to accept a restructuring of their claims in favour of the debtor.

In parallel with other European Union (EU) legislatures, Croatia has sought with the pre-bankruptcy settlement procedure to introduce an innovative mechanism for addressing issues of illiquidity and insolvency. With the long-anticipated Consumer Bankruptcy Act under discussion at the time of this article, the Croatian legislature is certainly active in the field of insolvency law.

Alternative debt restructuring methods in Serbia

Similar to Croatia, the global financial crisis severely impacted the corporate sector in Serbia and contributed to a sharp rise in the number of insolvent and illiquid companies. Since the crisis began, a number of measures have been introduced to promote quicker resolution of escalating non-performing loans (NPLs) and financial restructuring of the corporate sector. These include the adoption of a new Law on Bankruptcy⁵ and the Law on Consensual Financial Restructuring.⁶ The new legal framework provides different, albeit complementary options that may be used to resolve the financial difficulties of a business in an expedited manner. The first approach is the pre-packaged reorganisation plan (PPRP), a court-supervised procedure based on majority creditor consensus with cramdown of dissenting creditors.⁷ The second approach is consensual financial restructuring (CFR), a voluntary out-of-court procedure. While each approach has advantages and limitations, both offer a valid and distinct framework for debt restructuring that allows the debtor's management to remain in place (with little or no formal control on their activities). If necessary they may in fact be undertaken in sequence, starting with the less formal, quicker and cheaper CFR and only proceeding with PPRP in circumstances where no consensus can be reached among key creditors in CFR.

An overview of the pre-packaged reorganisation plan

The PPRP is a court-supervised procedure in which the debtor submits a pre-negotiated reorganisation plan to the court. The plan is put to a vote, to be accepted or rejected by the debtor's creditors. Creditors vote in a number of classes depending on their legal position and the status of their claims (secured or unsecured). Essentially, PPRP is a hybrid work-out procedure, where the parties (debtor and majority creditors) first engage in a voluntary contractual work-out outside of the court procedure, followed by limited court intervention. Judicial oversight is confined to examining the legality of the reorganisation plan (such as formation of creditors' classes) and supervising the voting process. If approved by the relevant creditor majorities, the plan is confirmed by the court and, as a court judgment, becomes an enforceable instrument.

Given the nature of the procedure and the ability to impose a majority creditor decision on a dissenting minority of creditors, the Law on Bankruptcy introduced a series of public disclosure requirements. These are aimed at reducing uncertainty and ensuring equal access to information by all creditors, especially those who have not participated in the initial negotiation phase prior to filing. The extraordinary auditor's report on the debtor's financial statements is an important element of the disclosure requirements and forms part of the documentation submitted with the plan. These financial statements must have a cut-off date of no more than 60 days before the filing date. The extraordinary auditor's report is important because it contains an overview of all creditor claims (as per the legal criteria set out in the plan) and determines the relevant percentages within each class for voting on the plan. In practice bankruptcy judges generally appoint an interim bankruptcy administrator to establish the accuracy of the information included in the reorganisation plan and control the debtor's payments during the course of the proceedings. A moratorium preventing creditors from taking certain enforcement actions is normally imposed by the court for the entire duration of the procedure to safeguard the debtor's assets. The bankruptcy judge will then review the information presented by the debtor, the interim administrator and any creditors who file objections, and decide whether or not the procedure and the contents of the plan comply with relevant legal requirements. The judge not only examines procedural issues, but more fundamentally, is required (and empowered) to look into the overall legality of the plan, the formation of classes, as well as the treatment of creditors and creditors' rights under the reorganisation measures proposed in the plan.

Use of pre-packaged reorganisation plans to date

In the past four years approximately 160 pre-packaged reorganisation plans have been filed in Serbia, involving claims exceeding €1.5 billion. The PPRP process is reasonably efficient, with an average case running for 4.7 months from the plan's initiation to its adoption (the fastest PPRP was adopted in only 31 days). Costs as a percentage of total claims range from 0.1 per cent in large cases to 2.6 per cent in small and medium-sized

cases. These figures do not, however, take into consideration the time and cost of negotiating and preparing the filing, which may take several months. If dissenting creditors wish to appeal the court's decision to confirm the plan, they must do so within eight days of receiving the decision. The appeal may take up to 30 days to process.

To date nearly 75 per cent of PPRPs proposed by debtors have been approved by the court and requisite creditor majorities. Yet in many cases the final outcome of the reorganisation process remains problematic. This is due to a number of factors including limitations in the plan designs, debt sustainability assumptions and the feasibility of the reorganisation measures proposed under the plan. The main issue, however, is a lack of creditor involvement and financial support in the form of "new money". Most often, creditors prefer simple debt rescheduling solutions over more substantial forms of financial/operational restructuring, which might involve de-leveraging by limited debt write-offs (and/or debt-to-equity swaps, even though this solution is often widely unacceptable to banks for various reasons).

Main advantages of PPRP and implementation challenges

The PPRP not only successfully combines a formal and informal approach, but also contributes to quick and less costly resolution of corporate financial distress. It has greater appeal than ordinary reorganisation within bankruptcy because reputational and legal risks are limited (no formal bankruptcy is opened) and debtor's management remains in place for the duration of the proceedings. Further, creditors and the debtor have more control over the process (no bankruptcy administrator is appointed and the court and interim administrator have limited roles). Another advantage for debtors is that if creditors fail to vote for the plan, it does not automatically trigger bankruptcy and liquidation, as in the case of ordinary reorganisations.

However, the PPRP has a number of shortcomings. Because it was built on the existing "ordinary reorganisation" procedure, certain issues regarding PPRPs, such as cut-off dates for claims, changes to claims and procedures for listing creditors, are not fully or properly regulated by the Law on Bankruptcy (mainly due to the fact that both pre-packaged and ordinary reorganisation make use of the same set of legal provisions). Further, some judges and interim administrators demonstrate a lack of bankruptcy expertise and occasionally take a "form over substance approach" when assessing the legality of the plan, creditors' objections and the procedure. In certain cases this is exacerbated by a lack of proper involvement by creditors (especially larger creditors such as banks). A combined lack of oversight by such key parties may result in (attempted) abuses by debtors, poorly drafted plans and, equally important, improper implementation of plans once they are approved. One problematic area relates to the treatment of the debtor's affiliated legal entities,⁸ which are entitled to vote on the plan, provided that their participation in any given class does not exceed 30 per cent of the voting rights in that class. Nevertheless, debtors often fail to disclose that some of their creditors are affiliated entities and it may be difficult to prove whether they should be excluded from voting, especially when key parties fail to look into such issues. By treating related legal entities as an ordinary claim, they may impose by majority vote undesirable debt restructuring solutions on other unrelated creditors. Pre-packaged reorganisation plans may also be used to conceal the accountability and liability of the debtor's management (in particular with regards to those activities that led to financial difficulties). Since full bankruptcy is avoided under the PPRP, there is no review of previous management's activities by an independent bankruptcy administrator. One final challenge to the successful management of PPRP cases is that, to date, first instance courts do not appear to have invested efforts in formulating a common court practice. This is left to the second instance court, which naturally requires much more time to establish. The Law on Bankruptcy is expected to be revised imminently to address a number of shortcomings in the legal framework, which may have a positive impact on PPRPs.

Consensual financial restructuring explained

In comparison to the PPRP, the CFR procedure is an institutional, voluntary and out-of-court restructuring solution. It is modelled on international best practice (based on the INSOL Global Principles for Multi-Creditor Workouts) and is designed to facilitate mediation-driven negotiations between companies and banks as major creditors. Other creditors, such as key suppliers, may nonetheless participate on an equal footing with banks. Parties involved in the CFR are entitled to certain tax and banking incentives not otherwise available in private, out-of-court restructuring. These include: longer tax debt rescheduling, tax breaks for debt write-offs and more favourable reclassification of debtors within the banks' balance sheets and books. However, the CFR procedure requires the participation of at least two banks, since it is aimed at incentivising multi-bank (rather than bilateral) restructuring. This requirement also seeks to prevent a party from potentially abusing the procedure in order to gain access to the tax and banking incentives.

The CFR procedure is initiated when the debtor or a bank creditor files an application with the Serbian Chamber of Commerce and Industry (CCIS), the official mediating institution for consensual financial restructuring. If the basic legal prerequisites are met (for example, two banks participating), an individual mediator is appointed and a kick-off meeting is scheduled with all relevant parties. Several meetings between the debtor and its creditors may be held at the CCIS. The restructuring proposal is usually submitted by the debtor and is discussed with participating creditors, who may, given the voluntary nature of the procedure, decide to withdraw from the process at any given time. A moratorium on debt payments and enforcement may be agreed between the parties executing a standstill agreement to allow time and stability for negotiations. Nevertheless, execution of a formal standstill agreement rarely occurs in practice – many participating creditors fear that other creditors (especially those outside the process) will benefit from their standstill obligations because standstill agreements are private and only apply to parties subject to the agreement. The procedure is successfully completed on execution of a CFR agreement, or in some cases, multiple bilateral agreements between the debtor and key creditors.

Benefits of consensual financial restructuring

One of the major advantages of the CFR procedure is its confidentiality – no public disclosure is required – which alleviates reputational and public confidence concerns for the debtor (associated, for example, with the PPRP). If a common understanding is reached between the debtor and all its key bank creditors and the debtor has sufficient liquidity to continue meeting its ordinary financial (and supplier-related) obligations, this procedure seems to be sufficient and efficient for all participants. However, if not all key creditors agree, the PPRP may become necessary since the CFR does not contain a cramdown measure to impose a restructuring on minority dissenting creditors. CFR is typically a shorter procedure than the PPRP. On average CFR takes a few months to complete and some simple CFR cases have been completed within one month.⁹ Another advantage of CFR is an explicit statutory protection of the security positions¹⁰ of participating creditors. Any agreement to restructure under the CFR procedure does not trigger the novation of their claims, loss of security or the need to re-take security exams, all of which is costly and may undermine the position of participating creditors in relation to the debtor and other non-participating creditors. These are the risks associated with ordinary multi-party restructurings under the general legal framework.

Implementation challenges

Although the Law on Consensual Financial Restructuring was adopted in September 2011, it did not come into full effect until the spring of 2012 (when all the secondary implementing legislation became effective). Within the first two years, 25 cases were initiated, of which 14 were processed and eight successfully concluded. Out of the eight successful cases, three cases were concluded with a CFR restructuring agreement (in the form of an overriding creditors' agreement) and in the remaining five cases, separate bilateral agreements were reached. While parties to bilateral agreements were not able to benefit from the CFR incentives, the CCIS had an active role in successfully mediating these agreements.

So far the number of CFR cases is significantly lower compared with the PPRP. An independent review and assessment of CFR cases conducted by the authors of this article and others under the guidance and sponsorship of the EBRD,¹¹ reveals that most debtors involved in CFR are small and medium enterprises from the manufacturing sector. Several cases have, however, involved corporate groups. While companies applying for this restructuring procedure appear to have had viable businesses, an overwhelming majority of companies entering the process had their bank accounts “blocked” for over a year by creditors attempting to recover their claims. Where the businesses had insufficient liquidity, bank accounts remained “blocked”. In some cases, companies sustained operating losses for two to three years before initiating the process.

On average eight creditors have been invited to participate in the CFR process, with nearly 40 per cent of participating creditors being banks and financial institutions. This indicates that the process tends to be restricted to the largest and most critical creditors, as intended by the legislature. The duration of the process depends on the preparations and negotiations between the parties. On average it takes about 40 days from the initiation of the CFR case to the first meeting between parties. The CFR procedure is considerably cheaper than the PPRP with mediation costs capped at €5,500 for successfully completed cases and payable only in the event of a successfully completed mediation and execution of a CFR agreement.

Nevertheless, one of the reasons for the low number of CFR cases appears to be the limited knowledge of the existence and understanding of the details/advantages of the CFR procedure among debtors (and, to some extent, banks). This underscores the need to raise public awareness about the procedure. Even though banks are generally familiar with the process and its details, including the CCIS’s role as institutional mediator, many are concerned about the voluntary nature of the process and the inability to bind other dissenting creditors. Another issue is that CFR may in some cases be triggered too late – when the debtor’s financial condition is irredeemably impaired and formal court-driven proceedings (such as the PPRP or full bankruptcy proceedings) are more appropriate.

The range of issues identified and experience to date, though limited, suggests that the CFR process would benefit from raising awareness, promoting specialised CFR training among certain groups of bankers, improving the skill-set and specialisation of mediators handling CFR cases and standardising some of the agreements frequently used in the process. Legal recognition of the CCIS as the institutional mediator in restructuring cases has enabled the CCIS to offer CFR mediation as a new service under the Centre for Services and Mediation. This has facilitated the development of a unified and structured approach to CFR because the CCIS handles all requests to initiate CFR proceedings, is responsible for overseeing the list of individual mediators, organises meetings and facilitates negotiations between the parties, which ultimately leads to the execution of debt standstill agreements and/or financial restructuring agreements. Although it appears that the CFR process requires further refinement and streamlining, this “institutionalisation” of services represents an opportunity for the future development of mediation services in effective resolution of CFR cases and the more widespread use of mediation in resolution of commercial disputes generally.

Overall it appears that the Serbian legislature decided to offer two options to both troubled businesses and banks for the potential resolution of NPLs. While the approach of the legislature in relation to CFR is more flexible and less burdensome, the PPRP is a much more regulated (and transparent) exercise, undertaken before an independent court of law and providing sufficient protection (mainly) to minority creditors given its power to cram down dissenting minority creditors. With these new restructuring models, Serbia has joined a limited number of countries that offer a full scale of voluntary, hybrid and formal court-supervised restructuring options for their businesses and banks.

Table: Comparing Croatia and Serbia/Frameworks for corporate restructurings

| Comparison criteria | Croatia | Serbia |
|---|--|--|
| Legislative framework(s) for restructuring | The Financial Operations and Pre-Bankruptcy Settlement Act. | PPRP – The Law on Bankruptcy (LoB). CFR – The Law on Consensual Financial Restructuring (LoCFR). |
| Grounds for initiation of the procedure | Up to 60 days of illiquidity or 21 days of insolvency. | PPRP – permanent illiquidity (inability to pay debts for 45 days), pending illiquidity, or over-indebtedness (insolvency). CFR – no explicit financial difficulties. |
| Party/parties able to initiate the procedure | The debtor. | PPRP – the debtor. CFR – the debtor or the creditor. |
| Effect of procedure on creditor enforcement rights | Upon the formal opening of pre-bankruptcy proceedings, any litigation and other court procedures are halted and only secured creditors with special security – for example, a pledge on real estate or movables – can enforce or continue to enforce their security. <u>Before</u> the procedure's formal opening, creditors with a debenture note ¹² issued by the debtor are entitled to deliver it to FINA with a request for seizure of funds that can lead to an automatic freeze on all the debtor's bank accounts by FINA. | PPRP – the bankruptcy judge may, within five days of the plan being filed, prohibit enforcement against the secured and unsecured assets of the bankruptcy debtor. CFR – a moratorium on debt payments and enforcement may be agreed between the parties executing a standstill agreement to provide time and stability for negotiations. |
| Appointment of insolvency office holder? | A pre-bankruptcy trustee is appointed for the duration of the pre-bankruptcy procedure. | PPRP – the bankruptcy judge may, upon the request of an interested party or <i>ex officio</i> , appoint an interim bankruptcy administrator or retain other experts to ascertain the accuracy of data referred to in the PPRP and to control payments from debtor's accounts. CFR – none. |
| Party/parties able to propose a restructuring plan/agreement | The debtor is initially able to propose a plan, but creditors can propose a competing plan under certain conditions. | PPRP – the debtor. CFR – both the debtor and creditors. |
| Availability of cramdown (of dissenting creditors) | Cramdown is available within each class of creditors if more than one half by value vote in favour or if two-thirds of creditors by value across all classes vote in favour of the plan. | PPRP – cramdown is limited to the minority of creditors within each class of creditors. For a plan to be passed all classes must vote in favour and consenting creditors must represent in aggregate more than 50 per cent of creditors' claims within each class. CFR – does not contain any cramdown mechanism enabling a restructuring to be imposed on minority dissenting creditors. |
| Other conditions for confirmation of the restructuring plan/agreement | The competent commercial court must confirm (with a decision) that all the procedural requirements of the administrative phase conducted before FINA have been fulfilled. | PPRP – the court has to confirm the plan voted by the creditors. CFR – none. |

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¹ FINA, established in 2002, is a Croatian state entity with offices throughout the country and a wide set of responsibilities, including providing IT assistance for the State Treasury, financial mediation, currency exchange services and calculation, payments and control of obligatory contributions, taxes and surtaxes.

² Article 29 Paragraph 1 of the Constitution of the Republic of Croatia.

³ Article 6 Paragraph 1 of the European Convention on Human Rights.

⁴ As of 26 June 2004. See www.iusinfo.hr (last accessed 30 July 2014).

⁵ "Official Gazette" RS 104/2009.

⁶ "Official Gazette" RS 36/2011.

⁷ So-called "cramdown" enables a debtor to force a minority of creditors to accept the terms of a plan that has been accepted by a majority of the creditors. Under the Serbian Law on Bankruptcy, cramdown is limited to the minority of creditors within each class of creditors. For a plan to be passed all classes must vote in favour of it and consenting creditors must represent in aggregate more than 50 per cent of creditors' claims within each class.

⁸ Article 125 of the Law on Bankruptcy defines affiliated legal entities as parties related to debtor's shareholders, debtor's sister companies and similar.

⁹ Although at first glance the CFR and PPRP procedures appear to last for the same length of time, the filing of a PPRP is preceded by substantial debtor-creditor negotiations, which in the case of CFR are most often conducted during the course of the procedure. Thus, because of the additional formalities and other circumstances, the duration of a PPRP procedure (including the preceding negotiations) is somewhat longer.

¹⁰ This relates to strict security rights only, as banks and/or personal guarantees remain in place even after a successful restructuring (sometimes even under the previously existing terms, unless agreed otherwise).

¹¹ In order to enable efficient and widespread implementation of consensual financial restructuring as a method of rearranging relationships between companies with financial difficulties and their creditors, specifically commercial banks, the CCIS, as the institutional mediator authorised by the Law on Consensual Financial Restructuring, with support from the European Bank for Reconstruction and Development (EBRD), is implementing a project called *Support for Effective Implementation of the Consensual Financial Restructuring Law in Serbia (Out-of-Court Restructuring)*. The project is implemented by an international consortium of expert consultants, consisting of Partners Serbia, Andric Law Office, EMA Global (USA) and ADR Centre (Italy) with the active participation of the EBRD. The goal of the project is to promote greater use of the consensual financial restructuring procedure and to facilitate implementation of the Law on Consensual Financial Restructuring. The expected outcomes of the project are:

- raised public awareness of the restructuring framework established by the Law on Consensual Financial Restructuring, particularly among small to medium-sized enterprises and the banking community
- streamlined consensual financial restructuring procedure to ensure that it is as efficient as possible
- strengthened role and interaction of key players, including the Centre for Services and Mediation of the CCIS.

¹² A debenture note (in Croatian "*zadužnica*") is a type of instrument issued by the debtor (and solemnised by notary public) in favour of the creditor, whereby the debtor specifically allows the creditor to collect the moneys evidenced by the instrument in the event that the underlying debt is not repaid.



Revolutionising jobs: can insolvency reform reduce credit risk for investors and help address unemployment in the Middle East and North Africa region?

Mahesh Uttamchandani, Antonia Menezes, John Christian Vieira

Political and economic changes are continuing to reshape the Middle East and North Africa (MENA) region. Ultimately, whether these political transformations lead to shared prosperity and reduced poverty will depend on whether they facilitate the creation of jobs for the millions of unemployed people in the region and the millions more leaving the workforce each year.¹ This paper suggests that policy-makers should consider the regulatory environment (particularly regulations governing insolvency) that is impeding the development of the private sector in many MENA countries, and reducing its capacity to generate jobs.² Reforming these regulations can potentially lead to more jobs by encouraging the growth of new businesses, providing new credit for these businesses and protecting existing businesses. This article summarises why unemployment in the MENA region needs to be urgently addressed. Focusing on the role of insolvency regimes, empirical evidence shows the positive economic impact of mitigating creditor risk and enhancing job preservation and entrepreneurship through insolvency reform. Lastly the article investigates some of the primary obstacles in existing insolvency laws in the MENA region that are impeding investment and access to credit.

A lack of jobs is an important drain on society in the MENA region. As stated in the World Bank Group's report *Jobs for Shared Prosperity: Time for Action in the Middle East and North Africa*, "The MENA region has vast untapped human resources, along with the world's highest unemployment rate among youth and the lowest female participation in the labour force."³ The unemployment rate in the MENA region is currently averaging 15 per cent, with youth unemployment reported at 29 per cent.⁴ Labour force participation is particularly low for women, with an average of 24.1 per cent compared with 77.2 per cent for men.⁵ Overall the region's labour markets can be characterised as inefficient, inequitable and locked in low-productivity equilibrium.⁶ The rules and incentives that govern labour markets in the MENA region have often been attributed as causes of these

low labour participation rates. There are many complexities to this problem, which cannot be examined in detail in this article. For example, the public sector still provides the majority of formal jobs, but access to such jobs is usually restricted.⁷

In order for economies to grow and businesses to develop, there needs to be investment. Promoting investment, both for domestic and foreign investors, requires a balance of risk and reward. To enhance risk management in the financial system, the World Bank's *World Development Report 2014* argues that public policy should focus on establishing strong macroprudential frameworks, including resolution measures equipped with adequate tools, while fostering the safety and efficiency of financial market infrastructure.⁸ The role of insolvency law is generally to provide for the orderly collective reorganisation of viable enterprises or liquidation of insolvent entities and an effective insolvency regime aims at striking a balance between debtor protection and creditor recovery. Insolvency laws are therefore part of the suite of financial sector laws that can help strengthen the domestic job market and stimulate private sector development. This sentiment is echoed in the report, which further argues that enhanced predictability and improved bankruptcy procedures can help facilitate responsible risk-taking and reduce associated costs.⁹ Insolvency regimes therefore play several roles in risk mitigation: (i) they help ensure that investors can recover their investment in case of default, which in turn mitigates the risk they face in taking ownership stakes or lending funds; (ii) they promote private sector development by ensuring that non-viable firms can efficiently exit the market and redeploy assets to more productive uses; and (iii) they can reduce risks for entrepreneurs entering the market that might otherwise be dissuaded from starting a business because of the harsh penalties on failure.

Insolvency regimes help to preserve jobs

Countries with strong insolvency regimes will typically seek to maximise creditor recovery by helping to ensure that viable businesses can continue to operate as going concerns, thereby preserving jobs, supply chains and asset values, which would often be lost in liquidation. It is estimated that there are around 200,000 businesses facing insolvency across the European Union alone, with 1.7 million people losing their jobs each year as a result.¹⁰ The European Commission has therefore recently issued a "recommendation" on common principles for business rescue, to be reflected in the law affecting businesses in financial difficulties in Member States.¹¹

Changes to insolvency legislation can have a positive impact on business rescue. A new corporate reorganisation code in Colombia enacted in 1999 was found to dramatically improve the efficiency of reorganisation proceedings, the duration of which fell from 34 to 12 months. Observations show that post-reform liquidating firms were unhealthier than reorganising firms, which led to the conclusion that reform allowed healthy firms to enter reorganisation rather than liquidation, and to do it sooner, while still able to recover. After controlling for macroeconomic conditions, reorganised firms were also found to recover faster and better under the new law, and thus enjoyed greater equity value.¹²

Effective reorganisation frameworks, which promote the survival of underlying businesses, can allow a company's workforce to remain employed and productive. A recent study in the United Kingdom¹³ found that in 65 per cent of sales of insolvent businesses and 92 per cent of so-called "pre-packaged" sales,¹⁴ the entire workforce was preserved by transferring it to the new business. Even where retention was not 100 per cent, it was significant. For sales of businesses, 73 per cent of such sales saved over 75 per cent of jobs. For pre-packs, 95 per cent of sales resulted in workforce retention of 76 per cent.¹⁵ This demonstrates the ability of a well-functioning insolvency regime to preserve jobs on a meaningful scale, particularly where there is a limited time spent in formal insolvency procedures, as in the case of pre-packaged plans used in conjunction with administration procedures in the United Kingdom.

Insolvency regimes help to stimulate new jobs

Entrepreneurship benefits an economy through job creation, productivity growth and the production and commercialisation of high-quality innovations.¹⁶ Even more significantly, 57 recent studies in various countries show that entrepreneurial firms produce important spillovers that affect employment growth rates of all companies in the region in the long run.¹⁷ Insolvency laws do not only affect employment at the stage when a business is evaluating whether or not to close, they can also be an effective tool to promote entrepreneurship.

In common law countries, non-corporate enterprises, such as sole proprietorships and many partnerships, do not benefit from limited liability. This means that if the business goes bankrupt, potentially overwhelming debts accrue to the individual. Insolvency laws can help reduce the risk that business owners face. For example, the “fresh start” policy helps financially distressed individuals productively rejoin the market free from some or the entire burden of pre-existing debts.¹⁸

Several studies have shown a positive correlation between forgiving insolvency laws and entrepreneurship in a country. A 2003 study compared asset exemptions during insolvency proceedings among states in the United States. The study, which surveyed 20,000 families, found that there are more entrepreneurs in states with higher asset exemptions from an individual entrepreneur’s personal property.¹⁹ A 2008 study that compared self-employment in 15 countries in Europe and North America between 1990 and 2005 found that more forgiving personal bankruptcy laws and ready access to limited liability enhance entrepreneurial activity.²⁰ A 2009 study, again comparing US states and their bankruptcy exemptions for personal property, found that the predicted probability of starting a business is 25 per cent higher in states with greater exemptions.²¹

Moreover, a strong insolvency regime will help reassure entrepreneurs that the loss of their personal assets will be minimised should the business fail. This mitigates investor risk, encourages entrepreneurial activity and ultimately encourages venture capital funding. A 2004 study of 11 countries (the United States and 10 European countries) found a correlation between forgiving personal bankruptcy regimes and levels of venture capital funding. The authors speculated that there were more willing entrepreneurs who generated demand for and attracted venture capital in those more lenient countries, with better protection for personal assets.²²

Insolvency law reform in the MENA region is still needed

While effective insolvency regimes have proven to be a strong factor in job preservation for businesses in financial difficulty and organic job creation generally, the establishment and implementation of insolvency regimes has not been an easy task for countries within the MENA region. The following analysis particularly focuses on those laws in Egypt, Jordan, Morocco and Tunisia.

Insolvency proceedings are typically lengthy, costly and inefficient in many MENA countries

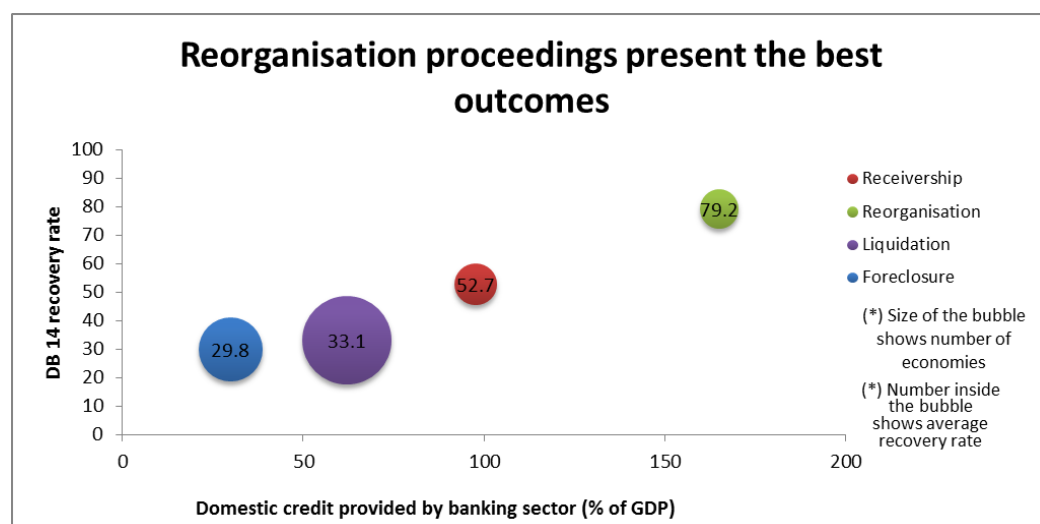
The World Bank Group’s *Doing Business 2014* report found that the MENA region had the world’s smallest share of economies implementing at least one business regulatory reform (including insolvency reform) in 2012-13.²³ The report’s resolving insolvency indicator tracks the efficiency of a country’s insolvency regime. According to the 2014 indicator, the average time for creditors to recover their credit in the MENA region is 3.2 years, nearly double the time required in the Organisation for Economic Co-operation and Development (OECD) jurisdictions. This statistic is greatly improved for Tunisia and Morocco, who report much shorter times at 1.3 and 1.8 years, respectively. However, in Jordan and Egypt, where insolvency proceedings can reach an average of 3.0 and 4.2 years, the drawn-out processes can have a detrimental effect on creditor recovery and the wider economy. It is also costly for creditors in many MENA countries to go through insolvency proceedings. This is especially the case in Jordan and Egypt, where the cost of insolvency proceedings averages 20 and 22 per cent of the value of the debtor’s estate – more than double the OECD average.²⁴ This prevents a dynamic culture of business rescue which could promote

both job preservation through restructured companies and job creation through stimulation of entrepreneurship.

The outcome of insolvency proceedings is usually a piecemeal liquidation rather than the preservation of the business as a going concern

MENA countries are not able to take advantage of the job preservation aspect of insolvency systems because reorganisations are rare in the MENA region. In Egypt, Jordan, Morocco and Tunisia, liquidation is typically favoured above reorganisation and business assets are usually sold piecemeal.²⁵ This results in an average creditor recovery rate of just 29.4 cents on the US dollar, compared with 70 cents for OECD countries.²⁶ In OECD countries, on the other hand, a significant proportion of insolvency proceedings result in companies continuing operations as going concerns, allowing for full recovery of creditors' claims and no lost value. Most importantly, this allows for the preservation of a substantial number of jobs within the company, thus maintaining or potentially improving the employment climate within the country.

Chart 1: Reorganisation proceedings present the best outcomes.



Note: Domestic credit provided by banking sector (% of GDP) means all credit provided by the banking sector to various sectors on a gross basis with the exception of credit to the central government, which is net. For further explanation please see www.data.worldbank.org/topic/financial-sector (last accessed 25 September 2014).

Source: World Bank *Doing Business 2014* report and World Bank Development Indicators.

Existing reorganisation frameworks are weak and ineffective, and thus rarely used

As suggested above, there are few reorganisations in MENA countries despite the fact that many of those countries have some sort of restructuring provisions in their laws. While some countries in MENA have implemented insolvency reform in relatively recent years (Morocco 1996, Egypt 1999 and Tunisia 2003), other countries have not reviewed their insolvency systems in decades (Lebanon 1942, Jordan 1966). The provisions in the current laws are usually two-fold: (i) a form of pre-insolvency compromise procedure that allows a delay in the declaration of bankruptcy in order to attempt an amicable settlement with creditors; and (ii) a type of formal court-supervised reorganisation.

While the intention of the pre-insolvency compromise regime is to encourage amicable settlements between debtors and creditors, the compromise mechanisms are sometimes vague and leave parties to largely negotiate on their own, without any structure or timeline. None of these countries have out-of-court work-out guidelines in place to restructure non-performing loans (NPLs). In Morocco, the country's regime allows for a four-month preventive period during which the debtor may attempt to reach an amicable settlement with its creditors. Egypt has a similar pre-insolvency conciliation procedure, whereby conciliation or settlement procedures can begin on the day the proceedings start.²⁷ Tunisia has *règlement amiable* proceedings, with the threshold requirement being that the debtor is not yet insolvent or is not yet in *cessation de paiement*, which has led to very few

proceedings being opened.²⁸ In Jordan and Lebanon this pre-insolvency regime is only partially addressed through the composition procedure mentioned below, which also applies to existing insolvent debtors.

All MENA countries have a court-supervised restructuring regime although very few are up to date with best practices. In Egypt a business debtor can formulate a reorganisation plan and put it to the creditors' vote under the law's composition procedures.²⁹ In Tunisia opening the *règlement judiciaire* process gives rise to an observation period during which time the *administrateur judiciaire*, appointed by the president of the court, is required to develop a recovery plan within a maximum of six months. There are no consequences to the *administrateur judiciaire* should he or she fail to submit the recovery plan and there are no important provisions relating to creditors voting on the plan and the ability to bind dissenting creditors. As a result, the reorganisation procedures in these jurisdictions are rarely successful in achieving the goal of rehabilitating distressed companies prior to insolvency. Jordan and Lebanon have a composition procedure that allows distressed debtors to call a creditors' meeting and propose a scheme of arrangement, which must include certain minimum returns for creditors and be approved by a wide majority of creditors.³⁰ However, secured creditors are not bound by this arrangement and may enforce their security separately.³¹

Despite these provisions, countries within the MENA region generally have restructuring frameworks that lack core modern elements which include, among other things, the ability to obtain debtor-in-possession financing during reorganisations. Further, the existing frameworks typically only allow debtors to achieve either a reduction or a rescheduling of the terms of the debt and do not allow the debtor to undertake much-needed changes at the operational level, such as the confirmation or rejection of essential contracts, which are essential for the continuation of business operations during the course of restructuring. As a result, once businesses enter into formal insolvency proceedings, they generally liquidate due to the weakness of the reorganisation frameworks. In Egypt the law imposes no moratorium on secured creditors for initiating individual enforcement actions after the declaration of bankruptcy. Such a stay only applies to unsecured or general lien creditors.³² Similarly, in Jordan and Lebanon, secured creditors are not subject to a moratorium on execution/collection proceedings. While the decision to extend the moratorium to secured creditors must also balance considerations of how to safeguard their rights, the unrestricted right of secured creditors to take enforcement actions can significantly hinder the reorganisation process and lead to the premature division of a viable debtor's assets. At the same time, where a moratorium exists and extends to ordinary creditors, there is no time limit on its duration, which can lead to lengthy and costly proceedings.

In many countries that have successful reorganisation regimes, there is a practice of leaving debtor management in place during the reorganisation, as the current management is most likely to understand the business well enough to reorganise it.³³ In Egypt debtors remain in possession of their assets during the composition procedure, but a composition trustee is appointed to oversee and supervise their actions.³⁴ Jordan takes this one step further by having the courts enumerate the division of powers in the order of appointing the trustee before a liquidation decision, and the powers of the liquidators after the decision are well enumerated. While it might be advisable to appoint new management under certain circumstances, excluding debtors from managing a company that is reorganising may undermine the potential for the business's recovery. Individuals, such as chief restructuring officers (CROs), can assist in executing operational improvements by working with senior management to define the company's financial goals necessary for achieving a successful restructuring. This enables senior management to stay focused on making day-to-day decisions consistent with the overall restructuring plan.

Many of the laws are punitive towards bankrupt debtors and inhibit their economic rehabilitation

Many of the insolvency laws in MENA are outdated and take a punitive approach rather than a rehabilitative approach to individuals and business owners, which prevents MENA countries from encouraging entrepreneurship and risk-taking. Bankruptcy in many MENA countries can lead to criminal prosecution and civil penalties, even in the absence of fraud. For example, in Egypt, debtors can be taken into custody or forbidden from leaving

the country when they declare bankruptcy.³⁵ In some circumstances the debtor can also be subject to restrictions on his or her freedom of movement within the country.³⁶ In addition, an individual debtor who has been declared bankrupt may not hold public office, be a member of a professional association, serve as a director on a board, work in banking, commercial agencies, importing, exporting, or for a brokerage firm buying or selling securities.³⁷ These restrictions are lifted three years after the bankruptcy.³⁸ In Lebanon a bankrupt manager is deprived of his or her civil rights and cannot hold public office, nor be part of a professional or political assembly.³⁹ The Tunisian Bankruptcy Law makes frequent cross-reference to the provisions of the Penal Code. Under the Tunisian Bankruptcy Law the court may hold an individual trader in prison or suspend business trading, and a non-rehabilitated debtor may no longer vote, be eligible for appointment to a political or professional assembly or occupy any public role.⁴⁰ The criminalisation of insolvency prevents the proprietor of a failed business from re-entering the economy productively, and can be a serious inhibitor to risk-taking in the economy, as fear of imprisonment detracts debtors from filing bankruptcy even when it is in the best interest of the creditors.

In Lebanon another example of this punitive approach is that, once a composition filing has been made, the law requires the court to engage a public prosecutor to confirm that the filing has not been made fraudulently.⁴¹ Fraudulent and negligent bankruptcy filing is considered to be an economic crime subject to the criminal code. While the fraudulent filing of bankruptcy cases is to be discouraged, the automatic involvement of the public prosecutor immediately upon filing is a deterrent to parties that might be acting in good faith.

Beyond the criminal sanctions, procedurally, most MENA insolvency laws and systems tend to view debtors as offenders, rather than economic actors in financial distress. There is a fear of fraud and abuse of the system by debtors, based on asset concealment, asset stripping and defrauding of creditors that has occurred in many developing countries. Focusing on the suspicion of debtors primarily, over the economic process, undermines the efficiency of the procedures in an insolvency case, and ultimately lowers recovery rates for creditors.

The priority rules are outdated and inhibit availability of credit – a necessary underpinning of economic growth and job creation

The pre-bankruptcy rights of secured creditors are often not well protected in the MENA region, where many jurisdictions prioritise public policy exceptions over creditors' rights, including secured creditors. Many regional insolvency laws, such as in Egypt, Jordan, Kuwait, Lebanon, Morocco, Tunisia and Qatar require that certain labour and tax claims be paid in full before payments are made to secured creditors.⁴² As they stand, the priority rules add an extra layer of difficulty to creditors attempting to recover their collateral, thus inhibiting the overall willingness of creditors to extend credit to businesses from the outset.

Conclusion

Unemployment continues to remain a major problem for governments in the MENA region. A lot of research has shown that an effective insolvency system can be an important instrument to strengthening job markets and even encouraging entrepreneurship and job creation. Similarly, weaknesses in many MENA insolvency regimes may have the effect of exacerbating its existing unemployment problems by magnifying job loss. Long and cumbersome insolvency proceedings have the effect of limiting returns to creditors, leading to limited access to credit for entrepreneurs. In addition, excessively punitive provisions deter many individuals from taking on business risk to begin with. Added to this, antiquated conciliation and reorganisation frameworks lead to piecemeal liquidations, rather than efficient reorganisations that would help to preserve thousands of domestic jobs. While many MENA jurisdictions have undergone insolvency law reform in the last decade, more change is needed to obtain the structural foundation required for organic job creation and domestic employment preservation. The policy discussion must start with the understanding that solid insolvency regimes can play a strong role in preserving jobs and encouraging entrepreneurship, which in turn can mitigate the stigma associated with bankruptcy. As stated by author C.S. Lewis, "failures are finger posts on the road to

achievement". With the same spirit that led to fundamental political transitions in the region, it is time to examine how insolvency law can help mitigate risk and revolutionise the job market.

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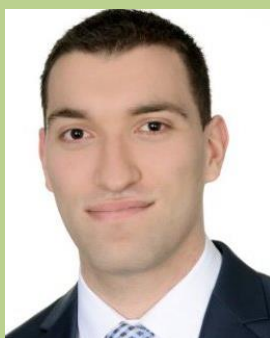
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¹ World Bank (2013), *Jobs for Shared Prosperity: Time for Action in the Middle East and North Africa*, Washington, D.C.

² *Ibid.*

³ *Ibid.*

⁴ <https://en-maktoob.news.yahoo.com/jarring-unemployment-arab-countries-174949086.html> (last accessed 22 July 2014).

⁵ Brookings Institute, "Arab World Learning Barometer".

⁶ *Op. cit.* 4.

⁷ *Ibid.*

⁸ World Bank (2013), *World Development Report 2014: Risk and Opportunity – Managing Risk for Development*, Washington, D.C.

⁹ *Ibid.*

¹⁰ http://europa.eu/rapid/press-release_IP-14-254_en.htm (last accessed 22 July 2014).

¹¹ *Ibid.*

¹² X. Gine and I. Love (2010), “Do reorganisation costs matter for efficiency? Evidence from a bankruptcy reform in Colombia”, *Journal of Law and Economics*, Vol. 53, p. 833.

¹³ S. Frisby (2007), “A preliminary analysis of pre-packaged administrations”, *Report to The Association of Business Recovery Professionals*.

¹⁴ A pre-packaged sale is an arrangement under which the sale of all or part of a company's business or assets is negotiated with a purchaser prior to the appointment of an administrator, and the administrator effects the sale immediately on, or shortly after, their appointment.

¹⁵ *Ibid.*

¹⁶ M. Van Praag and P.H. Versloot (2008), “The economic benefits and costs of entrepreneurship: a review of the research”, *Foundations and Trends in Entrepreneurship*, Vol. 4, No. 2, pp. 65-154.

¹⁷ *Ibid.*

¹⁸ M. Uttamchandani and A. Menezes (2010), “The freedom to fail: why small business insolvency regimes are critical for emerging markets”, *International Corporate Rescue*, Vol. 7(4), pp. 262-68.

¹⁹ W. Fan and M.J. White (2003), “Personal bankruptcy and the level of entrepreneurial activity”, *Journal of Law and Economics*, Vol. XLVI, p. 543.

²⁰ J. Armour (2004), “Personal insolvency and the demand for venture capital”, *European Business Organization Law Review*, Vol. 1, p. 87.

²¹ A. Mathur (2009), “A spatial model of the impact of bankruptcy law on entrepreneurship”, *Spatial Economic Analysis*, Vol. 4, pp. 25-51.

²² *Op. cit.* 20.

²³ *Doing Business* report for 2014 is available at www.doingbusiness.org (last accessed 22 July 2014).

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ *Ibid.*

²⁷ Egyptian Trade Law Articles 662-683 and 725-767.

²⁸ World Bank Group analysis of the *Code de Commerce* (1959) and *Loi de Redressement des Entreprises en Difficultés Economiques* (1995).

²⁹ This is true both for the pre-bankruptcy composition procedure (Art 725-767) and the post-bankruptcy judicial composition (Art 662-682).

³⁰ Jordan Companies Law Article 262, Jordan Commercial Code Articles 290-325.

³¹ Lebanese Commercial Code, Article 503, and MENA Report, Chapter 7 Egypt, Chapter 8 Jordan.

³² Egyptian Trade Law Article 605.

³³ The United States, United Kingdom and France, among other countries whose insolvency systems result regularly in reorganisations, all allow the debtor to continue to manage a business during its restructuring within insolvency.

³⁴ Egyptian Trade Law Articles 735, 736, 740.

³⁵ Egyptian Trade Law Article 586.

³⁶ Egyptian Trade Law Article 587.

³⁷ Egyptian Trade Law Article 588.

³⁸ Egyptian Trade Law Article 712.

³⁹ Articles 499, 500 of the Lebanese Code of Commerce.

⁴⁰ Debt Resolution & Business Exit, World Bank Group analysis of *Code de Commerce* (1959) and *Loi de Redressement des Entreprises en Difficultés Economiques* (1995).

⁴¹ Lebanese Commercial Code, Articles 496 and 539.

⁴² M. Uttamchandani (2011), “No Way Out”: The Lack of Efficient Insolvency Regimes in the MENA Region, The World Bank, p. 7.



Recent legislative changes in Slovenia to promote corporate restructuring

Srečo Jadek

On 27 November 2013 the National Assembly of the Republic of Slovenia adopted the Amendment Act (the Act) to the Financial Operations, Insolvency Proceedings and Compulsory Dissolution Act (ZFPPIPP), which came into force on 7 December 2013. This was the sixth amendment of the ZFPPIPP, which has been operating in Slovenia since 1 October 2008. The Act represents the most significant change in the nature of stakeholder relationships in insolvency proceedings since 1991, when Slovenia declared its independence. Historically speaking, Slovenia used to be a “pro-debtor jurisdiction” but since the adoption of the Act, the scales have tipped significantly towards the creditor side.

Although the Act was prepared within a very short timeframe – it took slightly more than two months from the time the team was appointed by the Minister of Justice to the effective date of the Act – it appears that these changes and amendments are quite significant and will enable quicker, more effective and more equitable resolution for pre-insolvent and insolvent companies.

The most important changes introduced to the ZFPPIPP by the Act, which only apply to large and medium-sized companies,¹ are as follows:

- a new preventive procedure has been introduced for restructuring the financial liabilities of debtors who are likely to become insolvent within one year
- the compulsory settlement procedure has been amended to reflect the “absolute priority rule”² and the principle that claims are to be paid in full to creditors before equity holders
- creditors have been granted the power to initiate compulsory settlement proceedings (which previously could only be initiated by the debtor)
- it is now possible to effect a limited compulsory restructuring of secured claims in the new preventive restructuring procedure and the amended compulsory settlement procedure
- the compulsory settlement procedure has implemented the principle of preserving a healthy core of a debtor’s business by enabling the transfer or spin-off of the debtor’s assets to a NewCo.

Preventive restructuring procedure

This new procedure is intended for restructuring the financial liabilities of debtors in pre-insolvency situations. The only participants in this procedure are the debtor and the creditors with financial claims. The prerequisite for a debtor to initiate this procedure is the consent of creditors with claims exceeding 30 per cent of the total sum of the debtor’s financial liabilities. While the court announces the initiation of preventive restructuring

proceedings on the Agency of the Republic of Slovenia for Public Legal Records and Related Services (AJPES) website, the proceedings themselves are confidential. The initiation of proceedings normally leads to an automatic stay or moratorium on actions against the debtor, but this does not apply to financial collateral arrangements.

The objective of the procedure is to reach an agreement on financial restructuring with financial creditors, which has the same restructuring terms for all financial claims (including the financial claims of dissenting creditors). Negotiations with financial creditors may last up to three months in the case of medium-sized companies, with the option of a two-month extension; and in the case of large companies, they may last up to five months, with the option of a three-month extension. This is also the deadline by which the debtor is obliged to submit to the court (for its approval) the relevant agreement on financial restructuring signed by the creditors holding at least 75 per cent of the total sum of all unsecured financial claims against the debtor. If the agreement on financial restructuring applies to secured claims, it must also be signed by secured creditors holding at least 75 per cent of the total sum of all secured financial claims.

Holders of at least 30 per cent of the total of all financial claims (both secured and unsecured) against the debtor may terminate the preventive restructuring proceedings at any time.

It should be noted that there are restrictions on the cramdown of secured creditors within the procedure. Any agreement on financial restructuring can compulsorily defer the maturity of secured claims for a maximum of five years, and can only reduce the interest rates, not the principal amounts of secured claims. On the other hand, restructuring measures regarding claims of unsecured financial creditors are not subject to any limits. While adjudicating on the approval of an agreement on financial restructuring, the relevant court only reviews whether the creditors are treated equally under the agreement and whether the prescribed 75 per cent majority of the total amount of all claims has been achieved in both classes – ordinary creditors and, if applicable, secured creditors. Once the court approves the agreement on financial restructuring, the effects of this agreement also extend and apply to those financial creditors that have not signed the agreement.

Absolute priority rule

In Slovenian insolvency legislation, compulsory settlement is a debtor-in-possession reorganisation procedure based on a reorganisation plan that is similar to the insolvency proceedings of Chapter 11, Title 11 of the United States Bankruptcy Code.

Until the enactment of the Act, the absolute priority rule was not applicable to the compulsory settlement procedure against the debtor's owners. As such, creditors were not motivated to undertake restructurings of debtors because the approved compulsory settlements only resulted in a reduction or deferred maturity of their claims, while the debtor's owners (and ownership rights) remained unaffected. Nowadays in the case of compulsory settlement for large and medium-sized companies, the Act consistently applies the absolute priority rule (because in the case of bankruptcies, the absolute priority rule had already been consistently applied before the Act) through the following methods:

- a compulsory alternative offer (to be chosen by the creditors) by the debtor to creditors for the repayment of their claims, either by payment in cash or by conversion into capital
- the simplified compulsory reduction of the debtor's share capital in the case that (i) the debtor reports uncovered losses in its accounting statements, namely a reduction in the amount of such uncovered losses; and (ii) if the value of the debtor's assets reported in its accounting statements is higher than the liquidation value of its assets, then the compulsory reduction equals the difference between these two values.

Given the financial statements (and negative equity) of insolvent debtors in Slovenia, reports show that, in practice, compulsory settlement always results in the elimination of existing shareholders' equity and in the subsequent entry of creditors into the debtor's ownership structure. It should be understood here that throughout the financial and economic crisis in Slovenia, with the exception of claims/receivables, there has been

practically no other capital available for investment, so conversions of debt to equity are inevitable for eliminating indebtedness in the Slovenian economy. It is hoped that after the absolute priority rule has been consistently applied, banks will start providing new money as a result of the acquisition of ownership rights over the debtor's business.

Creditor initiative

In the compulsory settlement procedure, which in Slovenian insolvency legislation is the only procedure intended for the restructuring of insolvent debtors, the Act shifted the balance of power significantly to the side of creditors. Financial creditors that hold 20 per cent of a debtor's financial liabilities are thus entitled to propose the initiation of the compulsory settlement procedure for an insolvent debtor and to prepare a plan for the financial restructuring of the debtor on which they later vote. In such a procedure, the court appoints the official receiver based on the creditors' choice.

The creditors can (but are not obliged to) take over the management of an indebted company, among other matters, if the sum of the debtor's liabilities exceeds the liquidation value of the debtor's assets, which is the case with most insolvent debtors.

The creditors may also propose their own financial restructuring plan for compulsory settlement proceedings that are initiated by debtors. In this case, the creditor's proposed plan has absolute priority over the debtor's plan, and only the former is voted on. However, under the amended legislation the case remains that a compulsory settlement plan must be approved if it was voted for by creditors holding unsecured claims amounting to at least 60 per cent of the total sum of all unsecured claims. An additional consent threshold for secured creditors applies (see below) if the plan affects secured claims.

The creditor board may hire legal and financial consultants on behalf of and for the account of the debtor in order to prepare an appropriate financial restructuring plan for the debtor.

With such a significant change in the balance of power within the compulsory settlement procedure, creditors (primarily banks and other financial institutions) have been given important tools to restructure the economy. Within the framework of the procedure, courts and insolvency office holders (also known as official receivers) only guard the legal aspect of the procedure and do not play an active role in preparing, negotiating and assessing the restructuring plan. The assessment of restructuring plans for debtors remains in the hands of certified/authorised company value appraisers, and of the creditors themselves.

Restructuring of secured claims

Since all debtors' assets in Slovenia are typically pledged, restructuring the economy would not be feasible without the compulsory modification of secured claims. Within this framework, the Act has introduced the following two important clauses:

- revaluation of secured assets and splitting of each secured claim into two new claims: a secured claim and an unsecured claim
- compulsory cramdown of secured creditors' rights with respect to debt maturities and interest rates.

Splitting of claims

It is important to be aware of the fact that the practice of taking syndicated loans did not previously exist in Slovenia and financing of the economy was based on multiple bilateral loan agreements with banks. It was actually not unusual to see one hundred bilateral loan agreements per individual debtor.

The compulsory splitting of claims is a means of reducing the burden of secured claims on insolvent debtors in a fair manner in order to enable the debtor's business to continue operating with the assets it urgently needs.

Frequently the same asset was pledged to several different creditors for different claims with different repayment rankings. However, the value of this asset usually did not even suffice to repay the first-ranking creditor. Before the splitting of the claims, debtors that

urgently needed an asset to operate their business would essentially be “captive” to a number of creditors and would not be able to pursue their business activities because the creditors would be entitled to sell the pledged asset at any time to repay their claims. If the debtor wanted to free its asset from any security interests, it was obliged to repay all of the pledgees, including any second- or third-ranking creditors, whose claims, although technically “secured”, would never be satisfied from the proceeds of any sale of the (over-collateralised) asset, the value of which could not even pay back the first-ranking creditor. This would also preclude a successful transfer of the business to a NewCo structure by way of spin-off (see below).

The Act addressed this issue by forcing a division of old secured claims (exceeding the present-day market value of the secured asset) into two new claims, namely (i) a new secured claim equal to the lesser of 120 per cent of the market value of the collateral or the amount of the old secured claim; and (ii) to the extent applicable, a new unsecured claim equal to the excess above the value of the new secured claim, up to the total amount of the old secured claim. The 20 per cent cushion above the collateral’s market value was added because of the potential future increase or “upside” in the value of the collateral. The legislator was well aware that because of the financial and economic crisis, the present market values of assets are lower than what they may perhaps be after the crisis. Since the splitting of claims is an irreversible legal procedure that takes place with the final approval of the compulsory settlement, the 20 per cent buffer is intended to compensate creditors for the potential future risk of an appreciation in value of the secured asset, which may have been valued during the time of economic crisis and resulted in the splitting of their secured claims into secured and unsecured parts.

Restructuring of secured claims

Compulsory settlement proposals can also be designed in such a way that the compulsory settlement plan effects a restructuring of secured claims, as follows: (i) the maturity of secured claims can be deferred for as long as necessary (in the preventive restructuring procedure this can be done only for a period of up to five years); and (ii) the interest rates for secured claims can be reduced as desired (without limit).

It should be noted that even compulsory settlements cannot compulsorily reduce the principal amounts of secured claims, with the exception of splitting the claims. Splitting the secured claims is the legal consequence of the final approval of the compulsory settlement.

If a proposal for compulsory settlement also focuses on secured claims, voting on compulsory settlement has to be done in two classes – in the class of unsecured creditors (votes involving at least 60 per cent of the total sum of all ordinary claims are required for the approval of compulsory settlements) and also in the class of secured creditors (votes involving at least 75 per cent of the total sum of all secured claims are required for the approval of compulsory settlements).

Spin-off

The changes introduced to the ZFPPIP by the Act aim to preserve the debtor’s healthy core business through a transfer or spin-off to a NewCo(s), leaving behind any (unsecured) liabilities in the debtor’s old corporate entity.

A financial restructuring plan in compulsory settlements for large and medium-sized companies may involve the spin-off of part or several parts of the debtor into a new legal entity or several legal entities. This is a separation by which the owner of the spin-off company remains the debtor himself; the latter usually goes bankrupt on separation, while the spin-off company continues to perform its original business activities.

Only those debtor assets that are essential for further business activities may be transferred to a spin-off company. Contrary to the general corporate regulations and based on an explicit provision of the Act, a spin-off company shall not be liable for the obligations of the debtor. Hence the spin-off company remains unaffected by the debtor’s subsequent bankruptcy.

Since all of the debtor's assets are usually pledged, the Act stipulates that all secured claims shall be transferred to the new spin-off company. As stated above, only new, revalued secured claims are to be transferred to the spin-off company, amounting to the lesser of (i) 120 per cent of the market value of the collateral; or (ii) the amount of the old secured claim. For this reason, spin-off companies are likely to have insufficient capital when they start up. Therefore the Act gives pledgees the option of converting their secured claims (which are transferred to the new spin-off company within the compulsory settlement procedure) into capital for the new spin-off company. This completely devalues the debtor's ownership share in the spin-off company, effectively performing a take-over.

It should be emphasised that the ordinary, unsecured claims of creditors remain with the debtor – the old company – which usually enters into bankruptcy thereafter.

All of the above events (splitting of claims, foundation of spin-off companies – including the transfer of assets and secured claims to such companies – capital increase of spin-off companies by converting the claims and initiation of the bankruptcy proceedings in relation to the old company) take place at the same moment, that is, when the court decision to approve the compulsory settlement plan becomes final. It should be noted that if compulsory settlement is not approved by creditors voting on the plan (shareholders with a majority share in the debtor and related companies in which the debtor has a majority ownership, do not have voting rights), bankruptcy proceedings are automatically and immediately initiated with respect to the debtor.

Conclusion

Although relatively little time has passed since the effective date of the Act and the changes to the ZFPPIPP, it appears that the new legal framework for pre-insolvency and insolvency has already had a significant impact.

According to official statistics for the period from January to May 2014:

- a total of 19 compulsory settlements have been initiated compared with 28 compulsory settlements in the entire year of 2013 (these data relate to companies of all sizes)
- of these 19 compulsory settlements, two proceedings were initiated by creditors (and therefore under the new rules for large and medium-sized companies)
- three preventive restructuring proceedings under the new preventive (pre-insolvency) restructuring procedure have been initiated.

In June 2014³ at least six additional preventive restructuring procedures have been initiated and at least one additional compulsory settlement for a very important Slovenian company has been initiated by creditors.

It seems that stakeholders are becoming more familiar with the new insolvency regime, which will likely accelerate the restructuring procedures in Slovenia and increase their efficiency in the long term.

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¹ These are companies, which according to data for the last two consecutive business years have met at least two of the following three criteria: (i) more than 50 employees; (ii) net income from sales in excess of €8,800,000; or (iii) value of assets in excess of €4,400,000.

² Under this rule, which has been codified in section 1129(b) (2) (B) (ii) of the US Bankruptcy Code, claims must be paid in order of contractual priority. Senior creditors' claims must be paid in full before junior creditors are paid anything and, subject to limited exceptions, equity cannot receive any property under the plan where the debt has not been paid in full.

³ This data are gathered from publicly available sources and are not based on official statistics.



Internet revolution in bankruptcy information in Russia reduces risks for creditors

Alexey Yukhnin

Many countries are turning to technology to increase the level of transparency and access to information for creditors and other stakeholders in bankruptcy procedures. In the European Union, impending changes to the Regulation (EC) No 1346/2000 on insolvency proceedings will make it obligatory for Member States to publish key information on insolvency proceedings in electronic insolvency registers. This topical article examines the reasons behind the recent introduction of a Russian internet portal for information on bankruptcy proceedings, and its many benefits for stakeholders.

The Unified Federal Register of Bankruptcy Information (the Bankruptcy Register)¹, through which virtually all existing information about bankruptcy proceedings in Russia is disclosed, celebrated on 1 April 2014 the three-year anniversary of its full-scale launch. On average 100,000 new reports are released through the portal annually, making it possible to follow all stages of about 35,000 bankruptcy cases that are underway at any given moment, from the filing of a lawsuit to the sale of assets in electronic auctions.

What came before?

The Bankruptcy Law of 2002 required all insolvency office holders (known in Russia as arbitration managers) to publish key information about the course of bankruptcy proceedings in official publications designated by the government of the Russian Federation. The national daily newspaper *Kommersant* has been such an official publication since 2005 and bankruptcy notices make up three-quarters of its Saturday issues.

This approach of disclosing information was found to be unsatisfactory for a number of reasons. First, the depth of information disclosure was extremely low, since in the modern world it is difficult to imagine a manager reading through 1,200 notices in small print in search of their counterparty or an interesting asset to acquire. Second, information disclosure experts noted the fairly low level of reliability – about 40 per cent of notices contained false information (mistakes in debtors' names, their identification codes or addresses), and about 10 per cent of mistakes prevented the correct identification of debtors (cases where names, identification codes and locations did not match at all). Third, the high cost of publication in print media² led to the use of abbreviations, which caused further reading challenges. Publishing notices exclusively in print publications made searching and structuring information much more difficult.

Given the drawbacks of disclosure and dissemination of information in hard copy, the Ministry of Economic Development decided in 2008 to develop an electronic portal for the disclosure of bankruptcy information via the internet. Changes were made to the Bankruptcy Law that set out the basic principles for the establishment of the Bankruptcy Register (Law No. 296-FZ dated 30 December 2008). The Interfax Information Services

Group developed the portal's software and also became its operator when the portal was launched in 2011.

How does the Russian portal compare with other national portals?

Similar principles for the disclosure of bankruptcy information via an internet portal appear to be used in Australia, but in Russia information is published directly by the source of the information (the insolvency office holder). The other key difference between the Russian and Australian systems is that in Australia a fee is payable for obtaining information from the register, whereas in Russia bankruptcy information can be accessed free of charge.

In a number of countries, such as Latvia, insolvency administrators provide information to authorised government institutions, or companies designated by them, for subsequent publication on the internet. In this case, the government-authorised institution essentially acts as an intermediary for the publication of bankruptcy notices and can review (correct) notices while overseeing their conversion to electronic form for public access.

Yet there are fundamental differences between the Russian portal and other prominent foreign online systems for disclosure of bankruptcy information. In the Czech Republic, for example, information about bankruptcies is disclosed by the courts, which, in addition to their normal judicial functions, maintain a register of legal entities that includes bankruptcy information. Such an option was not possible for Russia since Russian courts do not have registration powers in relation to companies and do not have any duties other than in respect of judicial proceedings.

Portal roll-out

When designing the Russian portal, the following strategic objectives were set for its creation and operation:

- ensuring public accuracy and legal relevance of information
- minimising fraud risks by identifying those persons disclosing information as well as debtors
- prompt disclosure of information
- future reduction of the costs of bankruptcy proceedings by completely transitioning to electronic disclosure and abandoning disclosure in hard copy form.

These objectives were achieved by ensuring integration with other federal resources – in particular the Unified State Register of Legal Entities and Individual Entrepreneurs, the system for disclosure of information about court orders and the Unified State Register of Self-Regulating Organizations of Arbitration Managers – as well as by introducing enhanced digital signatures of notices using certified encryption tools.

Disclosure of information through the portal made it possible to ensure the publication of notices within a very short timeframe (no later than the next working day after payment for publication, and with prepayment immediately upon submission of notices). The publication price was determined by calculating the cost of maintaining the Bankruptcy Register and amounted to 640 roubles³ per notice, regardless of the type and size of the notice. This was just a fraction of the cost of print publication.

The biggest challenge in developing and rolling out the portal was the implementation of enhanced digital signatures, because when the portal was initially developed the use of such signatures was essentially limited to tax reporting. Consequently, almost no software or organisational solutions for digital signatures were available on the market and they had to be developed for the first time within the context of the project. The Russian Union of Self-Regulating Organizations of Arbitration Managers, a voluntary organisation for self-regulating associations of insolvency practitioners, provided invaluable assistance in organising effective training for arbitration managers on how to use the portal.

The introduction of enhanced digital signature tools ensured that information on the portal was of legal relevance, since such signatures not only make it possible to identify the exact

person who placed the notice, but also ensures the integrity and inalterability of the placed notice.

The main software for the portal took three years (2008-10) to develop and the portal was launched commercially on 1 April 2011. In its first year of operation, about 70 per cent of registered arbitration managers posted information on the portal on more than 18,000 debtors.

Types of information disclosed

At present most of the content on the portal consists of information that is disclosed by arbitration managers over the course of bankruptcy proceedings.

The Bankruptcy Law requires arbitration managers to post the following information on the Bankruptcy Register:

- key court orders concerning a bankruptcy case – implementation of proceedings, appointment and dismissal of arbitration managers, cessation of bankruptcy proceedings
- asset sales – announcements of sales, results of sales
- the assets of debtors – results of asset inventories, reports of asset appraisals
- meetings with creditors and the results of those meetings.

The portal is also used to disclose: (i) information about arbitration managers and the self-regulating organisations to which they belong; (ii) information about the sales process on electronic trading platforms (from the publication of an application to conducting a sale to the publication of sales results); and (iii) information about court orders issued in bankruptcy cases.

Under bankruptcy legislation, the first publication on the portal is supposed to be made by the arbitration manager within 10 days of commencement of the first proceeding in the bankruptcy case, and subsequent publications must be posted at key stages in the bankruptcy, including on: finalisation of the inventory and appraisal of assets, organisation of asset sales, and convening of creditors' meetings. Essentially, all material information about the bankruptcy case is made accessible to creditors and other interested parties.

The types of content published on the portal make it possible to obtain sufficient information to monitor any given bankruptcy case by studying key notices on the case.

In the near future there are also plans to introduce the publication of arbitration managers' reports on the results of bankruptcy proceedings (Law No. 189-FZ dated 2 July 2013 calls for mandatory publication of such reports as of 1 July 2014).

In addition to arbitration managers and their self-regulating organisations, information on the portal is disclosed by the Central Bank of Russia (CBR) when it relates to lending and other financial organisations. The CBR publishes information about the revocation of such organisations' operating licences, details of insurance payments to the depositors of such organisations and the financial condition of the organisations, among other things.

Obtaining information from the portal

Russian bankruptcy legislation provides fairly short timeframes for carrying out legal proceedings, so promptly obtaining reliable and accurate information about a bankruptcy case is critical for creditors to effectively exercise their rights in the proceedings.

With this in mind, the portal provides several options for obtaining relevant information:

- Information can be obtained online through the portal's website using built-in search tools. This access is obtained using standard web browsers without charge, allowing any interested party to easily monitor the course of bankruptcy proceedings without any additional costs. There are no restrictions for this means of access (with the exception of standard constraints of internet bots).

- Another basic function of the portal is the option to subscribe to updates over the course of bankruptcy proceedings regarding certain debtors. When new information appears, the subscriber is notified by email that new information about a debtor is available on the portal. This tool is limited to five subscriptions per email address, but is also offered free of charge.
- If users need to obtain information about a broad range of debtors, they can connect to the data download gateway, where information is provided on all notices published in the system in machine-readable XML format. This type of access is primarily of interest to information agencies for inclusion in their own databases, as well as to systemic participants in bankruptcy proceedings, such as major banks, because of the option to integrate the data into their own electronic file management system. This type of access is offered for a modest fee of less than 15,000 roubles (about €330) per month.

Additional features

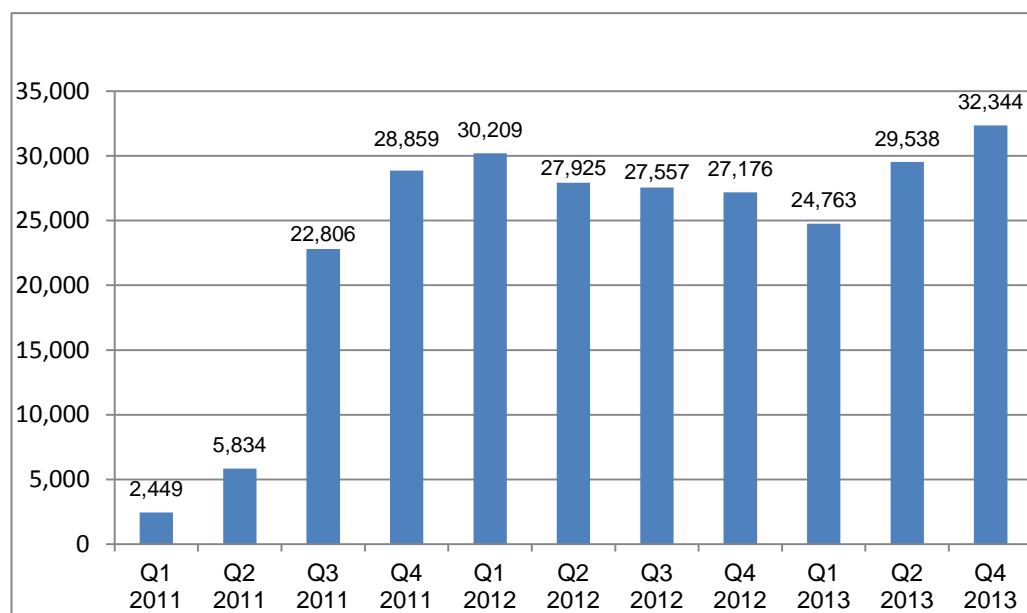
In addition to ensuring free and unfettered access to information on bankruptcies for interested parties, the portal provides fairly extensive opportunities for analytical research in the area of bankruptcies.

Under the current regime, the total number of bankruptcy practitioners is known (9,535 people as of 5 May 2014), as is the number of arbitration managers who have published notices on the portal at least once (7,923). This also makes it possible to determine the number of non-practising managers. For example, in 2013 at least one notice was published about 27,736 debtors, 62 of which were natural monopolies (such as utility and power networks, municipal transport and railway services). The largest number of natural monopolies subject to bankruptcy proceedings was in the Vladimir region (6).

The portal also receives a large amount of information for analysis from separate electronic trading platforms that sell the assets of bankrupt debtors. Since 2011 real estate, securities, pledged assets, objects of historical or artistic value, items with a market value in excess of 500,000 roubles (about €11,000), property rights, as well as enterprises (businesses) as a whole have all been sold through an electronic bidding process.

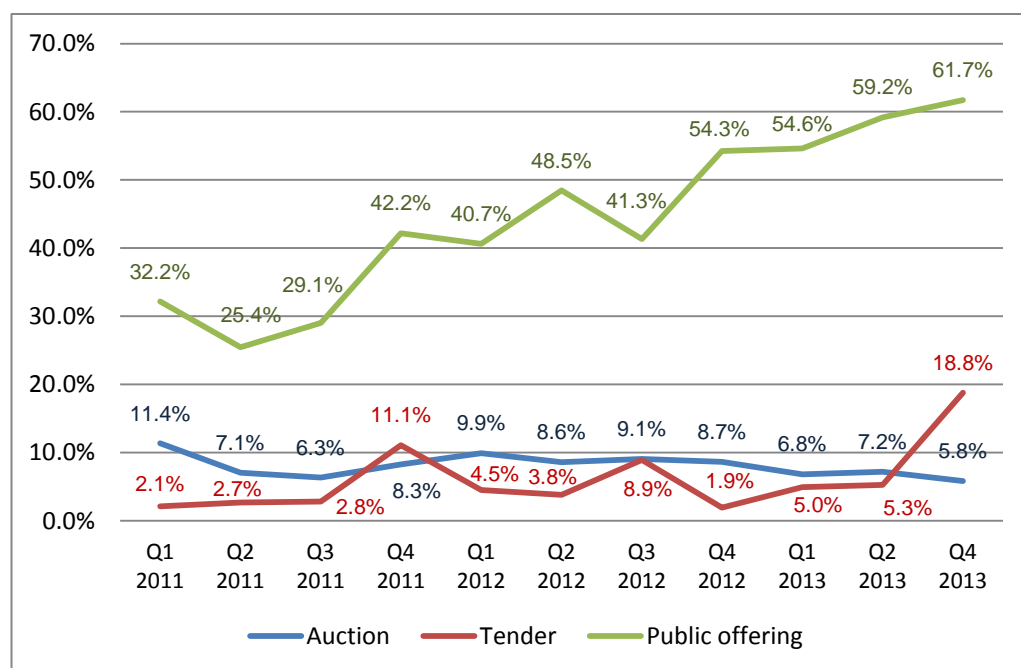
Statistics show that about 30,000 bidding processes for the sale of debtors' assets are held in Russia quarterly (see Chart 1), with the 10 largest trading platforms (out of a total of 55) accounting for 86 per cent of bidding processes. Furthermore, no more than 10 per cent of assets are sold in bidding processes that are ascending price auctions (5.8 per cent in the fourth quarter of 2013) (see Chart 2), while in descending price auctions, the average discount to the starting price ranges from 65 to 70 per cent (see Chart 3).

Since 1 July 2014 arbitration managers' final reports have been posted on the portal. This makes it possible to analyse and determine to a greater extent the effectiveness of bankruptcy proceedings by looking at the cost of proceedings, the degree to which creditors' claims are satisfied in full, the number of filed and upheld appeals against arbitration managers as well as the value of assets and amount of debt held by the debtor, among other things. Clearly such information is highly relevant for government legislators interested in reforming bankruptcy regulation in order to increase the effectiveness of bankruptcy proceedings. In general, the new resource introduced by the Bankruptcy Register has made the whole field of financial recovery and bankruptcy in Russia more civilised, transparent and clear to the public.

Chart 1: Total number of electronic sales (quarterly)⁴ in Russia

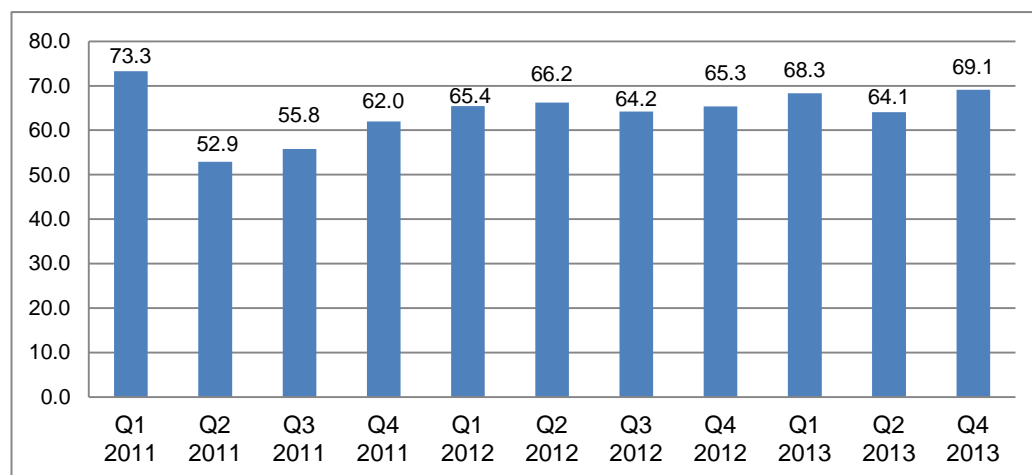
Source: Data gathered from the Unified Federal Register of Bankruptcy Information at www.bankrot.fedresurs.ru.

Chart 2: Share of completed sales (Russia)



Source: Data gathered from the Unified Federal Register of Bankruptcy Information at www.bankrot.fedresurs.ru.

Chart 3: Average discount (in per cent) to starting price in descending price auctions (Russia)



Source: Data gathered from the Unified Federal Register of Bankruptcy Information at www.bankrot.fedresurs.ru.

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¹ See www.bankrot.fedresurs.ru (last accessed 16 September 2014).

² The average publication cost for print publications between 2002 and 2013 was about 150 roubles per square centimetre of printed area, which resulted in a minimum publication cost of 7,000-8,000 roubles (about €175 on the basis of the exchange rate current on 31 December 2013), while the maximum cost of publication could reach hundreds of thousands of roubles.

³ Approximately €14 (on the basis of the exchange rate current on 31 December 2013). The publication price in roubles has not changed since 2011.

⁴ Data for Q3 2013 were removed deliberately from the three charts. During this period the Deposit Insurance Agency, which is the liquidator of insolvent banks in Russia, held over 30,000 unsuccessful trades of small assets. As a result, the statistics were extremely distorted in terms of the number of trades and percentage of successful/unsuccessful trades.

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