Insolvency and Privatization: The European Transition Economies in the 1990s

Dieter Stiefel

Insolvency policies played a different role in transition countries than in established market economies. This was, first, the result of the pre-existing planned economy, subsequently succeeded by the radically different market economy. There were, however, remarkable differences. The fact that the Eastern Bloc was perceived as a unity was in essence a result of successful political propaganda during the cold war. In fact, centrally planned models and their exhibited characteristics were as different in the various countries as their preconditions had been. Only in two cases, those of East Germany and Czechoslovakia, could one speak of industrial states at the moment of the communists’ introduction of a centrally planned economy. All other communist countries were initially agrarian states, showing only the first signs of industrialization. Until 1918, some of them had been part of the Austro-Hungarian Empire, which had advanced insolvency legislation. Some successor states, such as Yugoslavia and Hungary, permitted private initiatives, primarily family enterprises, alongside state-owned enterprises, especially in the sectors of public service and tourism; others, such as Czechoslovakia, were prevented from developing a ‘human form of communism’ by the troops of the Warsaw Pact, and others such as the DDR saw themselves as model acolytes of the planned-economy system. The Soviet Union, with its communist past of 80 years, had almost no experience of a market economy at all, whereas Central European countries could refer to their experience and in particular to their insolvency laws that had been enacted 40 years before. The era of the centrally planned economy also had very different priorities. Hungary and Czechoslovakia never neglected agriculture. In this field, they had no shortage of supply and reached high quality and considerable export opportunities. Unlike these, Poland focused on heavy industry, which entered a crisis not only within the centrally planned economies but also globally from the 1980s onwards. Differences in the number of state-owned enterprises, their industrial focus and the possibility of private initiatives during the era of the centrally planned economy characterized the transition of these countries to a market economy.
The transit from a centrally planned economy to a market economy presupposed a complete reorientation in the management of enterprises. Today, enterprises are regarded as ‘learning units’, because not only individuals, but also groups and organizations, can learn. That is the only way in which the ‘physics of market economy’, as one might call it, can work, i.e. phenomena of expansion and reduction of enterprises, of their adaptation or resistance. The entirety of experience was suddenly no longer valid. Literature on this subject thus speaks correctly of a ‘shock’ in the economic sphere. In communism, there is no separation between politics and economy. Economic activity thus becomes political activity. Accordingly, the leading positions are occupied by people with a clear political orientation, who may well be good managers, but do not have to be. The reluctance to embrace innovation is thus explicable, first, by the fact that the managers’ economic aim is restricted to high employment quotas and the achievement of their production targets. The lack of interest in innovation is either also due to the firms being monopoly enterprises or to their being in a sellers’ market, and to the consideration that every change in production entails dangers. Unlike their market economy counterparts, the personal success of managers in a centrally planned economy, i.e. social advancement and material reward, cannot be reached through the enterprise itself, but primarily through the party. A manager’s main interest, therefore, had to be focused on political activity. Further, the centrally planned economy thinks in quantities, not in prices. Its typical representative is the engineer, whereas in a market economy it is the Chief Financial Officer (CFO), the controller. In a centrally planned economy, enterprises had to produce certain quantities, the unit costs were in most cases not known and even if they were, this was not of vital importance. The transition from one economic system to the other meant a change in the way of thinking, from production-oriented to cost-oriented, and was thus a ‘cultural shock’. The legislation on insolvency was part of this shock. The essence of the transition is a radical change of the type of management, of its incentives and risks policies.

The problems of a state-owned economy are not completely unknown to market economy countries. Economic history shows the different functions of the private sector of the economy and the state during the past five centuries. They are the two partners in the advancement of capitalism (or, as one might say, of market economics), where the enterprise qua ‘homo oeconomicus’ must pursue its own interests while the state gives the general rules. They need each other, like two card players, to play the game: one takes care of the economic production and the other of the social compatibility of this dynamic process. The risk of nationalization is that public functions are transferred to the private sector of the economy, i.e. a card player ends up playing with himself and the game thus loses its dynamics. As a result, regional social interests, which may sometimes be an obstacle to economic efficiency, become part of the decision-making process (Brada 1992,
Because in centrally planned economies the capital city was often far away, it was, as a rule, the regional party that had the largest influence on the appointment of a business’s management. The party’s interest focused on employment and production in its own region. Even in those cases where the government emphasized the importance of efficiency, decision-making processes were influenced by considerations regarding the regional repercussions of the reorganization or closure of firms.

The Czech Republic

Bankruptcy legislation in the Czech Republic derives from the Austrian bankruptcy law of 1915, which also applied to Bohemia and Moravia. In 1931, in the newly formed Czechoslovakia, this law was changed but it lost its importance completely during the communist era. In 1950, these regulations were lifted and replaced by civil proceedings. The concept of bankruptcy was replaced by that of liquidation, which could be imposed by court decision. The creditors’ autonomy was thus removed and courts deliberated exclusively on the distribution of the revenues from liquidation. In a nationalized economy, insolvency proceedings were no longer important because both creditor and debtor enterprises were state-owned. For political reasons, mainly related to reciprocity with foreign countries, a few insolvency regulations remained. The regulation of insolvency cases concerning real estate was transferred to the notary chamber, which had been created in 1950 (Tichy 1993, p 96). The opening up of Eastern Europe led to new legislation on bankruptcy in 1991 – with amendments in 1993 and 1996 – which now did not refer only to its Austrian predecessor but also to the German example. The transition program of the Czech government of January 1991 provided for a rapid transition to a “market economy without adjectives”, as the then Prime Minister Václav Klaus phrased it, i.e. a market economy and nothing else, without adding ‘social’ or other adjectives. This meant the introduction of price elasticity, the liberalization of foreign trade, the discontinuation of subsidies and the introduction of real, market-oriented interest rates. These regulations, together with the extensive loss of the Eastern market, especially of the former Soviet Union, and the confrontation with a highly competitive market economy in the West, came as a shock to almost all enterprises. The strict credit policy in Czechoslovakia and high interest rates led to enterprises having difficulties in obtaining foreign capital. Enterprises solved this transition problem by increasing their indebtedness with each other, delaying payments for increasingly long periods. This made possible the survival of insolvent enterprises.

The economic structure inherited from a centrally planned economy had a disproportionately large heavy-industry sector and an underdeveloped service sector, and thus required a rapid restructuring of economic resources,
with the risk, however, of widespread bankruptcy. The government implemented a number of regulations in order to avoid this: their aim was to reduce the burden of the past, to promote the privatization of heavily indebted enterprises and to increase the liquidity of banks that had a considerable amount of doubtful receivables. Most important among such regulations were a limited debt cancellation in 1991 (to the value of 50 billion crowns), the foundation of the Konsolidaeni Banka in 1991, which took over short-term corporate loans from other banks (110 billion crowns), the suspension of the new bankruptcy law until April 1993, the clearing of all debts enterprises had incurred with each other in May and September 1993 (980 million crowns) and the implicit credit cancellation of some enterprises that were in the process of being privatized (Hoshi et al 1998, pp 129-130). These regulations absorbed the shock of the transition to a market economy and facilitated the privatization or closure of state-owned enterprises by means of workouts, restructuring changes and downsizing. From 1993 onwards, however, insolvency proceedings were to become the usual solution for unprofitable enterprises.

In the Czech Republic, insolvency means that either an enterprise cannot discharge its payment obligations or that it is heavily indebted. A petition for insolvency can be submitted both by debtors and by creditors (Tichy 1993, p 84). Until 1996, in concord with the Austrian model, proceedings were initiated only if the assets could cover legal expenses. As of then, the payment of one lump sum is requested at the moment of the submission of the petition (10,000 crowns). In the case of state-owned enterprises, a petition for insolvency needs the approval of the relevant ministry; enterprises that are the object of a voucher privatization were excluded from bankruptcy proceedings until the change of ownership was completed. A petition of insolvency, just like in Austria, grants the debtor 3 months to solve his financial problems. During this period, called ‘automatic stay’, his creditors cannot prosecute him, the only exception being the employees’ claims and the taxes for the continuation of his business activity. The automatic stay is mainly for newly privatized enterprises in order to give them an opportunity to negotiate with their creditors before insolvency proceedings become unavoidable.

After this period of transition, courts appoint a trustee and all asset-based transactions that have taken place 6 months before the petition for insolvency are invalidated. The trustee has heavy responsibilities, he is personally liable for the correct treatment of the proceedings and he can prosecute the current management for irregularities dating back up to one year. Payment is determined according to a fixed tariff, which is rather low. The trustee makes a list of all assets and liabilities and creditors form a committee in charge of the supervision of his activity. Proceedings can end in simple restructuring, bankruptcy or enforced restructuring.

Within the 3-month automatic stay, the creditor can apply for simple restructuring, which must contain a rehabilitation plan and the cancellation of
at least 45% of unsecured debts within 2 years. If this plan meets with the creditors’ approval, courts can authorize restructuring. If this does not happen, courts order the liquidation, i.e. bankruptcy of the enterprise. Courts often fix the price at which the enterprise’s assets are to be sold in order to prevent malpractice. However, this has repeatedly led to delays, as the prices that have been fixed have often been hard to meet. If creditors have securities on individual assets of the enterprise, they can realize them for their own profit. Otherwise, Czech insolvency law provides for three classes of creditors: the first class includes the employees’ claims from the previous 3 years; the second class includes taxes, expenses and receivables of social security from the same period; and the third and last class contains all the remaining claims. Each class receives payments only after the class above it has been completely satisfied.

During insolvency proceedings, the debtor can also apply for enforced restructuring. This must lay out a plan for the payment of preferred debts and at least a third of the creditors’ doubtful receivables. This plan must meet the approval of the majority of creditors (three thirds of their receivables) and of the courts. The courts must check the debtor’s ‘honest intention’, above all that the application for enforced restructuring does not aim only to delay bankruptcy proceedings. If courts authorize enforced restructuring, a debtor is fully in charge of his enterprise again.

Between 1992 and 1996, the ever-accumulating petitions for insolvency reached 8,647 in the Czech Republic. In 1996, 53% of these had not yet been settled, 29% had been rejected for lack of assets or lacking formal preconditions and in 18% the verdict was bankruptcy. During this period, there were only 11 cases of restructuring (Hoshi et al. 1998, p 135). The number of petitions for insolvency was surprisingly small, especially if one considers the problematic situation of a transition country. In the past, debtors with financial difficulties were not immediately forced to go to court. Above all, the large number of pending cases shows the overburdening of the courts. Ultimately, the strictness of this type of restructuring kept its number extremely small. Insolvencies affected in most cases small- and medium-sized enterprises. Unlike its Hungarian counterpart, Czech economic policy kept the number of insolvent large, state-owned enterprises quite small; for those that had been privatized, this was possible only with the conclusion of the voucherization from 1995 onwards.

This procedure, however, displays a whole series of problems (Hoshi et al. 1998, p 137). Because of the still underdeveloped financial market and accounting standards, it was hard to gain insight into the financial situation of an enterprise. The bankruptcy law did not really change these circumstances. Before the 1996 amendment, management was not obliged to describe the state of the firm when they filed a petition for insolvency. The current management had little motivation to file such a petition, as it was more profitable for them to privatize the enterprise and thus keep their position. Bankruptcy
was to put an end to all this. On the other hand, the conditions for restructuring (45 or 33%) were extremely strict and could be met only rarely. Many Czech enterprises were financially burdened as a result of their past in a centrally planned economy and were now able to reach this restructuring rate only in rare cases. Therefore, firms that under more generous insolvency conditions would certainly have survived were closed. Czech bankruptcy legislation adopted this hostility towards the rehabilitation of enterprises from its German model, although here, too, an amendment in 1999 was to facilitate the reorganization of enterprises in insolvency proceedings, which follows the general trend. Initiating rehabilitation is also difficult because only debtors, not creditors, may submit a plan for it. As a result, it becomes harder for foreign capital to flow into the enterprise and for the trustee to act only as an umpire. Additionally, losses incurred during insolvency proceedings are not tax-deductible.

Generally speaking, insolvency proceedings burden the courts excessively. The Czech procedure is thus the opposite of the American one. The extensive involvement of courts is especially problematic in the case of a transition country, where more is lacking than the requisite number of judges with good knowledge of economics. Therefore, courts cannot cope with the situation and this results inter alia in the length of the proceedings. An opposite policy could be observed in Hungary, where courts dealt with approximately 90% of insolvency proceedings quickly and effortlessly.

The payment of a trustee was a further problem, which theory identifies as the classical problem of the principal-agent. Until 1996, a trustee was paid according to a fixed scheme, which was not very generous. Accordingly, he was not particularly motivated to achieve the highest possible realization value of the insolvent enterprise. Few counselors applied for this position and those who did, did not devote themselves exclusively to this task. At the end of the 18th century, the father of classical economics, Adam Smith, stressed that a market economy is based on the motivation of the individual and thus on his own interest, i.e. his selfishness. This principle must be accepted in order to adopt a market-economy system. The unsatisfactory payment of trustees may explain why some did not hesitate to line their own pockets during insolvency proceedings. This can only be avoided when the interests of the agent coincide with those of his principal, i.e. quick proceedings and high insolvency revenues are in the latter’s interest too. In 1996, therefore, a more generous amendment reworked the remuneration of trustees: they now receive a fixed salary and a results bonus that varies according to the revenues from the insolvency proceedings.

A special problem of the transition economy in all countries was the ‘creditors’ passivity’ (Hoshi et al. 1998; Mitchell 1993). In a market economy, the creditors force an enterprise to resort to foreign capital: they request repayment with interest rates and know their last resort well – insolvency proceedings. In a transition economy, however, and especially at its
beginning, creditors were state-owned firms or state-owned banks that were
not expected to justify the course of action of their management. They were
linked to their clients by long business relations dating back to the planned-
economy era, and a coherent application of insolvency policies would have
revealed the plight in which banks found themselves. Also, they could still
hope, as in 1991 and 1993, to be able to write off part of their problematic
loans through governmental subsidies. The uncertainty as to how the transi-
tion phase would affect the whole economy of a country and its individual
enterprises was a further reason not to be too strict with defaulting clients, all
the more so as insolvency proceedings were highly bureaucratic and time-
consuming. However, this was to change as a result of the increasing inter-
est of foreign banks – mainly German and Austrian ones – in the Czech Re-
public.

Hungary
The introduction of insolvency law in planned-economy countries produced
the most extraordinary results in Hungary. The problem of insolvency arose
in Hungary as early as in the 1970s with the introduction of the new eco-
nomic mechanism, through which profit was made the essential yardstick for
the success of enterprises, including state-owned firms. However, as bank-
ruptcy law would have addressed the question of property rights, develop-
ment in this direction came to a halt. Instead, the relevant ministry/office or
political institution dealt with problems individually. Small enterprises were
usually merged with larger ones in case of difficulties. A first governmental
decree dealt with insolvency proceedings in 1978, providing for both liqui-
dation and rehabilitation. However, the proceedings were not very transpar-
ent and were left in the hands of the minister of finance or a specific minis-
ter. Only taxes, social security contributions and bank loans were taken into
consideration. In the 1980s, only 13 state-owned firms were liquidated,
which is negligible when compared with the growing number of state-owned
firms in trouble. Nonetheless, this was a first step, and the insolvency decree
of 1978 contributed inter alia to a growing privatization in which insolvent
state-owned firms and parts of enterprises or assets were sold to private indi-
viduals. In 1990, a third of all enterprises incurred losses. As a result, the
government requests ministries to initiate liquidation in case of a protracted
reluctance to pay, or to double interest rates in case of delays in payment. In
the 1990s, the last communist government enacted a law forcing all the en-
terprises that could not meet their financial commitments into liquidation.
This law caused panic in state-owned enterprises, as the financial policy that
had hitherto been customary had led to indebtedness which for hundreds of
state-owned firms would now imply immediate liquidation. The new parlia-
ment softened these regulations and left space for individual treatment.
However, a clear message had been sent to the Hungarian economy (Mizsei 1993, p 24).

As the first transition country par excellence on January 1, 1992, Hungary enacted a strict insolvency law with a trigger mechanism for petitions for insolvency. All enterprises that had delayed payments to their creditor for over 90 days had to file a petition for insolvency within a week. Management was obliged to implement this measure under a threat of punishment. The law granted a grace period of 90 days before its introduction, after which 3,500 petitions were filed. Overall, in 1992-1993 there were 22,000 petitions for insolvency, which was far beyond all expectations (Gray et al 1998, p 175). In 1992, 83% of the petitions for insolvency had been filed as a result of this trigger mechanism and 85% of the petitions for liquidation were filed by creditors. In 1991, the enterprises for which petitions of insolvency were filed in 1992 had produced 14% of the GBP, 25.5% of exports and employed 17% of the workforce. Eleven per cent of these enterprises were state-owned firms and 26% were cooperatives that, at the same time, also represented large firms. Only 10% of state-owned firms were closed, whereas the percentage of cooperatives (50%) was very high (Hegedus 1994, pp 104-105). The new Hungarian insolvency law was modeled on the American one in many respects, with the exception of the compulsory, automatic petition mechanism. The debtor can file a petition for reorganization or liquidation, whereas the creditor can apply only for liquidation. When the debtor applied for rehabilitation, management remained in its role and had a 3-month ‘automatic stay’, that could be prolonged by a month. During this period, a debtor was expected to produce a rehabilitation plan that had to be unanimously accepted by creditors. Trustees and committees of creditors were not mandatory, but could be requested by the creditors themselves. New loans did not have a preferred status during rehabilitation proceedings. If an agreement with the creditors was reached, an automatic liquidation would ensue by law. In case of liquidation, a trustee was appointed who would deal with it and would distribute the revenues according to an order of preference: first, bankruptcy expenses; second, creditors with securities, taxes and social security contributions; third, those without securities and, last, the owners. The law regulated the payment of trustees and their professional qualification. Proceedings had to be completed within 2 years.

The aforementioned experiences with insolvency law led to some changes in September 1993. The creditors’ unanimous approval of the rehabilitation plan was regarded as too strict and was thus adapted to international standards, namely half of the creditors and three quarters of debts. The automatic stay was not only regarded as being too generous, but it also led to malpractice. For this reason, its ‘necessity’ was replaced by its ‘possibility’ if half of the creditors agreed. The automatic petition of insolvency and the automatic liquidation in cases of failed rehabilitation plans were lifted in order to staunch the flood of petitions for insolvency. Payment of liquidators was
here, too, increased, their obligation to submit a report became stricter and the creditors’ control over them was intensified. Foreign firms, too, could act as liquidators. The appointment of a trustee was now mandatory for all cases of rehabilitation.

After the 1993 amendments to the law, however, the number of cases of reorganization decreased dramatically. First, the carrot-and-stick mechanism, i.e. the ‘carrot’ of automatic stay and the ‘stick’ of automatic petition, disappeared. Also, the presence of a now mandatory trustee increased the costs of proceedings and granted outsiders an unwelcome insight into the enterprise. Moreover, at the end of 1993 an out-of-court proceeding for the consolidation of debtors was introduced, which was regarded as being more profitable in many cases. Finally, the economic situation improved considerably after 1994 (Grey et al 1998, p 179).

The enormous number of petitions for insolvency in 1992 was a consequence of the trigger mechanism: 17,000 petitions of a total of 22,000 were filed for liquidation and 5,000 for reorganization, a third of which, however, eventually also resulted in liquidation. It is hard to say how efficient these proceedings actually were and how much they separated the wheat from the chaff. In essence, there were three groups for liquidation: firms without assets, privately owned firms (mainly small ones) and state-owned firms. Gray emphasizes that in conversations with managers and trustees it became clear that the reorganization option was initially often chosen because the proceeding was still unknown. Also, one could gain time to sell off parts of the enterprise and assets to private firms, knowing full well that these transactions could not be controlled by anyone because of a lack of sources of information. Thus, a tacit privatization, so to speak, took place in which economic resources were redirected from troubled state-owned firms towards private firms and the related documents subsequently disappeared. Creditors, too, reached individual agreements and took their retrievable from the enterprise at the expense of other creditors, which in all bankruptcy laws is prosecuted. Since the ‘watch dogs’ of the market economy, i.e. accounting standards, lawyers, courts and credit rating agencies, were still underdeveloped in the transition countries and information was expensive and unreliable (Grey et al 1998, p 185/6).

The most astonishing element was the speed at which insolvency proceedings were dealt with in Hungary. In Budapest, there were only eight insolvency judges to deal with over 15,000 cases in 1992. Despite this, 60% of the cases of reorganization were concluded by 1992 and 95% of the cases in 1992-1993 by the end of 1993. On average, a debtor submitted a rehabilitation plan 8 weeks after the petition for insolvency and 8 months later all arrangements for both small and large enterprises had been concluded. The reason for this lay in the limited involvement of courts and trustees in insolvency proceedings. Once a case had been accepted by the courts – which
took about 3 months as a result of the work overload —, proceedings were dealt with in a ‘decentralised’ manner by a debtor and his creditors.

Only in cases of liquidation were there difficulties because a court’s appointment of a liquidator alone lasted half a year and many cases had not been concluded within the mandatory 2 years. Also, a liquidator mostly used his strong position to keep the work places of the threatened firm as long as possible and tried to sell the enterprise as a whole to private individuals. The lack of co-determination among creditors in liquidation proceedings led to their incurring considerable losses, which also increased the cost of loans for the entire Hungarian economy. In the case of state-owned Hungarian banks, too, creditors’ passivity can be observed. After these banks had been recapitalized by the state between 1991 and 1995, there was little urge to deal with defaulting debtors with the strictness ordered by law. A considerable part of their receivables were therefore doubtful claims.

Nonetheless, insolvency proceedings in Hungary have not only produced professional trustees and liquidators who understand the financial demands of the market economy, they have also forced enterprises to think in the categories of the market economy, namely profit and loss.

Poland

In 1993, the Polish government issued a plan for the reorganization of enterprises and banks. Its aim was to rehabilitate (and prepare for privatization) seven of the nine commercial banks that had derived from the National Bank in 1989. At the same time, these banks were meant to direct and control the rehabilitation and privatization of state-owned banks that had financial troubles. There were 787 of these enterprises, with a volume of credit of $1.43 billion at that time. By April 1994, banks had first to implement regulations on loans that, at the end of 1991, had been regarded as doubtful or lost. Then, they had to differentiate between enterprises according to the following criteria (Gray/Holle 1998, pp 207-208):

− a debtor has redeemed his loans in the last three months. These enterprises were regarded as healthy and were the only group for which liquidation was not taken into consideration. They were usually large enterprises which temporarily had not been able to make a profit as a result of the dramatic transition to market-economy conditions in 1991/1992. A large number of these enterprises began repayments only as a result of new borrowings.
− court-managed or banking conciliation proceedings were carried out. These were for enterprises with the potential to survive and for which a rehabilitation made sense. Court-managed restructuring proceedings had
existed since the communist era (1934 Law) but had rarely been applied. The banking conciliation proceedings introduced by the plan for the re-organisation of enterprises and banks were flexible and for three years they were available for banks and enterprises in trouble.

- bankruptcy proceedings according to the 1934 bankruptcy law provided for the court-managed closing of enterprises in trouble if debts exceeded the assets or if the liquidation value was higher than that of the enterprise as a productive unit. The revenues from the liquidation were then distributed among the creditors.

- privatization or liquidation is in progress: this was the case of state-owned firms that were not insolvent.

- debt instruments were sold on the secondary market. In this case, debt instruments were sold to enterprises that had better prospects of collecting such debts. This solution was rarely applied, as losses were not tax-deductible, unlike all other insolvency proceedings. Whenever debt instruments were sold, however, they were sold to clients of the enterprise who wanted to pay their deliveries with them or who might consider taking a stake in the company.

Court-managed restructuring proceedings were part of the 1934 bankruptcy law and were meant to offer an alternative to the closure of enterprises. Proceedings proved to be rather laborious, which is why banking conciliation proceedings were introduced in 1993. Court-managed restructuring does not affect creditors with securities and the public authorities (taxes and social security contribution), but only trade credits and unsecured loans. Proceedings refer only to financial reconstruction, not to other measures, such as headcount reduction. Every arrangement must be authorized by two thirds of the creditors’ claims, which was increased to four fifths if the write-offs amounted to more than 40%. However, only creditors who took part in the proceedings were entitled to vote. If courts approved the debtor’s application, a court commissioner and a reorganization trustee were appointed to control the management. Creditors with securities were excluded from losses but had to leave their securities within the enterprise, if this was unavoidable for the continuation of its activity. In 1990, this pre-war regulation was reactivated, leading to a rapid increase in the number of petitions. However, only 98 of the 688 petitions for restructuring in 1992 led to proceedings being initiated; 73 of these were rejected and the rest was either still pending or settled in out-of-court proceedings. Overall, court-managed restructuring proceedings achieved their aim only partly.

Polish bankruptcy proceedings were based on the 1934 law which was amended in 1990. Surprisingly, the bankruptcy law of the 1930s was never lifted: it was simply not applied in the era of centrally planned economy. Like the 1934 economic law, which had been instrumental in the transition to a market economy, the bankruptcy law of the 1930s could be applied im-
mediately, without much bureaucracy (Szlezak 1994, p 110). It resulted from the mentality of the years before the war and aimed at the liquidation of insolvent enterprises. Creditors, owners or management can file a petition for bankruptcy. As soon as insolvency becomes evident, management is obliged to file a petition within 2 weeks under personal liability. If an enterprise can cover their cost, proceedings are initiated. All debts are immediately due and creditors must declare their receivables in court. A trustee is appointed to be in charge of the continuation of the enterprise’s activity, if this can secure the preservation of its assets. A bankruptcy judge fixes the trustee’s payment. The trustee lists assets and debts, interest rates no longer increase, with the exception of secured loans. If 20% of creditors demand it, a committee of creditors can be created. These proceedings aim to pay the public authorities first and are therefore uninteresting for unsecured creditors. If the cost of proceedings, taxes and social security contributions do not exhaust the assets available, the rest almost certainly goes to the claims of employees. Also, creditors are obliged to pay the court between 5 and 13% of their receivables in advance to cover the cost of the proceedings, which is a further loss of money. Finally, a trustee’s potential malpractice is hard to prevent in Poland, too. Fraudulent transactions must have been widespread and must have reduced faith in the reliability of court-managed proceedings (Gray/Holle 1998, p 223).

The number of bankruptcy petitions increased to over 5,000 from 1990 to 1993 but decreased again thereafter. However, courts rejected more than half of them for lack of assets. Proceedings are impaired not only by bad conditions for simple creditors but also by institutional weaknesses. Courts are understaffed, have only a small budget and limited knowledge of economic matters. Moreover, there is a clear lack of auxiliary professionals, such as lawyers, trustees and accountants that take care of the necessary information flow in developed free-market economies. A study of 80 bankruptcy proceedings for the year 1993 showed that only 15 had been completed. The others were rejected for lack of formal requirements or because the assets were not sufficient to meet the cost of the proceedings. This study detected malpractice in most of these cases. The majority of assets were either sold before the bankruptcy petition or they disappeared in other ways. However, inquests were rare in these cases because the necessary information was missing (Jan Brol, quoted in: Gray/Holle 1998, p 224)

Liquidation within a process of privatization was rather widespread in Poland. Between 1990 and 1995, more than half of approximately 1,300 firms were either liquidated via privatization or ended in bankruptcy proceedings. Three quarters were enterprises with up to 200 employees and only 9% were large firms (over 500 employees). However, a constantly increasing tailback caused many cases to have to wait for more than 2 years for these proceedings. The management or the owners (Ministry, etc.) requested the liquidation and had it under their control. It was mainly creditors that incurred
greater losses as there were no clear prescriptions for dealing with their claims. Although the law did, at least in theory, permit the closure of insolvent state-owned firms, in practice this seems rather an option for the current management in order to avoid bankruptcy and to remain in control of the assets of its enterprise. As this prevented creditors from exercising their rights, it excluded the positive role they can play in insolvency proceedings in free-market economy countries.

The most innovative measure was banking conciliation proceedings, i.e. restructuring proceedings managed by a bank. Polish state-owned firms had begun their market-economy reorganization under a heavy burden of debts. These dated back to the centrally planned economy era, and above all to the early years of economic transition. Initially, enterprises solved their liquidity problem by means of bank loans, as it was not clear how far the reforms would ultimately go. Banks preferred to give new loans rather than having to write off old ones as this would have worsened their balance sheet performance. In 1992, it was estimated that 40% of enterprises incurred losses and the percentage of doubtful receivables for banks was 24% (Mizsei 1993, p 10). Restructuring proceedings under the direction of banks were a workout that is reminiscent of ‘Chapter 11’ or of the Hungarian proceedings. Banking restructuring proceedings were aimed to reorganize enterprises whose company value was higher than the estimated revenues from its liquidation. In return for the partial write-off of loans, creditors could not only demand a share in the ownership of an enterprise but also its radical reorganization, all of which increased the chances of a successful redemption of the remaining financial liabilities. Banking restructuring proceedings were limited to 3 years and shifted the competences from courts to banks. Banks had the right to negotiate and to impose the result on reluctant creditors, as long as 50% of creditors agreed to that result. A debtor could submit a request for these proceedings at the bank that had at least 20% of the total debts; in the case of more than 2 billion Zloty, 10% was enough. The advantages were, first, that proceedings could take place without the costly involvement of courts. Also, the creditors’ preferred order changed. The state lost its preferred position and social security contributions, creditors with securities and the employees’ receivables remained outside the agreement and were thus fully satisfied. Smaller claims of the creditors were unable to block the solution and the bank took full responsibility for the proceedings. In cases in which the rehabilitation plan was not successful, the bank was liable to pay for the additional costs resulting from it. Finally, the possibilities of a solution were many, not only with reference to the reduction of debts and the postponement of terms. It was the legislator’s intention that creditors accept a compensation for their claims in the form of interests in the enterprise in order to achieve a reduction of debts. This option, which was applied less than would have been desirable, motivated all those with interests in the enterprise to achieve success because in the case of failure, the threat of legal proceedings
was imminent (Gray/Holle 1998, p 250/1). The enterprises that chose this solution were usually large and highly indebted with banks, but they were more profitable than those that had to opt for liquidation or bankruptcy. In this case, too, creditors formed several committees with similar claims in each. No one of the committees of creditors was allowed to achieve a worse solution than that of the committee representing the bank that managed the proceeding, and for this reason the bank had no interest in separating creditors. To achieve the 50% that was necessary for the approval of the rehabilitation plan, small creditors were often treated better than big ones in that their approval was less expensive. This was also explicable by the fact that banks charged interest on outstanding loans, even in the case of non-redemption, whereas suppliers usually did not. The average duration of the proceedings was approximately 4 months though many were dealt with much more quickly, as negotiations had already begun before the proceedings’ official commencement.

Summary

Between 1990 and 1994, the number of persons in dependent employment decreased by about half a million in the Czech Republic, 1.3 million in Hungary, 2 million in Poland, whereas the number of the self-employed increased by a million in the Czech Republic, half a million in Hungary and over a million in Poland (Balcerowicz, Eva et al 1998, p 92). This shows the extent of the transition process, which was characterized by denationalization, demonopolization, reduction of subsidies, liberalization of trade, restrictive monetary policy, stricter conditions of credit, reduction of employment, restructuring and the introduction of bankruptcy legislation. In this process, resources had to be redirected from individual sectors (agriculture and industry) to others, above all the service sector, and the enterprises themselves had to be reorganized.

In a market economy, the aim of insolvency proceedings is to solve the problems of individual enterprises. The underlying assumption is that a debtor is liable for the difficulties he creates. In times of economic growth, insolvency affects 1 or 2% of enterprises annually and even in serious economic crises, such as in the 1930s, insolvency legislation has fulfilled its function. Only in individual branches/sectors, such as agriculture and banks, have governmental subsidies and special laws been necessary. In transition countries, individual enterprises and their management were no longer considered liable for the financial burden and operational structure they had inherited from the planned-economy era (Hoshi 1998, p 20). According to the standards of the market economy, whole sectors were to be considered insolvent and a large part of the economy bankrupt. In such a situation, where insolvency becomes a widespread problem, the function of insolvency pro-
ceedings changes from a problem of business management to one of economic policy.

Today, it has been almost forgotten that market-economy countries also had similar problems in the twentieth century. Reconstruction after World War II presented many analogies with the reconstruction after the cold war, which is now called ‘transition’. For example, German and Austrian banks and insurance companies during the Nazi era had been forced to invest a large part of their financial resources in government bonds that became worthless after the War. Basically, the whole branch/sector would have had to file a petition for bankruptcy in 1945 because their liabilities surpassed their assets considerably and they were no longer able to pay. The state could not, of course, accept the collapse of the whole financial sector, and this led to financial support, subsidies, mergers, etc., under the direction of the state and finally to reconstruction laws that would re-create order. However, until 1955, Austrian banks and insurance companies were exempt from the obligation to issue a financial statement, as this would have implied the obligation to file a petition for insolvency, according to the current legal situation. Only in 1955, was it possible to draw up a balance sheet for the whole period in addition to the first balance sheet denominated in Austrian schillings. This shows clearly that the transition period after World War II lasted 10 years.

The fear that the valuation of enterprises in accordance with market-economy standards would have caused a catastrophic wave of insolvency petitions across the transition countries has not proved true. This is explicable by the fact that individual countries have accorded different priorities to bankruptcy law. Some countries, such as the Czech Republic, delayed the introduction of bankruptcy law and relied, rather, on rapid privatization. Other countries, such as Hungary, focused on radical insolvency legislation as a means to prepare for privatization; Poland was somewhere in the middle (Grosfeld 1998, p 278). Insolvency regulations, however, were not applied across the board. Thus, e.g., the government supported a recapitalization of banks that enabled them to be more tolerant toward their insolvent clients. Also, state-owned firms that were officially involved in liquidation proceedings were often preserved intact, as this was in the interest of the liquidator, of the management and of the employment market. The positive role of bankruptcy legislation is that it offers orderly proceedings for eliminating sources of losses and redirecting economic resources. It was also meant to have a disciplining and motivating function for management. Now management could no longer rely on governmental support, but rather had to consider the possibility of closing the enterprise and the consequences this would have for them. The aim was to promote a market-economic way of thinking and financial responsibility. Of course, this also depended on legal certainty, i.e. how coherently the legislation was applied in practice. Therefore, not only the length of the proceedings was criticized but also the irregularities that resulted from a still underdeveloped jurisdiction over economic
matters. As this was the biggest/most important change of ownership in the history of these countries, it was not surprising that some people took advantage of the opportunity in every possible way. This concerns not only irregularities but also the current management’s interest in preventing the firm from being liquidated and in trying to preserve its position as long as possible at the expense of others or even in permitting the firm’s privatization. Much criticism is also raised over rehabilitation proceedings being initiated with too little know-how and their concentration in most cases is limited to financial problems without considering the situation of the whole enterprise. Finally, insolvency legislation in transition countries proved very debtor-friendly. This may have been politically necessary in order to prevent production and employment from dropping further, but – despite some exceptions, such as Poland’s rehabilitation proceedings under the guidance of banks – the position of creditors was weak and unsatisfactory. For this reason, creditors were in most cases little involved in reorganization and liquidation proceedings and regarded the financial market as uncertain. This led not only to high interest rates but also to considerably higher security claims than in market-economy countries.

Of course, insolvency legislation is debtor-friendly in the USA and in France, too. But the question is if a country that has yet to develop a money and capital market can allow himself to be debtor-friendly. The USA and France initially gave more importance to creditors in the 19th century. Only in the second half of the twentieth century, when they had developed their financial market enough, did they become more debtor-friendly. Their debtor-friendliness is linked to extensive legal certainty, which makes possible losses predictable and calculable. From this point of view, Central and Eastern European countries still find themselves first and foremost in transition.

References


