

Insolvency law and practice in Europe's transition economies

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In 2004 the European Bank for Reconstruction and Development (EBRD) completed two major insolvency-related studies: the Insolvency Sector Assessment (ISA) and the Legal Indicator Survey on Insolvency (LIS).

Since its inception in 1998, the EBRD's Legal Transition Programme has made the assessment of commercial laws and legal systems a key component of its contribution to the reform of transition economies. These assessments have been continuously refined over the years and provide, among other things, detailed information to the EBRD's 27 countries of operation as to how their legal systems compare with international standards and best practices; they also help to inform the transition projects of the EBRD.

Extensiveness and effectiveness

Insolvency is one of the five areas of focus of the Legal Transition Programme and highlights the EBRD's unique status in the region as both a 'user' of insolvency legal regimes (in its context as a lender recovering bad debts) and a reformer of these systems. The EBRD's assessment work takes two broad measurements of insolvency legal regimes: their extensiveness and their effectiveness.

The extensiveness study - the ISA - looks at the 'law in transition' and measures the extent to which a country's key insolvency legislation complies with international standards and best practices. The effectiveness study - the LIS - looks at the 'law in action' and the extent to which the regime, in practice, achieves results in a timely, predictable and efficient manner. These two assessments, rather than measuring the same elements of the legal regime, assess its various practical and theoretical components to provide a complete, multi-dimensional picture of the legal system.

Bankruptcy and insolvency legal systems are often incorrectly thought to be solely about helping creditors recover loans made to debtors. In fact, these legal systems encapsulate a number of the commercial, social and political values of a society. Ultimately, the purpose of any insolvency regime is to redistribute the assets of uncompetitive or inefficient entities. This is done in many ways, including auctioning assets to more efficient entities, distributing assets to various constituencies such as governments and employees, or making the inefficient entity itself into a more efficient one through corporate reorganisation. Empirical evidence suggests, however, that legal systems that fulfil this purpose well, in a predictable and

Table 1: Level of legislative compliance with international standards and best practices of insolvency

Very low compliance	Low compliance	Medium compliance	High compliance	Very high compliance
Lithuania	Azerbaijan	Armenia	Albania	
Tajikistan	Georgia	Belarus	Bosnia & Herzegovina	
Turkmenistan	Hungary	Czech Republic	Bulgaria	
Ukraine	Latvia	Estonia	Croatia	
	Slovenia	Kazakhstan	Moldova	
	Uzbekistan	Kyrgyzstan	Romania	
		Macedonia	Serbia & Montenegro	
		Poland		
		Russian Federation		
		Slovak Republic		

efficient manner, will attract greater investment and make the cost of credit more affordable by giving creditors the certainty they crave (in particular, see the work of R La Porta, F Lopez-de-Silanes, A Shleifer and RW Vishny in “Legal Determinants of External Finance”, *Journal of Finance*, Vol 52; and A Ramasastry, “Assessing insolvency laws after ten years of transition”, *Law in transition*, EBRD (Spring 2000)).

The results of the LIS and the ISA reflect, in part, the sheer variety of legal and political cultures found in the EBRD’s countries of operation. Some countries stress the sanctity of the debtor-creditor contract, while others place a high level of importance on ensuring that the claims of employees and state agencies are met. If each country were an island unto itself, one could perhaps adopt a relativist view of these varying systems. Certainly, in any case, in reviewing each system local peculiarities and traditions must be respected. Nevertheless, the free movement of global capital and the desire of all countries, particularly emerging market ones, to attract the same pool of scarce capital make it necessary for all countries to strive for certain standard levels of extensiveness and effectiveness.

The insolvency sector assessment Methodology

The methodology of this assessment involved constructing a list of 97 fields of inquiry, created using the most widely accepted international standards adopted by the World Bank and the United Nations Commission on International Trade and Law, among others. Experts in the field of insolvency, retained by the EBRD, compiled legislation from all EBRD countries of operations and analysed these laws with regard to the 97 areas of inquiry. In almost every case, local practitioners in each country then verified this analysis.

The 97 fields of inquiry were then grouped into the five core areas listed below:

- commencement of proceedings;
- treatment of estate assets;
- treatment of creditors;
- reorganisation processes; and
- terminal/liquidation processes.

The fields of inquiry chosen and the scores assigned reflected the view that an insolvency legal regime should:

- allow for relatively easy and predictable access to insolvency proceedings by both debtors and creditors;
- provide alternative remedies (ie, liquidation and rehabilitation) for the financial problems of an insolvent debtor;
- permit the efficient, proper and timely administration of an insolvency case; and
- on balance, treat the interests of creditors as paramount.

In virtually every case, practitioners in each country were used to verify the assessments of the EBRD experts.

Results and the need for reform

In the end, a final numerical score was assigned to each country and the countries were then grouped according to their level of compliance with international standards, ranging from 'very high' down to 'very low', as illustrated in Table 1. In addition to these groupings, the following general observations can be made from the ISA results:

- Unsurprisingly, in an area as complex as insolvency, no country received an overall score of 'very high', while a number of countries scored 'very low';
- Although half the countries surveyed display at least a 'medium' level of compliance with international standards, the mean score of all countries falls in the 'low compliance' category;
- Every country scores in the 'low' or 'very low' category in at least one of the five core areas; and
- Many countries have made fairly recent attempts at reforming their insolvency laws with surprisingly little positive effect.

As described above, the insolvency assessments help to inform the reform work of the EBRD. Although each country's results must be read on a case-by-case basis, one can draw some broad conclusions from the ISA results about the most pressing needs for reform in each of the five core areas.

Commencement of proceedings

Far too many countries employ unclear or limited tests for the commencement of insolvency proceedings. In many insolvency legal regimes either the balance-sheet or liquidity test for determining insolvency is often ignored, and debts often have to be overdue for significant periods before they can count for the purposes of insolvency proceedings. This can have the effect of significantly delaying proceedings which, in virtually all cases, will cause erosion in value.

Treatment of estate assets

Many countries in the region have expressed concern over how to deal with insolvent companies where the assets in the insolvent estate will not even cover the cost of liquidating and winding up that estate. This can become a costly issue for many countries as international insolvency standards generally promote the need for finally disposing of an estate, regardless of the value of its assets. In many cases this leaves the state having to pay the costs of winding up a significant number of estates. In part, this problem is caused by the delays in commencing proceedings described above. A significant contributor to this problem, however, is the pervasive weakness of avoidance provisions. Insolvency administrators and other appointed functionaries must be given both access to the debtor's assets, books and records (usually facilitated by requiring the debtor's officers to deliver these to the functionary), and the power to review suspicious transactions taken on the eve of the debtor's insolvency. In many countries provisions dealing with such powers are woefully inadequate.

Treatment of creditors

For an insolvency legal regime to be credible, and therefore effective, it must be seen by the constituencies it affects to be fair and transparent. This is particularly important in the treatment of creditors. Creditors must be given a reasonable opportunity to file their claims in the insolvent

estate and these claims must be adjudicated fairly. At the outset, however, creditors must first be made aware of insolvency proceedings and the timelines within which they must make their claims. Without a reasonable level of notice, the claims process becomes arbitrary and loses its efficacy. Surprisingly, too few countries require the insolvency administrator to use best efforts directly to inform the debtor's known creditors based on a review of the debtor's books and records. In many cases simple publication in an arbitrarily chosen newspaper satisfies the administrator's obligation to notify creditors of their one and only chance to make claims (Ukraine and Georgia are among the worst offenders on this issue). A creditor which misses these notices and the deadlines stipulated therein is effectively barred from asserting its claim in the estate. This absence of procedural fairness serves to discredit the claims process, particularly with respect to extra-jurisdictional creditors.

Reorganisation processes

This is, by far, the area that requires the greatest improvement among virtually all countries surveyed. Indeed, no country scored higher than 'medium compliance' in this area and the vast majority scored 'very low compliance'. Often, the most basic element of a functional rescue process - a provision protecting the debtor from immediate enforcement by creditors - is missing. Where laws surveyed do provide for reorganisation, these protective provisions are often non-existent or severely deficient. In addition, very few countries in the region have begun to address the need that restructuring businesses will have for ongoing working capital or debtor-in-possession financing.

Terminal/liquidation processes

This is generally the area in which many countries rated highest. There is, however, a general lack of clarity as to how these laws propose to deal with secured creditors in the context of insolvency proceedings. In many cases, for example, it is

unclear as to whether secured creditors will have the ability, once their claims are proven, to realise upon their secured assets themselves, or whether they will have to rely on the insolvency administrator to complete this realisation. Clarity in this area is essential to ensure that the realisation is completed in an orderly and efficient manner.

The legal indicator survey

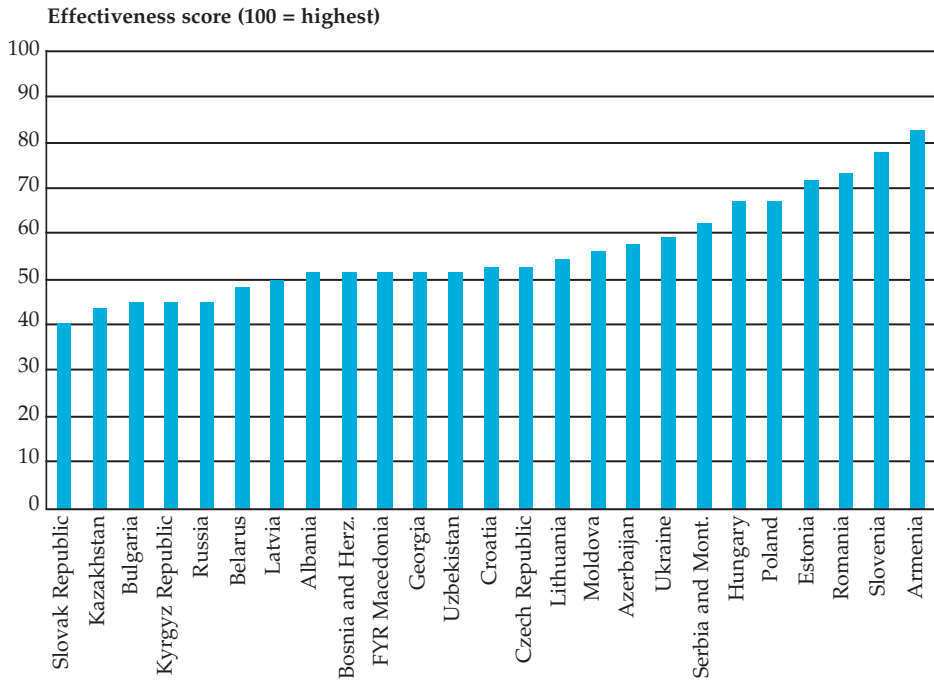
The quality of codified laws only provides part of the picture of the insolvency legal regime's quality. The balance of the picture requires an understanding of how well (or poorly) the regime functions in practice.

Methodology

The aim of the LIS is to assess how the legislation works together with the local institutional framework (including rules of procedure, insolvency administrators and judicial officials) to create the insolvency legal regime.

In the EBRD's experience, the most effective way of conducting such an assessment is by presenting local practitioners with a 'real-life' scenario that they might encounter in their practice and asking them to answer a series of questions relating to how they might counsel a particular, hypothetical client. The EBRD worked with an outstanding cross-section of lawyers in the region, ranging from those practising in large, global firms to sole practitioners.

Insolvency laws affect a variety of constituents, including banks, employees and governments. Ultimately, however, the users or 'clients' of insolvency laws can be divided into two broad groups: debtors and creditors. Consequently, proceedings under most insolvency laws can be commenced by one of these two groups. Although each group is affected by the actions of the other, the party commencing the proceeding often dictates, at least at the outset, what type of proceedings will be taken. As a result, it was determined that the functioning of the insolvency

Figure 1: Effectiveness of legal regimes in creditor-initiated insolvencies

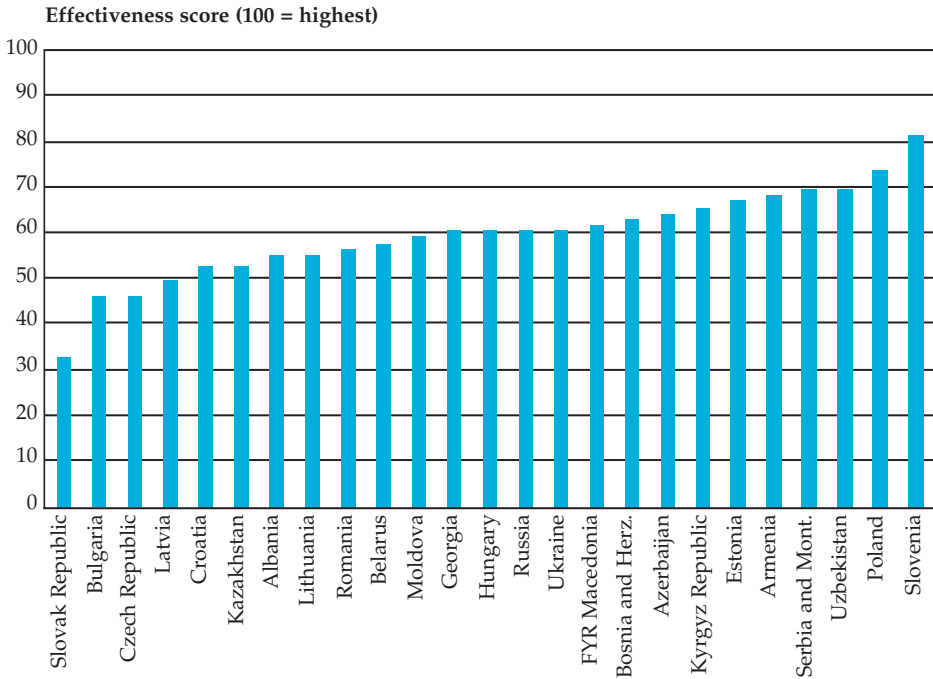
Note: Survey respondents were asked about the overall effectiveness of the insolvency regime. Scores are calculated as a percentage of the maximum score. Data for Tajikistan and Turkmenistan were not available.

Source: EBRD Legal Indicator Survey, 2004.

law regime needed to be measured both in instances where a creditor commences liquidation or terminal proceedings, and those where a debtor commences reorganisation proceedings. These scenarios were chosen as terminal proceedings commenced by a debtor are rarely contested and reorganisation proceedings are, for obvious reasons, rarely commenced by a creditor against the wishes of an insolvent debtor. This necessitated two different case studies, asking participants to assume the roles of counsel to the debtor and counsel to the creditor, respectively.

In light of the breadth of the countries surveyed and the complexity of the various factors affecting insolvency proceedings, and in particular the role of commercial factors in influencing the outcome of such proceedings, the scope of the survey was very specific. The survey focuses on the most critically important area of insolvency law: the ability, of either core constituent, effectively to initiate insolvency proceedings such that future matters in respect of the insolvent debtor are dealt with under the umbrella of those proceedings.

Figure 2: Effectiveness of legal regimes in debtor-initiated insolvencies



Note: Survey respondents were asked about the overall effectiveness of the insolvency regime. Scores are calculated as a percentage of the maximum score. Data for Tajikistan and Turkmenistan were not available.

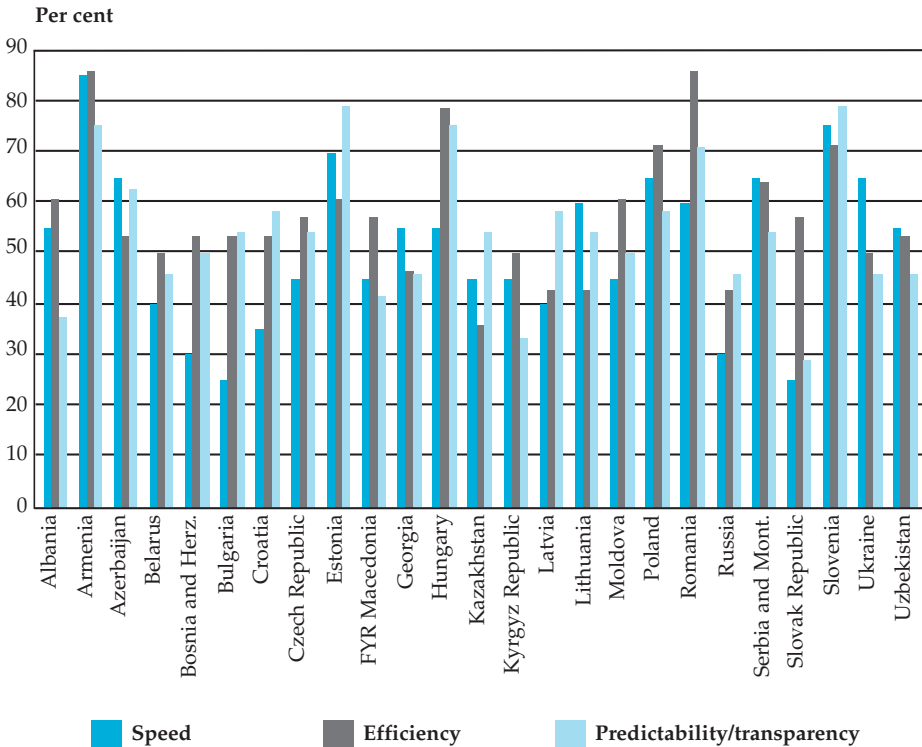
Source: EBRD Legal Indicator Survey, 2004.

The hypothetical cases employed were each followed by approximately 20 questions designed to measure varying aspects of the legal system, including:

- ease of access to the insolvency system;
- experience of the court assigned to hear insolvency cases;
- whether the rule of law is closely observed;
- the speed, cost and complexity of the process; and
- the competence of the judicial and other officials involved.

The answers were scored on a five-point scale ranging from 'very low effectiveness' to 'very high effectiveness' and the results from each of the various aspects tested were distilled down to three principal measurements - speed, efficiency and predictability/transparency:

- 'Speed' refers to the time it takes from the litigation of a legal process to (in creditor-initiated processes) the granting of the initial order or (in debtor-initiated processes) the confirmation of the reorganisation plan;

Figure 3: Speed, efficiency, predictability/transparency of legal regimes in creditor-initiated insolvency cases

Note: Survey respondents were asked a series of questions about the speed, efficiency and predictability/transparency of creditor-initiated proceedings. Scores are calculated as a percentage of the maximum score for each principal compliance area. Data for Tajikistan and Turkmenistan were not available.

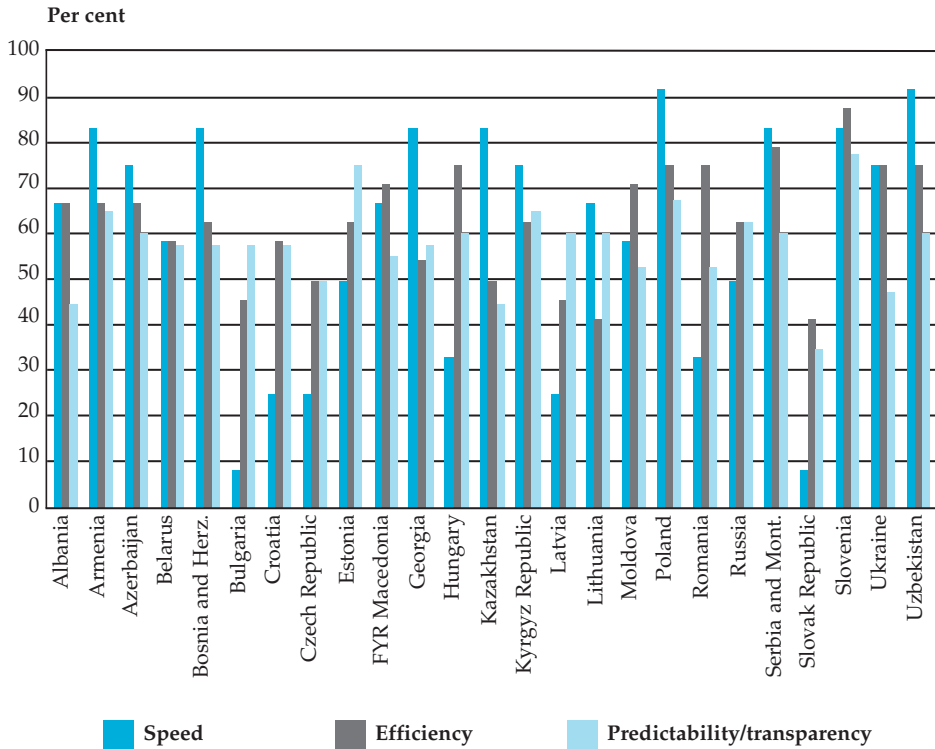
Source: EBRD Legal Indicator Survey, 2004.

- ‘Efficiency’ is a measure of composite factors designed to test the extent to which the process is procedurally accessible to clients, expensive and perceived as useful; and
- ‘Predictability/transparency’ refers to the competence and predictability of judges and insolvency administrators, and the level of application of the rule of law.

Results and the need for reform

The complete results of this survey are available on the EBRD’s website at www.ebrd.com. Figure 1 shows the results of each country for the case dealing with creditor-initiated proceedings. (No results were available for Tajikistan and survey results for Turkmenistan revealed too few experiences with practical, litigated insolvency cases to be used. These

Figure 4: Speed, efficiency, predicatbility/transparency of legal regimes in debtor-initiated insolvency cases



Note: Survey respondents were asked a series of questions about the speed, efficiency and predictability /transparency of debtor-initiated proceedings. Scores are calculated as a percentage of the maximum score for each principal compliance area. Data for Tajikistan and Turkmenistan were not available.

Source: EBRD Legal Indicator Survey, 2004.

two countries have therefore been omitted from the survey results.) Figure 2 shows each country’s results for debtor-initiated proceedings.

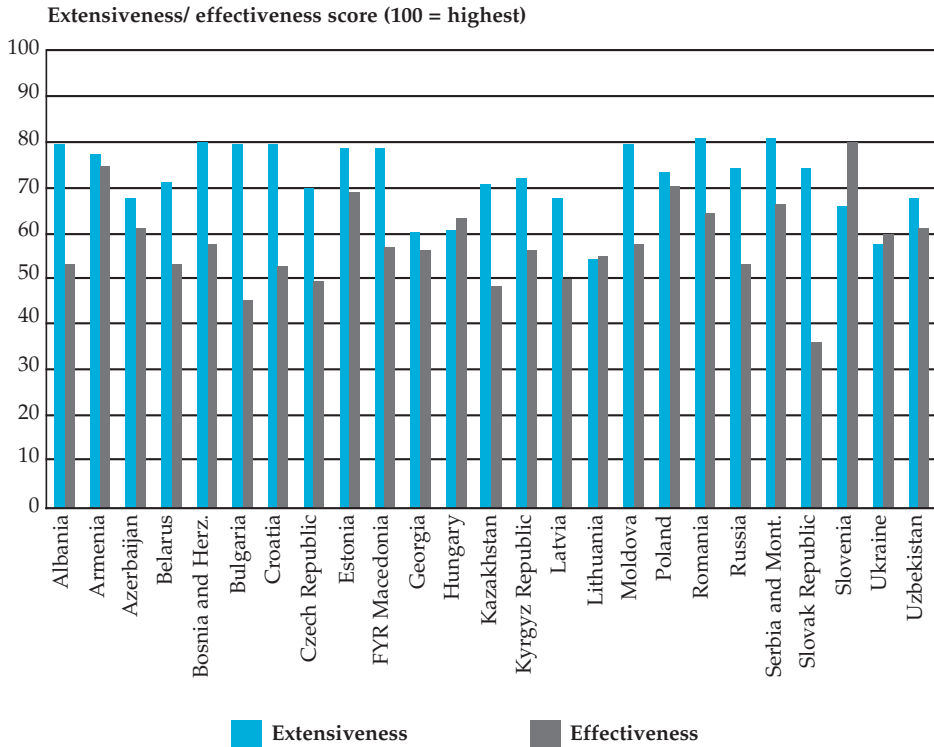
Figure 1

These results demonstrate the difficulty that creditors in most countries experience in accessing an effective bankruptcy system as a ‘weapon of last resort’ to

wield against debtors. The results also reflected a high degree of debtor interference in these processes, which often effectively allowed debtors to neutralise the threat of being petitioned into bankruptcy.

Figure 2

Predictably, most countries scored better on the debtor-initiated case than on the creditor-initiated

Figure 5: Extensiveness and effectiveness of insolvency legal regimes

Note: The extensiveness score is based on an expert assessment of the insolvency laws in each country. The effectiveness score refers to the findings of the Legal Indicator Survey. Scores are calculated as a percentage of the maximum score. Data for Tajikistan and Turkmenistan were not available.

Source: EBRD Legal Indicator Survey, 2004.

one. This does not suggest that most countries have better reorganisation processes than liquidation ones (in fact, the ISA results suggest that the opposite is true). Rather, it suggests that the initiation of a reorganisation process by a debtor - a step that is often taken unilaterally and is therefore not contentious until after it has occurred - can be achieved more easily than the initiation of liquidation by a creditor. As noted above, however, effecting a complete

reorganisation will depend on a number of factors, including commercial ones, and is not made easier by the insolvency legislation of most EBRD countries.

Figures 3 and 4 take the total score of each country, in each case, and break them out into the three principal measurements.

Viewing the results in this format reveals a number of problems with the effectiveness of insolvency legal regimes. For example:

- Only four countries (Armenia, Poland, Azerbaijan and Slovenia) have processes that could be regarded as reasonably fast by both debtors and creditors. Some countries, such as Slovakia, may take as long as one year to resolve a relatively simple case.
- The level of predictability and transparency across the entire region is woefully low.
- Only three countries (Armenia, Poland and Slovenia) achieved consistently high results in all three areas in both cases. Because no one principle criterion was valued more than the others, many countries (such as Bulgaria) achieved modestly high overall results by succeeding in two areas but letting the third languish.

Finally, Figure 5 shows the total score of each country, in both cases and in all three principal measurements ('effectiveness'), and compares it to the score of that country in the ISA ('extensiveness').

Figure 5

Figure 5 illustrates that most countries have better legislation than they do the means to implement such legislation. This is commonly referred to as the 'implementation gap', and underscores the need for legal reform to go beyond legislative reform and extend into implementation assistance. This can include such varied activities as the training of insolvency judges and administrators, the development of standard-form documents or 'precedents' for practical use, or the creation of a secured charges registry system. Each of these forms of implementation assistance has been undertaken in the past by the EBRD. A recent example of insolvency-related implementation assistance involved the provision of judicial training assistance to the government of Poland and was completed in 2004.

As can be seen in Figure 5, there is a clear correlation between the relative quality of a country's insolvency legislation and the relative

effectiveness of its insolvency regime. This suggests that the foundation that a good law provides can be a prerequisite to an effectively functioning system.

Earlier work published by Anita Ramasastry in the 2002/2003 edition of this guide suggested that a bad set of laws with an effective regime would attract greater external finance than a good set of laws which are implemented poorly. Such a conclusion is beyond the scope of the 2004 LIS. Nevertheless, Ramasastry's conclusions, read in conjunction with the LIS results presented herein, form a complete circle and suggest that a country with a strong legislative foundation will likely have effective implementation, and that such effective implementation is likely to lead to an increased level of foreign direct investment and other external finance.

In this regard, the EBRD remains committed to assisting its countries of operation in legal reform, both in the legislative sphere and in the form of implementation assistance.

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