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ESTABLISHING FINANCIAL DISCIPLINE: EXPERIENCE WITH BANKRUPTCY LEGISLATION IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

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TABLE OF CONTENTS

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INTRODUCTION

Bankruptcy laws and other procedures governing financial default are key elements in the functioning of market economies for several reasons: they codify and protect the rights of creditors, thus tending to reduce the cost of credit; they enhance global efficiency by forcing unprofitable firms to exit, allowing the reallocation of their resources into more productive uses; and they provide to company owners an indirect device for controlling and overseeing the management by subjecting poorly-performing managers to the threat of a transfer of control.

In market economies, bankruptcy is one among several mechanisms by which corporate control can be transferred to more efficient owners. Other mechanisms include takeovers or the sale of shares on the stockmarket. But, to be effective, these devices require the existence of well-developed capital markets. However, financial markets are in their infancy in countries undergoing transition from centrally-planned to market economy. Hence, the design and implementation of effective bankruptcy procedures and enforcing them is a critical step in laying the foundations for effective corporate governance in post-communist economies.

The experience so far of Eastern and Central European countries with bankruptcies indicates clearly that this step has not yet been successfully completed. This is not surprising. There are substantial differences between bankruptcy laws in market economies and no consensus on what would be the "optimal" bankruptcy law. As well, bankruptcy law of an established market economy may well not work effectively during the early stages of the transition because of the limited number of creditors; the fact that often both creditors and debtors are still more or less under the control of the government; and the long tradition of government bailout. More importantly, bankruptcy procedures are still largely ineffective in Eastern European countries because judicial systems largely lack the capacity and the expertise required to face the large number of cases.

This article compares the design, operation and outcomes of bankruptcy legislation in Hungary, Poland, the Czech Republic' and Russia. The first section summarises the analytical foundations of bankruptcy with explicit reference to the situation in Eastern Europe. The second section gives a short overview of the principles guiding bankruptcy legislation in some major OECD countries: The third section describes the process of rehabilitating bankruptcy laws in Eastern Europe and shows how country-specific institutional traditions have shaped their design and implementation. It also illustrates the increased reliance on a variety of out-of-court procedures to resolve insolvency problems of privatised companies. In the fourth section, more systematic comparisons are made of the procedure designs, the specific features which drive the outcome of the bankruptcy decision. The fifth section demonstrates how bankruptcy laws have had little practical effect, so far, in transition economies and tries to identify some of the reasons of this lack of effectiveness. In the final section, we draw some broad guidelines about desirable features of bankruptcy procedures to be implemented during the transition process in other post-communist economies.

AIMS AND LIMITATIONS OF BANKRUPTCY LAWS

The economic literature has long tried specifically to identify the functions that bankruptcy laws play in market economies (see, for instance, Stiglitz, 1972; Weston, 1977; Bulow and Shovèn, 1978). These functions deal with overall efficiency, transaction costs of credit and corporate governance. In this section, these functions are reviewed and their relevance in the context of transition economies is examined.

Firm liquidation and economic efficiency

From an economic point of view, a primary aim of bankruptcy procedures is to increase overall efficiency by eliminating firms whose assets can be used more productively elsewhere. Therefore, the "ideal" bankruptcy law should always satisfy the *overall efficiency criterion* following which a firm is liquidated if its value as an ongoing concern *(i.e.* the sum of discounted future profits) is lower than its liquidation value which corresponds to its opportunity cost.

In practice, however, none of the existing bankruptcy procedures used in market economies guarantees that the overall efficiency criterion is satisfied. There are at least two reasons why the decision to put a firm into liquidation or to allow it to continue operating is not necessarily taken in a way that is socially optimal. Taking a schematic view, the decision involves three classes of claimants – the bondholders, the bank lenders and the equity holders – who do not have equal weights in the decision-taking process. And, the attitude of a given bank lender is likely to differ. If only small loans are involved, the bank is likely to want the firm to be liquidated in order to be repaid. On the other hand, a bank with a large loan is likely to weigh the potential losses from liquidation against expected benefits from maintaining the firm in operation after the other current creditor's claims have been paid. Therefore, the decision lies in the hands of a coalition grouping the equity holders (who have the lowest priority in terms of repayment and therefore generally want the firm to stay operating) and the bank(s), which could act as a lender of last resort, while the other creditors have considerably less bargaining power. It has been demonstrated that, under these conditions, there is a risk that the coalition makes the wrong decision from an overall efficiency point of view to liquidate a firm whose ongoing value exceeds the liquidation value.[2] In addition, the uncertainty which surrounds any estimate of the values of the firm in liquidation and in continuation increases the risk of inefficient outcome.

In post-communist economies, these two factors are influential to an even larger extent. Capital markets are virtually non-existent and it is therefore more difficult to "properly" evaluate the liquidation value of a firm against its expected value as an ongoing concern, especially given that the future performance of a company cannot be inferred from its past records. Credit is expensive and limited, reinforcing the risk that illiquid but solvent firms be liquidated. The design of the liquidation procedure is also a key factor: for instance, low priority given to the lender of last resort in the distribution of the liquidation proceeds reduces his willingness to extend credit in order to let the company continue. In some Eastern European countries, bank claims have a lower priority than taxes, duties and social security arrears which increases the risk that illiquid companies be unduly liquidated. However, under certain circumstances there is more danger of the opposite risk in which the coalition may agree to roll over a growing stock of non-performing loans in order to escape liquidation. This is especially likely to occur if the survival of the last resort lender depends on the continuation of the firm.

Firm reorganisation and economic efficiency

In Eastern and Central European economies even more than in market economies, there is a need for alternative procedures of reorganisation which allow the coalition decision to internalise creditors' interests. This need arises from the fact that the coalition optimum may be different from the social optimum when the value of the firm as an ongoing concern is higher than the liquidation value but still not high enough to repay all the creditors according to the prevailing priority rule.

Creditors' strategy in a reorganisation procedure may be viewed in terms of the so-called "prisoner's dilemma". Each individual creditor is unwilling to grant any debt write-off and would prefer to sue the debtor on his own, with the hope of getting repaid in full. However, if creditors cannot agree among each other about debt restructuring, the coalition will decide to liquidate the firm and, since the liquidation value is lower than the ongoing one, creditors as a whole will be worse off.

However, creditors do agree to forgive part of the debtor's debt, the coalition will also be less reluctant to finance the liquidity gap as the risk that the last resort lender will not be fully repaid is reduced. Therefore, the existence of a reorganisation procedure increases the probability that the outcome of the bankruptcy procedure be socially optimal compared with a situation in which the only alternative is liquidation. Besides, under uncertainty the coalition has an even stronger incentive to reorganise as it gets the upside benefits while creditors bear the downside risk.

In principle, the maximum rate of debt forgiveness that creditors as a whole would be willing to grant should correspond inversely to the liquidation value of the company. But creditors, as we have already noted, do not form a homogenous group: some have secured claims; others not. Secured creditors have a stronger bargaining position and are likely to require a higher pay-off rate for their claims. Hence, where the proportion of secured claims is high and their rights well protected, it is less likely that an agreement on reorganisation will be reached. The legal requirement to reach an agreement also has an important influence: a unanimity condition will grant unsecured creditors a huge bargaining power, thus making an agreement much more difficult to reach than if only a qualified majority is required. The opposite may also happen: creditors may forgive debt to an extent which exceeds the level corresponding to the liquidation value of the company. This is likely in economies in transition when insolvent firms and the last resort lender have tight connections with the government and the decision to liquidate the firm has strong social implications. Here too, the outcome would be sub-optimal from the point of view of global efficiency since it implies an income transfer from the other creditors to the coalition. Therefore, in theory, for bankruptcy legislation to yield an efficient outcome in transition economies, firms and commercial banks need to be privatised and the bankruptcy procedure to be mediated by courts independent of political pressure.

Enforcement of property rights

From a legal point of view, the primary role of bankruptcy legislations is to codify the property rights of the creditors. By resolving some of the uncertainties arising from default, bankruptcy legislation contributes to lower the costs of contracting credit. While, in most countries, the Civil Code provides with procedures that allow individual creditors to sue bad debtors at courts in order to recover their claims, bankruptcy is specific in that it provides a legal framework for resolving conflicts among *several* creditors. Therefore, it is important that the prioritisation of creditor rights be transparent and credible. By inhibiting individual creditors from suing on their own, bankruptcy protects the debtor's assets against piecemeal dismantling and ensures that creditors' claims be satisfied to the largest possible extent. Furthermore, it contains provisions which avoid fraudulent transfers of property as well as preferential repayment made by the debtor prior to the bankruptcy declaration.

Bankruptcy as a device of corporate governance

A fourth goal that bankruptcy laws serve in market economies is to help resolving the "agency problem" which occurs in the control of firm management. The problem arises from the fact that managers, who want to maximise their well-being over their tenure term, do not have the same interests as shareowners, who want to maximise the value of the firm over a much longer period. As monitoring of management is costly, supplementary control devices are needed.

In theory, there are four channels by which managers' interests may be aligned with the ones of shareholders: *i)* incentive devices (such as giving managers equity stakes or interests in profits); *ii)* shareholder mechanisms (takeovers, interferences by active blocks of investors, sales of shares by existing shareholders through which control of the firm may change and the managers be threatened); *iii)* product-market competition; and, *iv)* debt mechanisms (through which a firm is put in liquidation if it does not repay its debt) (Frydman et *al.,* 1993, p. 184). Shareholder mechanisms need well-developed equity, and in transition economies, stock exchanges are still in their infancy and likely to remain illiquid for a while. Therefore, an effective bankruptcy legislation is crucial for the two latter channels – market competition and debt mechanisms – to be able to exert a disciplinary influence on corporate governance.

Moreover, the role of bankruptcy as a control device in transition economies will remain limited as long as both bankrupt enterprises and creditors are under the control of the state and, therefore, bankruptcy hardly implies any real transfer of ownership. Here again, a prerequisite for bankruptcy to exert its role of enforcing financial discipline is that commercial banks be privatised. As long as this is not achieved, there is even the adverse risk of "re-nationalisation" as newly-created private companies that are declared bankrupt may fall under the control of state-owned banks after a reorganisation procedure.

However, it is unclear that incumbent managers of insolvent firms in transition economies should be sanctioned in the same way as in market economies. The financial disarray of many enterprises reflects the burden of inherited debts and exogenous changes of the economic environment rather than mismanagement. Managers tend to be best acquainted with the potential of their companies and, in some countries, they are hard to replace. It remains an open question whether bankruptcy laws should be amended, perhaps temporarily, in order to reflect these circumstances. Thus, instead of applying uniformly to all entities, as in market economies, bankruptcy procedures in transition countries could treat "first-time" failures differently from recurrent insolvency, for instance, by giving to lenders and managers enough time in order to estimate carefully the prospects of the company.

BANKRUPTCY LEGISLATION IN MARKET ECONOMIES

Bankruptcy laws in market economies typically involve two procedures: liquidation and reorganisation. In most countries, these two procedures are distinct. A company that is deemed insolvent is filed for liquidation; a trustee is appointed who takes control of the debtor's assets, checks that no creditor benefits from preferential repayment, sells the assets and distributes the proceeds among the various classes of creditors following a priority rule.

Alternatively, when reorganisation is carried out, the debtor is granted a breathing spell during which he is sometimes allowed to keep control of his business while being temporarily protected against creditors' claims. He may use this period to prepare a reorganisation plan for approval by a qualified majority of creditors. The plan may involve debt relief and rescheduling, payment by instalments or debt extension. If the plan is not approved by creditors, the enterprise is liquidated.

Both procedures make use of legal instruments that protect the debtor's assets. Once a procedure is initiated, a so-called "automatic stay" takes effect on most claims against the debtor for a given period of time. Moreover, the trustee is entitled with "avoidance powers" that allow him, *inter* alia, to inhibit fraudulent transfers of a debtor's property.

Although most bankruptcy legislations are organised following these broad lines, there are substantial differences in the way they strike the balance between liquidation and reorganisation.

Bankruptcy laws in the United States and France stand at one extreme of the spectrum where relatively less weight is accorded to creditors' rights. The bankruptcy legislation in the United States gives the debtor relatively large influence and rights. Petition for liquidation (Chapter 7) may be initiated by the debtor (voluntary petition) or by the creditors (involuntary petition). But, in the latter case, it is incumbent to the creditor to prove the debtor's insolvency. As long as insolvency is not proved, the debtor remains the owner of its assets; he can defend against the creditor allegations and often reacts to involuntary petition by filing for reorganisation. Some business categories, like family farmers, are protected against filing for liquidation by involuntary petition. The US insolvency legislation is unique among the major market economies in that it specifies no conditions under which the debtor is obliged to file for liquidation. The distribution of liquidation proceeds obeys the following priority rule: secured claims, administrative expenses, wage claims, tax claims and, finally, unsecured claims.

What makes the reorganisation procedure (Chapter 11) such an attractive alternative in the United States is the fact that, in most cases, the debtor may continue to operate is business (as a "debtor in possession") while enjoying the protection of the automatic stay and exerting most of the powers of the trustee (such as "avoidance powers", which prevent the debtor's assets from being prematurely dismantled through transfers made at the expense of some categories of creditors). The debtor has 120 days (possibly extended to 180) in order to prepare a reorganisation plan. To be valid, the plan must meet several requirements: it must be feasible and satisfy the "best interest of creditors" condition which provides creditors with a return greater or at least equal to that obtainable under liquidation. The plan has to be approved by a qualified majority of creditors in each class.[3]

Available evidence suggests that around 40 per cent of the companies that file for reorganisation under Chapter 11 reach an agreement and that unsecured creditors are better off than they would have been had the firm been liquidated (White, 1989). However, because reorganisation is often costly, access to it tends to be restricted to larger firms. As well, some studies (for instance, Weiss, 1990) suggest that Chapter 11 often yields outcomes that violate the priority of claims among unsecured creditors and between unsecured creditors and equity holders, which may contribute to increasing the cost of credit.

French legislation gives priority to the continued operation and employment of the firm relative to the protection of the creditors' rights. Restructuring or liquidation is initiated on a court decision under request of the debtor or a creditor. The court decides either to restructure the firm along the lines of a continuation plan or to implement a disposal plan under which assets or parts of the assets are sold to third parties with the commitment to continue the business activity (Lafont, 1994). If none of these arrangements is viewed suitable by the court, the firm is liquidated.

In contrast with the US and French legislation, German bankruptcy law envisages liquidation as the main outcome of insolvency. Bankruptcy may be initiated by the debtor or a creditor, with the former being liable to civil and criminal penalties in case of delay in filing a petition. A manager is personally liable to civil and criminal penalties if he does not file for bankruptcy within three weeks after his company is unable to repay debt. An important feature of the German law is that secured creditors have to assert their rights outside the bankruptcy proceedings, this further reduces the likelihood that a reorganisation agreement will be reached. The legislation makes provision for reaching an arrangement between the debtor and his creditors within the bankruptcy procedure ("involuntary" or "compulsory" composition) or outside bankruptcy, through a "voluntary" composition procedure. The latter requires that creditors be paid at least 35 per cent of their claims, a condition which, in practice, denies access to reorganisation for a majority of insolvent firms.

In the United Kingdom, too, bankruptcy considers liquidation as a first resort. Rescue alternatives involve voluntary arrangements, administrative orders which suspend claims until an arrangement is settled, administrative receivers aimed at selling the company as an ongoing concern. As these procedures either suffer from legal defects or are very costly, rescue outcomes account for less than 1 per cent of all company insolvencies (Hill, 1994).

Bankruptcy is not the only way of transferring ownership in market economies. Evidence suggests that the debtor and the creditors often try to avoid the legal process of bankruptcy and to solve the financial distress of the company through private negotiation or portfolio reorganisation, especially where bankruptcy costs are high or where companies are virtually certain to be forced into liquidation under available procedures. Even in the United States, where the legislation favours debtors, a large proportion of Companies in financial distress prefer to resolve their problems through private negotiation rather than through Chapter 11.

Legislators in market economies have so far failed to produce the "ideal" bankruptcy law, given the inherent conflicts between different objectives of such legislation. Indeed, existing laws are regularly amended and their focus changed. The French law was modified in 1994 in order to take better account of the interests of the creditors. By January 1999, the current German law will be replaced by a new law which will provide more practical opportunity for reorganisation. In light of this experience, it may not be appropriate for bankruptcy laws in transition economies simply to revert to Western-type legislation inherited from their pre-communist past. In particular, the Czech and Polish laws derive from the German insolvency law, the one among Western laws that gives most weight to creditor protection. Under a law with this emphasis, privatised enterprises in transition economies may not be given a fair chance to restructure.

HISTORICAL OVERVIEW OF INSOLVENCY PROCEDURES IN POST-COMMUNIST ECONOMIES

During the 1980s, while the power of the communists declined, there were attempts in most centrally-planned economies to transfer part of the enterprise control to insiders (management or workers). This resulted in a situation, when the traditional command economy was finally dismantled, in which state enterprises (SEs) found themselves with unclear ownership rights and a hybrid structure of central and insiders' control rights. Facing a recession of an unprecedented magnitude during the early 1990s, a large majority of these state enterprises encountered liquidity problems which resulted in increased inter-enterprise indebtedness, surging arrears of taxes and social security contributions and a growing stock of bad and doubtful loans in bank portfolios.

Table 1 shows the extent to which financial disarray was widespread in Eastern Europe and in Russia during the early 1990s. The proportion of bad and doubtful loans in total bank loans ranged from 12 to 20 per cent (except in Russia which has not experienced any serious bad loans problem so far), while inter-enterprise credits accounted for up to 20 per cent of GDP. These failures to meet budget constraints had a number of adverse effects. Bad and doubtful loans undermine the financial stability of the banking system and force commercial banks to increase the spread between lending and borrowing rates, therefore imposing a "tax" on performing debtors. Inter-enterprise debts make it more difficult for monetary policy to control inflation, thereby undermining the whole stabilisation process.

Table 1. **Non-performing loans and inter-enterprise credits in economies in transition**

	Bad and doubtful loans as % of total bank loans	Inter-enterprise arrears as % of GDP
Hungary	16.6 (1992)[1]	10.7 (1992)[2]
Poland	12.0 (1993)[3]	15.7 (1993)[3]
Czech Republic	20.0 (1993)[4]	22.0 (1992)[5]
Russia	n.a.	11.7 (end 1992)[6]
France		16.7 (1990)[7]
United Kingdom		12.4 (1990)[7]
Sweden		7.6 (1990)[7]

n a Not available
1 OECD (1993), p 141
2 Frydman er *al* (1993), p 104
3 OECD (19946)
4 OECD (1994*a*), p 89
5 OECD estimates
6 Goskomstat and OECD Secretariat (industrial enterprises only, excluding small ones and enterprises with foreign investment)
7 Overdue trade credit estimated on the basis of data reported in Bonin and Schaffer (1995), p 31-32

However, the level of firms' mutual debts *per se* is not a good indicator of financial indiscipline. Indeed, data reveal (see the bottom of Table 1) that overdue trade credits in some European economies also account for a non-negligible proportion of GDP. According to these data, the proportion of inter-enterprise credit in transition economies was not unusually high compared with a country like France. What makes inter-enterprise credits a concern about financial discipline is the proportion of "involuntary" debts in contrast with payments delays which are granted voluntarily to customers in market economies as part of commercial strategies (Bonin and Schaffer, 1995, p. 33).

Also, during the same period, inherited bankruptcy legislation from the pre-communist era were revived, sometimes without modification, with the expectation that the privatisation process could be accelerated through the liquidation of insolvent companies. But it rapidly became evident that this expectation would not be fulfilled. The reasons for this lack of effectiveness of bankruptcy laws will be analysed below. However, the most important lesson is that Western-style bankruptcy legislations, although they may work reasonably well for the emerging private sector, proved inadequate to solve the inherited insolvency of the state sector. Had they been effective, they would probably have led to the collapse of the entire economy and social chaos due to the high level of mutual indebtedness, including in the financial sphere.

The following sections describe briefly how bankruptcy laws have been progressively revived during the early nineties and what accompanying measures governments have implemented in order to accommodate the growing insolvency of the state sector. Each country's experience is specific and, not surprisingly, reflects historical patterns of insider and central controls as they emerged at the end of the 1980s (Phelps *et al.*, 1993).

Hungary: shock privatisation through bankruptcy

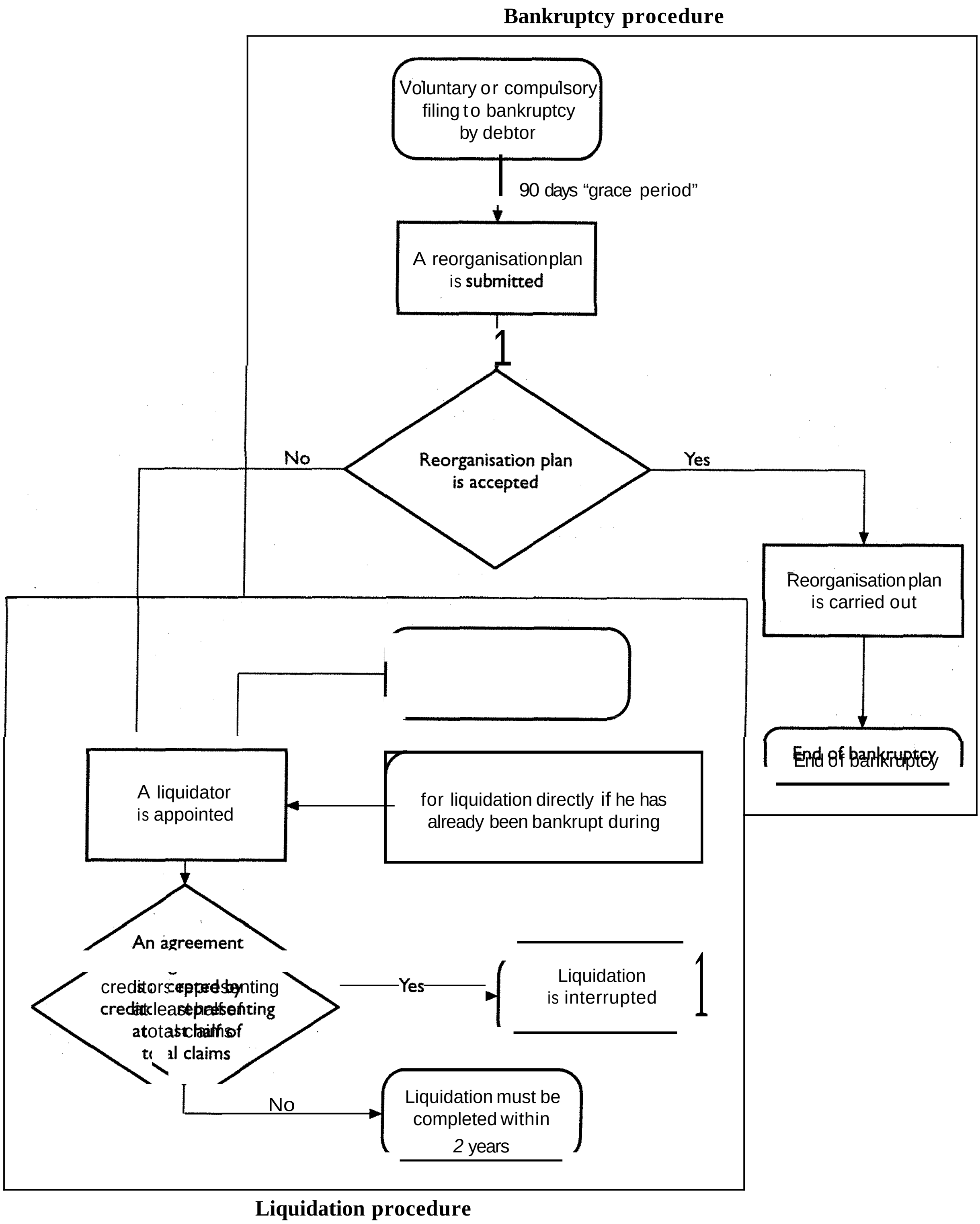
Efforts to reduce the role of the state in Hungary trace back to the early 1960s. The command economy was formally abolished in 1968 with the introduction of the "New Economic Mechanism", a reform which gave rise to a hybrid system, sometimes characterised as an "indirect bureaucratic control", in which the manager was acting as a "proxy" of the market in a true market economy. As decentralisation proceeded, the role of managers in enterprise governance increased, while their subordination to bureaucracy remained strong. In 1989, as reformers came to the foreground of the political scene, the Company Law allowed SEs to transform themselves into various forms of private corporations. Although this contributed to launching the privatisation process, it also made apparent the extent to which managers had retained the prerogatives of the former system. Indeed, some of them used this opportunity to carry out fraudulent transactions, known as "spontaneous privatisations", by selling state assets to themselves or to newly-created associated private enterprises at grossly undervalued prices.

Judicial procedures

Against the background of popular dissatisfaction with growing practices of "spontaneous privatisation", the parliament approved a new bankruptcy law which went into effect in January 1992.[4] The intention of the drafters of this new law was to break down the network of privileged relations that managers of SEs used to have with each other and with the major commercial banks. Another aim was to curb the "queue" of payables at banks, which grew dramatically from HUF 67.5 million at the beginning of 1990 to 158.6 million forints by the end of 1992. By two aspects at least the new 1992 law appeared to be extremely stringent, even by Western standards: first, bankruptcy was *obligatory* and *automatically* triggered by the debtor himself (see below); second, to be adopted, a reorganisation plan needed to be agreed by all creditors. Financial institutions were exempted from bankruptcy. A number of SEs under the control of a state holding or subject to specific crisis management programmes also escaped the law.

Figure 1 illustrates the working of the 1992 Hungarian Bankruptcy law. According to the Hungarian terminology, bankruptcy refers to the reorganisation procedure, as opposed to liquidation which corresponds to the sale of the assets.

Figure 1. ***Hungary: 1992 Bankruptcy law***



Source: OECD.

Bankruptcy (*i.e.* reorganisation) could only be initiated by debtors. Once his petition was registered, the debtor benefited from a 90 days' "grace period" in regard to pecuniary claims other than wages, allowances, severance payments, life- and compensation annuities. During this period, the debtor was obliged to prepare a reorganisation plan which needed the agreement of *all* creditors in order to be implemented (unanimity requirement). If the plan was rejected, liquidation of the debtor's assets automatically followed.

Besides resulting from the failure of a bankruptcy (reorganisation) procedure, liquidation could be directly initiated by the debtor or the creditors. A debtor who had reorganised his business could not apply for another bankruptcy (reorganisation) within the following three years: within this period, he had no alternative other than to file directly for liquidation. The liquidation procedure had to be completed within a two-year period and could be interrupted if a compromise was reached between the debtor and the creditors.

Soon after it came into effect, the law caused an unprecedented wave of bankruptcies and liquidations and courts were soon overwhelmed. It thus became obvious that the automatic triggering brought companies facing temporary liquidity problems into unnecessary bankruptcy procedures. At the same time, a certain proportion of insolvent firms may have escaped from liquidation by elaborating "*pro forma*" reorganisation plans which ultimately failed to restore their solvency. But most important was the fact that courts found themselves unable to carry out liquidations within the delay specified by the law.

These circumstances prompted the Hungarian government to make several amendments to the bankruptcy law in September 1993: *i)* the "automatic triggering" procedure by the debtor was removed; *ii)* the 90-days' "grace period" was made dependent on majority agreement instead of being automatically granted; *iii)* a qualified majority instead of unanimity was required to approve a reorganisation agreement; and, *iv)* the period within which a reorganised company was barred from renewed reorganisation was reduced from three to two years.

Non-judicial procedures

By the end of 1993, the Hungarian Government also implemented a loan consolidation programme integrated into the 1994 bank recapitalisation. The aim of this programme was to give participating commercial banks an opportunity to clear their portfolios of bad and doubtful loans, while being involved in the restructuring of the debtor companies. Any debtor whose loan was classified as bad or doubtful was notified by the bank about the possibility of reaching an agreement in order to settle the debt. The debtor had to prepare a reorganisation plan which had to be accepted by all creditors. Financial restructuring could involve debt forgiveness, rescheduling or debt/equity swaps. If the plan was not accepted, the Government had the right to buy the debt at its net value in the banks books.[5] Failure of the reconciliation procedure opened the possibility for any creditor to initiate liquidation. There was also an accelerated procedure in which the relevant branch ministry had to select a number of ailing companies still partly state-owned.[6]

Poland: the decentralised approach

The pattern of governance evolved differently in Poland where the weakening of state power tended to benefit workers rather than managers. In 1981, following the emergence of the Solidarity union, workers obtained a legal guarantee of participation in the management of the SEs. When communism collapsed, employees' councils and the general employees' assemblies found themselves with governance rights similar to those exerted by the board of directors and the general shareholders' meeting in Western companies (see Phelps *et al.*, 1993).

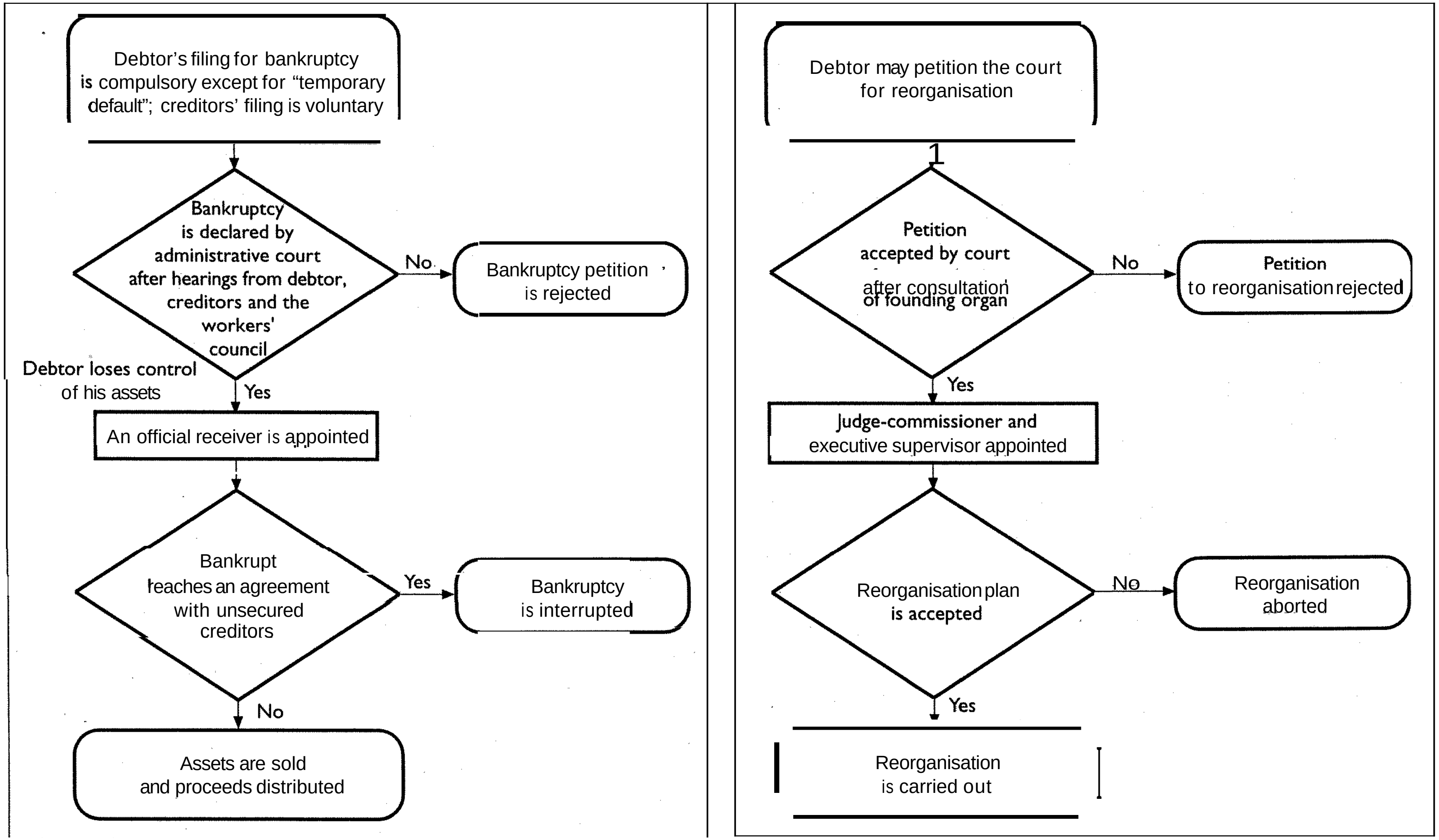
Judicial procedures

Legal regulations to solve firm insolvency in Poland comprise two decrees of 1934: the *Bankruptcy Decree,* amended by the Insolvency Act of 1990, rules liquidation, the *Reorganisation Decree* deals with reorganisation.

The *Bankruptcy Decree* only involves liquidation (Figure 2a). The right to apply is vested in both the debtor and the creditors. After hearing the debtor, the creditors and, in case of a SE, the employees' council, an administrative court declares bankruptcy, provided that the assets of the candidate for bankruptcy are deemed sufficient to cover the costs of the bankruptcy proceedings. Upon the declaration of bankruptcy, the debtor loses the right to manage and dispose of his firm's assets and an administrator (receiver) is appointed to administer the liquidation proceedings. One important aspect of procedure is that the liquidator must solicit the approval of the employees' council before selling the assets of a SE (Frydman *et al.*, 1993; Mizsei, 1994). In addition, the selling of a SE is subject to the approval of the founding ministries and the organs authorised to represent the State Treasury.

As in German bankruptcy law, from which it derives, the Polish legislation provides the opportunity for debtors to reach agreements with creditors both inside and outside the bankruptcy procedure. The bankruptcy procedure may be interrupted if the debtor reaches an agreement with the unsecured creditors, provided that this agreement is approved by a majority of creditors jointly holding two-thirds or more of the unsecured claims and that the claims of the secured creditors are guaranteed. Alternatively, a debtor may use the *Reorganisation Decree* (Figure 2A), a procedure which has the advantage that the debtor stays in partial control of his assets. In addition, the reorganisation procedure provides special forms of settlement for SEs, such as debt/equity swaps subject to the transformation of such enterprises into limited liability or joint-stock companies.

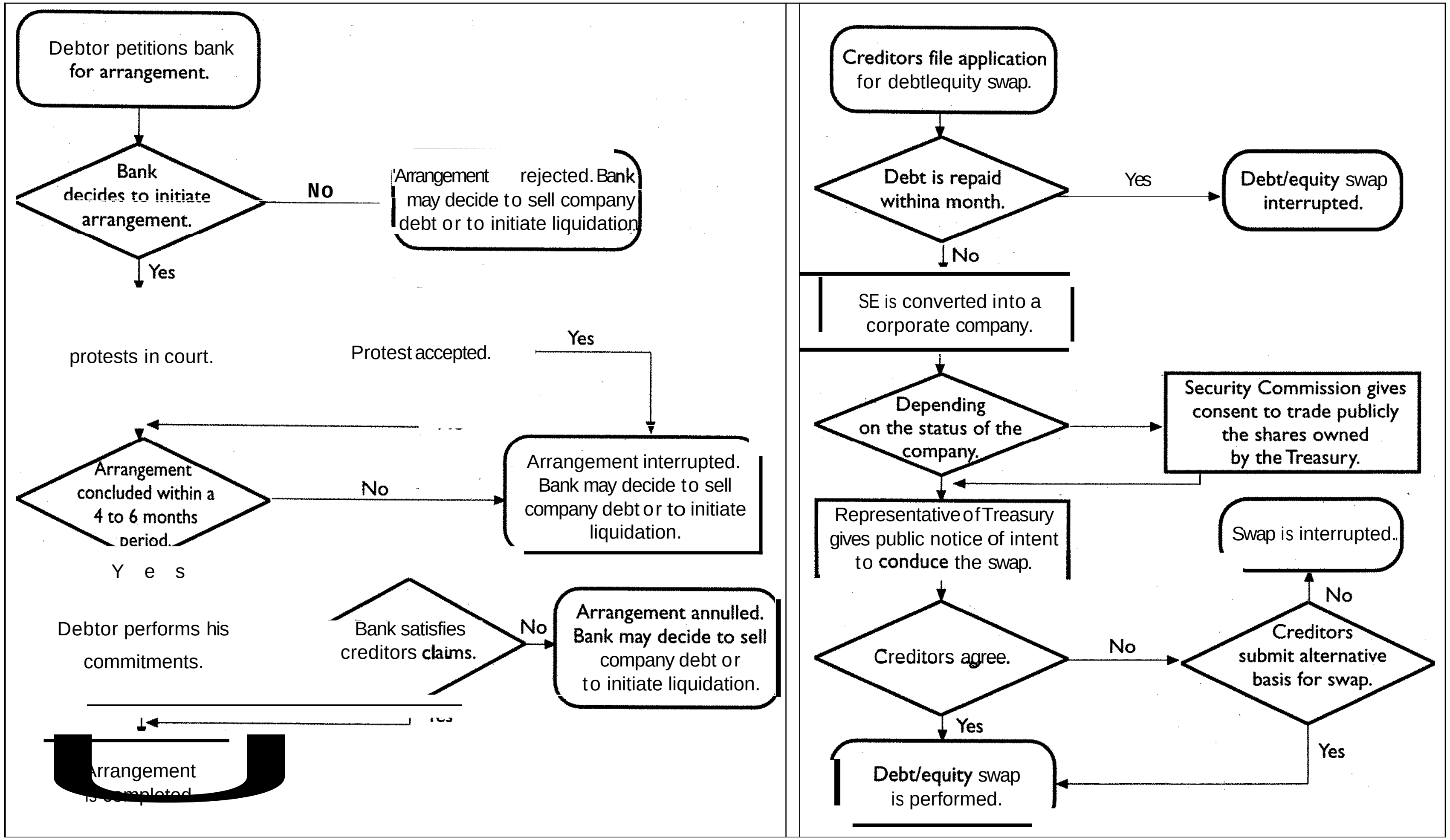
Figure 2A. ***Poland: Bankruptcy and Reorganisation Decrees of 1934***



Polish Bankruptcy Decree **Polish Reorganisation Decree**

Source: OECD.

Figure 2B. ***Poland: Bank restructuring programme of 1993***



Bank arrangement procedure | **Debt/equity swap procedure**

Source: OECD.

Non-judicial procedures

In contrast to Hungary, the Polish authorities followed a strategy of developing *outside the courts* a number of alternative instruments aimed at privatising and/or reorganising SEs at the lowest possible cost in terms of unemployment.

First, *Article 19 of the Law on State Enterprises of 1981* empowers the founding organ of a state enterprise to liquidate it in case of non-payment of the "dividend", *i.e.* the asset tax on the capital contributed by the state. The procedure requires the consultation of the employees' council and the director, and contains various provisions which favour the sale as a "going concern", as well as the continuation of production without employment cuts. Article 19 has proved to be a major channel for restructuring SEs, especially smaller ones. Beside this, *Article 37 of the Law on Privatisation of State Enterprises of 1990* provides SEs with the opportunity to transform themselves into private corporations through a procedure called "privatisation liquidation". The term "liquidation" is misleading in the sense that it is not a default procedure, but rather a process voluntarily initiated by either the founding organ or the employees' council and through which the ownership of the state assets is spontaneously transferred to the firm insiders, often through a leasing arrangement.

In addition, the Polish Government has developed specific non-judicial instruments in order to deal with the largest indebted companies responsible for the building up of non-performing loans in bank portfolios. Since these procedures do not necessarily follow from declared insolvency, they are instruments aimed at restructuring rather than resolving financial default. The *Financial Restructuring Act*, passed in March 1993, pursues almost the same objectives as the US Chapter 11 reorganisation, but the approach is fully decentralised with the commercial banks being empowered to conduct reorganisation. The programme concerns SEs or enterprises with more than 50 per cent of equity held by the Treasury. It involves two instruments:

1. The *Bank Arrangement* procedure (Figure 2B) the structure of which corresponds to a simplified version of the Reorganisation Decree. It is up to the debtor to file for an arrangement with his bank. After having analysed the application, the bank decides to institute the arrangement or, alternatively, to either sell the debts on the secondary market or to initiate bankruptcy. The final arrangement plan must be accepted by creditors holding at least 50 per cent of total claims; as well, it is implemented only if no creditor successfully files a protest in court. In case of the debtor being unable to meet his commitments, the creditors may ask the bank to reimburse them or to nullify the arrangement and sue the debtor in the courts. Subsequent privatisation is a condition for a SE to benefit from a bank arrangement.

2. The *Debt/Equity Swap* procedure makes possible the conversion of debts of SEs or companies wholly Treasury-owned into equity (Figure 2*b*). Contrary to the bank arrangement procedure, the debt to equity swap is initiated by creditors, even in the case where their debt is not yet due. The procedure does not require any decision on incorporation by the founding organ or the employees' council; the only possibility that these bodies have to inhibit the swap is to repay the debt within one month. Here too, the procedure implies the conversion of a SE into a registered company. The workforce retains the right to acquire 20 per cent of the total shares. The Treasury makes public notice of intent to conduct the debt-equity swap, including the specification of the method to be used in acquiring equities.

The Czech Republic: a story of persistent state governance

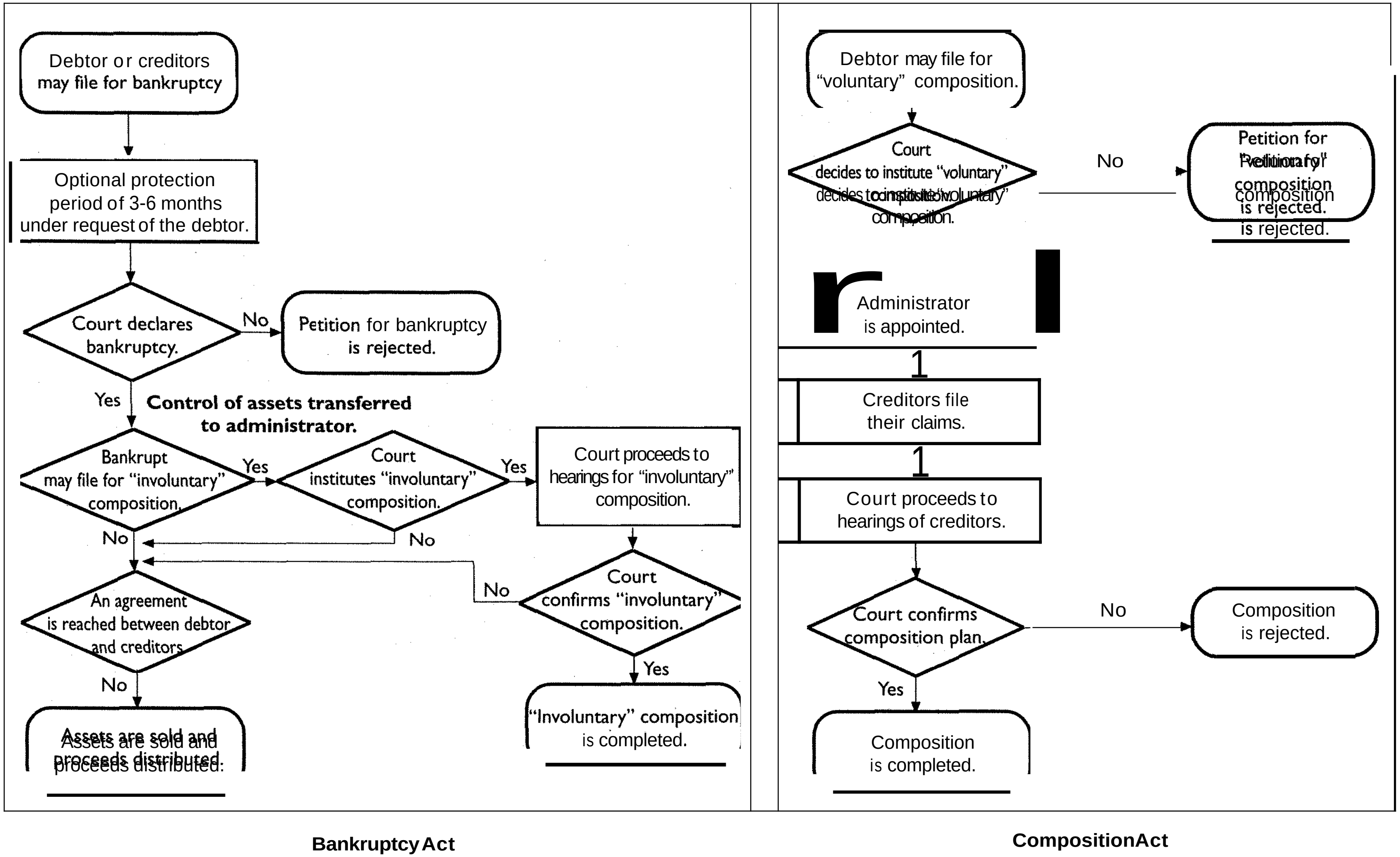
Compared with other Central European economies, the Czech Republic has only limited experience with bankruptcies to date. This relates to the fact that, contrary to Hungary and Poland, there had been no shift of corporate governance from the state to enterprise insiders in the former Czechoslovakia during the 1970s and the 1980s. As the communist era ended, Czechoslovakia found itself with the inherited governance structure from the command economy where ministries interfered directly with virtually all decisions and managers as well as work councils played only a minor role.

The Bankruptcy and Composition Act which took effect in October 1991 drew inspiration from the Czechoslovak Bankruptcy Act of 1931 and the Austro-Hungarian Bankruptcy Act of 1914. The structure of the bankruptcy legislation in the Czech Republic is inherited from the German law; hence, it provides opportunities to reach an agreement with creditors inside and outside the bankruptcy procedure (Figure 3). During the process of bankruptcy, the bankrupt firm is entitled to petition for the so-called "involuntary" or "compulsory"[7] composition (reorganisation). Besides, any debtor may file for "voluntary" composition, a procedure which is distinct from bankruptcy, provided that it is not the subject of a current bankruptcy procedure.

The Czech parliament adopted an amended version of the Bankruptcy and Composition Act in March 1993. The amendments aimed at introducing a three to six months' protection period for all debtors as well as specific measures to protect SEs and farmers.

However, what mostly characterises the Czech bankruptcy legislation relative to the other Eastern and Central European countries, is the discretionary power given to courts at various stages of the procedures. in particular, the courts have the right to refuse to confirm a composition arrangement (voluntary or involuntary) even if creditors have expressed their consent.

Figure 3. ***Czech Republic: Bankruptcy and Composition Acts of 1991, amended in 1993***



Source: OECD.

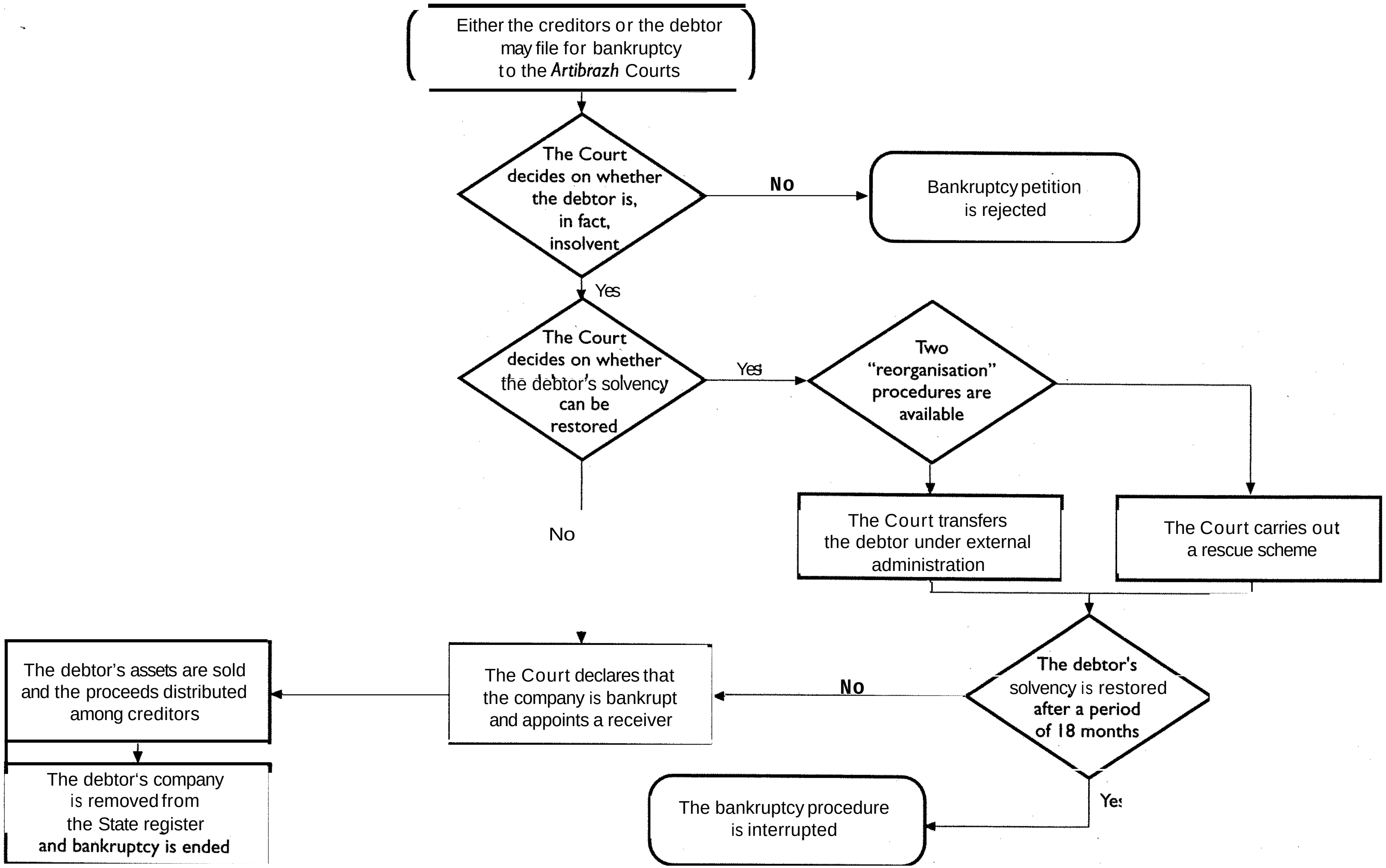
Russia: bankruptcy as a political weapon

Despite undeniable achievements, reform progress in Russia has been slowing down, reflecting the still fragile balance of power between reformists and corporatist lobbies (defense, agrarians, energy producers). In the meantime, there have been continuous attempts to resuscitate the old structure of branch ministries under various new forms (trade associations, financial-industrial groups, bank consortia). The mass privatisation process launched in mid-1992 reflected the underlying political instability: its aim was to achieve the "depolitisation" of Russian enterprises within the shortest possible period of time, an aim which made it necessary to "buy" the support of enterprise insiders (managers and the work collective) by giving them most of the ownership control of their enterprise. However, the government was aware of the fact that an insider-dominated corporate structure would not improve the efficiency of the Russian enterprises. In consequence, during the latter stages of privatisation, there have been continuous efforts to open enterprise ownership to outside investors.

The evolution of insolvency procedures in Russia reflects these tendencies and the fact that the Russian Government did not want to exert a strong pressure on newly privatised enterprises, at least in the early stages of the privatisation. The first attempt to deal with insolvency came well after the process of privatisation had begun. The Act "Concerning corporate insolvency (bankruptcy)"[8] came into force in March 1993. The law in itself is rather simple (Figure 4). It concerns any entrepreneurial entities and envisages that either a debtor or a creditor may apply to an Arbitration (*Artibrazh* = commercial) court when a payment is overdue. The court decides whether there is evidence of bankruptcy. If the court judges that the solvency of the company cannot be restored, the company is placed under receivership (liquidation) and compulsorily wound up. Alternatively, the court may suspend the bankruptcy proceedings and carry out reorganisation procedures. The Act makes provision for two reorganisation procedures. One is the external administration through which management of the company is transferred for a period of no more than 18 months to a court-appointed administrator whose role it is to restore the solvency of the firm in accordance with a reorganisation plan approved by the creditors. Alternatively, the insolvent company may benefit from a corporate rescue scheme which consists of financial assistance being given to the debtor by the proprietor of the company, the creditors or other individuals upon the approval of an agreement specifying the proportion of claims to be met (no less than 40 per cent) within a given period of time (no more than 12 months). In addition, the law provides for the possibility to reach a voluntary settlement with a qualified majority of the non-preferential creditors at any stage of the bankruptcy procedure.

With inflation as high as 15 per cent monthly, it is not surprising that the bankruptcy law has had little effect so far in Russia. Even assuming that courts would be able to complete liquidation in the minimum time, the real value of

Figure 4. ***Russia: The Act "Concerning corporate insolvency" of 1993***



Source: OECD.

creditors' claims would vanish very rapidly. However, after the election at the end of 1993, one of the most noticeable trends in economic policy has been an attempt to introduce some elements of financial discipline. The approach followed by the Russian authorities is non-judicial and centralised. A Federal Bankruptcy Agency (FBA) was created at the end of 1993[9] in order to represent state interests in case of bankruptcy petition against companies with a substantial state shareholding, to prevent insolvency of these companies and to organise their restructuring before they become subject to the judicial bankruptcy procedure.

The FBA is accountable to the Russian State Property Committee (CKI) which is responsible for implementing the Russian privatisation programme. The role of the FBA is restricted to SEs and joint-stock companies in which the state owns 25 per cent of the shares or more. The FBA investigates balance-sheets of the companies and identifies those that do not comply with given solvency criteria (see below). The Agency has the right to change or appoint new management, to split the company into smaller sub-units, to sell parts of the assets (for instance, the social utilities), or to decide the liquidation of the company. However, another body – the Federal Property Fund – is responsible for the sale of the assets, a feature which restricts the effectiveness of the FBA in practice. Furthermore, the legal power and the technical capacity of the FBA are not sufficient for the Agency to exert a nationwide institutional function and its actions are often not only partial but also unpredictable and arbitrary, in particular regarding the choice of the companies to investigate (Ivanter *et al.*, 1995, p. 178). Hence, as a government agency, the FBA does not operate independently from the political power, as should be the case for any device dealing with insolvency *per se*.

SPECIFIC ASPECTS OF DEFAULT PROCEDURES

An assessment of the efficiency and effectiveness of bankruptcy laws has several aspects: whether specific economic entities are not covered by the bankruptcy law; how the bankruptcy procedure is triggered; whether some provisions predispose the outcome of bankruptcy to reorganisation versus liquidation; whether – or how far – incumbent managers can retain control rights during the procedure; and whether – or how far – the priority order in meeting claims in case of liquidation determines the outcome of the procedure. This section analyses how these aspects have been dealt with in the four transition economies under review.

Coverage of bankruptcy law

At first glance, bankruptcy laws in the four countries under review apply to any type of legal entities (limited and joint-stock companies) as well as natural persons. But all four contain specific provisions which reduce their coverage. The Hungarian law does not apply to financial institutions, insurance companies and individual entrepreneurs (Hegedus, 1994, p. 101). The Polish law concerns all types of legal persons, including banks, insurance institutions, state-owned enterprises and co-operatives, but bankruptcy and reorganisation proceedings cannot be initiated against some SEs (public utilities, airports, railways, etc.) or require the consent of the State Treasury. In the Czech legislation, bankruptcy cannot be filed against certain SEs[10] and against any SE with 50 per cent or more of its share capital being subject to voucher privatisation. In addition, private farmers could not be declared bankrupt without their own consent until December 1994. Under any circumstances, legal or natural persons with primary agriculture as their main activity cannot be declared bankrupt between April and September. The Russian law concerns all companies under all kinds of ownership, including SEs, but applications concerning commercial banks can only be made after their licenses have been withdrawn by the Central Bank.

In comparison with bankruptcy laws in most Western countries, these are significant restrictions, although one noticeable parallel is the US Bankruptcy Code which does not apply to banks and insurance companies and contains special provisions for farmers.[11]

Triggering mechanisms and definition of insolvency

Crucial for the effective enforcement of bankruptcy are the conditions under which the procedure is initiated. Appropriate provisions should distinguish insolvent business from those which are temporarily illiquid and should not impair the efforts of the debtor to restore solvency, while at the same time protecting creditors' rights. In most OECD countries, the definition of insolvency involves a cash-flow criterion (payment discontinuation) or a balance-sheet criterion (debtor's liabilities exceed assets). Both the debtor and the creditors are entitled to file for bankruptcy. The debtor is subject to severe legal penalties if he Fails to file for bankruptcy within a given period of time (usually two to three weeks) following a payment becoming overdue. The main exception is the US law where there is no condition specified in which the debtor is obliged to file for bankruptcy and it is to the creditor to demonstrate the insolvency of the debtor.

Currently, bankruptcy laws in the four transition economies more or less resemble the loose conditions of the US legislation. Indeed, imposing a strictly defined insolvency criterion automatically triggering a compulsory filing for bankruptcy has proved very difficult in economies with a very high level of mutual enterprise indebtedness. The Hungarian experience is illustrative of these difficulties (Mitchell, 1993). In the 1986 law, initiation of bankruptcy was voluntary. Faced with the passivity of creditors (see below), the Hungarian Government decided to deny access to financial support to firms who did not initiate bankruptcy against their insolvent debtors and, later on, to offer financial institutions to exchange uncollectible claims and losses due to liquidation against housing bonds. As these measures had no effect, compulsory filing for bankruptcy was stipulated in 1990 for debtors who have "discontinued making payment". A subsequent amendment restricted the legal obligation of debtors to declare bankruptcy against themselves to those whose due payments to creditors exceeded the value of their unsatisfied claims.

Faced with growing inter-enterprise indebtedness and the ineffectiveness of the bankruptcy procedure in resolving it, the Hungarian authorities decided in 1992 to implement a new bankruptcy law. So far, this has been a unique attempt among post-communist economies to impose an unambiguous definition of insolvency complemented by the obligation to file for bankruptcy, like in most Western laws. Independent of the amount due, any debtor which failed to pay his debt within a period of 90 days had to declare bankruptcy within eight days of this date, subject to penal sanctions if he did not do it. However, prompted by the difficulties posed by the large number of cases and growing dissatisfaction expressed by Hungarian opinion, the parliament passed an amendment in September 1993 which suppressed the "automatic trigger" (i.e. the obligatory filing by the debtor). The main criticism against the "automatic trigger" was that it pushed into bankruptcy businesses facing temporary liquidity problems. More fundamentally, evidence (see below) suggests that the procedure mostly affected small and medium-sized firms, while large indebted businesses managed to reach an agreement with their creditors in order to elude the "automatic trigger" mechanism. Notwithstanding these limitations, one advantage of the "automatic trigger" was to provide evidence on the magnitude of the payment crisis in Hungary.

Compared with the Hungarian law of 1992, mechanisms which trigger bankruptcy in the other Eastern European countries are much less rigorous in design and, therefore, are less likely to enforce an effective discipline. As in Western countries, insolvency is defined by a cash-flow criterion or by a balance-sheet criterion. However, the latter is often difficult to evaluate given the uncertainty about asset values and, in practice, only the former criterion serves as a basis for initiating bankruptcy. In Poland, a debtor is obliged to file for bankruptcy within no more than 14 days from ceasing to pay debts, but a "short-term suspension of payments due to temporary difficulties" is not a ground for declaring bankruptcy, although what this particular restriction means is unclear. Even more loose are the conditions under which bankruptcy is declared in the Czech Republic. Bankruptcy petition by the debtor or the creditors is voluntary. Conditions for declaring bankruptcy involve the insolvency of the debtor, the existence of more than one creditor and the requirement that the debtor's property at least covers the procedural costs. A debtor is considered insolvent if *i)* he is unable to reimburse his debts for a "protracted period of time" (Trade Links, 1993), although the length of this period is not specified; or *ii)* if the net value of his assets is negative.

Payments more than three months overdue is the criterion of bankruptcy in Russia. Only claims higher than 500 times the statutory minimum wage[12] give rise to a bankruptcy procedure, while claims lower than this figure are submitted to non-judicial procedures. Filing by the debtor or the creditors is voluntary. In contrast to judicial procedures, the Russian Federal Bankruptcy Agency takes balance-sheet criteria as the sole element to identify bankrupt SEs. The FBA notifies managers of any SE with a current liquidity coefficient[13] lower than two that measures will be taken if the financial performance of their enterprise does not improve. Two other indicators – a ratio of internal working capital[14] and a ratio of restoration (or loss) of solvency[15] – are used as subsidiary information. The merit of the FBA approach is that it is based on a precisely quantified definition of insolvency. However, the action of the Agency is basically a case-by-case one and, instead of being systematic, the decision of the Agency to bring one specific sector or group of companies under scrutiny is subject to political pressure.

Balance between liquidation and reorganisation

In the four countries under review, the bankruptcy legislation makes provision for the debtor to reorganise his business. Unique among the four countries, Hungary has a unified procedure in which the debtor *automatically* benefits from the opportunity to reorganise his business before liquidation is decided (see Figure 1): a structure which, by itself, encourages reorganisation of insolvent enterprises. In contrast, in the Polish (see Figure 2a), Czech (see Figure 3) and Russian (see Figure 4) laws, bankruptcy is mainly geared towards liquidation and the possibility of finding a settlement with the creditors during this process (compulsory or involuntary composition) is mostly at the court's discretion. Therefore, once bankruptcy is initiated, the debtor and the creditors may have relatively little latitude to find an agreement in order to avoid liquidation. However, the existence of distinct reorganisation procedures (voluntary composition) partly mitigates this aspect. The chances that a reorganisation plan is implemented depend on numerous factors, the most crucial being *i)* the eligibility conditions for reorganisation, and *ii)* the requirements concerning approval of the reorganisation plan.

Eligibility conditions for reorganisation

In principle, requirements for reorganisation should distinguish between an illiquid and an insolvent debtor. This means that all conditions needed to apply for bankruptcy (liquidations) also have to be fulfilled to file for reorganisation. In addition, in Western laws, there is a wide variety of circumstances under which a debtor is eligible for reorganisation. In the US law, any debtor may voluntarily file to the Chapter 11 (reorganisation) as long as he has "a good faith intention to file a plan of reorganisation" (Swaim, 1994, p. 62). In contrast, following the German law, a debtor who applies for a "voluntary composition" has to satisfy at least 35 per cent of creditors' claims in cash, a requirement which only few debtors are able to meet in practice. In France, where the bankruptcy procedure is a unified one,[16] it is up to the court judge to decide whether a company can be reorganised.

The Polish and Czech laws, which derive from German legislation, are typically biased against reorganisation in the sense that secured claims are excluded from reorganisation. This often means that the debtor's entire assets are recovered by secured creditors, leaving nothing for unsecured creditors and making the adoption of a reorganisation plan even more unlikely.[17] Besides claims secured by liens and mortgages, the Polish Reorganisation Decree also excludes tax liabilities, social security arrears, salaries and wages of employees, annuity and alimony claims. Given the level of tax and social security arrears and the fact that mortgages are widely used as collateral instruments in Poland, the Decree in practice contributes little to dealing with the financial situation of the SEs. This partly explains why Polish authorities have developed alternative reorganisation procedures specific to SEs and instituted by the banks.[18] Similar conditions exist in the Czech bankruptcy law: a filing for "involuntary" composition is only valid if bankruptcy costs, wage claims and taxes and social security claims incurred during the three years before the filing are guaranteed. Moreover, the debtor who is engaged in a voluntary composition (outside bankruptcy) has to satisfy at least 45 per cent of unsecured claims in order to be eligible for reorganisation. In contrast, petition for reorganisation in the Hungarian law is not subject to any restriction. In Russia, secured claims have to be dealt with outside the bankruptcy procedure. In practice, given that securing assets remains rather unusual so far, this has little effect on the decision to reorganise a business. It is mostly the Arbitration Court which decides whether a debtor company should be placed under external administration or benefit from a rescue scheme or, alternatively, be placed under receivership (liquidation). The Court may also decide to suspend the reorganisation and re-institute liquidation.

There are also additional restrictions aimed at avoiding repeated *"pro forma"* reorganisations. The Czech law requires the absence of previous bankruptcy proceedings as a prerequisite to apply for "involuntary" composition, while a petition for "voluntary" composition will be rejected if the debtor has been subject to bankruptcy or convicted of a criminal offence with regards to creditor rights in the five years before the filing (Tichy, 1994, p. 81). The Hungarian law bars from reorganisation debtors who have had bankruptcy proceedings declared against them during the two previous years.[19]

Requirements for approval of the reorganisation plan

Conditions for a reorganisation plan to be confirmed in Western laws involve: i) the approval by a qualified majority of creditors; ii) the requirement that dissenting creditors are treated fairly and equitably; and, iii) the confirmation that the reorganisation plan is feasible in the sense that it is not likely to be followed by liquidation. For dissenting creditors to be treated fairly, they must receive payments at least equal to the amount they would receive in case of liquidation.

Compared with Western standards, the 1992 Hungarian law was very harsh. The reorganisation plan had to be approved within the 90 days grace period by *all* the creditors.[20] While concern about creditors' rights inspired such a stringent provision, it probably had the adverse effect of inciting creditors and the debtor to roll-over debts instead of initiating bankruptcy. This provision was relaxed by the amendments to the law passed in September 1993. Since then, approval of reorganisation plans in Eastern and Central European countries has been subject to roughly the same conditions as in Western countries. With the exception of Russia, where the Arbitration Court has full discretionary power, reorganisation plans have to be approved by a majority of creditors owning at least two-thirds of the value of the claims within a delay of one-and-a-half to two months, a period which is rather short in view of the difficulties raised by inherited debt in transition economies.

However, courts in Poland and the Czech Republic still enjoy significant discretion in rejecting reorganisation plans, even when they are agreed to by the debtor and the creditors (Sak and Schiffman, 1994, p. 941). For instance, according to the Polish law, the judge can reject a plan which has been agreed to by creditors if the creditors' vote has been manipulated, if the plan "conflicts with decency or public order" or is too disadvantageous to dissenting creditors. The Czech law also contains restrictions that allow the court to substitute for creditors' decisions (for instance, the court may reject a settlement in which at least one-third of the unsecured claims are not scheduled to be repaid within one year) or leave room for arbitrary value judgements (for instance, the court may oppose a plan which involuntarily impairs the rights of secured creditors, which gives the debtor "advantages ... at considerable variance with his recognised financial status", or which does not sanction the debtor's "dishonest or carefree management of his economic affairs").

Control rights of insiders during bankruptcy

The overall rule in Western bankruptcy procedures is that as soon as liquidation is instituted, the right to manage the enterprise assets is transferred from the incumbent management to an appointed administrator (trustee). On the other hand, reorganisation procedures make it possible for managers to keep control of the enterprise – and even to obtain additional credit – while benefiting from a protection period on most claims. There are restrictions, however, on what actions can be undertaken during this protection period.

Similar rules apply in post-communist economies. The major difference relates to the structures of the procedures. In Poland, the Czech Republic and Russia, as soon as bankruptcy (liquidation) is declared, the debtor loses its capacity to administer, use and dispose of the assets, whereas, following the Hungarian legislation of 1992, the debtor automatically benefited from a 90-days' moratorium period (which implied a stay on the collection of most claims). During this period, the incumbent management could continue to operate under the supervision of a trustee. In practice, however, since overloaded courts were unable to meet the legal deadlines, debtors were protected for a much longer period (Sak and Schiffman, 1994, p. 937). The amendments made in September 1993 made the law slightly less favourable to debtors. The moratorium is no longer automatic, but subject to a decision to be taken by a qualified majority of the creditors within 15 days after the filing for bankruptcy. Moreover, the appointment of the trustee became obligatory and his control rights were strengthened.

In all the four countries under review, debtors benefit from a stay on claims collection during the period between the filing and declaration of bankruptcy. Most favourable to the incumbent management is the amended Czech law which grants to all debtors on their request a three-months' grace period which the court may decide to extend for another three months, dependent on the consent of the creditors' committee. During this period, creditors cannot demand satisfaction of their claims (except those pursuant to labour contracts, taxes, customs duties and social security payments), while the debtor remains in control of his business, subject to the condition that none of his acts are detrimental to creditors' interests (Trade Links, 1993, p. 14).

Although the debtor normally keeps the right to manage the assets under reorganisation, "voluntary" reorganisation procedures in Poland and the Czech Republic bar the debtor from undertaking certain acts the result of which might curtail the creditors' rights, while other acts are subject to the consent of the administrator and the court. In Russia, reorganisation sometimes implies the removal of the management. The Arbitration court has the right to transfer the management function to an appointed administrator when the company is put under external administration. The Federal Bankruptcy Agency may change the management of a SE destined to be reorganised.

Priorities in distribution of proceedings

Critical in determining the aggressiveness of each category of creditors in trying to recover their claims are: i) whether secured claims are included in the bankruptcy procedure or not; ii) the priority ordering for distributing the proceeds from liquidation. In Western laws, secured claims and administrative expenses related to the bankruptcy procedure have the highest priority; then come workers' claims which, in general, have priority over taxes and other claims owed to the state. Unsecured creditors have the lowest priority. Exceptions are the French and the Japanese laws which give priority to wage claims over secured creditors. In the German law, preferential creditors do not participate in the bankruptcy proceedings. Their rights are asserted in priority in accordance with appropriate laws and bankruptcy only concerns the difference between the assets realisation and the preferential claims which often implies that unsecured creditors receive nothing (Fialski, 1994, p. 25).

As in Western economies, bankruptcy legislations in the four countries under review give priorities to wage claims and tax and social security arrears over unsecured claims (Table 2). In three countries, laws follow the German model (Poland, the Czech Republic and Russia) in placing secured creditors before wage and tax claims. The implications of this ordering are twofold. In countries where debt securities are well developed (such as Poland or the Czech Republic), since all secured claims have to be settled outside bankruptcy, this leaves little opportunity for the debtor to find an agreement with creditors within bankruptcy and might even

Table 2. **Priority rules in bankruptcy laws of eastern European countries**

Hungary	Poland	Czech Republic	Russian Federation
Bankruptcy costs, wage claims, liquidator's salary.	Secured claims (satisfied according to the order specified in the Code of Civil Procedure).	Claims secured by lien (pledge, mortgage), by "retention right" are settled before the distribution process.	Debts secured by mortgages are satisfied outside the receivership (liquidation).
Secured debts, mortgage.	Bankruptcy costs; salaries and wages of employees.	Wage claims which arose in the three-year period before bankruptcy.	Administration costs
Taxes, social security contributions.	Claims resulting From acts made by the administrator.	Taxes, social security contributions which arose in the three-year period before bankruptcy.	Life and health liabilities of the debtor.
Unsecured debts.	Tax arrears (for two years), other public charges, claims to the State Treasury.	All other claims.	Wages, deductions payable to the Pension Funds.
Interest payments	Social security contributions (one year).		Payments to the budget and to extra-budgetary funds (for one year).
	Other claims; costs of execution and court proceedings.		Other claims.

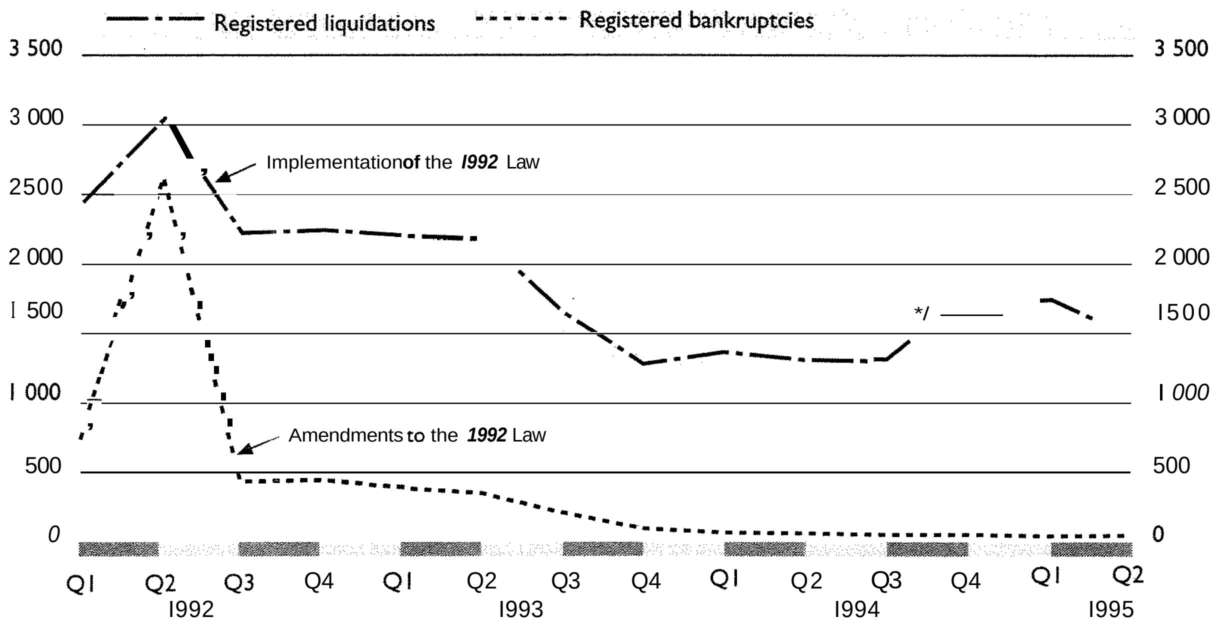
discourage creditors from initiating any bankruptcy procedure at all. But, more important, is the fact that creditors extending credit during the process of reorganisation are not given sufficient priority for their claims. Only the Czech law gives priority to creditors providing credit after the initiation of the bankruptcy. In all other countries, wage and tax arrears are given higher priorities.[21]

BANKRUPTCY PROCEDURES IN OPERATION

Hungary

Data on bankruptcies in Eastern European countries are sparse and often contradictory. Hungary is the only country where it is possible to draw a somewhat detailed picture of how bankruptcies (equivalent to reorganisation in the normal terminology) and liquidations have affected the economy. Figure 5 illustrates the one-off nature of the shock related to the implementation of the new Hungarian bankruptcy law in January 1992. In April 1992, at the end of the 90-days period over which bankruptcy had to be declared if a debt was overdue, the number of registered bankruptcies (reorganisations) jumped up to 2 500. A parallel, although smaller, increase of the number of liquidations was recorded, reflecting the imposi-

Figure 5. ***Registered bankruptcies and liquidations in Hungary***



Source: Hungarian Ministry of Finance.

tion of a more stringent insolvency definition. The number of liquidations jumped again in June 1992, possibly because a number of the reorganisations initiated in April failed and turned into liquidation procedures. But, rather strikingly, both bankruptcy (reorganisation) and liquidation numbers stabilised at below their levels of the first quarter of 1992 during the following months of 1992 and 1993. A significant reduction of both bankruptcies (reorganisations) and liquidations was observed in September 1993, when the law was amended. During 1994 and the first half of 1995, the number of filings for bankruptcy (reorganisation) became negligible (ten per month, on average, during the first six months of 1995, according to data from the Ministry of Finance), but the number of filings for liquidation increased and stabilised at a relatively high level (around 550 monthly, on average, during the first half of 1995), as courts progressively completed the liquidations which had been declared during the period when the new law went into force.

It may seem puzzling that the implementation of the "automatic triggering", after an initial "stock effect", did not yield a persistent increase of the number of declarations. In fact, this confirms the view – further discussed below – that an automatic triggering mechanism is not a substitute for adequate incentives. Further evidence also suggests that the companies to be liquidated were significantly smaller than those that applied for reorganisation (Hegedus, 1993). Some large indebted companies, initially trapped in the bankruptcy process following the automatic triggering, were subsequently able to avoid bankruptcy, probably by finding some agreement on "*pro forma*" reorganisations with their creditors. This may explain the relatively high proportion of reorganisation agreements relative to liquidations during the early stage of the implementation of the law: 64 per cent during 1992, a quite large proportion compared with the US Chapter 11.[22] But this proportion fell dramatically thereafter and, during 1994, only a quarter of the declared bankruptcies ended with an agreement, despite the removal of the unanimity requirement for approval of a rehabilitation plan.

A marked feature of the Hungarian experience has been the apparent passivity of commercial banks: by the end of 1993, they had only initiated 1.5 per cent of all applications for liquidations, a fact which also accounted for the relative small number of larger companies in liquidation (Baer and Gray, 1994; OECD, 1995). The strategy of the banks is highlighted in an interesting study by Bonin and Schaffer (1995): while they stopped giving new credits to their bad customers, banks tried to extract repayments of earlier loans, but without using bankruptcy. There are at least two explanations for this behaviour: first, once a debtor is declared bankrupt, his loans have to be qualified as "bad" and the bank has to provision against them accordingly; second, until the liquidation is completed (which, in practice, takes more than two years), the debtor is not required to service or repay inherited debts.

It has been widely argued that the 1992 bankruptcy legislation had a dramatic impact on the Hungarian economy. At the end of 1992, there were 4 231 companies registered for bankruptcy (reorganisation) and 10 062 companies had been filed for liquidation. All together, these companies accounted for 14 per cent of total output, 25.5 per cent of exports and 17 per cent of employment (Hegedus, 1994, p. 104). At the end of January 1994, 17 586 companies had registered for liquidation since the new law came into force in January 1992, which means that one among every four Hungarian companies had been affected by liquidation.

Filing numbers, however, are misleading. The number of cases which have been effectively started is significantly lower than the number initially registered: by the end of January 1994, 66 per cent of declared bankruptcies (reorganisations) have been instituted, while the proportion of registered liquidation cases that were effectively carried out was less than one in three. A lot of registrations were rejected on the basis of procedural irregularities, while creditors often withdrew their petition for liquidation after having been paid. According to data from the Ministry of Finance, instituted bankruptcy (reorganisations) and liquidation procedures would account at any time between the start of 1992 and September 1994 for less than 2 per cent of gross production and 4.2 per cent of employment only.

A prominent fact about bankruptcies in Hungary is that courts proved unable to meet the deadlines provided by the law. In the Budapest court which handles 30 to 40 per cent of the cases, each of the eight judges had to treat 147 restructuring and 337 liquidation cases (Mizsei, 1994). Apparently, the Hungarian authorities had not anticipated the need for court capacities to be expanded when they passed the new bankruptcy law. A related, but more long-term problem, is the lack of qualified judges, trustees and liquidators, a problem common to all post-communist economies.

Poland

In Poland, fragmentary and often contradictory data suggest that the number of judicial procedures have increased substantially,[23] but also point to the fact that many petitions are withdrawn, discontinued or rejected by the courts (for instance, when the value of debtors' assets are lower than the administration costs). It also appears that judicial procedures have not been the main channel for solving insolvency problems in Poland. By mid-1994, a quarter of the 8 453 SEs existing in 1990 had been privatised through non-judicial insolvency procedures.[24] Privatisation through Article 37 often involved leasing followed by employee/manager buyouts, an option which has proved popular since it legitimated the worker/management control which prevailed in most SEs (OECD, 1994*a*, p. 79). In addition, 793 larger SEs were subject to the Bank Arrangement procedure, 200 of which were expected to benefit from a settlement of their debt. However, it appears that many of these settlements are likely to be challenged by courts and to end with liquidation (OECD, 1994*a*, p. 12).

Czech Republic

In the Czech Republic, the wave of bankruptcies which was expected after the implementation of the amended bankruptcy law in April 1993 has not materialised so far, partly because of the looseness of the bankruptcy criteria, the lack of creditor incentive to file and the numerous restrictions on coverage, but also due to the fact that courts were overburdened. During the period from October 1992 to April 1995, there were 3 986 petitions for bankruptcy, of which only 502 led to bankruptcy declaration. 2 176 cases are still pending while 1 296 petitions have been interrupted or rejected by courts.[25] Most cases relate to small, private businesses, while large SEs have escaped bankruptcy either because they benefited from formal exemptions[26] or because of more informal interventions by the Government.

The Russian Federation

In Russia too, the 'bankruptcy legislation has had little effect so far. During the past two years, only around 250 cases were introduced before the courts. A majority of these procedures were interrupted on procedural grounds reflecting the ambiguties of the law. According to available information, no case has been completed so far.

In comparison, the action of the Federal Bankruptcy Agency (FBA), which came into operation by mid-1994, has been more substantial, although still very limited in relation to the magnitude of the insolvency problem in Russia.[27] By mid-1995, the FBA had declared insolvent 1 400 enterprises with a collective debt of Rb 14 trillion and employment of over two million. However, the Agency considers that more than 4 500 SEs (or enterprises in which the state holds more than 25 per cent of shares) are actually insolvent. Of these insolvent enterprises, only 200 were effectively put into liquidation. In most cases, the notification of insolvency by the FBA sufficed to induce managers to restore the solvency of their enterprises. The FBA also deliberately leaves a considerable time gap between the notification of insolvency and the final decision. The action of the FBA is somewhat restricted by the fact that any single creditor can oppose the Agency's decision to put the company into liquidation, in which case liquidation has to be handled by courts.[28] The FBA is also entitled to carry out privatisation and restructuration: so far, around 100 companies have been reorganised by the Agency.

Creditor passivity in post-socialist economies

The experiences so far in the four countries under review point to a common outcome: despite the existence of Western-style bankruptcy laws, the number of registered cases remained negligible relative to the real level of corporate insolvency. Even the Hungarian law of 1992, which was unusually stringent compared with Western legislation, did not induce a durable change in the nature of the relationship between debtors and creditors. In fact, it is a widespread phenomenon in Eastern European countries that creditors are unwilling to initiate legal bankruptcy procedures, even when these procedures are at their disposal. In particular, commercial banks have appeared as the most inactive creditors in reforming socialist economies.

Mitchell (1993) provides a comprehensive analysis of the possible explanations of this perceived "creditor passivity". A first category of reasons relate to the fact that creditors have no incentive to initiate bankruptcy against a debtor whose assets are worthless. In some countries, for example Poland and the Czech Republic, bankruptcy procedure can only be initiated when debtor assets suffice to cover the administrative costs. The risk of lengthy liquidation processes and uncertainty about asset valuation are factors that make creditors even more reluctant to initiate bankruptcy.

Second, are reasons deriving from consideration about the creditor's own solvency. In economies burdened with large amounts of inter-enterprise credits, a creditor may fear that pushing a debtor into liquidation would eventually force itself into bankruptcy. As illustrated by the Hungarian case, prudential regulations may provide commercial banks with a strong incentive to avoid filing their debtors for bankruptcy. This is reinforced by the fact that, in most transition economies, bank loan portfolios are still highly concentrated in both sectoral and regional terms, so that causing the liquidation of one of their large customers may induce the economic collapse of an entire city or even a region. Mitchell argues that, in this case, the imposition of an automatic triggering mechanism, like in Hungary, will *not* suffice to make the bankruptcy legislation more effective. Both the debtor and the creditors have a common interest in avoiding bankruptcy and the bank will prefer rolling over the debt before it becomes due. The incentive to find an agreement outside the bankruptcy procedure is even higher when the design of this procedure leaves few opportunities for the firm to reorganise, such as in the new Hungarian law of 1992.

A third category of factors underlying creditor passivity reflects the relationship between the Government and commercial banks. As most commercial banks in transition economies are still either state-owned or under the control of the Government or branch ministries, continuous interferences by the Government in bank management have created the expectation that firms with bad debts will ultimately be bailed out in one way or another.[29] These expectations reduce incentives to exert financial discipline. A "true" and rapid privatisation of the banking system is the only remedy to this situation.

CONCLUDING REMARKS

Most post-communist economies inherited bankruptcy legislation from the period before World War II, when they belonged to the capitalist world. At the fall of the communist order, these laws were revived, but it rapidly became apparent that legal procedures conceived for a market environment did not work effectively in the hybrid environment of the economic transition

Therefore, governments attempted to modify bankruptcy laws in a way which initially reflected concerns about economic efficiency principles, but which was also influenced by the gradually evolving patterns of control rights between central governments and insiders. It is interesting to note how these patterns differed across the four post-communist economies under review in this paper and how the design of bankruptcy procedures reflected these differences. However, despite numerous amendments to the original procedures, the view seems to prevail that so far bankruptcy laws in Eastern Europe have not satisfactorily filled the role which one would expect them to have in market economies.

That bankruptcy legislation is needed to impose financial discipline on the emerging private sector is beyond debate. Evidence suggests that, at least in some transition economies, the "flow problem" related to bankruptcies occurring in this sector is progressively coming under control.[30] On the other hand, the experience in the four countries under review in this article clearly illustrates that Western-type bankruptcy laws have proved inadequate to deal with the inherited "stock problem" of insolvent SEs. The most direct reason is that courts had neither the capacity nor the expertise to handle the huge amount of bankruptcy cases that would normally arise from the application of existing procedures to these cases. But a more fundamental underlying reason is that creditors, and commercial banks in particular, had no incentive to sue their bad debtors in courts. Moreover, substituting an automatic mechanism for the lack of proper economic incentives has proved costly: as the Hungarian experience illustrates, both debtors and creditors lost when they were trapped by the automatic mechanism, and rapidly adjusted their behaviour accordingly.

But restoring the right incentives to collect claims is not easy, especially in respect of the inherited stock of bad debts. Banks will not sue their bad debtors in courts as long as it will cost them more than what they would get from the liquidation of the debtor's assets. In practice, as the Hungarian experience shows, banks prefer "to keep their debtor alive" by rolling over loans, while extracting as much debt-service payment as possible, rather than to run the risk that their debtor be liquidated if they initiate a bankruptcy procedure In that sense, current bankruptcy legislations in transition economies, most of them deriving from German law, are inadequate in dealing with the inherited stock of insolvent companies because they are biased towards liquidation. The clearest illustration of this is the Hungarian law of 1992 with the unanimity requirement for approval of the reorganisation plan and the lack of absolute priority for loans granted during reorganisation. In addition, the Czech and Polish examples suggest that too much discretion is given to courts to reduce the chances of rehabilitation.

Given the lack of effectiveness of existing bankruptcy laws in solving the inherited "stock problem", it is not surprising that governments in Eastern and Central

European countries have attempted to rely on accelerated non-judicial procedures. Different approaches have been used: decentralised and bank-initiated arrangements in Poland, more centralised rescue schemes and debtor reconciliation programmes in Hungary, purely bureaucratic insolvency procedure without any intervention of the banks in Russia. It is beyond the scope of this article to discuss the pros and cons of these alternative approaches. Most authors agree that decentralised approaches should be preferred, although it is clear that they are unlikely to work efficiently unless the banking system is fully privatised and freed from state intervention.

Turning next to the distinct role of bankruptcy laws with respect to the developing private sector, one may ask whether procedures used in Western economies are appropriate also for transition economies or, alternatively, whether they should be modified in order to cope with specific aspects of the transition. As the introductory analysis made clear, none of the existing Western bankruptcy procedures guarantees an efficient outcome. In addition, they are unlikely to work effectively once they are transposed in Eastern and Central European countries where the judicial systems are weak and the capital market underdeveloped. However, from the experience of bankruptcy in the four countries under review in this paper, it is perhaps possible to draw some broad conclusions about the features that are desirable in bankruptcy procedures during the period when banks are still more or less under the state control, waiting to be privatised, and the capital markets not fully mature.

First, it is important that payment discipline be enforced in the new private sector and that any payment problem be detected as soon as it appears so as to prevent the building up of new arrears. The mechanism which triggers bankruptcy should not be "automatic" in the sense that creditors should not be constrained to be involved in a bankruptcy procedure if they do not want it. But any payment arrear exceeding a given amount over a given period should be recorded to courts. In addition, the debtor should be made legally liable for the damages incurred by creditors due to non filing – as is the case in most OECD countries. Moreover, the definition of insolvency should be as unambiguous as possible. None of the laws reviewed in this article currently meet these conditions.

Second, the experience so far with bankruptcy in transition economies raises the question of whether the existing legislations are unduly biased towards the liquidation of the debtor. In particular, do current procedures fully guarantee the right of creditors to give any debtor who defaults for the first time a fair chance to make a "fresh start" by reorganising his business? First-time bankruptcy procedures could provide all parties with a greater opportunity to find an agreement that is now the case. This is justified on efficiency grounds – because the risk of liquidating firms which are only temporarily illiquid, but nonetheless solvent, is high. Furthermore, if the bankruptcy process is obligatory but too rigidly biased in favour of liquidation, there is a risk that the law not be used, liquidity crisis being resolved informally, which may cause the stock of inter-enterprise credits and bad loans to increase further. The duration of the protection period during which a reorganisation plan has to be agreed should be long enough – especially with regard to the low judicial experience – to allow the best possible assessment of the future profitability of the firm. Most important, the right of the last resort lender should be more protected than it is the case now, by giving any new credit granted during the reorganisation a high priority in case of liquidation. Finally, courts should not interfere arbitrarily with the creditor's decision.

On the other hand, there is a risk that transaction costs of credit increase due to the "moral hazard" problem arising from repeated but vain restructuring steps. Therefore, second-time bankruptcies should end exclusively with the satisfaction of the claims or the liquidation of the defaulting company. The liquidation procedures should be as transparent and rapid as possible and incumbent managers should be penalised, for instance, by being inhibited from managing another company during a given period of time.[31] All incentives should be brought in, in order to encourage creditors, particularly banks, to sue defaulting debtors at courts. Absolute priority in assets distribution should be enforced and it may be advisable that bank claims have a higher priority in the distribution of liquidation proceeds over government claims (taxes, import duties, social security contributions). There are, of course, various trade-offs between the financial stability of the banks and the soundness of their portfolios in view of their earlier privatisation, the cost of credit and what is sustainable from a fiscal point of view. However, giving the bank claims a higher priority has two advantages: first, to reduce the cost of credit and, second, to contribute to the socialisation of the underlying liquidity crisis, i.e. its replacement by claims on the government budget which are more transparent and easy to control.

NOTES

1. The Slovak Republic is not included in this analysis, although bankruptcy law in the Slovak Republic in many respects resembles that of the Czech Republic.
2. This socially sub-optimal outcome arises because the coalition's decision takes no account of the fact that the other creditors lose less under continuation than under liquidation (Bulow and Shoven, 1978).
3. Besides, there exists an alternative procedure ("cram down") following which confirmation of the plan only requires the approval of at least one creditor's class.
4. This new law replaced the 1986 bankruptcy law which envisioned the possibility of conciliation with creditors or reorganisation before the firm was liquidated. Despite the fact that insolvency of Hungarian enterprises was growing dramatically during the late 1980s, virtually no filings for bankruptcy were submitted.
5. There also existed a simplified procedure with no buy-back option on the part of the Government.
6. 55 companies were involved in the accelerated procedure, 24 of which were under the control of the Ministry of Agriculture, and 31 under the Ministry of Industry and Trade. Most of these companies were managed either by the State Property Agency or the Hungarian State Holding Company (Bonin and Schaffer, 1995, p. 37).
7. "involuntary" or "compulsory" in the sense that this provision is automatically provided to any bankrupt as part of the Bankruptcy Act.
8. For a description of the Russian bankruptcy legislation, see Yakovlev (1994) and Bergstrom (1994).
9. The activity of the FBA is mainly regulated by five decrees in addition to the 1992 Bankruptcy Law: the Governmental Decree No. 926 (September 1993), the Presidential Decree No. 1169 (November 1993), the Governmental Decree No. 498, "On measures to implement the legislation on bankruptcy" (May 1994), the Presidential Decree No. 1114, "On sales of state owned insolvent enterprises" (June 1994), the Presidential Decree No. 2264, "On enforcement of legislative acts on bankruptcy" (December 1993).
10. Included in a list approved by the Government and published in the Business Bulletin.
11. Creditors cannot file a bankruptcy petition against a family farmer. Moreover, specific provisions (Chapter 12) are made for the reorganisation of family farmer business.

12. By the end of 1994, the minimum wage amounted to Rb 20 400.

13. Cash, securities, receivables and inventories to total short-term liabilities.

14. Internal working capital (equity minus current value of fixed capital minus current value of liquid assets) divided by total liquid assets.

15. This is a dynamic indicator based on the linear trend calculated on the previous accounting period and aimed at showing whether the enterprise is able to restore a current liquidity ratio above two within a half-year period.

16. In the sense that it involves both reorganisation and liquidation (like in Hungary) which implies that a debtor is automatically considered for reorganisation.

17. For instance, because the administrative costs and employees' claims cannot be repaid in full.

18. Indeed, the Bank Restructuring Act passed in 1993 provides for an equivalent treatment of tax liabilities and those of private sectors.

19. This was three years in the initial 1992 law.

20. Interestingly, the Hungarian law also allowed a compromise to be reached during the liquidation under much less stringent conditions, namely that at least one-half of the creditors holding two-thirds of the claims agree on it.

21. The situation is even getting worse in Russia, where new amendments to the Civil Code, if they are passed to the bankruptcy law, would imply that claims secured by collateral, which so far had to be settled outside receivership (liquidation), would become subordinate to health and life damage liabilities as well as wages and severance arrears ("The Moscow Times", 31 January 1995).

22. But half of these reorganisations ultimately failed, leading to liquidations (Hegedus, 1993).

23. The number of petitions to the Reorganisation Decree has increased from 76 in 1991 to 665 in 1993, while the number of petitions to bankruptcy (liquidation) have increased from 1 250 in 1991 to 5 249 in 1993. But, according to recent data (March 1994) from the Privatisation Ministry, only 1 125 companies have commenced liquidation and 203 cases have been concluded.

24. 1 171 small and medium SEs had been liquidated through the Article 19 of the Law on State Enterprises and 961 had been privatised through the "privatisation liquidation" procedure provided by Article 37 of the Law on Privatisation of State Enterprises.

25. *Hospodarske Noviny*, June 1995.

26. For instance, firms with debts covered by a state guarantee, undergoing privatisation or having allotted at least 50 per cent of their shares to vouchers are protected from bankruptcy proceedings (Hansson and Luthman, 1995, p. 4).

27. By January 1994, the State Statistics Committee estimated that only 13 per cent of the industrial enterprises had a current liquidity ratio equal or lower than the minimum value (2) considered by the FBA.

28. By the beginning of 1995, 115 cases had been transferred to courts.

29. Successive banks' recapitalisation programmes in Hungary provide a good example of how such an expectation can be fed.

30. For instance, in Hungary. See Bonin and Schaffer ***(1995).***

31. In Western legislation, managers may incur civil liability and may be prohibited from managing a company during a given period of time (for instance, five years in Germany) if they have committed criminal bankruptcy offenses against creditors.

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