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## A Conception of a New Act on Insolvency

**Abstract.** The author—being a well-known expert of the field of law of bankruptcy and liquidation—gives a critical analysis of the present status of the Hungarian bankruptcy law. It is a commonplace to say that this field of the law is in very tight connection with the economy. Therefore the changes and the changing trends of the economy may have huge influence on the law of liquidation and bankruptcy, as well.

As it is known the effective act on bankruptcy, liquidation and voluntary dissolution was adopted in 1991 in Hungary. Nevertheless there have been modifications on this act since then, the new economic conditions require a more appropriate regulation of this field.

The author presents a thorough summary on the critical points of the valid regulation. The author applies a comparative method by referring to the legal solutions of different European countries concerning this branch of law. The author underlines that there are even significant terminological differences between the Hungarian regulation and e.g. the regulation of the EU-countries. This circumstance itself would demand modification of the law of bankruptcy in Hungary with respect to the join of Hungary to the European Union.

The author mentions examples of the everyday practice of bankruptcy and liquidation, which can also prove the necessity of creating a new act on this issue. The author puts high emphasis on the role and activity of the liquidator (trustee in bankruptcy). Finally the author attempts to outline those essential elements of this branch of law, which should be taken into consideration during the codification of the new act on bankruptcy, liquidation and insolvency.

**Keywords:** bankruptcy, insolvency, liquidation, regulation, modification

### I. On the necessity of ceating a new act

During the process of legal harmonisation, the reconciliation of norms governing specific areas of Hungarian law with the legal materials of the European Union has become an established practice. This, in a certain cases may imply the adoption of a new act, while in other cases, some sort of adjustment is sufficient.

Directive no. 1346/2000, which created the international bankruptcy law on the level of the European Union was promulgated in Hungary on 15th May, 2002 and shall be effective law on the accession of Hungary to the EU. By reason of the content of the directive, this implies the possibility of subjecting

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the debtor's assets scattered on the territory of several EU member states to one main procedure, permitting that supplementary procedures on the territory of one member state are pursued according to the substantive law of the specific country. Therefore, the fundamental amendment of bankruptcy law is not necessary since only procedural issues are concerned.

As opposed to the above, it is obvious that the common system of procedural law shall lead to the advance of the rules of substantive law and it can be assumed that substantive bankruptcy law, even if no measures were taken, would be adjusted to the norms followed and established by the majority of the member states within 4 or 5 years after accession of Hungary to the EU. This circumstance, in our point of view, according to our view, evokes the reformation of our bankruptcy law, which has been a practical problem since the bankruptcy act of 1991 came into effect.

It is nearly a cliché that bankruptcy law is a major instrument of the actual economic policy, which the legislators actually resorted to as it is marked by several minor amendments besides two amendments to supplementary law, which are equally designed to ameliorate the respective law. At this moment, we cannot endeavour to assess the impact of these amendments, which, has already been manifested both in legal practice and in expert literature. In this respect we should mention that legal practice even today has to deal with four different groups of legal materials, which significantly differ from one another. This obviously imposes disproportionate and unnecessary workload on the actors and encumbers the completion of the procedures.

It is fortunate that Hungarian legal codification has already employed a new legislative method (competition act, act on business associations) of framing formally new and unified law instead of greater amendments and thereby facilitated jurisdiction and made the Hungarian legal system more transparent.

The facts outlined above justify our proposal for *drafting a new bankruptcy law*, instead of the mere amendment of the old one.

## **II. Conceptual definitions**

As it is widely known, the terminology of our effective law is in compliance neither with domestic legal traditions nor international practice. This, in itself would not pose a problem since the basic content-based criterion of the applicability of a term is that it should define the respective legal institution markedly and distinctly. At the same time, safeguarding that content-based aspect when translating the term into other languages should be observed.

The present phrasing, however, does not meet any of these requirements. In 1986, the use of the term of “bankruptcy” was impossible for political reasons, therefore we assigned the term of liquidation to the law-ecree in a quite adverse way. Unfortunately, this terminology following the transition period prevailed, hence, the strange situation has occurred that we use such widely known notions, which are juxtaposed to our historical traditions with different implications, which create a different impression in the non-ungarian reader and may result in a greater problem.

Let’s illustrate the case above with an example: what we denominate as liquidation proceedings is termed bankruptcy proceedings in Austrian law, whereas Hungarian bankruptcy proceedings is designated as prejudicial action or reorganisation procedure in Austrian terminology, while full settlement is designated as liquidation proceedings in the legal terminology of our Western neighbours. As a result, the Austrian reader will find something quite different from what would be expectable under the term of *Konkurs* in the German translation of a Hungarian text.

Therefore it is obvious that the terminology, also on the grounds of the international directive for bankruptcy law as referred to above, has to be rendered approximately the same content.

*Our recommendation for terminology is as follows:*

In the title of the act we propose the application of the term of insolvency. The underlying reason is that the German insolvency act, which came into effect at the 1st January, 1999 made a significant impact in the sphere of influence of German doctrines, thereby also in Hungary, both on account of its broad scope and its extraordinarily thorough, 20-year-long preparation period, furthermore, by reason of the fact that it was adopted and promulgated already in 1994. We can safely state that insolvency law has become an established term in the course of the recent 5–6 years.

We propose to replace the present term of liquidation proceedings for bankruptcy proceedings. It is undeniable that the German insolvency act referred to above does not use this term any longer, while other German-speaking countries, i.e., Austria and Switzerland do, and the term of bankruptcy proceedings has also integrated into the established legal terminology in other countries of the Union. By means of this modification, we could join the sweeping majority.

We propose however, to maintain the term of full settlement. On the one hand, it has become fully established in Hungarian legal terminology, on the

other hand, doctrinally, it does not fall under the competence of insolvency law. Hence our worries concerning the terms of bankruptcy and liquidation do not pertain to the term of full settlement. From a strict doctrinal point of view, it should not be included in this act, nevertheless, since we propose radical changes in the regulation area of this procedure, it can be retained under the scope of the act on the grounds of the principle that “we should not incur unnecessary trouble”.

### **III. The objectives of the act**

In a significant segment of domestic jurisdiction we grave deficiencies occur from the economic point of view. That’s why the new act needs to be relatively simple, which has to be matched by expeditiousness, transparency and accountability. In a given case, the automatism of procedures also has to be taken into consideration.

In the present Hungarian economic situation, in our view, the major emphasis needs to be put on the priority of creditors’ interests. This, from a theoretical point of view, means that it is obvious that bankruptcy law crosscuts normal liability relations, which shall be replaced by specific procedural rules in the moment of the adjudication of bankruptcy. It is natural in itself, therefore, we cannot forget that a special legal relation obtains here, since the debtor does not deny that the legal title of debt or the amount are valid, therefore, the creditors’ claim is valid and it is merely the debtor’s incapability of compliance with his liabilities that underlies the fact of non-payment.

It is an undeniable fact that upon the considerations of the interest of national economy, the legal development of the recent 100–150 years has shifted in the direction of solutions protecting the debtor, which, understandably, could only be accomplished at the damage of creditors. However, the systematic overshadowing of creditors, on the one hand, does not correspond to the fundamental principles of the legal system, on the other hand, it may cause disturbances in the functioning of the economy under normal liability relations. Economic analyses also to support the fact that the new Hungarian act has to be fundamentally creditor-friendly, whereas the creditor’s interest needs to be construed in a broad scope. This not only implies that the creditor should be capable of obtaining the greatest possible share of the demand, but also that the creditor could achieve this purpose, it also has to play an active role in the reorganisation of the debtor if possible and necessary.

#### IV. Conceptual modifications

1. The pragmatic analyses positively support the fact that extraordinarily many liquidation proceedings are initiated. In several cases, the creditors resort to this legal institution only as a psychic threat, and thereby produce unnecessary workload for the courts as well as undermine the credit of the legal institution. Hence in the future the statutory encumbering of the conditions of the commencement of bankruptcy proceedings seems to be expedient. The amendment, which came into force as of 1st September, 2001 was framed in this spirit, since, with the termination of the right of the prenotation of dues, the commencement of the proceedings shall cost 40.000.- HUF in each case.

Proceeding with this line of argument, we propose on the one hand, that in some cases a mandatory procedure is initiated by the debtor, on the other hand, that the limit of the claimed amount for the creditors is prescribed.

2. The present effective solution fundamentally undermines the role of securities protected with *ius in rem*, which leads to an imbalance of the economy. With respect to the fact that a hinge of our conception is the protection of creditors' interests, we propose the division of the assets of the debtor into two parts. The items of property secured under *ius in rem* for the creditor shall be indemnified directly. (Separate right of indemnification.) Supposing the sale of the security covers the claim, the creditor status entailing a separate right of indemnification shall be terminated and the potential residue shall be added to the other segment of bankruptcy assets. In an opposite case, the creditor with an unsatisfied claim shall be determined as a normal bankruptcy creditor and shall be included in the creditors' indemnification sequence.

3. In a number of cases, due payment of the employees causes a grave problem. Even if there is adequate coverage available for that purpose, the claims of secured creditors cannot be fully satisfied. In case our recommendations are accepted, the settlement of employees' lawful claims will be even more endangered, since it may well be the case that a more substantial part of the debtor's assets would be fused into funds for separate indemnification. In order to secure that both employees get their due emolument and the primacy of creditors' interests is not curbed, we recommend that a monetary fund is set up. This monetary fund could be managed by the Hungarian Treasury, and its resources would spring from the payment of a certain percentage of the wages paid. In the event of the provisional exhaustion of the fund, additional resources could be arranged for by means of the provisional redistribution of the state budget with the prescription of a refund liability.

Of course, this would further put up the price of labour, whereas, since claims with security coverage are essentially guaranteed in the system, what can be expected is either a greater tendency for the provision of loans on the part of banks or the decrease of credit interest rates. In this later case, the extra costs that burden the employer would return.

4. According to our effective law, the liquidator shall be designated *ex officio* by the court. The scope of those to be liquidated shall be determined in a government decree. The government shall invite tenders for entering the liquidators on the rolls. The government decree on liquidators does not require special amendments. The method however, by which the liquidators or the trustees in bankruptcy are appointed should be definitely changed in the future. The courts shall have to consider only one circumstance when appointing the liquidators, namely, that the liquidator to be appointed is included in the list of those registered to proceed as such. At the moment this list encompasses 120 or 130 liquidators.

According to IM-Directive no. 123/1983 on the rules of judicial procedure, the appointment of the liquidator (assets supervisor) shall be administered by a computer program in the event of the adjudication of liquidation (bankruptcy proceedings). The computer program shall offer a list of liquidators registered and operating in the competency area of the court for appointment with special respect to the order of importance as specified in the liquidation registry and the work pressure on the respective liquidator.

The directive on the rules of judicial procedure raises several problems concerning the appointment of the liquidators, since the referred code of practice pertains to the liquidator registered in the competency area of the court, which as a legal term is not positive or distinct under any circumstances. According to the referred government decree, any liquidator included in the supplement may be appointed by any court in Hungary, therefore, such a nomenclature as liquidators registered in specific areas of competence does not prevail in any statute. Such statutory authorisation does not exist.

In practice, what happens is that the courts in charge of liquidation shall register 10 or 30 companies arbitrarily out of more than 100 liquidators in the competency area of the court and further liquidators shall not be concerned in the course of the proceedings. A number of methods are available for the appointment of liquidators at courts. One of these is the so-called automatism, which in practice means that the liquidators shall be appointed in a specific order but in a contingent manner. In this case, the experience and the expertise of the liquidator shall not be taken into consideration. As a consequence of such automatic appointment, the factors of expert knowledge, the work pressure and

the potential special professional skills of the liquidators shall be disregarded, since the computer system appoints the liquidators on a schematic and linear basis. In this framework, we can't assume that the court or the liquidating judge, after due consideration of all circumstances of a specific case, shall appoint the liquidator with the greatest expertise and professional skills.

Another option is that the court, considering all circumstances of the case, including the particular circumstances of the business association and the preparedness of the liquidator, endeavours to appoint the most adequate liquidator in the given case. Unfortunately, this system also has its disadvantages, so far as we tend to encounter the ungrounded charges that the courts give preference to certain liquidators in the liquidation proceedings.

Therefore, on the appointment of the liquidator (trustee in bankruptcy), even the appearance that the court in the course of the appointment procedure would favour certain liquidators (trustees in bankruptcy) should be avoided, hence, in the future, instead of the application of the automatic system or the systematic appointment by the court, a new and adequate system should be developed in all respects.

In practice, the option that the debtor requests the appointment of a specific liquidator (trustee in bankruptcy) that it deems as favourable has also occurred. This fact, however, does not seem a proper solution, since in some cases the debtor is interested in the withdrawal of further stakes from the residue of the assets. So far as the debtor recommends and decides on the entity of the trustee in bankruptcy, we might face the threat that the debtor and the trustee in bankruptcy appear to collaborate in the procedure.

In our viewpoint, the following pattern of the appointment of the trustee in bankruptcy would be the most adequate and objective solution.

With respect to the confidentiality of the matter, either the creditor or the creditors' board should be put in charge of the appointment of the trustee in bankruptcy, implying that the trustee in bankruptcy would be appointed by the creditor or the creditors' board and the only agency of the court in its ruling that affirms the case of insolvency would be to appoint the entities of the trustees in bankruptcy as designated by the creditor or the board.

We also mention as a viable option that the creditor or the board could make a recommendation for the entity of the trustee in bankruptcy with the consent or the approval of the National Association of Liquidators.

So far as this construction seems reasonable, the potential ways of the implementation of the recall of the liquidator in the course of the procedure also need to be considered. According to the present regulation, the liquidator cannot be recalled unless the procedure has finished.

In case the legislator's intention in the course of the potential amendment of the statute is to allow for a broader scope for the creditors' board, a decision needs to be reached whether to facilitate for the creditors or the creditors' board to recall the liquidator under definite and strict conditions, in case the reasons as specified in the act obtain.

5. In our viewpoint the most neuralgic points or terms of the present liquidation proceedings are the following: the determination of the insolvency of the debtor by the court, the appointment of the liquidator and subsequently, the appeal for a review of the ruling of the court by the debtor. The sweeping majority of appeals for review, according to some surveys a rate of up to 90 p.c., are formal. By filing such an appeal, the debtor's intention is to gain time and within this time, with special respect to the exceptions, the debtor will make an attempt to withdraw the remaining assets of the association. Such procedures seriously violate the creditors' interests and the jurisdiction is unable to handle this problem according to the present practice.

The analysis of cases appealed so demonstrates that on an average it takes one or one and a half years for the Supreme Court to reach a firm decision, which, in practice means that a crucial majority, i.e., 90 per cent of the appealed rulings shall be affirmed. Whereas, in that term of one or one and a half years or in an even longer period the unscrupulous proprietors or the officials of the debtor's association may incur grave damages to the creditors, who stand by helplessly.

As we see it the emergence of this adverse situation may be prevented by the introduction of a single new institution of law, i.e., the designation of a provisional guardian *ad litem ex officio* by the court immediately after liquidation proceedings have commenced.

The task of the provisional guardian *ad litem*, without aiming at completeness in its agency, would be the protection of the creditors' interests and monitoring the economic activities of the debtor until the court appoints the ultimate trustee in bankruptcy on the basis of the creditors' request. The task of the provisional guardian *ad litem* would be to survey the debtor's assets, which implies an overall inspection of the debtor's financial situation, including the inspection of bookkeeping and of the cashier's book, as well as of the securities and the goods stock, contracts and bank accounts. The provisional guardian *ad litem* could request information from the leading officials of the business association, about which the creditors and the creditors' board shall be continuously provided information.

In our assumption, it is reasonable that the provisional guardian *ad litem* affirms the pecuniary covenants of the debtor that emerge after the commencement of the bankruptcy proceedings.



The debtor would actually not suffer damages by reason of the appointment of the provisional guardian *ad litem* and consequently, would not be more disadvantaged. So far as the bankruptcy proceedings are instituted by the debtor or the Court of Registration, the limitation of the rights of the debtor as outlined above would obviously not be hindered. So far as it is the creditor that initiates the bankruptcy proceedings, the theoretical possibility arises that it is exactly the market rival, which initiates the proceedings against the debtor so as to incur an awkward market situation, since the provisional guardian *ad litem* necessarily impedes the operation of been determined as insolvent, the creditor, who initiated the bankruptcy the debtor. In that case, our recommendation is that if the bankruptcy proceedings were not instituted by the court, since the debtor has not proceedings, shall be obligated to indemnify the debtor. The provisional guardian *ad litem* would by all means proceed with its activity until the appointment of the ultimate trustee in bankruptcy, and thereby, the unjustified marking time and the appeals that are designated to play for time would be eliminated.

6. The present regulation of the activity of the creditors' board can't secure that the objective the legislator intends to attain is accomplished. In the majority of cases, the creditors' boards are not operative or they are not established, while in other cases the established boards are designated to implement merely formal tasks. According to our standpoint, the establishment of the boards in the future should be mandatory under the new regulation. So far as the number of creditors does not reach the minimum limit of three, each creditor shall automatically become a member of the creditors' board. In our view, the trustee in bankruptcy should be appointed by the creditors' board or the creditors under specific conditions, but the dismissal of the trustee in bankruptcy should also be permissible. The role of the creditors' board in the procedure should be definitely reinforced. Hence, the introduction of the Anglo-axon practice would be reasonable, according to which, it is the creditors' board that assigns the task of the sale of the assets to the creditors. In that case, the role of the trustee in bankruptcy would be restricted to an assessment, adequate sequencing and categorisation of the creditors' claims. So far as the reorganisation of the debtor is deemed necessary, the trustee in bankruptcy shall ensure that the tasks the reorganisation entails are fully complied with and the collection of outstanding debts is accomplished. All functions however, related to the sale of assets would be transferred to the powers of the creditors or the creditors' board. Of course, it is not impeded legally that the creditors' board instructs the liquidator or any other party to sell the assets. Our proposed solution, in our conviction, would facilitate that the procedures related to the

sale of the assets become more simple, expeditious and efficient. Thereby, the rumours and assumptions implying that liquidators tend to spin out the procedures or obtain undesirable financial advantage would be refutable. Hence the inadequate practice, which the liquidators resort to almost without exception could also be ended, namely, that the majority of liquidators systematically makes use of the debtor's physical assets, primarily, the vehicles under liquidation without financial compensation, and thereby, causes considerable damage to the creditors. By the regulation, the creditors or the creditors' board should be granted substantially more entitlements in the course of the entire procedure, while the liquidator (or the trustee in bankruptcy) would be perpetually obligated to report to the creditors on the specific stages of the bankruptcy proceedings according to a certain scheme.

7. In our present practice, several problems arise from the fact that the debtor's assets prove to be so insufficient after the commencement of the liquidation proceedings that they shall not even cover the costs of the procedure. This means, that thereby we impose not only superfluous workload on the courts, but also incur groundless or non- or slowly remunerative, basically unnecessary costs for the liquidators. Therefore, we propose that the well-known solution as pursuant to Act XLIX of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution is employed, which, in the light of contemporary practice, has proved suitable, namely, that the insufficiency or deficiency of assets should be determined as an impeding factor of the commencement of the procedure. In that case, we would save the actors from doing ... a lot of superfluous work, whereas, the possibility, that the debtor withdraws the assets in the last minute, can be impeded by the establishment of the institution of the provisional guardian *ad litem*.

8. As it is known, the definition of pledge as specified under Article 266 of the Civil Code was re-codified under Act CXXXVII of 2000, which introduced a new concept of pledge on real property. The core of that legal institution is defined as follows: "The creation of a pledge on real property is permissible on the entire assets or part of the assets (operated as a self-contained economic unit without the determination of its constituents, rights and liabilities, i.e., real property) of a legal entity or a business association without a legal entity via a pledge contract, which shall be documented in front of a notary public and this pledge shall be recorded in the pledge property register. The pledge on real property, after the conclusion of the pledge contract, shall pertain to the real property that shall be included in the obligee's assets when the obligee obtains the concerning right of disposal, however, shall be terminated when the real property is removed from the obligee's assets."

In the event of the introduction of a separate indemnification law, it is logical that the creditor who holds a pledge on real property stands basically alone, since it shall seize hold of the assets obtainable until the claim is satisfied. So far as the bankruptcy proceedings are commenced by one creditor, the procedural rules modelled primarily on several creditors would lose their relevance. Therefore, we propose that in such a case no bankruptcy proceedings are instituted, but only and exclusively a reorganisation procedure according to the decision of the creditor. Whereas, the creditor can be expected to take additional care to monitor the activity of the debtor, which can possibly entail a financial benefit consisting in the accomplishment of the financial reorganisation and consolidation of the company. In that case, of course, the facilitation of the creditor's actual influence on the debtor's usual economic activities must be reinforced, possibly in other cases of reorganisation, too.

In that case, the ranking of the creditor in the indemnification sequence also has to be addressed. If the obligee of the lien on real property is preceded by one or several creditors in the sequence, they can't be disadvantaged, so the obligee of the pledge on real property shall be obligated to ensure that the indemnification of the creditors preceding in the sequence is accomplished. This is implemented by redemption from the assets of the debtor in the reorganisation procedure, but we think that it is also doctrinally feasible that the obligee of the pledge on real property reaches an agreement with the creditors preceding in the sequence via the instruments of civil law.

9. As already mentioned under the point above, bying to our view, granting more management entitlements in the reorganisation procedure to the creditor would be expedient. In this respect, we may choose between two conceptual options, i.e., on the one hand, the contemporary system, which works based on the joint management by the debtor and the asset supervisor, on the other hand, the creditors become entitled to appoint the reorganisation-trustee, who shall be responsible for the implementation or effecting the implementation of the reorganisation.

10. The provisions of Act IV of 1997 on Business Associations have principally transgressed the institution of limited liability with respect to bankruptcy cases. Whereas, in case of associations with legal entities, it was not only the factor of inflation that evoked the determination of higher nominal capital and authorised capital, but also the more powerful enforcement of the protection of creditors. On that basis, as far as bankruptcy proceedings are concerned, in our view, when the nominal capital or the authorised capital are not actually available and the company shall not initiate proceedings against itself, its limited liability should be terminated.

11. With respect to full settlement, it can be definitely asserted that at the moment the proceedings are unnecessarily complicated, so that the proprietors of an association with minor capital shall be advised to reconsider their concerning decision. Contrary to the established legal regulation and Hungarian jurisdiction, we can state that on the one hand, full settlement in the European Union member states does not fall under the competence of bankruptcy law, which is doctrinally justifiable, on the other hand, it is essentially covered under financial and company law and shall be handled accordingly without a special procedure. As for our view, the adoption of that practice is by all means reasonable. Therefore, in our draft the regulations of substantive law concerning the decision on full settlement would be sustained, whereas both the practice of the appointment of the trustee in full settlement and the mandatorily prescribed order of procedures would be terminated. Accordingly, the decision on full settlement shall be announced to the Registry Court by the management, which shall request its publication in the Company Gazette. Subsequently, the daily balance sheet and the recommendation for the division of assets shall be prepared within the term as defined by the proprietors without any formal procedures, which shall be filed to the Registry Court by the management in line with a request for the liquidation of the company. As a result, the entitlements for full settlement would be terminated, which are subject to our effective law. This standpoint is tenable since full settlement is a sovereign proprietor's decision in itself, which does not concern the public. On that basis however it can be concluded that an intervention into normal liability relations with the instruments of law cannot be substantiated. To shed light on the issue from another viewpoint, that implies that full settlement in the future can only and exclusively be realised if, on the one hand, the case of insolvency or its threat does not obtain, or on the other hand, the company can settle all its liabilities deriving from contract law with the instruments of civil law.

Of course, it cannot be excluded either, that such a claim arises, which the company managers have not been aware of in spite of their greatest care. These extreme cases also have to be taken into consideration. Therefore, in our recommendation, the proprietors of the company cancelled under the legal title of full settlement shall bear one year's liability for such claims, which have an effect on the distributed assets for one year after cancellation. This, however, is a forfeiting deadline. In an opposite case, the principle of the security of circulation would be damaged.

## V. The structure of the law

The objectives that the legislator sets have to be framed in the introduction of all significant codes, i.e., in the preamble. In this respect, we propose the extension of the preamble with a definition of the basic principles to be followed in both procedures, according to their substance, content and objectives, with reference to the fact what attitude the parties are obligated to demonstrate in the course of the procedures. The relevance of this extended preamble would be that both procedures allow for grave financial abuse and even the strictest legal regulations cannot offer protection against these. Therefore, it is uncertain if the general notions of the Civil Code are satisfactory in terms of the notion of liability, since it is obvious that in these cases the parties have to comply with the norm of increased care.

### 1. *The definition of the concept and norms of substantive law*

Similarly to our effective law, the new act initially provides *a definition of the concept or basically, the norms of substantive law*.

#### a) *The effect of the act*

With respect to the effect, a recurrent pragmatic problem is that, on the one hand, bankruptcy law uses the *terminus technicus* of economic organisations, on the other hand, it separately enumerates the entities that qualify as economic organisations. This, in case of all formations that the lawmaker intends to include under the effect of the law, entails that a direct amendment of the act is necessary. With respect to the circumstance that it already crystallised in the course of the codification of the Civil Code that the term of economic organisation was deemed to be exiled from Hungarian law, we propose that this notion was revoked under the act of insolvency. As a consequence of which, since bankruptcy law regulates business activities, we could apply the definition below: the effect of the law pertains to *legal and non-legal entities engaged in business activities*. One can highlight, this notional definition seems to be adequate to include all those associations under the effect of the law, which are engaged in business activities only as a supplementary activity. Primarily societies and foundations need to be mentioned. The administration of the bankruptcy situation of these associations poses a recurrent problem for Hungarian law-making, however, the acceptance of our draft could solve this problem. Of course, adequate amendments shall be necessary in the relevant statutes, and a responsibility regulation has to be integrated in the Civil Code, which prescribes

the full and unlimited liability of those legal entities that have been in the position to make decisions in those foundations and societies, in which as a consequence of its business activity, a bankruptcy situation occurred. The term of “business activity” has to be rendered an economic content as an auxiliary rule.

*b) Debtor*

The debtor as a term with all its legal implications is applicable in the bankruptcy proceedings or the reorganisation procedure. Therefore, the uphold of the contemporary effective regulation also seems adequate, according to which the debtor is the entity that was not able to, or presumably will not be able to settle its debt (debts) on the due date.

*c) Creditor*

The creditor is the party, who has money or property claims expressed in monetary terms against the debtor and has been registered so by the liquidator in the bankruptcy proceedings.

The creditor, who has security protected with *ius in rem* against the debtor, is entitled to separate indemnification.

*d) Assets*

All property that the debtor’s proprietary rights obtain for as pursuant to the Civil Code. Both the right of lease, which is effective for more than ten years or an indefinite term and the usage rights attached to a particular item of property are applicable under the definition.

*e) The Bankrupt’s estate*

The bankrupt’s estate is that part of the debtor’s assets, which is not burdened with securities protected with *ius in rem*.

## *2. Bankruptcy proceedings*

*a) The commencement of the proceedings*

In accordance with our effective law, the proceedings can be commenced upon the initiation of the debtors or the creditors. The difference however, consists in when and on what conditions this is conceivable.

We recommend that the debtor is obliged to commence the proceedings if it is a legal entity, and if, on an average of the previous financial year, the nominal or the authorised capital was not at the debtor’s disposal, or if the debtor’s public liabilities approximate the amount of the debtor’s capital. In

that case the basis of reference versus the APEH (Hungarian Financial and Tax Administration Authorities) would be the balance of the annual current account including those “hiding” nominal liabilities not shown on the current account balance of the APEH (Hungarian Financial and Tax Administration Authorities). Furthermore, those cases can be also applied, when the given firm has not settled the payment of the due general sales tax or the personal income tax. The non-payment of the personal income tax by the debtor’s association could also be considered as a case subject to criminal law, since under private law, the amount of the personal income tax is a legal due of the employee, i.e., a third party, and its non-payment on the part of the company can be considered as fraud.

The debtor can apply the commencement of the bankruptcy proceedings in a case when, according to its discretion, it shall presumably not be able to meet its foreseen liabilities. The creditor is entitled to commence the proceedings, if the due claim expired and the conditions of the debtor’s insolvency obtain and the amount of the claim reaches ... HUF.

*b) Insolvency*

Classical bankruptcy law in this respect provides significant scope for judicial discretion, since the initial supposition was that such economic-structural problems underline the fact of pecuniary non-ayment, which cannot be remedied. At the same time, it was publicly known that bankruptcy proceedings implied a basically drastic intervention into economy and it was a long and expensive process, therefore, its avoidance was by all means expedient and reasonable. It would be very easy to assume that a return to this principle would be favourable and the judges should be granted discretionary powers. This, however, by reason of the current workload on the courts, would obviously not be an advantageous decision. Whereas, the three currently regulated cases in bankruptcy law seem to adequately and relatively normatively secure the reassuring solution of the case, as this is justified by practice. Therefore, we recommend the uphold of the a)–b)–v) framework of conditions as pursuant to Para. 2 of Article 27 of Act XLIX of 1991 on Bankruptcy Proceedings, Liquidation Proceedings and Voluntary Dissolution with the relevant amendment of terminology that the debtor did not comply with the agreement as framed in the reorganisation procedure.

*c) The proceedings of the provisional guardian ad litem*

The immediate appointment allows that the provisional guardian *ad litem* offers a general insight into the financial situation of the debtor before its office

expires. In this respect, it shall make a declaration if the transactions within a year preceding the commencement of the proceedings can be challenged and in the event of their challenge what rate of return can be expected. So far as the provisional guardian *ad litem* is capable of implementing this activity efficiently, upon the appointment the ultimate liquidator, the proceedings can enter into a more active phase, since the ultimate trustee in bankruptcy shall start the activity in possession of such preliminary information, the determination of which has to be devoted more time.

*d) The activity of the liquidator (trustee in bankruptcy)*

In compliance with classical law and contemporary international legal practice, the trustee in bankruptcy receives direct entitlement to manage and dispose of the bankrupt's estate or the creditor is entitled to separate indemnification. On the one hand, the trustee in bankruptcy controls the actual property that was sold, therefore, shall be entitled to challenge and stop the process.

One neuralgic point of our present act is that neither the creditors, nor the proprietors of the debtor's association are supplied with continuous information on the present status of the liquidation, since the liquidator is obligated to do this on request. We think that in the future a system of the provision of constant information should be established as a consequence of which both the creditors and the creditors' board, and the proprietors can receive meritorious information on the actual financial situation. Therefore, the prescription of a 15-day-deadline is expedient.

The registration of the creditors' claims would follow the present system so far as the liability of the creditors to pay registration fees would be sustained. Although this solution can be strongly debated doctrinally, we still propose its sustenance, since there are no other liquid resources available, from which the activity of the liquidator could be remunerated. Whereas, it is a basic market principle that any economic activity is due its equivalent.

This is the period, when it is actually decided whether the liquidation proceedings continue or do not, since the ultimate liquidator has been appointed, the financial situation has been clarified, the scope of the creditors securing substantive additional obligation has been shaped. Disregarding the activity of the liquidator, we propose that the act stipulates that the creditors' board shall be summoned within 30 days of the commencement of the bankruptcy proceedings, which later will have a major role.

According to one view, the creditors' board should include the creditors with the three most outstanding claims, while in another view this circle should also involve the representative of the financial institution that keeps the account



of the debtor. The creditors' board, after it has been set up on a mandatory basis, would supervise the activity of the liquidator. The liquidator would be obliged to provide information to the creditors' board on the continuation or cessation of sub-ransactions and on the actual sale of assets, and would be permitted to administer any asset flow, which equals or exceeds 10 per cent of the bankrupt's estate, exclusively if the consent of the creditors' board has been guaranteed. Of course, the scope of the competence of the creditors' board also encompasses the supervision of the economic activity of those creditors entitled to separate indemnification.

So far as the creditors' board is unsatisfied with the activity of the liquidator, the creditors would be entitled to replace him, but the normative conditions for that measure shall have to be set forth. This implies that it has to be outlined in what cases and after what warning the board shall be entitled to resort to this measure. The replaced liquidator would be entitled to the equivalent of its activity, except when the creditors' board can prove that the liquidator did not proceed according to the requirement of increased care and breached that. After the closure of its economic procedures, the liquidator shall prepare a general balance sheet and a recommendation for the division of assets. Until that time the creditors' board can initiate the conclusion of the bankruptcy agreement with the purpose that the completion of the bankruptcy proceedings, that is, the actual liquidation of the debtor can be avoided. As for the present situation, at that point the creditors' board on behalf of the creditors is entitled to negotiate with the debtor's representative. In that case however, it is advisable, whereas this is contrary to the present practice, to consult the experts of the liquidator, since that is the legal entity that managed the debtor's association up to that date.

A classical task of the bankrupt's trustee is the classification of the creditors of the estate. In our framework, the method of classification would undergo significant changes, therefore, it deserves explanation in a separate sub-section. So far as the court accepts the general balance sheet or the recommendation for the division of assets, the liquidator (trustee in bankruptcy) shall be absolved from responsibility, and it shall provide for its due payment.

*e) Indemnification sequence*

In our framework, the indemnification sequence would undergo basic changes, since secured creditors' claims have been transferred to a different branch of indemnification, therefore, they do not burden the estate any longer. With respect to this factor, and on the grounds of the sustenance of basic principles of bankruptcy law, i.e., no creditors shall receive indemnification unless full satis-

faction of the creditors ranked as preceding in the sequence have been fully indemnified, our proposed indemnification sequence can be outlined as follows:

1. Cost: this category includes all costs of the judicial procedure and the overall fees of the liquidator,

2. Mass liabilities: a continuous and well-established institution of bankruptcy law. All payments, practically without a legal title, are covered by this term, which have arisen on the grounds of the provision of the trustee of bankruptcy, in which the mass was involved either in the position of the obligee or of the obligor. Since it is easy to understand that in a given case the suppliers are exclusively willing to make external tools, which are necessary for the completion of semi-manufactures, available on condition that they are paid the equivalent and do not become the bankrupt's creditors. As a result of this category, these payments shall be made in the course of the proceeding, therefore, these payments shall already be settled in the moment of the judicial proceedings.

3. Claims made upon the warranty or guarantee: according to contemporary notions these are claims, which arise from the non-economic activities of the individual person. Classically, we distinguish between two categories, which are obviously applicable with respect to debtors engaged in such activities, whereas, the classification of the obligees into the creditors' first group seems expedient by reason of the relevance of the interest to be protected. In this case, which special regard to the type of payments, the liquidator shall determine a separate amount, which shall presumably cover these liabilities until the expiration of warranty. So far as the separated fund is not exhausted, the indemnification basis of other creditors shall be extended.

4. A share of public liabilities calculated with capital—and transaction interest: as it is known, in terms of public liabilities, several types of fines or interest surcharges may be charged. It however is not unusual that the obligors because of the contingent discrepancies of data—flow only subsequently receive the concerning information. It would be contrary to the objective of the bankruptcy proceedings that other creditors bear the costs of the extraordinarily great interest surcharges and fines that have to be paid on certain outstandingly enormous public liabilities, which sometimes exceed the total of the capital claim itself. Therefore, the mere calculation of the normal transaction interest seems logical in the event of indemnification of the creditor on a privileged ranking.

5. The capital claim calculated with normal transaction interest of the creditors qualifying as small or micro-ventures: The subsidising of small and micro-ventures is an objective of economic policy, which is relevantly

manifested as pursuant to Act XCV of 1999 on small and medium-size enterprises and on the subsidy of their development adopted in this scope. This act provides a brilliant notional definition of small and micro-ventures, according to which a venture, in which the total of employees does not reach 50 and the annual net revenue does not exceed HUF 700 million, or the balance-sheet total does not exceed HUF 500 million and the stake held by the state and the self-government jointly or separately does not exceed a rate of 25% in the proprietors' group, shall qualify as a small venture. A micro-venture is a venture, which employs less than 10 employees and the annual net revenue or the balance sheet total does not reach the upper limit as specified for small ventures.

6. Other capital claims.

7. Interest fines and bonuses.

Obviously, the overall calculation of the transaction interest may be accomplished before the proceedings are commenced.

*f)* The court, after the acceptance of the general balance sheet and a recommendation for the division of the assets, as we already noted, shall recall the liquidator and transfer the power to manage the existing assets to the creditors' board. Subsequently, the creditors' board shall be entitled to sell the assets on the market and since it is basically and definitely interested in obtaining the highest possible price for the assets, the present complicated regulation of the sale of the assets is deemed necessary.

*g)* The regulation of the bankruptcy proceedings as outlined above entails the overall reconsideration of the charge of liquidation and liquidation costs. With respect to the fact that it is not the liquidator that shall sell the assets at the closure of the proceedings, the basis for the calculation of the charge won't equal the amount of the sold assets. We think, however, that the level of the consultation market price as developed recently adequately facilitates the determination of the real price by the court, in the course of which it shall take the opinion of the creditors' board into consideration. The principle of the formation of the charge as well as the itemised enumeration of the type of costs that can be utilised by the liquidator needs to be established in a decree issued by the Ministry of Finance, since in that case the legislator could take into consideration the price changes in Hungary more effectively than today. Of course, as a basic principle we have to assert that the activity of liquidation is a business venture like any other venture, therefore, a decent profit needs to be secured for that specific activity.

### 3. *The reorganisation procedure*

The commencement of the procedure may be requested without limitation by the debtor or the creditor, who holds a pledge on real property on the debtor's assets under Article 266 of the Civil Code and any other creditor, the worth of whose assets secured under right *in rem* equals half of the property the debtor disposes of.

The procedure shall be commenced by registration at the court. The court may only investigate the personal particulars, and if the procedure is instituted by the creditor, it may examine the legitimacy of the claim, and consequently, provide for the commencement of the reorganisation procedure in its ruling. This also entails that the debtor shall be entitled to three months' moratorium on payment, in the course of which the claims put forward shall bear normal "transaction" rates without late payment surcharges and fines. If the procedure was instituted by the debtor, it shall be obligated to recommend a binding reorganisation program within two months of the institution of the proceedings, to which it should request the consent of the creditor in the course of the conciliation. As an alternative to securing a valid approval, reverting to the solution effective between the period of 1991–1993 is conceivable, when the consent of all the creditors present was necessary for the adoption of the reorganisation scheme, or the solution of a legal settlement technique, which has been basically non-operative since 1993, could also be followed.

So far as the creditors initiated the bankruptcy proceedings, it is subject to their decision whether they appoint a reorganisation-trustee with full competence to manage the debtor's association.

In case an agreement is concluded, the debtor shall be obligated to proceed in full compliance with the reorganisation agreement and any essential deviation from the scheme (what qualifies as essential deviation shall be determined in the agreement) would entail the entitlement to an automatic commencement of the bankruptcy proceedings. Therefore, the debtor is sufficiently encouraged to implement the scheme developed or approved of jointly with the creditors. The accomplishment of the scheme can take a maximum period of 3 years and after the expiration of the period, the court must stay the procedure or proceed with it in the scope of bankruptcy proceedings.

So far as no agreement is reached and otherwise the conditions of insolvency obtain, the reorganisation procedure should be remitted to bankruptcy proceedings, which is not necessary in every case, since the commencement of the reorganisation procedure, according to special literature in economics, is advisable in case insolvency is merely a remote threat. Therefore, it may well be likely that the debtor is still solvent in the moment of an unfruitful agreement.