Dr. Valéria Széplaki: Reform of the Hungarian corporate insolvency regulation and its financial stability aspects

Corporate insolvency regulation is of decisive relevance for banks in terms of their secure operation and ability to recover outstanding claims from corporate clients. This topic has been the subject of many debates lately, as Hungarian corporate insolvency regulation has been undergoing reforms since 2003. One of the main objectives in this regard was to adopt new measures to improve the mediation of funds in the economy. This study introduces reviews leading to the reform, demonstrates the measures already adopted and those in the pipeline, and finally offers an assessment of the measures in general and from the perspective of financial stability. Reform measures adopted so far are favourable from the perspective of financial stability, since the international standards which have been introduced improve the secure operation of commercial banks when mediating funds. However, the reform has to be carried on, with special regard to the enhanced creditor protection temporary administrators and liquidators must be enabled to protect the interests of creditors in any situation and creditors should be afforded means to enforce it.

INTRODUCTION

It is the legal responsibility of the Magyar Nemzeti Bank to support financial stability. This activity includes monitoring the factors that have an impact on the operation of the financial system. In this context, domestic corporate insolvency regulation plays a definitive role since it affects the secure operation of the commercial banks and their ability to recover outstanding claims from corporate clients. These factors combined have the capacity to determine the ability of the banking system to carry out its basic responsibility, i.e. to mediate funds between savers and borrowers.

In Hungary, the change in the political system in 1989 brought along economic development and, consequently, changes in the insolvency regime. The first major overhaul of corporate insolvency regulation was commenced in 2003 in the wake of strong criticism articulated by different sources. The World Bank, the International Monetary Fund and the European Bank for Reconstruction and Development voiced their worries on the subject that creditors have little say in the business affairs of insolvent companies, and that it is difficult for them to exercise even the scant rights they have. Judges, liquidators and temporary administrators pointed out that they have no means to block attempts to rescue assets to the detriment of creditors. The Hungarian Financial Supervisory Authority and the Magyar Nemzeti Bank underlined that the current regulation is inadequate to guarantee that banks operate safely in accordance with international standards.

Regulatory changes so far indicate a shift toward better and improved regulation as they now contain facilities enabling creditors to recover their outstanding claims at a higher rate. Thanks to the application of international standards, commercial banks are now able to mediate funds under better safety conditions, i.e. they can operate more beneficially from the perspective of financial stability. Corporate insolvency regulation nevertheless remains imperfect. The entitlements of creditors have to be further improved so as to enable liquidators and temporary administrators to better represent the interests of creditors in the proceedings.

Credit risk, insolvency proceedings, securities

Risk is inherent in any business relationship where one party owes money to the other, namely that he or she will not honour the debt. This uncertainty factor is referred to as *credit risk*. Moreover, creditors may face the possibility of being able to have a claim repaid only in an *insolvency proceeding*, where they are prone to share the debtor's assets with other creditors. Among two types of insolvency proceedings in Hungary, *bankruptcy proceedings* are lodged by the company's management in an effort to persuade its creditors to accept that the current financial difficulties are only temporary, and that these difficulties may be resolved by rescheduling. *Liquidation proceedings* may be requested by the creditors as well, with the aim of liquidating the company's assets and terminating the company's corporate existence. Having more than one creditor involved is enough in itself to increase the possibility of receiving little money in the end. Moreover, the situation is worse if the regulatory environment is inad-

equate to guarantee that the debtor's assets are protected from any infringement and that the court proceedings will not consume what remains. Creditors may also be interested in the survival of their trading partners facing temporary financial strains.

For creditors, one way to reduce exposure to credit risk stemming from credit relations is to secure items from the debtor's estate, for example real estate or securities in advance. For the entitled creditor these 'fixed' property items serve as a financial source of debt repayment in case the debtor goes bankrupt. These securities will be able to reduce risks only if the creditor is not blocked in any way or form from satisfying his or her claim. Consequently, the prerequisite of using securities in the commercial world is that they must continue to serve as a security in insolvency proceedings. This means ideally that they should remain 'effective', meaning that they cannot be taken over and made part of the bankruptcy estate. Should they become part of the bankruptcy estate, the liquidator shall represent the interest of the creditor entitled to the security, i.e. the security has to be sold quickly and at the highest possible price, and the creditor has to be paid off in a timely manner.

WHY WAS THE REFORM OF CORPORATE INSOLVENCY REGULATION INDISPENSABLE?

Since the change of the old political regime in 1989, efforts have been made to bring the Hungarian insolvency regulation up to date with economic developments. However, the criticism that proceedings are far too costly still stands. Some of the reasons for expensive proceedings are that the proceedings are time consuming, the regulation lacks the facilities to allow financially troubled companies to reorganise properly and creditors are granted weak means to protect their interests. All of these issues were highlighted recently partly by Hungary's accession to the European Union, and also by expert surveys of international bodies conveying a dim picture on Hungarian corporate insolvency regulation. Finally, local experts have been viewing national regulations and practices with increasing alacrity and growing expectations in tune with international standards.

In the following, we elaborate on some of the issues involving Hungary's corporate insolvency regulation that have recently surfaced.

Costly proceedings

Proper corporate insolvency regulation enables companies facing temporary financial difficulties to reorganise at the lowest possible cost, and to terminate the activities and existence of non-viable ones. The quality of regulation can be measured by the time required for secured and non-secured creditors to recover their outstanding claims in full or in part.

In Hungary - before the reform - secured creditors were able to recover 50% of their claims, while the ratio of recovery of non-secured creditors was around 2%. In international comparison, this index was 83% for secured creditors in Great Britain, and 62% for non-secured creditors in France (Sussman, 2005).

The low recovery of non-secured creditors was due to the fact that in Hungary most proceedings, i.e. 90%, (Csőke, 2004) were commenced against companies with no assets. As for the remaining 10%, the assets were consumed by the high costs of court proceedings, or were lost due to poor management decisions or fraud. According to previous experience, the nominal value of creditors' claims decreased to 64% by the mere fact of entering the liquidation proceeding (Frank-Lóránth, 2006). In other words, even under the best case scenario, it is impossible to achieve a higher percentage of recovery on the account of the indirect costs involved, such as the claim registration fee, the liquidator's fee, and the wage and tax costs of the company's ongoing operation. Additional real losses are generated by the lengthy proceedings.

On the other hand, the lack of protection of security in proceedings presented a greater problem from the perspective of financial stability. Protection was available subject to an agreement between the creditor and the debtor only if concluded at least six months before the time of commencing the liquidation proceedings. Moreover, even if fulfilling this requirement, effective securities were included in the bankruptcy estate. The decision on the sale of security in terms of time and procedure used to lie with the liquidator. Due to the high costs of liquidation proceedings, secured creditors could reasonably expect only half the market value of the security. Therefore, when calculating the securities effects on reduction of credit losses the effective value was far below market value, which made bank loans more expensive in two different ways. On the one hand, directly as banks demanded more securities to cover credit risk, and on the other hand, indirectly since banks' incurred higher operating expenses due to higher regulatory capital requirements.

Lengthy proceedings

A driving factor for the costs of insolvency proceedings is the actual length of the proceedings. More particularly, if a decision is adopted in insolvency proceedings in a short time, financial troubles faced by the debtor will have a lesser impact on the flow of funds between the economic participants affected. In bankruptcy proceedings the debtor is either granted the moratorium or has no other choice but to terminate financially non-viable activities. In liquidation proceedings the company is quickly expelled from the economy, and secured and non-secured creditors hastily receive repayment of their claims, or they learn the extent of their losses in a short time. In the banking system securities are quickly liquidated, the proceeds can be accounted and then deducted from credit losses in a timely manner.

However, Hungarian corporate insolvency regulation did not facilitate the swift conclusion of proceedings. Acknowledging creditors' claims was a time-consuming process, similar to taking inventory of the debtor's assets. Moreover, creditors had to be notified one by one, meaning close to ten thousand delivered documents in the case of larger companies. As far as technical aspects are concerned, regulation provided seven months for bankruptcy proceedings. As for liquidation proceedings, it took at least four months from the time the creditor's request was filed to the day the proceedings were actually opened. From the perspectives of both creditors and debtors, these durations jeopardised everyday business. In spite of the fact that under the regulation liquidation proceedings had to be finished in two years - in line with international standards - they generally lasted close to 4 to 5 years according to the banks. The reason for this is that liquidation proceedings cannot be closed while there is a lawsuit pending in connection with any creditor's claims.

The proceedings failed to provide any assistance for companies under temporary financial strains

Along with the duration of the proceedings, it is just as important that if the financial problems of the company are only temporary, regulation enables creditors to help their debtors to re-establish themselves, or to carry on with profitable business lines. This type of *reorganisation* of debtors is less expensive than setting up a new company.

In the Hungarian regulatory environment, bankruptcy proceedings were meant to provide for this type of distinction between companies in temporary and permanent financial distress and for continued operation or transformation of viable companies. However, bankruptcy proceedings failed to live up to this expectation, which is well demonstrated by the fact that from almost 20,000 insolvency proceedings in 2005 the number of bankruptcy proceedings reached only 26 (Creditreform, 2006). Since bankruptcy proceedings can only be initiated by the company's management, creditors had no other choice but to file for liquidation proceedings as part of a concerted effort to compel any commercial partner, who is otherwise in good financial standing but refusing to pay nonetheless, to negotiate a settlement. These proceedings usually end with a composition agreement, for example 62% in 2003 (Frank-Lóránth, 2006), while in few cases companies under proceedings facing only temporary liquidity problems had to be terminated because liquidation proceedings made their further operations impossible.

Yet another problem is that the management of debtor companies did not use the time and means of bankruptcy proceedings to negotiate with the creditors about the debtor company's future and to persuade creditors to reschedule their debts, but rather focused on rescuing the company's assets to themselves or to certain privileged creditors. This was made possible by the failure of the regulation to suspend all payments in bankruptcy proceedings. In addition, the legal entitlements conferred upon temporary administrators were not enough to fight fraud effectively.

Inadequate creditor protection

International institutions frequently emphasise that advanced corporate insolvency regulation ensures enforcement of creditors' interests. One aspect of this is that in proceedings the interests of creditors are represented by an independent participant. Furthermore, it is necessary that temporary administrators and liquidators have statutory rights that enable them to protect the estate of companies, or to increase its value by the continued operation of the company, as well as by recovering assets. Moreover, the protection of creditors' interests also means that creditors should be given legal means to compel liquidators and temporary administrators to represent their interests and to keep them properly informed. The theoretical basis for this requirement is that if a company becomes insolvent it also means that its owners have lost their investment, hence becoming an unlikely source for creditors to receive repayment. Consequently, creditors should have the right to take control of the company's management; furthermore, creditors should be able to claim any credit loss from the owners and/or members of management if they are found guilty in wilfully or negligently driving the company into the state of insolvency.

The domestic regulatory environment, however, did not provide a sufficient basis for the financial liabilities of management and owners. Although regulation contained some feeble attempts to allow creditors to exercise control over their insolvent debtors, these did not work in reality. In bankruptcy proceedings and liquidation proceedings external participants (temporary administrator, liquidator), who were theoretically independent, were appointed to monitor the affairs of debtors. The entitlements of temporary administrators, however, were insufficient to prevent attempts to rescue the company's assets, while there were conflicting interests in the proceedings of liquidators, for they were primarily tied to the debtors. As for liquidators, they received a percentage of the proceeds from continued operation and from the sale of assets. It was not in their interest to provide unbiased information to the creditors or the court. Moreover, they had to divide their attention equally among secured creditors and non-secured creditors, and bankruptcy creditors whose claims were ranked even more favourably. Creditors had no legal means to impose any sanction upon or seek the replacement of a liquidator who did not represent their interests. Likewise, on account of the troublesome nature of the obligation to provide information as mentioned before, creditors had no means to monitor whether the liquidator had actually acted in their interests. Furthermore, contrary to international best practice, there were no special qualification requirements liquidators had to satisfy, plus there were no means to exclude liquidators with an inappropriate background, more so as they often conducted proceedings hiding under the corporate veil. Similarly, the settlement of claims of creditors - including secured creditors - hinged upon the liquidators. If a liquidator fails to represent the interests of secured creditors it will ultimately jeopardise confidence in securities.

CURRENT STATUS AND THE FUTURE OF THE REFORM

The reform of corporate insolvency laws was launched with the goal of finding solutions to the above-specified issues. Additionally, some other measures had to be adopted in connection with Hungary joining the European Union, and besides, from a professional standpoint, the best international practice served as an example when designing the amendments to the regulation.

'Effective' securities in insolvency proceedings – harmonization with Community legislation

The role of 'effective' securities in an economy is recognised by the European Union as well. According to Community legislation the assets under financial collateral agreements for covering credit risk in the financial system cannot be considered as part of the debtor's bankruptcy estate.

Fulfilling our obligation as a Member State to harmonise with Community laws, since June of 2004, certain assets used as financial collateral have been removed from the debtor's assets under bankruptcy protection. According to Directives 98/26/EC and 2002/47/EC, creditors are allowed direct access to cash and securities pledged as collateral in connection with capital market transactions, without the need for opening insolvency proceedings.

Current reform measures were also adopted in consideration of the need that domestic banks enter into financial collateral arrangements with their clients and operate in accordance with Community laws governing banking activities.

One measure adopted in the reform procedure was to recognise collateral arrangements as of July of 2006 even if concluded just one day before the time of commencing the liquidation proceedings. Additionally, as of January 2007 securities are known to cover creditors' claims close to 100% (as opposed to 50%). Although, liquidators are still allowed to deduct a small portion of their expenses from the proceeds, the new provisions place a limit on the amount to be deducted and they prescribe that creditors are to be paid off forthwith. After these amendments Hungarian banks can act on a level playing field in Europe.

Insolvency proceedings of Community companies – simplified rules for opening the proceedings

The relevant Community legislation (Regulation 1346/2000) enables creditors to file for liquidation proceedings against companies registered in other Member States in Hungary. As a prerequisite these companies are required to have a business establishment in Hungary or manage the company from Hungary.

Proceedings taking place in Hungary are better for the creditors as the costs are less, and as a consequence of the European legislation, there is no chance that these proceedings will not be recognised in another Member State. To achieve the greatest benefits it is essential for the Hungarian court to reach a decision rapidly, and for the proceedings to start as soon as possible.

In the same context, the measures on opening of liquidation proceedings have also been simplified. Following the amendment, creditors are not required to wait out the 60-day late payment period to open liquidation proceedings, and it is no longer a prerequisite that the debtor acknowledges the claim. Since June 2006, if the creditor is able to prove having notified the debtor, and the debtor is unable to prove replying, the liquidation proceedings may be opened. Creditors' rights to open proceedings in an easier way is an internationally renowned practice. The new provisions provide facilities to reveal quickly as to whether a company exists only in name, or they do not have even the mere courtesy to correspond with their clients.

Strict regulations concerning qualifications and conflict of interest

Although some progress was made in the qualification of liquidators and temporary administrators, the major breakthrough is still three years away. Effective as of January 2010, liquidators are required to have proof of proper training. Furthermore, the amendment contains provisions to clearly separate the rules for conflict of interest for business associations and private individuals acting as liquidators. As of January 2007, the names of qualified companies and persons are listed in the register of liquidators along with the documents in proof of their compliance with requirements.

New rules of financial liability

The reform offers different ways to enforce financial liability if any unpaid claims of creditors remain at the end of the liquidation proceedings. According to the amendment entering into force in June 2006, the previous owners of a company may be held liable even if they sold the company that was losing money or existed only on paper before the time of the opening of liquidation proceedings. Majority owners are held accountable the same way if they had a history of making unfavourable business decisions from the standpoint of an affiliate. Furthermore, members of management are now subject to financial liability if they were or should have been able to foresee that they will not be able to settle their liabilities when due, yet they did not file for bankruptcy. This latter amendment, widely known as the concept of wrongful trading, is becoming widespread in international practice.

Measures expected beyond 2006

After 2006 the review of Hungarian corporate insolvency regulation continues, focusing on the remaining discrepancies.

An essential component remains to be addressed, notably that Hungarian regulation should provide for the continued operation of temporarily insolvent companies up to international standards. Another point is that in international commercial relations it is in the interest of Hungarian creditors to have insolvency proceedings opened a soon as possible. These two expectations emerge in tandem in one of the proposed reform concepts, according to which the insolvency proceedings would open upon submission of the creditor's request without undue delay. Opening the proceedings would not in itself mean that the company in question is insolvent; it would merely indicate that negotiations are required in light of the company's financial prospects, short or long term. The bill also calls for the creditors' meeting to convene promptly, to adopt a decision whether to keep the company afloat with the existing management or with a new one, or to wind it up.

In the near future new amendments are scheduled, simplifying the way for creditors to receive information concerning the management of their debtors and the steps taken by the liquidator. Notifying the creditors through the Internet will expedite all phases of the proceedings, and it also enables them to file their claims swiftly and to call the creditors' meeting in a faster and less expensive way.

In the near future some minor corrections are expected to be introduced as well, addressing, for example, technical issues in connection with simplified rules for opening the proceedings.

Assessment of reform measures, in particular from the perspective of financial stability

Comprehensive changes in corporate insolvency regulation were inspired by the heavy criticism. Some of the first measures of the reform procedure were aimed to offer solutions for certain urgent issues, others were introduced in compliance with the obligations stemming from Hungary joining the European Union, or to adopt international standards. The question is whether the measures adopted up to this point were enough to address existing discrepancies? To answer this question let us one more time go over the critical issues described earlier in this study.

Proceedings shall be less costly

From the perspective of financial stability it is of utmost importance that the high repayment ratio (close to 100%) guaranteed to secured creditors by law and the financial liability of owners and management both carry the promise of higher recovery rate of claims. This will enable banks to operate in a safer environment in accordance with international standards. In terms of cost efficiency another positive development is the possibility of opening proceedings in Hungary against companies registered in any Member State. Costs may be further reduced if the proceedings are conducted faster, which is now possible since the simpler rules for opening proceedings have been adopted. Strict regulations concerning qualifications and conflict of interest may have a similar effect on costs.

However, several uncertainty factors remain. There is still no guarantee that liquidators will strive to obtain the highest possible price for assets pledged as securities, or to pay off the claims of creditors as fast as possible. It is yet unforeseeable what will be the cost of proving the financial liability of owners and members of management. All in all, the single most important objective from the perspective of financial stability is to afford more direct means for creditors to assert their influence over the proceedings, in other words, temporary administrators and liquidators must be enabled to protect the interests of creditors in any situation and creditors should be afforded means to enforce it.

Proceedings should be less time consuming

One factor to reduce costs is that measures on the opening of proceedings against Hungarian and Community companies have been simplified, which reduces the time required for the payment of claims. This is beneficial for non-secured creditors, including banks.

Nevertheless, the regulation contains nothing about the necessary technical aspects. There are still no provisions to reduce the length of court proceedings. Furthermore, the 15-day period allowed for decisions could be too long in proceedings against companies registered in other Member States, for it leaves the possibility open for proceedings to be initiated sooner in another Member State, in which case Hungarian creditors would be forced to file their claims in that court. Moreover, the simplified opening of proceedings is not enough in itself by any means, for additional incentives should be introduced to further simplify matters when the proceedings are in progress. In this context as well, the protection of creditors' interests must be intensified.

Regulation remains unchanged in terms of offering help to companies in temporary financial difficulties

So far the reform failed to introduce measures to improve the regulation of bankruptcy proceedings.

There are some improvements in the means afforded to creditors to protect their interests

The higher ratio of recovery guaranteed to secured creditors, the strict regulations concerning qualifications and conflict of interest and the financial liability of owners and members of management offer some improvement in the way of helping creditors to better protect their interests.

At the same time, despite the efforts to make securities more effective, non-financial assets pledged continue to comprise a part of the debtor company's bankruptcy assets and decision for the sale of collateralised property in terms of time and procedure lies with the liquidator. Consequently, additional guarantees should be introduced to compel liquidators to protect the interests of creditors in connection with securities, meaning to obtain the highest price possible and to pay off the claims of creditors as fast as possible. On the other hand, temporary administrators should be empowered to better protect or to recover the company's assets. These points again indicate that it is essential to further improve the entitlements of creditors.

Proposed reform measures: are they sufficient to address the problems that remain?

The measures and concepts in the pipeline promise to improve the legislation and are important factors for the reform procedure to be a success. They have the capacity to upgrade the quality of regulations, as they reduce the costs of the proceedings and thus enhance the ability of the banking system to mediate funds between savers and borrowers. At the same time, we should point out that – in this context as well – it is essential that the entitlements of creditors be further improved.

CONCLUSIONS

The measures taken so far in the process of reforming Hungarian corporate insolvency regulation are favourable from the perspective of financial stability, i.e. the application of international standards improve the security factor in mediating funds from the viewpoint of commercial banks. In this context, it is of special importance that the ratio of recovery for secured creditors is expected to rise, due to the legal guarantees and the financial liability of owners and members of management. All in all, proceedings should be less costly under the new provisions simplifying the opening of proceedings and because proceedings may be filed against Community companies in Hungary as well. Strict regulations concerning qualifications and conflict of interest of liquidators and temporary administrators may have a similar effect on costs.

However, several uncertainty factors remain. There is still no guarantee that liquidators will strive to obtain the highest possible price for assets pledged as securities, or to pay off the claims of creditors as fast as possible. It is unforeseeable what will be the cost of proving the financial liability of owners and members of management. All in all, the single most important objective from the perspective of financial stability is to afford more direct means for creditors to assert their influence over the proceedings; in other words, temporary administrators and liquidators must be enabled to protect the interests of creditors in any situation and creditors should be afforded means to enforce it.

In due consideration of the remaining shortcomings and of the measures proposed to be introduced after 2006, we are of the opinion that the concepts presented so far point in a desirable direction.

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