COMPARISON OF HUNGARIAN AND US BANKRUPTCY LAW USING THE WORLD BANK'S DOING BUSINESS CRITERIA

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ABSTRACT

This thesis focuses on the laws related to insolvency in Hungary and in the US, comparing the two by the criteria used in the World Bank's latest Doing Business report, released at the end of 2016. The central topic is the 'resolving insolvency' index used in the Doing Business report to determine the overall performance of a given country's legislation in the field of insolvency proceedings. Although the index compares countries in several aspects, both economic and legal in nature, this thesis is dedicated only to the legal aspects, which are principally contained in the 'strength of insolvency framework' indicator.

The aim of the thesis is to provide lessons for Hungary about improving its performance by refining the existing legislation by observing the differences in US regulations and practice. By examining how insolvency proceedings in the US can be so much more efficient than most European ones currently are, drawing applicable conclusions might help Hungary to save more insolvent companies from liquidation, and improve competitiveness as well. The Doing Business report is a very efficient tool to this end, as it examines the same hypothetical situation in each country – making the two very different legal systems comparable – and provides all the necessary facts about the relevant legal practice that are collected from legal experts and government officials. The thesis analyzes and compares the underlying provisions of the US Insolvency Code and the Hungarian Act XLIX. of 1991 on the reorganization and liquidation procedures, seeking what is handled differently in each legal system, and what may be learned by Hungary from the US example.

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Introduction

Today the world economy is driven by international competition, as all countries are striving to attract the most foreign direct investment (FDI) as possible in order to boost their economies. The outcome of this race is very much affected by the efficiency and business-friendliness of each competitor's legal system as it determines how easy – or burdensome – it will be for investors and businessmen to carry out their business activities in the given state. The existence of a well-functioning, supportive legal environment is vital to domestic companies as well.

There are several ways to compare different States' performance with regard to the efficiency of their legal systems. To this end, many international organizations have developed elaborate methods and ranking systems[1], which take into account several criteria upon which the comparison may be conducted. These indicators and sub-indicators are designed to capture those aspects that are the most important for foreign investors when they consider choosing a country to establish their next businesses.

One of the most widely recognized and applied international tools for measuring competitiveness is the World Bank's Doing Business Report (hereinafter: Doing Business report), which is published annually since 2004. In this publication, there are 10 main topics that serve as the key factors upon which the World Bank measures each of the world's 188 countries' performance and compares them with each other. These topics take into account many different factors, both legal and factual in nature. As the factual aspects are often very hard to change[2], it is much easier for any government to boost the competitiveness of its country

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[1] The most widely recognized examples besides the World Bank's Doing Business report are the World Economic Forum's Global Competitiveness Report (available at: https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1 (accessed 29 Nov. 2016), and the IMD World Competitiveness Center's World Competitiveness Yearbook. (Available at: http://www.imd.org/uupload/imd.website/wcc/scoreboard.pdf, (Accessed 29 Nov. 2016).

[2] For example, the time requirements of an administrative process is affected by a number of factors, such as manpower, equipment, workload, budget, and many others, which cannot be improved overnight, definitely not on a national scale.

by refining its legislation which regulate the topics discussed in the Doing Business report. Moreover, a spillover effect to business practice is likely to follow well-crafted legal reforms, as in a better legal environment where the rules are reasonable and clear, all stakeholders are likely to perform better.

There is a wave of insolvency reforms initiated by leading economies, such as the United Kingdom, Singapore, Australia, India and the European Union[3], with the aim of stimulating reorganization and promoting second chance policy, while at the same time improving their competitiveness via legislative reforms. A common feature of these reforms is that they all try to mimic the United States' reorganization system due to it being one of the most successful ones. Another key motivation for these initiatives is to improve the country's rankings in the World Bank's Doing Business report, which is becoming very influential in the field of investments. The underlying reason for this wave of reforms is a serious problem that is well-known among legislators. The problem itself was aptly stated in one of the earliest[4] Doing Business reports as the following:

> *„Bankruptcy is hopelessly inefficient in most countries. Claims are eroded by long delays, by high costs and by laws that either kill viable businesses or keep unviable ones alive."*[5]

Unfortunately, this decade-old grim observation is still true in most countries. Currently reorganization proceedings[6] are seldom initiated in Hungary[7], as it is very difficult to reach an agreement between different groups of creditors and allow businesses to reorganize themselves – instead, liquidation is the primary procedure used to end the life of a company facing financial

[3] Each of these reform policies will be mentioned in the introduction in more detail.
[4] The World Bank started issuing its Doing Business reports every year from 2004.
[5] Doing Business in 2006, p. 69.
[6] In Hungarian, reorganizations are called 'bankruptcy', which is one of the two main insolvency procedures besides liquidation proceedings int he Hungarian legal system.
[7] According to the official judicial statistics. Available at: http://birosag.hu/sites/default/files/allomanyok/media-lapszemle/stat-adatok/kiadvany.2015.ev_ertekkel_tvi_vh-val.xls

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distress. This is an obstacle for Hungary to the prospect of providing a business-friendly legal environment, which hampers its overall competitiveness[8]. There may be reasons for this that lie beyond the reach of law[9], but this thesis only sets out to seek legal solutions to this problem.

This is the idea behind very recent initiatives in several global economy leaders aiming to reform their respective bankruptcy laws. The United Kingdom has launched a consultation on reform possibilities in the field of corporate insolvency, with one of the main goals being becoming the leader in Europe in the Doing Business Report[10]. The Australian government has also proposed reforms in the field of bankruptcy in April 2016,[11] experimenting with the idea of introducing an insolvent trading safe harbor. Singapore has announced a major bankruptcy law reform[12] at the end of 2016 directly taking over parts of the United States Chapter 11[13] in order to become a regional debt restructuring hub[14]. India has implemented an insolvency reform in 2016 as well,[15] in hopes of revitalizing debt markets and improving its rankings in the Doing Business Report. Meanwhile, the European Commission has also completed a

[8] Hungary is currently ranked at 41st in the World Bank's Doing Business Report on the global 'ease of doing business' index, while most of its regional competitors – Slovakia, Slovenia, Romania, Czech Republic, and Poland – achieved a better place in the rankings. The full data on the rankings is available at: http://www.doingbusiness.org/rankings

[9] One of the underlying reasons may be that Hungarians – like many other civil law nations – do not trust businesses that are insolvent, which phenomenon is commonly being referred to as the "bankruptcy stigma".

[10] This is specifically stated in the executive summary (p. 6.) of the official consultation document titled „A review of the corporate insolvency framework – a consultation for options for reform". The whole document can be reached through the following link: https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/525523/A_Review_of_the_Corporate_Insolvency_Framework.pdf Accessed 15 February 2017.

[11] A detailed summary of the government's proposal can be found here: https://www.herbertsmithfreehills.com/latest-thinking/major-insolvency-law-reform-government-sets-sail-towards-an-insolvent-trading-safe Accessed 15 February 2017.

[12] There was an open consultation about the proposed amendments to the Companies Act of Singapore, the contents of which can be found on the website of the Singaporean Ministry of Law: https://www.mlaw.gov.sg/content/minlaw/en/news/public-consultations/public-consultation-on-proposed-amendments-to-the-companies-act-.html Accessed 15 February 2017.

[13] Chapter 11 of the US Bankruptcy code deals with reorganizations, and this is one of the most successful parts of US bankruptcy laws.

[14] An overview of the planned reform can be found in the following article: https://www.herbertsmithfreehills.com/latest-thinking/singapore-unveils-major-debt-restructuring-law-reforms Accessed 15 February 2017.

[15] The Indian Insolvency and Bankruptcy Code merges the rules on bankruptcy and liquidation proceedings into one legal act. There is also a heavy emphasis on the training of insolvency professionals. For more information, see the following article: http://www.thehindubusinessline.com/economy/economy/article9434825.ece Accessed 15 February 2017.

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proposal for an insolvency directive that could set a common framework for promoting early restructuring of distressed companies[16]. These examples clearly show that the importance and relevance of both insolvency reforms and the rankings in the Doing Business Report cannot be overstated.

This was also the central idea at the Hungarian Ministry for National Economy where I used to work as a regulations expert – to determine what was necessary to change in the legislation in order to improve Hungary's rankings in Doing Business. Every year it caused quite a fuss when the new edition of the Doing Business Report came out, as the leaders of the Government were very interested whether we were able improve from last year's rankings or not. All the major news media immediately cited the new report's main findings about Hungary, eager to speculate what were the causes of any changes, whatever the results were. So it got quite some attention at home, which suggests that foreign investors were also following closely. In the Ministry, rapid analyses, government statements were required first, but then we had to conduct in-depth analyses of the data provided. Eventually, we were asked to formulate suggestions based on our findings about what should be changed and how, if we wanted to directly focus on eliminating the issues that hampered our competitiveness in the World Bank's opinion. Some of these issues are almost impossible to deal with on paper, as they simply cannot be changed overnight. Another problem is that legal experts, who have the knowledge and authority to shape the law are generally reluctant to give more freedom to entrepreneurs, as they presume that this would lead to further diminishing of the rule of law[17].

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[16] For more information, see the press release of the Commission on 22 November 2016: http://europa.eu/rapid/press-release_IP-16-3802_en.htm Accessed 15 February 2017.
[17] *The Global Competitiveness Report 2015-2016* (hereinafter: WEF report) published by the World Economic Forum shows that in Hungary, the public's opinion concerning the 'ethical behavior of firms' is generally poor. On a 1 to 7 scale – 1 being very bad, 7 being the best in the world – Hungary has scored 3.4 on this topic, based on data collected via surveys. This result places Hungary in the 114th among the 140 compared nations. The data can be found on pp. 196-197 of the WEF report. Available at: http://www3.weforum.org/docs/gcr/2015-2016/Global_Competitiveness_Report_2015-2016.pdf Accessed 6 Dec. 2016.

One of the topics of the Doing Business report which could be influenced mainly by changing the law is resolving insolvency. It is discussed as a complex set of indicators that explores the requirements and characteristics of both liquidation and reorganization in each country, by taking into account both legal and factual aspects. It measures the recovery rate of debts owed to secured creditors by an insolvent company; the average time the proceedings take; the total cost of the procedures (as a percentage of the estate); the outcome of the proceedings, favoring the reorganization of the company over piecemeal selling of its assets; and finally, the overall 'strength' of insolvency framework. As we can see, the first 4 indicators discuss not legal, but factual issues, and only the last indicator – which is devoted to the insolvency framework – can be directly affected by amending legislation.

A very good recent example of such achievement is the decade-long activity of the Polish government, which was described by the World Bank as follows: "through extensive efforts to build a full-fledged insolvency regime, it reduced the cost to complete an insolvency proceeding by a third between 2007 and 2012 – and double the recovery rate."[18] As Poland was determined to constantly enhance its insolvency legislation, another reform in 2015[19] has enabled Poland to further improve its rankings by 6 (from 33rd to 27th) in just one year. The key improvements enabled by this reform in the Polish bankruptcy system[20] make it a good source to draw ideas from for the purposes of a similar Hungarian reform in the near future.

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[18] Doing Business 2013, p. 97.
[19] The new Restructuring Act of 2015. (May 15.). Main changes are discussed in the following article: A. Bunk, '*New restructuring law in Poland coming into force in 2016'*, Linkedin (27. August 2015). Available at: https://www.linkedin.com/pulse/new-restructuring-law-poland-coming-force-2016-bunk-artur Accessed 6 Dec. 2016.
[20] The World Bank describes the Polish reforms in the following way: *'Poland made resolving insolvency easier by introducing new restructuring mechanisms, changing voting procedures for restructuring plans and allowing creditors greater participation in insolvency proceedings. It also established a central restructuring and bankruptcy register and released guidelines for the remuneration of insolvency representatives.'* (Doing Business in 2017, Poland Economy Profile 2017, p. 104. Available at: http://www.doingbusiness.org/~/media/wbg/doingbusiness/documents/profiles/country/pol.pdf Accessed 6 Dec. 2016.

Hungary has always followed the example of German legislation, and this is also true for its insolvency regulation. But since the German system is hampered by stigmatizing rules which discourage reorganization and mirror the fear of the public of giving second chances to bankrupt businessmen, Hungary is making the same mistakes as well, which render doing business – or rather, starting business anew in this case – quite difficult. The World Bank has also drawn attention to the negative effects related to the so-called bankruptcy stigma, describing it as follows:

> *"The word bankruptcy often evokes negative associations with failure and shame. And fear of bankruptcy and its consequences can deter potential entrepreneurs from starting a new business venture."*[21]

At the same time, going bankrupt in the US is an everyday issue with over a million cases of bankruptcy every year[22], and for many reasons reorganization and liquidation both serve their purpose well overseas. The World Bank's idea is that a well-functioning insolvency system can minimize the stigmatizing effect associated with business failure[23]. This is the very reason why this thesis will try to draw conclusions from the American bankruptcy regulation.

This thesis is based on the methodology and findings of the Doing Business report. The main issues are the reorganization proceedings index and the creditor participation index, both in which Hungary lags behind its competitors significantly. These indexes are centered on issues in which America excels, namely the creation of classes, the possibility of cram-downs, the appointment of the bankruptcy trustee, and particular rights of creditors. The possible uses of these tools in Hungary are presented with the goal of eliminating concerns of legislators

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[21] Doing Business 2015, p. 96.

[22] See J. Kilborn, *'National report for the United States'* in D. Faber, N. Vermunt, J. Kilborn (*eds*), *'Commencement of insolvency proceedings'* (Oxford University Press, 2012), p. 767.

[23] *Ibid.*

about their introduction into the Hungarian insolvency framework by showing that they are in fact vital for saving companies in distress and they can work without robbing all the creditors.

In the latest Doing Business report, Hungary is ranked 63rd, while the US is 5th on the 'resolving insolvency' list. It is interesting that Germany has managed to perform on paper even better than the US, claiming 3rd place in the rankings, despite the fact that reorganization was not long ago practically nonexistent[24] in the country. This seems to suggest that in order to have successful reorganizations in a country more than just well drafted regulations are needed, but the implications of this idea are beyond the scope of this thesis.

The first chapter of this thesis will discuss the 'resolving insolvency' index of the Doing Business report in detail. As it is yet an uncommon tool for theses to rely so heavily on this ranking instrument, it is necessary to explain the main features and underlying methodology of the index in a separate chapter[25]. The second chapter will then deal with the main features of insolvency laws in Hungary and in the US in order to compare those aspects that are important from the point of view of the World Bank. Consequently, the third chapter will analyze the possibilities for improvement of Hungarian bankruptcy laws with the aim as suggesting as practical solutions as possible by observing the US Chapter 11 rules. Finally, the conclusions will include other possible ways to further improve Hungary's rankings in Doing Business with respect to insolvency.

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[24] According to an article in the Wall Street Journal published in 2003, more than 99% of bankruptcies in Germany ended in liquidation. (In: John Carreyrou & Matthew Karnitschnig, '*Paris Looks to U.S. – on Bankruptcy*', in: The Wall Street Journal Europe 25. (Sept. 2003). Available at: http://www.wsj.com/articles/SB106443422391544900 Accessed 1 Dec. 2016. However, newer data shows that since the 1999 German bankruptcy reform, Germany was able to improve on this issue.

[25] Due to the obvious limitations of the short thesis, the underlying best practice considerations for the issues addressed by the 'resolving insolvency' index cannot be explored in detail, so this thesis will be confined in this regard to giving an overview only.

CHAPTER I.

BACKGROUND AND ASSESSMENT OF THE 'RESOLVING INSOLVENCY' INDEX IN THE WORLD BANK'S DOING BUSINESS REPORT

1.1 BACKGROUND OF THE INDEX

The 'resolving insolvency' index is a set of indicators which was originally titled 'closing a business' in the Doing Business report, but was renamed in 2011 (while its contents did not undergo any meaningful change). The World Bank has introduced one major reform to this index in the Doing Business Report 2015, by adding a new indicator, which was titled the 'strength of insolvency framework'[26].

To understand how this index and its methodology has evolved, first we have to examine their origins, as they have more than a decade long background history. It is also vital to see that the issue of creating sound insolvency legislation has been in the center of attention of several international organizations, and they have produced valuable documents which unfortunately are not as widely known as the Doing Business report itself. The collections of good practices that serve as the benchmark for measuring each of the 88 countries that provide data necessary to determine their performance in this index is on the one hand the *World Bank's Principles for Effective Insolvency and Creditor/Debtor Regimes*[27] (hereinafter: the ICR Principles), and on the other hand the *United Nations Commission on International Trade Law's Legislative Guide on Insolvency Law*[28] (hereinafter: Legislative Guide). Together these documents served as the main sources of information to design the Insolvency and Creditor Rights Standard (ICR Standard)[29], which is the most comprehensive study of good practices

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[26] As this is stated at the end of the description of the methodology of the index. Available at: http://www.doingbusiness.org/Methodology/Resolving-Insolvency). Accessed on 3 April 2017.
[27]Further information available at: http://www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-rights
[28] Available at: http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2004Guide.html
[29] Available at: http://siteresources.worldbank.org/INTGILD/Resources/ICRStandard_Jan2011_withC1617.pdf

related to the regulation of insolvency. The ICR Standard also served as the very basis for the 'resolving insolvency' index in the Doing Business report.

Before discussing the underlying methodology of the index itself, it is important to briefly touch upon the above mentioned documents, as they are vital in understanding in a broad sense what is *expected* of a well-functioning insolvency law, and how these expectations are translated into the 'resolving insolvency' index.

1.1.1 The ICR Principles and the UNCITRAL Legislative Guide

The ICR Principles and the UNCITRAL Legislative Guide together serve as a basis for creating and effective credit economy in any given country. They are the result of more than a decade of international cooperation between national governments, experts, the World Bank and the IMF. They are both based on the recognition of the fact that credit is the fuel on which any economy runs and grows, therefore a harmonized national system is required that enables the easiest access to credit while offering sound protection to creditors at the same time. Yet the focal point of these documents is the latter issue, as they are focused on creating a "predictable, transparent, and efficient framework to resolve debts in the context of business distress or failure"[30].

The ICR Principles were "developed in 2001 in response to a request from the international community in the wake of the financial crisis of the late 1990s"[31], and they were the first international tools to evaluate insolvency systems. They offer a more generalized approach, and they are not solely devoted to discussing insolvency, but also creditors' and debtors' rights, pre-insolvency situations, such as risk management and informal workout solutions. Also, there is a set of principles devoted to the implementation of insolvency laws that deal with judicial

[30] Foreword of the revised 2015 version of the ICR Principles document, p. iii.
[31] Official description of The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes. Available on the World Bank's website at: http://www.worldbank.org/en/topic/financialsector/brief/the-world-bank-principles-for-effective-insolvency-and-creditor-rights Accessed on 5 April 2017.

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issues, such as the integrity and independence of judges. For our purposes, *Part C* of the ICR Principles is relevant, as this contains the description of an efficient legal framework for insolvency. Without getting lost in the details – as this is the most detailed part, consisting of 17 topics, with several sub-topics in each – a sample of the key policies here include "the timely, efficient, and impartial resolution of insolvencies; the prevention of the improper use of the insolvency system; and the prevention of the premature dismemberment of a debtor's assets by individual creditors seeking quick judgments"[32]. No matter how clear and undisputable these principles are, these are issues that may very well still be present in many countries' insolvency framework, including Hungary.

The UNCITRAL Legislative Guidelines focus more deeply on the practical aspects of insolvency legislation, with four parts sprawling over 500 pages. The purpose of the Legislative Guide is "to assist the establishment of an efficient and effective legal framework to address the financial difficulty of debtors."[33] Part one and two[34] are the core documents that deal with the key objectives of insolvency laws, and also discuss all aspects and steps of the insolvency procedure in its entirety with individual attention paid to voluntary and involuntary procedures, reorganization, the insolvency representative, priorities, etc. The Legislative Guidelines offer invaluable insight into the different approaches and solutions that might be chosen by legislators dealing with certain issues related to insolvency, as each of these issues are discussed in a manner that first describes the problem and how it is typically dealt with by different national laws, suggesting which of them is the best practice in the given situation, then offering a set of recommendations at the end of each problem description. Part three[35] of

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[32] ICR Principles, Part C, C1 (p. 20.).
[33] Legislative Guide, p. 1.
[34] Available at: http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf
[35] Available at: http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part3-ebook-E.pdf

the Legislative Guidelines deals with the treatment of enterprise groups in insolvency, and part four[36] is devoted to director's obligations in the period of approaching insolvency.

This detailed approach makes the Legislative Guidelines a very useful tool in shaping each country's own legislation. However, little may be known about how often do countries really make use of these documents. Unfortunately, the extent and detail of these documents make them difficult to handle despite their simplified and clear language, especially in the typical course of legislation, where legislative experts have very limited time to contemplate different solutions to the same problem and their possible effects, and are primarily occupied with keeping the deadlines set by their superiors.

1.1.2 The ICR Standard and the Reports on the Observance of Standards and Codes

The ICR Principles and the UNCITRAL Legislative Guidelines are complementary products that could be better applied combined into one document. The recognition of this fact resulted in the creation of the ICR Standard document issued by the World Bank in 2011[37]. It effectively combines each of the ICR Principles with the corresponding recommendations from the Legislative Guideline. The main benefit of this product is the significant decrease in extent compared to the original documents' combined length, mainly due to the careful selection of the most relevant issues from the Legislative Guidelines. This also means that the Legislative Guidelines cannot be discarded, as the ICR Standard only offers a schematic overview of the same issues.

The main relevance of the ICR Standard is that it is the basis for the 'resolving insolvency' index contained in the Doing Business report. In this respect, the ICR Standard is the suggested set of best practices, and the Doing Business Report is the review of the success rate of their

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[36] Available at: http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-Insol-Part4-ebook-E.pdf
[37] The document is available online at: http://siteresources.worldbank.org/EXTGILD/Resources/5807554-1357753926066/ICRPrinciples-Jan2011%5bFINAL%5d.pdf Accessed on 5. April 2017.

implementation. Furthermore, the ICR Standard is also the underlying system upon which another powerful regulatory performance assessment tool similar to the Doing Business report is based, which is one of the so-called Reports on the observance of standards and codes (ROSC)[38]. These are projects that are carried out by the working staff of the World Bank jointly with the International Monetary Fund (IMF) in 12 areas[39], on the request of certain countries. One of these areas is insolvency, and the reports on these issues are referred to as ICR ROSCs. The goal of the reports is to assess the overall performance of the country's insolvency framework compared to existing best practices (namely the ICR Principles and the Legislative Guidelines). There is a detailed assessment methodology[40] underlying the ICR ROSC which is also based on the ICR Standards, and in many aspects, it is similar to the methodology of the resolving insolvency index found in the Doing Business report. However, the ICR ROSC methodology only seeks answers to generalized questions like how clear the legal rules are on a certain issue, while the resolving insolvency index approaches these issues from a more specific angle as it seeks answers in a hypothetical (though also generalized) situation.

Unfortunately, most of the reports prepared so far were not made public[41]. Compared to the resolving insolvency index of the Doing Business Report, the ICR ROSC assessments are more personalized type of research documents as they look at the peculiar issues of the client country and describe all their findings in much greater detail, with individual focus on the causes of

[38] The official description of the ROSC reports can be found on the IMF website. Available at: http://www.imf.org/external/np/rosc/rosc.aspx Accessed on 5 April 2017.

[39] The 12 policy areas are listed on the World Bank's website. Available at: http://www.worldbank.org/en/programs/rosc Accessed on 5 April 2017.

[40] The description of the ICR ROSC methodology is available at: http://siteresources.worldbank.org/INTGILD/Resources/ICR_ROSC_AssessmentMethodology_Jan2011.pdf Accessed on 5 April 2017.

[41] On the official site, only 10 of these ICR ROSC assessment reports can be found, some of which were prepared for the same country. However, it is stated in the foreword of the revised 2015 version of the ICR Principles document (on p. iii.) that 79 ICR ROSCs have been prepared for 75 countries so far, which shows that most client countries have not received praise from the World Bank for their insolvency frameworks. For the purposes of this thesis the one made for the Slovak Republic in 2002 was consulted in some detail. The 10 ICR ROSC assessments can be found at: http://documents.worldbank.org/curated/en/docsearch/document-type/904581 .

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perceived shortcomings. In addition to providing a snapshot of the country's legal environment, the ROSC assessments also contain customized solutions that may help in overcoming the identified problems[42]. Of course, this service is not for free, and if the findings are not too favorable, the client country will probably choose not to authorize sharing it with the public. In this sense, it is much more than a ranking system but it is limited in its effectiveness due to the lack of accessibility.

1.2 Assessment of the resolving insolvency index

1.2.1 Core aspects of the index

The resolving insolvency index in the Doing Business Report is a streamlined tool designed to compare the insolvency systems in all countries (currently data on insolvency[43] is only provided for the Doing Business Report by 88 countries out of 190[44]). Such generalization bears the risk of becoming frivolous, that is why the index is built around a hypothetical situation. Without mentioning all the details[45], the case is about a domestically owned hotel, which is at the brink of insolvency. It has one major secured creditor (a bank), 50 other unsecured creditors (suppliers), and 201 employees. Only the secured creditor is interested in the piecemeal sale of the company (as this would be the fastest and cheapest way for it to get its money back), all the others' interest lies in keeping the business as a going concern.

[42] For example, in the ICR ROSC assessment made for the Slovak Republic in 2002. Available at: http://documents.worldbank.org/curated/en/312891468101658916/pdf/351820SK0REV0Insolvency0rosc0icr1svk.pdf (Accessed on 14 February 2017). There are detailed findings discussed in the order the ICR Principles are organized, followed by a summary of the findings and then, probably most importantly, policy recommendations as well. The assessment is quite in-depth, analyzing many of the practices of stakeholders with regard to all relevant aspects of insolvency. The findings do not shy away from outlining shortcomings of State practice, or abuses by creditors or debtors, so they are quite revealing and not just tools to praise a paying client. If properly understood by the client government, they could very well facilitate a successful reform.
[43] As it is stated on the Doing Business website, *'the data for the resolving insolvency indicators are derived from questionnaire responses by local insolvency practitioners and verified through a study of laws and regulations as well as public information on insolvency systems*.' (Cited from: http://www.doingbusiness.org/Methodology/Resolving-Insolvency) Accessed on 14 February 2017.
[44] All the other countries are ranked 169. in the category of 'resolving insolvency', with the indication of „No practice", and points of 0 assigned to them. See for example Iraq on p.214. of the Doing Business report in 2017.
[45] For the details of the hypothetical case, see: http://www.doingbusiness.org/Methodology/Resolving-Insolvency Accessed on 14 February 2017.

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Basically, if the data shows that it is more likely that the business can be saved in this situation, rather than liquidating its assets and terminating it, the country will get a higher score, meaning that its insolvency laws are competitive on the international market. In contrast, those insolvency laws that enable the major secured creditor to get out of the procedure with all the money, leaving the other creditors unpaid will not get a favorable review. The underlying principle is that whenever possible, reorganization should be applied rather than liquidation, as preserving a company is better for all stakeholders, and it is better for the economy as well.

The index observes this situation through five main topics:

a. Recovery rate (cents on the dollar)
b. Time (years)
c. Cost (percentage of the estate)
d. Outcome (piecemeal sale or going concern)
e. Strength of insolvency framework (on a scale of 1-16)

Since the first four of the above-mentioned indicators are a result of underlying non-legal but rather economic factors, they are more difficult to improve. Nevertheless, legal reforms may have a positive influence on these aspects too, e.g. time required for the process can be shortened by blocking some of the more obvious delay tactics of the parties and also by setting shorter deadlines for certain actions in the procedure, and costs may be reduced by lowering the prescribed fees of courts, trustees, etc. Hence, our primary topic will be the final indicator, which is the 'strength of insolvency framework' (hereinafter: SIF). The World Bank itself describes this indicator as the primary source of interest for legislators seeking reforms, as "it can be a useful tool for governments seeking to reform their insolvency laws because it helps in identifying specific areas where insolvency regulations are lacking."[46] According to Doing Business, the purpose of the introduction of the SIF into the Doing Business report in 2014 was

[46] Doing Business 2015, p. 101.

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to "provide a more complete and balanced view of the insolvency framework in each economy"[47] by measuring the quality of insolvency laws, as the other indicators were focused only on measuring the insolvency practice.

The SIF is a complicated set of sub-indicators (or indices), which together aim to determine how effective a country's insolvency laws are in enabling the reorganization to commence. The SIF has a 0-16-point scale, 16 being the best practice. It is divided into four indicators, which are the following:

a. commencement of proceedings indicator (0-3 points)
b. management of debtor's assets indicator (0-6 points)
c. reorganization proceedings indicator (0-3 points)
d. creditor participation indicator (0-4 points)

There are questions within each indicator that can be answered by looking at the legislation of the given country, and they aim to grasp some of the most important aspects of a well-functioning bankruptcy framework. This thesis will focus on two of these indexes (reorganization proceedings and creditor participation), as these are the ones where Hungary shows poor performance compared to best practices. The other two indicators only contain two aspects that need adjustment in Hungary in order to reach the highest score (these will also be discussed in chapter 3). The US in contrast performs almost flawlessly throughout the whole SIF[48], so it will be a good example to draw conclusions from.

1.2.2 The 'reorganization proceedings' indicator

This indicator deals only with one of the two branches of insolvency, which is reorganization. As Hungary is performing rather poorly regarding reorganizations, this might

[47] *Ibid* p. 97.
[48] For more details, see the economic profile for the US, available on the website of Doing Business: http://www.doingbusiness.org/~/media/wbg/doingbusiness/documents/profiles/country/usa.pdf Accessed on 5 April 2017.

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be the key aspect where this thesis must assess possibilities for improvement. Also, as it was briefly mentioned in the introduction, reorganizations are the hot topic among the biggest economies' legislators these days, so it would be very beneficial for Hungary to follow in their steps, maybe even try to become a regional debt restructuring hub like Singapore is striving to be in its region[49]. As the US is a country where successful reorganizations happen on a massive scale, it is paramount to examine why this is a success story over there, and what can be learnt from it.

The indicator itself deals with three questions, and depending on the answer, a maximum of 1 point can be given for each. The first question is "whether the reorganization plan is voted on only by the creditors whose rights are modified or affected by the plan."[50] The main idea here is that creditors should be allowed to have a say about the reorganization plan, but only those who are affected by it, so those whose rights are unaffected cannot veto the plan. The worst case scenario is that a country does not even have a reorganization procedure, or if the creditors cannot vote on the reorganization plan (resulting in 0 score); if all creditors are allowed to vote, the country will only get 0.5 points. If all requirements are satisfied (which means that only affected creditors get to vote), the country gets 1 point.

The second question requires three features: "whether creditors entitled to vote on the plan are divided into classes, each class votes separately and the creditors within each class are treated equally."[51] Separate voting and equal treatment of members of each of creditors' classes are joint requirements: failing to provide for any of these aspects results in a score of 0.

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[49] See Supra note 11.
[50] The official description of the 'reorganization proceedings' indicator can be found on Doing Business website. Available at: http://www.doingbusiness.org/Methodology/Resolving-Insolvency
[51] *Ibid*.

The last question here requires that "dissenting creditors receive as much under the reorganization plan as they would have received in liquidation"[52]. If such guarantee exists in the bankruptcy law of the country, then the score will be 1.

1.2.3 The 'creditor participation' indicator

This indicator assesses 4 aspects of insolvency rights of creditors, pertaining to the individual sale of assets, acceptance or rejection of creditors' claims, and creditors rights vis-à-vis the bankruptcy trustee (or more commonly referred to as 'bankruptcy representative'). The first issue here is whether creditors have a right to participate in choosing the bankruptcy representative (if yes, the country gets 1 point). The second issue is whether creditors have a remedy against the courts' or the bankruptcy representatives' decision concerning the acceptance or rejection of creditors' claims (if yes, the country gets 1 point). The third is creditors' right to the debtors financial information (if they individually have access, then the country gets 1 point). The last one is whether creditors' approval is needed to sell substantial assets of the debtor in insolvency (if yes, then the country gets 1 point).

These questions aim to assess whether the creditors are mere subjects in the insolvency procedure without any substantial rights to affect it, or they have some key rights to protect their interests, making them strong participants in the procedure. The answers to these questions really paints a picture about how each country considers the role of insolvency, the function and possible primacy of the bankruptcy representative, and the position of creditors as merely being interested third parties or something more. It is interesting to observe that even countries that have the highest ranking in resolving insolvency cannot provide legislation that scores full points. For example, in the US, no approval is needed for the sale of substantial assets of the debtor; while in Germany (3rd in the world rankings in this aspect) does not provide

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[52] *Ibid*.

information rights to creditors about the debtor's financial situation. This shows that the 'best practices' put forward by the World Bank are not fully understood by any competitor country[53], which in turn means that there is a possibility to get ahead of them[54] by providing a 'best practice-based' legislation in Hungary.

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[53] A somewhat more realistic interpretation of this would be that even the most developed countries have their own social background that drives them to maintain limitations on creditors' rights because they consider them to be still important despite being fully aware that other countries may have already done away with such rules. This is particularly interesting in the case of the US, being the world leader in insolvency legislation and still clinging to certain old restrictions.

[54] This is only true in the context of insolvency legislation only, as the bulk of the work would be about speeding up the procedure, or providing higher return rates for investors. Nevertheless, foreign investors would find it noteworthy if Hungary had a 'best practice-based' legal framework for insolvency.

CHAPTER II.

KEY DIFFERENCES BETWEEN THE BANKRUPTCY REGULATIONS AND PROCEEDINGS OF HUNGARY AND THE US

2.1 THE IMPORTANCE OF REORGANIZATIONS, CHAPTER 11. OF THE US BANKRUPTCY CODE

The reason why the US insolvency system was chosen as a best practice example for Hungary to improve its own insolvency legislation was already discussed earlier in this thesis. The purpose of this chapter is to discover the exact rules that make such a meaningful difference overseas, through the lens of the Doing Business report. First I will examine what were exactly the World Bank's conclusions about the American insolvency system, then I will take a look at the relevant legal provisions themselves, with an aim to select and compare the legal norms that regulate the same matters in the US and in Hungary respectively.

A preliminary observation I have to make is that although the American insolvency framework – and in particular the reorganization rules contained in Chapter 11 of the Bankruptcy Code – is considered to be the leading model for all other economies[55], this is not apparent from the results contained in the Doing Business report. The World Bank had been monitoring the countries' performance with regard to their insolvency systems from the beginning of the Doing Business project, but the US had never received a ranking better than 4th, and until 2014 it has been ranked around the 15th. Moreover, it is evident from the rankings that the US had benefited greatly from the introduction of the SIF index into the Doing Business methodology in 2014 – immediately jumping ahead 13 places (see *Table 1* below) –, which on the one hand was probably one of the main reasons the World Bank brought it into the system in the first place. On the other hand, however, this fact contradicts the negative allegations related to the Doing Business report about it being tailored to the American

[55] B. Wessels, R J de Weijs, '*International contributions to the reform of Chapter 11 U.S. Bankruptcy code'* (Eleven international Publishing, 2015), p. 3.

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systems in every respect, considering their solutions to be the best in the world. It is also worth noting here that Germany – despite having an insolvency system that is not performing quite as well as the American one[56] – has managed to jump ahead of the US to the 3rd place, thanks to the same change in the methodology that enabled the US to get to the top 5.

	2010	2011	2012	2013	2014	2015	2016
United States	14	15	16	17	4	5	5
Germany	35	36	19	13	3	3	3
Hungary	62	66	70	70	64	65	63

1. Table: Rankings in the 'resolving insolvency' index in the Doing Business report (2010-2016).[57]

Historically, the United States was among the first countries that recognized the importance of streamlined, predictable and flexible insolvency laws. America got ahead of its time when it introduced the possibility for unfortunate, but not fraudulent debtors to be relieved from their debts and start anew in the XIX. century[58]. As it is stated by Jason Kilborn, "there is a broad agreement that the operation of the system has historically focused and continues to focus on rehabilitation of the 'honest but unfortunate' debtor, on offering individuals and companies a 'fresh start' to maintain the going-concern value of their assets and reinvigorate and maximize their economic productivity".[59] After many short-lived bankruptcy acts, finally the Bankruptcy Act of 1898 managed to provide lasting solutions for companies in distress and for their creditors as well. It also provided for separate bankruptcy courts. The next American Bankruptcy Code – enacted in 1978[60] – was so advanced,

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[56] According to Doing Business respondents, less than a quarter of businesses filing for insolvency undergo a successful restructuring procedure. In: Doing Business report 2015, p. 104. (n 31).
[57] Source: The World Bank's Doing Business website. Available at: http://www.doingbusiness.org/ Accessed on 6 April 2017.
[58] It was the US that first introduced the possibility for debtors to file for a voluntary bankruptcy in 1841. Source: History of the Federal Judiciary – Bankruptcy jurisdiction in the Federal Courts; website of the Federal Judicial Center. Available at: http://www.fjc.gov/history/home.nsf/page/jurisdiction_bankruptcy.html Accessed 29 March 2017.
[59] J. Kilborn, *'National report for the United States'* in D. Faber, N. Vermunt, J. Kilborn (*eds*), *'Commencement of insolvency proceedings'* (Oxford University Press, 2012), p. 754.
[60] The Bankruptcy Reform Act of 1978, commonly referred to as the US Bankruptcy Code

particularly its rules on reorganization that most other countries are still trying to catch up with its novel solutions almost 40 years after its introduction. Today, Chapter 11 of the Bankruptcy Reform Act of 1978 (hereinafter: US Bankruptcy Code) is still considered to be "both in practice and conceptually the most important insolvency procedure worldwide."[61]

Even if Chapter 11 is only dealing with reorganizations, which is only one branch of insolvency laws, the World Bank is also focusing its methodology of Doing Business on this area, which explains why special attention should be paid to the American way of regulating restructuring procedures. The 'resolving insolvency' index clearly gives preference to reorganizations, as it awards higher points to a country's insolvency law in case the hypothetical case would be more likely to end in a successful reorganization than in liquidation (this is expressed via the 'outcome' indicator of the index, the result of which can be either a piecemeal sale or staying alive as a going concern[62]). This new preference for reorganizations – a so-called paradigm-shift in insolvency approach[63] – is also evidenced by the European Commission's Recommendation on a new approach to business failure and insolvency[64]. The second-chance and fresh start policies are the trend in the developed world right now. However, the World Bank also warns legislators that too much favoritism towards restructuring can also have adverse effects. In 2013, the Doing Business report stated that "an analysis of Italy's 2005–06 reform of its bankruptcy law shows that excessive use of reorganization proceedings increases interest rates on loan financing because it reduces the incentives for entrepreneurs to act prudently."[65] It is clear, that legislators have to strike a fine

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[61] See *supra* note 52.
[62] See the methodology description for the resolving insolvency index of Doing Business. Available at: http://www.doingbusiness.org/Methodology/Resolving-Insolvency Accessed 29 March 2017.
[63] See supra note 55.
[64] As it is expressed in the first paragraph of the preamble and determines the whole recommendation. Available on the EU Commission's website at: http://ec.europa.eu/justice/civil/files/c_2014_1500_en.pdf Accessed 29 March 2017.
[65] Doing Business 2013, p. 94.

balance between bankruptcy and liquidation, and only allow the survival of companies that have a reasonable chance at re-emerging as a going concern.

2.2 Comparing the 'Strength of Insolvency Framework' Indicators of Hungary and the US

The results themselves in Doing Business are the main focus of this thesis. As the World Bank's methodology is offering a way to compare the US and Hungarian laws on insolvency, it may be the best source to seek out the shortcomings Hungary has to cure in order to have a better functioning insolvency law.

As it was mentioned earlier, the US has greatly benefited from the introduction of the SIF indicator into the resolving insolvency index, which added a layer of quality control for the legal framework itself, but at the same time, it clearly showed a preference towards the American legal solutions. As Gerard McCormack notes, this can be viewed as a possible reason for criticism towards the World Bank, as "it assumes that particular legislative solutions are superior to others and misses out subtlety and nuances in the laws of a State."[66] In fact, all the questions examined under the SIF indicator are based on solutions that originated from the US, and this is not changed by the fact that the World Bank claims to have its inspiration drawn from the ICR Principles and the Legislative Guidelines[67]. The only curiosity is that the US has only managed to score 15 out of 16 points in the SIF indicator, which would suggest that even their system is not the very best practice available. But according to the Doing Business results, they are equally good as the new German bankruptcy laws.

In the aspects of the SIF indicator the US has managed to score flawlessly in the following areas: commencement of proceedings, management of debtor's assets, and reorganization

[66] G. McCormack, *'World Bank Doing Business project: Should insolvency practitioners take it seriously?'* Insolvency Intelligence Issue 8 (2015) p. 122.
[67] See the methodology section of the Doing Business report. Available at: http://www.doingbusiness.org/Methodology/Resolving-Insolvency, Accessed 29 March 2017.

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proceedings. They only lost one point in the category of creditor participation, which is because their insolvency framework does not require creditors' approval for the sale of substantial assets of the debtor[68]. This requirement however is only fulfilled by two of the four countries that managed to achieve a higher rank than the US (Germany and South Korea[69]), which makes one wonder why would a proclaimed "best practice" be in fact the practice in only 2 of the top 5 countries. The importance of this feature in any insolvency law does not seem to be supported by the international best practice documents either (the ICR principles or the Legislative Guidelines), as they do not contain any specific recommendation on this issue. The Legislative Guidelines only contains a much more generic recommendation that "the insolvency law should specify that adequate notice of any disposal conducted outside the ordinary course of business be given to creditors and that they have the opportunity to be heard by the court"[70]. It also recommends to give the right to the insolvency representative "to sell an asset that is encumbered or subject to other interest free and clear of that encumbrance"[71], provided that the holder is given a right to be heard by the court. However, these recommendations do not mention the substantiality requirement for the proposed sale of the assets, nor do they speak of any requirement for approval, only the much weaker right to be heard is mentioned. This makes it puzzling to identify the origins of such a recommendation, and undoubtedly makes it a questionable decision to include it among the 16 requirements that together constitute the SIF indicator, marking it as one of the cornerstones of any insolvency framework aspiring to be considered as a "best practice based" one in the eyes of the World Bank. Unfortunately, the

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[68] For all of the results on insolvency for the US, visit: http://www.doingbusiness.org/data/exploreeconomies/united-states#resolving-insolvency Accessed 30 March 2017.
[69] For the rankings, see the Doing Business website, available at: http://www.doingbusiness.org/rankings Accessed 30 March 2017.
[70] Legislative Guidelines, recommendation Nr. 55.
[71] Ibid, recommendation Nr. 58 (a).

World Bank does not explain[72] the importance or underlying considerations of any of the issues in the SIF indicator, so one has to simply accept it as the best practice "as is".

Apart from this issue, the US still greatly outperforms Hungary in both the 'reorganization proceedings' and the 'creditor participation' indicators (see Figure 2.2).

	Hungary		**United States**	
Issue in question	**Answer**	**Points**	**Answer**	**Points**
'Reorganization proceedings' indicator (0-3 points)				
Which creditors vote on the proposed reorganization plan?	All	0.5	Only the interested	1
Does the insolvency framework require that dissenting creditors in reorganization receive at least as much as what they would obtain in a liquidation?	No	0	Yes	1
Are the creditors divided into classes for the purposes of voting on the reorganization plan, does each class vote separately and are creditors in the same class treated equally?	No	0	Yes	1
'Creditor rights' indicator (0-4 points)				
Does the insolvency framework require approval by the creditors for selection or appointment of the insolvency representative?	No	0	Yes	1
Does the insolvency framework require approval by the creditors for sale of substantial assets of the debtor?	No	0	No	0
Does the insolvency framework provide that a creditor has the right to request information from the insolvency representative?	No	0	Yes	1
Does the insolvency framework provide that a creditor has the right to object to decisions accepting or rejecting creditors' claims?	Yes	1	Yes	1

2. Table: Results in Doing Business for 'reorganization proceedings' and 'creditor participation' indicators, Hungary and the US.[73]

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[72] The methodology description of the 'resolving insolvency' indicator does not discuss the reason why this question was included in the requirement list. The description can be accessed here: http://www.doingbusiness.org/methodology/resolving-insolvency Accessed on 5 April 2017.
[73] Data compiled from the latest Doing Business report (titled '2017', issued in November 2016). Available at: http://www.doingbusiness.org/~/media/WBG/DoingBusiness/Documents/Annual-Reports/English/DB17-Report.pdf Accessed on 5 April 2017.

As we can see, Hungary has only managed to score 0.5 point in reorganization proceedings, and 1 point in creditor participation. This means a total loss of 5.5 points from the maximum of 16, which is nearly one third of the aggregate points. In the other two big categories (commencement of proceedings and management of debtor's assets) Hungary has only lost 1.5 points, so it would definitely be a worthwhile effort to improve on these issues. Although the other 2 indexes do not seem to cause too much loss of points, the shortcomings themselves stem from Hungary's inability to keep up with the new trends, so I will briefly address these problems as well at the end of chapter III (in subchapter 3.3).

2.3 RELEVANT PARAGRAPHS OF THE US BANKRUPTCY CODE

In order to understand how the US is able to perform almost without fault in the two categories where Hungary's insolvency legislation seems to be the weakest, we have to examine the relevant provisions of the US Bankruptcy Code. I am going to identify the provisions that regulate the issue that is examined in the Doing Business report and keep them in the order the Doing Business report discusses them.

2.3.1 Reorganization proceedings index

a. "Which creditors vote on the proposed reorganization plan?"[74]

11 U.S. Code § 1126 - Acceptance of plan:

"(a) The holder of a claim or interest allowed under section 502 of this title may accept or reject a plan. If the United States is a creditor or equity security holder, the Secretary of the Treasury may accept or reject the plan on behalf of the United States.

(f) Notwithstanding any other provision of this section, a class that is not impaired under a plan, and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required.

(g) Notwithstanding any other provision of this section, a class is deemed not to have accepted a plan if such plan provides that the claims or interests of such class do

[74] For the full list of questions examined by the World Bank in the Doing Business report, see the methodology description. Available at: http://www.doingbusiness.org/Methodology/Resolving-Insolvency Accessed 5 April 2017.

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not entitle the holders of such claims or interests to receive or retain any property under the plan on account of such claims or interests."[75]

It is clear from the provisions that a holder of a claim or interest can vote on a reorganization plan, which in itself is a very broad formulation and would only earn 0.5 points for the US – as this would mean that all creditors can vote on the plan. The more important part is subsection (f), which stipulates that a creditor class that is not impaired under the plan – which translates to "disinterested" in the wording of the Doing Business report – is presumed to have accepted the plan and their vote is not required for its acceptance. Subsection (g) contains an important limitation on the presumption contained in subsection (f) in order to protect creditors.

b. "Does the insolvency framework require that dissenting creditors in reorganization receive at least as much as what they would obtain in a liquidation?"[76]

11 U.S. Code § 1129 - Confirmation of plan

"(a) The court shall confirm a plan only if all of the following requirements are met:
(7) With respect to each impaired class of claims or interests—
(A) each holder of a claim or interest of such class—
(ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date."[77]

This section of the Bankruptcy Code is the so-called "best interest test" or "liquidation test"[78], which is the counter-balance of a cram-down, protecting individual creditors against a plan that would leave them in a worse position than they would be without any reorganization plan. The underlying logic is that a reorganization plan should serve most creditors' interests, and under no circumstances should significantly impair their original position. This rule gives the right even to a creditor who is in a class that has already consented to the plan to attack it, and if he can prove his disadvantage, he will be able to defeat the plan.

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[75] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/1126 Accessed 5 April 2017.
[76] See *Supra* note 72.
[77] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/1129 Accessed 5 April 2017.
[78] J. Friedland, '*Confirming a plan'* (2005) American Bankruptcy Institute Journal, Vol. XXIII, No. 10, Dec/Jan. 2005) https://www.kirkland.com/siteFiles/kirkexp/publications/2365/Document1/Friedland%20-%20Confirming%20a%20Plan.pdf Accessed 30 March 2017.

c. "Are the creditors divided into classes for the purposes of voting on the reorganization plan, does each class vote separately and are creditors in the same class treated equally?"[79]

<u>11 U.S. Code § 1123 - Contents of plan</u>

"(a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall—
(1) designate, subject to section 1122 of this title, classes of claims, other than claims of a kind specified in section 507(a)(2), 507(a)(3), or 507(a)(8) of this title, and classes of interests;
(2) specify any class of claims or interests that is not impaired under the plan;
(3) specify the treatment of any class of claims or interests that is impaired under the plan;
(4) provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest;"[80]

<u>"11 U.S. Code § 1129 - Confirmation of plan</u>

(a) The court shall confirm a plan only if all of the following requirements are met:
(8) With respect to each class of claims or interests—
(A) such class has accepted the plan; or
(B) such class is not impaired under the plan."[81]

The cited provisions of the Bankruptcy Code stipulate that the reorganization plan has to divide creditors into classes, and those in the same class have to be treated equally, unless one freely accepts an inferior position. These rules are given court control, and they are prerequisites for the confirmation of the reorganization plan.

2.3.2 Creditor participation index

a. "Does the insolvency framework require approval by the creditors for selection or appointment of the insolvency representative?"[82]

<u>11 U.S. Code § 1104 - Appointment of trustee or examiner</u>

"(a) At any time after the commencement of the case but before confirmation of a plan, on request of a party in interest or the United States trustee, and after notice and a hearing, the court shall order the appointment of a trustee—
(b) (1) Except as provided in section 1163 of this title, on the request of a party in interest made not later than 30 days after the court orders the appointment of a trustee under subsection (a), the United States trustee shall convene a meeting of creditors for the purpose of electing one disinterested person to serve as trustee in

[79] See *Supra* note 72.
[80] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/1123 Accessed 5 April 2017.
[81] See *Supra* note 73.
[82] See *Supra* note 72.

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the case. The election of a trustee shall be conducted in the manner provided in subsections (a), (b), and (c) of section 702 of this title."[83]

The American law requires that the court appoint a trustee by closely cooperating with the creditors – in essence the creditors are the ones who elect the trustee. The law also requires that the appointed trustee has to be disinterested in the case.

b. "Does the insolvency framework require approval by the creditors for sale of substantial assets of the debtor?"[84]

According to the Doing Business report, the US Bankruptcy Code does not contain such rules.

c. "Does the insolvency framework provide that a creditor has the right to request information from the insolvency representative?"[85]

11 U.S. Code § 1106 - Duties of trustee and examiner

"(a) A trustee shall—
(1) perform the duties of the trustee, as specified in paragraphs (2), (5), (7), (8), (9), (10), (11), and (12) of section 704(a);"[86]

11 U.S. Code § 704 - Duties of trustee

"*(a) The trustee shall—*
(4) investigate the financial affairs of the debtor;
(7) unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest;"[87]

The duties of the trustee are located in more than one part of the Bankruptcy Code, with the substantive rules being placed in the part that governs liquidation (Chapter 7). Chapter 11 only contains a reference to them, as the duties of the trustees are the same in both procedures. The trustee has an active role in gathering information about the debtor's financial situation, and upon any of the creditor's request he has to give out certain details about it. Probably the most important notion here is that it allows any party in interest to request information (as we will

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[83] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/1104 Accessed 5 April 2017.
[84] See *Supra* note 72.
[85] *Ibid*.
[86] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/11046 Accessed 5 April 2017.
[87] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/704 Accessed 5 April 2017.

see in the next sub-chapter, in Hungary this is not a right that is given to any individual creditor, but only to groups of them).

d. "Does the insolvency framework provide that a creditor has the right to object to decisions accepting or rejecting creditors' claims?"[88]

<u>11 U.S. Code § 502 - Allowance of claims or interests</u>

"(a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.
(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that—
(1) such claim is unenforceable against the debtor and property of the debtor, under any agreement or applicable law for a reason other than because such claim is contingent or unmatured;
(2) such claim is for unmatured interest;"[89]

Subsection (a) contains the general rule that gives the right to interested parties to object to allowing claims into the procedure. It is generally recognized[90] that the right to object is mainly exercised by the trustee, who has a duty to examine all incoming claims. However, creditors may also exercise the right to object to other creditors' claims if they feel that it would be improper to confirm them. Subsection (b) contains a long list of such situations, that is not reproduced here in full length (only 2 examples are included which are fairly common situations in any bankruptcy procedure described in subsection (b) (1)-(2)).

2.4 RELEVANT PARAGRAPHS OF THE HUNGARIAN ACT XLIX. (49.) OF 1996 ON BANKRUPTCY AND LIQUIDATION PROCEEDINGS

The US Bankruptcy Code – which is quite technical – seems quite easy to follow compared to the Hungarian Bankruptcy Act, which is even more complicated, with sections that seem to

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[88] See *Supra* note 72.
[89] For the full paragraph, visit: https://www.law.cornell.edu/uscode/text/11/502 Accessed 5 April 2017.
[90] As it was stated in the notes of the Advisory Committee in 1983, "the demands of orderly and expeditious administration have led to a recognition that the right to object is generally exercised by the trustee". The whole section of the notes are available at the Cornell University Law School's Legal Information Institute website: https://www.law.cornell.edu/rules/frbp/rule_3007 Accessed 30 March 2017.

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go on forever. Maybe it is one adequate preliminary remark on the Hungarian law that the more technical and meticulously detailed its provisions get the harder will it be for them to provide the desired effect, as even legal practitioners may find it hard to decipher the exact meaning of such sections. And it will also be noticeable that in some sections that are meant to provide for the protection of certain parties, much is provided, but not what would be most beneficial for the parties. In this respect, I have to agree with the World Bank, that some core guarantees are missing from the Hungarian bankruptcy law, as pointed out below. The irony is that on more than one occasion they almost contain what the Doing Business report is expecting.

2.4.1 'Reorganization proceedings' indicator

a. "Which creditors vote on the proposed reorganization plan?"[91]

> *"Section 18 (4) In the composition conference voting right shall be held by any creditor:*
> *a) who registered its claim by the deadline specified in Paragraph f) of Subsection (2) of Section 10, and*
> *b) who paid the registration fee, and*
> *c) whose claim is shown under recognized or uncontested claims.*
> *Section 20 (1) A composition agreement may be concluded if the debtor was able to secure the majority of the votes for the agreement from the creditors holding voting rights according to Subsections (4)-(5) of Section 18, in respect of secured and unsecured claims alike."*[92]

The two above cited sections designate which creditors have a right to vote on the proposed reorganization plan. Section 18 (4) contains general conditions, while Section 20 (1) describes the requirements of a successful vote. The important rule here is that in order for the vote to be successful both secured and unsecured creditors have to always vote on it – and all of them, not only those who are interested.

b. "Does the insolvency framework require that dissenting creditors in reorganization receive at least as much as what they would obtain in a liquidation?"[93]

[91] See *Supra* note 72.
[92] English translation of the provisions of the Hungarian Bankruptcy Act is available via this link: http://matraholding.hu/images/userfiles/files/Legislation.pdf Accessed on 5 April 2017.
[93] See *Supra* note 72.

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"Section 20 (1) A composition agreement may be concluded if the debtor was able to secure the majority of the votes for the agreement from the creditors holding voting rights according to Subsections (4)-(5) of Section 18, in respect of secured and unsecured claims alike."[94]

(1a) The composition agreement has to be concluded in good faith, and the agreement cannot contain any provisions that are manifestly and flagrantly disadvantageous or unfair for all creditors or groups of creditors. It shall be deemed as so if the rate of satisfaction of all of the creditors' claims is unfairly low compared to the debtor's assets, or the claims of a group of creditors are satisfied at a manifestly lower rate or with unfairly disadvantageous conditions compared to the claims of other groups of creditors.[95]

"*(2) A composition arrangement shall also apply to non-consenting creditors who are otherwise entitled to participate in the composition agreement, or failed to take part in the conclusion of the composition agreement in spite of having been properly notified, and shall also apply to the creditors whose contested claims had to be secured by provisions or by way of guarantee (judicial arrangements). The composition agreement, however, may not stipulate less favorable conditions in respect of these creditors than to the creditors granting consent to the agreement in the given categories, or to the creditors mentioned in Subparagraphs bc)-bd) of Subsection (2) of Section 12. Payments may be effected from the said provisions to provide satisfaction for a contested claim (or a part of such claim) to the beneficiary of such contested claim if the said beneficiary filed charges against the debtor, and the court's final ruling declared the creditor's claim substantiated and awarded the amount of the claim, or if the creditor recovered its claim from the debtor by way of an administrative procedure."*[96]

Section 20 describes the manner in which the composition agreement has to be concluded. In Subsection (1a) – inserted into the Act in 2014 – it contains an obligation of good faith, and prohibits agreements that discriminate against all creditors or groups of creditors. Subsection (2) contains the minimum requirements with respect to dissenting creditors, i.e. they have to be treated the same way as those creditors of the same class who have given their consent. This is also an equal-treatment requirement. The problem is however, that none of these rules contain an objective minimum rate of satisfaction for dissenting creditors, only a subjective one. These rules mean that dissenting creditors are dependent on consenting ones, which defeats the purpose of the right to dissent, because dissenting makes no difference in case the plan gets accepted.

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[94] *Ibid*.
[95] As this subsection was introduced in 2014, there is no official English translation for it yet, so it has been translated by the author of this thesis.
[96] See *Supra* note 90.

c. "Are the creditors divided into classes for the purposes of voting on the reorganization plan, does each class vote separately and are creditors in the same class treated equally?"[97]

> *"Section 20 (1) A composition agreement may be concluded if the debtor was able to secure the majority of the votes for the agreement from the creditors holding voting rights according to Subsections (4)-(5) of Section 18, in respect of secured and unsecured claims alike."*[98]

The general division of creditors into secured and unsecured categories is an *ex lege* categorization, but the reorganization plan is not required to create any further groups of creditors. Secured and unsecured creditors have to vote separately on the plan, and there has to be a majority vote achieved in each group for the plan to be successful. But subsections (1a) and (2) of section 20 do not contain any anti-discriminatory rules with regard to intra-group relations, equal treatment is required for groups of creditors only. The rules also stipulate that a non-consenting creditor has to be given the same conditions in the reorganization plan as those within the same group that have consented, but this is only one aspect of intra-group relations where many other kinds of discrimination may happen.

2.4.2 'Creditor participation' indicator

a. "Does the insolvency framework require approval by the creditors for selection or appointment of the insolvency representative?"[99]

> *"5/A. § (1) Creditors may form a creditors' select committee for the protection of their interests and to provide representation, furthermore, to monitor the activities of the administrator and the liquidator. The select committee shall represent the founding creditors in court and during consultations with the administrator, temporary administrator and the liquidator, and shall exercise the rights and entitlements conferred by this Act.*
>
> *10. § (1) If the court did not refuse the request for the opening of bankruptcy proceedings, it shall forthwith provide for the opening of bankruptcy proceedings, and shall consequently provide for having the ruling thereof published in the Cégközlöny (Company Gazette) by way of the means described in specific other legislation and for having the indication "cs. a." entered in the register of companies next to the company's name. Publication in the Cégközlöny shall take place in the form of a display posted on the official website of the Cégközlöny at 0:00 hours, updated on a daily basis. The court shall ex officio appoint an administrator from*

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[97] See *Supra* note 72.
[98] See *Supra* note 90.
[99] See *Supra* note 72.

the register of liquidators in its ruling on the bankruptcy proceedings. The ruling may not be appealed."[100]

Section 10 (1) gives the exclusive right to the court to appoint an administrator for the bankruptcy proceedings, and its choice is contained in its ruling on the opening of the procedure, which is not actionable by the parties. Section 5/A (1) gives the right to monitor the activities of the administrator to the creditors' committee, but this right is limited in the sense that it only gives control to creditors after the appointment of the administrator. The issue of the appointment of administrators and liquidators is quite problematic in Hungary – in 2010, an electronic randomized selection system was introduced[101] for the purpose of equal treatment, but this system was criticized heavily for discarding professional aspects of the selection process almost completely[102].

b. "Does the insolvency framework require approval by the creditors for sale of substantial assets of the debtor?"[103]

"49. § (1) The liquidator shall dispose of the debtor's assets through public sales at the highest price that can be obtained on the market. The liquidator shall effect the sale by way of tender or auction. The liquidator may forego the application of these procedures only upon the prior consent of the select committee, or if the estimated proceeds are insufficient to cover the costs of sale, or if the difference between the prospective proceeds and estimated costs is less than 100,000 forints. In this case the liquidator may apply other public forms of sale for the purpose of achieving a more favorable result."[104]

The Hungarian bankruptcy Act gives all control to the administrator/liquidator with regard to the sale of the assets of the debtor. The law contains several requirements that have to be met throughout the sale, but essentially the creditors have no say in the process. The standard course of action in case of sales is the public auction or tender, which is a long and often not

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[100] See *Supra* note 90.
[101] The new selection method was introduced by the Decree of the Minister of Justice and Law Enforcement No. 36/2010. (V. 13.) on the rules of electronic appointment of liquidators, administrators and temporary administrators.
[102] There was even a constitutional challenge of this law, buti t was refused by the Hungarian Constitutional Court in its decision No. 1697/B/2010.
[103] See *Supra* note 72.
[104] See *Supra* note 90.

very successful method for the sale, as "there is no perfect market for failing firms"[105]. The purpose of the publicity is to avoid any favoritism or corruption in the sale, but due to reasons that are not to be discussed here this often proves to be a fruitless effort[106].

c. "Does the insolvency framework provide that a creditor has the right to request information from the insolvency representative?"[107]

"5. § Upon a request received during bankruptcy proceedings and liquidation proceedings, the head of the debtor, the administrator or the liquidator shall, within eight working days, inform:

a) the creditors' select committee and the creditors' representative, or, in the absence thereof, the creditor (group of creditors) representing at least 10 per cent of all notified and recognized creditors' claims, regarding the financial situation of the insolvent debtor;

15.§ (2) When so requested by the court, the creditors' select committee or the creditors' representative, the administrator shall give account of his activities and report on the financial standing of the debtor within eight working days."[108]

As it is clear from the rules, individual creditors in Hungary do not have the right to request information from the administrator, this is only a collective right that can be exercised by a group of creditors who together hold at least ten percent of all claims against the debtor, or the creditors' committee or their representative.

d. "Does the insolvency framework provide that a creditor has the right to object to decisions accepting or rejecting creditors' claims?"[109]

"12.§ (5) (5) The debtor and creditors shall be informed without delay concerning the classification of claims and on the amount registered, and they shall be given an opportunity to present their views within a time limit of not less than five working days. Such comments shall be decided by the administrator within three working days, of which the creditor and the debtor shall be notified immediately, upon which they shall have five working days to submit any objection to the court concerning the administrator's action pertaining to the classification process, including the case where the administrator registered a claim in the amount other than the one notified by the creditor. The court shall adopt a decision relating to such objection in priority proceedings, within not more than eight working days. The ruling may not be appealed separately. Where a claim is listed under uncontested claims on the strength of the court's decision shall not be

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[105] H. Eidenmüller, *'Secured creditors in insolvency proceedings'* in H. Eidenmüller, E. Kieninger (*eds*) '*The future of secured credit in Europe'* (Berlin, De Gruyter Recht, 2008) p. 280.
[106] *Ibid*. pp. 279-281.
[107] See *Supra* note 72.
[108] See *Supra* note 90.
[109] See *Supra* note 72.

> *construed as an admission of debt, and shall not prevent enforcement vis-à-vis the creditor."*[110]

This requirement is the only one within the 'creditor participation' indicator that is satisfied by the Hungarian bankruptcy framework, according to the Doing Business report. In the cited section of the Bankruptcy Act the process for the notification of the creditors and the method in which they can exercise their rights to object to the administrator's decision about their claims is discussed in much detail[111].

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[110] See *Supra* note 90.

[111] For further details, see M. Kengyel, *'Charges and security interest in insolvency proceedings in Hungary'* in R. Stürner, M. Kawano, *'Cross border insolvency, intellectual property litigation, arbitration and ordre public'* (Mohr Siebeck, 2011) p. 164.

CHAPTER III.

LESSONS FOR HUNGARY FROM THE US REGULATION WITH A VIEW TO IMPROVE ITS RANKINGS IN DOING BUSINESS

As we can see in the previous chapter the World Bank expects some selected basic guarantees to be included in any given country's bankruptcy laws which it considers to be decisive in determining the quality of said legislation. The selection of these rules may be arguable, but it is certain that the World Bank relies heavily on the US Bankruptcy Code as a best practice example. In this chapter I will examine what Hungarian legislators can learn from the US example by comparing the relevant rules of each country and pointing out what is missing that could improve Hungary's position in the Doing Business report.

3.1 IMPROVING ON THE 'REORGANIZATION PROCEEDINGS' INDICATOR

The 'reorganization proceedings' indicator is arguably the easier part to improve upon, as it contains fewer requirements that may not be too painful to satisfy by amending the Hungarian laws.

First, Hungary has to amend its legislation in a way that would only require the vote of those creditors on the reorganization plan whose rights may be affected by its acceptance. This could be achieved by stating that those creditors whose rights are not affected by the plan are presumed to have accepted it, so their vote is not required (just like it is contained in the US Bankruptcy Code). This rule could be inserted under Section 20 of the Hungarian Bankruptcy Act. As any change of the current order would not hamper the rights of any interested party, it could be relatively easy to go through with this change. The achievable benefit would be a higher rate of acceptance of reorganization plans, and an additional 0.5 points in the Doing Business report.

Second, there has to be a rule in the Hungarian Bankruptcy Act that contains a "liquidation test" similar to the one in the US Bankruptcy Code. The amendment of Section 20 in 2014

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already indicates that the Hungarian legislators are aware of the problem of discrimination and unfair treatment of certain creditor groups, the problem is that they only went halfway through with providing adequate protection. The protection of dissenting creditors must have an objective minimum level, which is already worked out by the Americans, i.e. they should get at least as much out of a successful reorganization as they would in normal liquidation. As a reorganization process is long and involves a significant business risk than simply cashing in with liquidation, it is understandable that creditors should not be required to take this additional risk without any hope of profitability. One more important observation is that the current rules do not give rights to individual creditors, and dissenting creditors are dependent on consenting ones. But as this logic denies that certain creditors may have conflicting interest within the same class of creditors, it should be changed to a more realistic solution. As the "liquidation test" is a tried-and-true standard, it seems to pose no legislative risks to include it in the existing provisions. By including it, Hungary could earn one additional point in the 'reorganization proceedings' indicator.

Third, the issue of classification of creditors and their equal treatment within the classes. The American law requires the reorganization plan to divide the creditors into classes, with detailed provisions on the treatment of impaired classes. However, the Hungarian law also creates the most basic classification by dividing creditors with secured and unsecured claims. The real issue here is that the Hungarian law does not require non-discrimination within any of the groups of creditors, only between creditors' groups. As this would be a very important guarantee without any conceivable downside to the procedure, it should simply be stated in Section 20 of the Hungarian Bankruptcy Act that all creditors within the same group or category have to be treated equally with respect to their procedural rights. By including this quite straightforward legal safeguard Hungary could get one more point in the 'reorganization proceedings' indicator.

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3.2 IMPROVING ON THE 'CREDITOR PARTICIPATION' INDICATOR

Improving on the 'creditor participation' indicator requires amendments to the Hungarian Bankruptcy Act in at least three instances.

The first is a major obstacle, as the selection of the administrator is an issue that could not be solved by Hungarian legislators for decades. Nevertheless, we can turn to the US solution for answers, as in the US Bankruptcy Code the court convenes a meeting of all creditors for the purpose of letting them elect a disinterested person as trustee in the case. In Hungary, the main objective of amending the selection process was to randomize it to avoid any concern of bias. The US solution places its trust in the creditors to choose whomever they deem most suitable for managing the case[112]. This certainly leads to a heavy competition among professional trustees, but the ultimate question is which is the more important interest in the whole process: supplying all professional administrators/liquidators with cases or ensuring that creditors will gain the most that is possible in the process? If the answer is the latter (which it should be), then the creditors should have the right to choose whom they want. Of course, this might need additional guarantees in the process, but in case such a right would be awarded to creditors, Hungary could gain an additional point in the 'creditor participation' indicator.

The second issue – that creditor approval shall be required for selling substantial assets of the debtor by the trustee – is one that is not yet solved in the American system as well, but one could turn to the example of Germany where the World Bank has found such rule to exist in the bankruptcy framework[113]. It may be argued that such a requirement could seriously hinder the process and possibly endanger the success of the whole reorganization, but keeping the

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[112] See J. Kilborn, p. 775.

[113] See the economy profile for Germany on the website of Doing Business. Available at: http://www.doingbusiness.org/data/exploreeconomies/germany#resolving-insolvency Accessed 6 April 2017.

bankruptcy estate as a going concern has an otherwise recognized benefit for all interested parties, which would warrant such a rule.

The third issue Hungary has to address in order to gain an additional point in the SIF index is granting the right to request information to individual creditors, not only to the creditors' committee, the creditors' representative or groups with an aggregate claim of at least 10 percent of all claims[114]. Of course, serving the demand for information of every single creditor could multiply the workload of any administrator, but considering that most cases are small where either there are few creditors or there is no valuable information to share (because the debtor has vanished already), the number of affected cases are expected to be significant. Also, the frequency of such requests could be limited as well in the amended provision.

3.3 Improving on the overall 'Strength of Insolvency Framework' Indicator

Although the stated focus of this thesis was the examination of the SIF indicator, this is not the only part where Hungary could improve its rankings in the 'resolving insolvency' index simply by amending its legislation. Hungary is already performing well with regard to the 'commencement of proceedings' and the 'management of debtor's assets' indicators, but there is still room to enhance the bankruptcy process here and earn more points.

Within the 'commencement of proceedings' indicator Hungary currently gets only 0.5 points, as creditors are only enabled to initiate liquidation proceedings, but not reorganization[115]. By looking at some of the leading economies and also Hungary's neighbors, it is clear that most countries do not deny this right from creditors. The US and Germany naturally allow it, but countries like Poland and Slovakia also enable it[116]. Among our most

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[114] As these are the only groups that may request information under Sections 5 and 15 (2) of the Hungarian Bankruptcy Act.
[115] See also V. Harsági, *'Hungarian judicial practice in Cross-border insolvency – main or territorial proceedings'* in R. Stürner, M. Kawano, *'Cross border insolvency, intellectual property litigation, arbitration and ordre public'* (Mohr Siebeck, 2011), pp. 97-98.
[116] based on the data found in the latest (2017) Doing Business report.

important competitors only the Czech Republic and Romania do not allow creditors to initiate reorganization proceedings[117].

Section 7 at the present only allows debtors to initiate bankruptcy (reorganization) proceedings:

"Section 7 (1) The directors of debtor economic operators may file for bankruptcy at the court of law. Legal representation for the debtor shall be mandatory."[118]

The underlying reason could be that creditors might try to initiate bankruptcy proceedings in order to hinder another, better-positioned creditor's efforts to receive satisfaction. Also, it could be viewed as a very serious interference with a company's functioning, which naturally requires certain legal safeguards. It is clear that in most developed countries this is a rule embedded in the legislation. By looking at the US legislation, the relevant rules are contained in § 303 of the US Bankruptcy Code, titled 'involuntary cases'[119]. The main requirements for the initiation of involuntary bankruptcy are that a certain number of creditors need to file the petition[120], and it must be shown that the target company is "generally not paying its debts"[121]. There are certain important differences between voluntary and involuntary bankruptcy cases in the US[122], but these differences are not in the focus of this thesis, so they will not be discussed in detail.

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[117] For the details, see the economic profiles of each country, available on the Doing Business website. For the Czech Republic, visit: http://www.doingbusiness.org/data/exploreeconomies/czech-republic#resolving-insolvency For Romania, visit: http://www.doingbusiness.org/data/exploreeconomies/czech-republic#resolving-insolvency Accessed on 6 April 2017.
[118] See *Supra* note 90.
[119] For the whole paragraph, visit: https://www.law.cornell.edu/uscode/text/11/303 Accessed on 6 April 2017.
[120] See US Code § 303 (b).
[121] See US Code § 303 (h) (1).
[122] For a good summary of these differences, see B. Eisenbach, *'Forced Into Bankruptcy: The Involuntary Bankruptcy Process'*, In the (Red) (24 May, 2012). Available at: http://bankruptcy.cooley.com/2012/05/articles/business-bankruptcy-issues/forced-into-bankruptcy-the-involuntary-bankruptcy-process/ Accessed on 6 April 2017.

As this is a requirement from the legal framework that requires many checks and balances to function properly, more than a simple legal amendment is necessary in the Hungarian Bankruptcy Act in Section 7. It would nevertheless be worth the effort to provide this opportunity for 'involuntary bankruptcy', as it has its uses, and it would also enable Hungary to receive an additional 0.5 points in the rankings.

In the 'management of debtor's assets' indicator the only shortcoming of Hungary is that although its insolvency framework allows debtors to obtain credit after the commencement of the reorganization proceedings, it does not assign any priority to post-commencement credit[123]. Post-commencement credit is vital for any reorganization, as the debtor is already in distress, and the existing creditors are probably not willing to lend to it anymore, so a new source of credit is required for the business to stay afloat. But that kind of new credit bears a greater risk, which makes it very expensive or even unavailable. The only condition under which new creditors would be willing to help the distressed company out is to get priority over pre-commencement creditors. Whether this would be a super-priority, preceding even secured creditors, or priority only over other unsecured creditors is another issue to be decided by the legislators, but some priority should definitely be given to such credit. The World Bank only gives 0.5 points if super-priority is given to post-commencement credit, and only gives a full point if priority is given over unsecured creditors. The explanations for this is that "*the provision of this new security should not affect the priority of existing secured creditors without these creditors receiving alternative protection—or at least notice of the change and an opportunity to be heard ... As a general rule, granting post-commencement finance 'super-priority' over all existing claims (secured and unsecured) is not recommended, because this*

[123] According to the findings of the World Bank. For more information, see the economy profile of Hungary on the website of Doing Business. Available at: http://www.doingbusiness.org/data/exploreeconomies/hungary#resolving-insolvency Accessed 6 April 2017.

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approach risks disrupting the extension of secured credit in regular commercial transactions."[124]

It may be debatable whether this favoritism towards the 'normal priority' rule and the depreciation of the super-priority method is adequately supported by the World Bank's reasoning[125], but the Doing Business report's results show that many developed countries already assign priority to post-commencement credit. In 2016, the World Bank found that "75 economies establish priority in the applicable insolvency law: 36 rank the claims of post-commencement creditors above those of existing unsecured creditors only, and 39 rank such claims above those of all existing creditors"[126]. Example countries that receive full points in this category include the US, Germany, Poland and Romania, while half point is given to the Czech Republic. It is worth noting that like Hungary, Slovakia has also not given priority to post-commencement credit, which offers a chance to get ahead of them in the rankings.

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[124] Doing Business report 2016, p. 101.
[125] McCormack, p. 122.
[126] Doing Business report 2016, p. 102.

CONCLUSION

This thesis set out to compare the American and the Hungarian insolvency frameworks for the purpose of finding ways to improve the quality of Hungary's legislative framework so it would get a better rating in the World Bank's Doing Business report. It has been argued that in certain areas much better results could be achieved by simply amending the existing rules so they represent what is currently considered as the 'best-practice approach' by the World Bank. By analyzing Hungary's shortcomings and taking a look at how these issues can be dealt with by one of the leading economies of the world that many consider to have the most advanced insolvency law to date, it can be concluded that such improvements are indeed possible, and most of them probably do not even pose serious risks with respect to the current balance in the rights and obligations of the parties in a bankruptcy procedure.

If the recommendations contained in this thesis - discussed in the previous chapter – would be accepted by Hungarian legislators, Hungary could have a flawless result in the SIF indicator of the 'resolving insolvency' index of the Doing Business report. The total improvement would be an additional 7 points to the current amount of 9, most of which only require simple modification of the current provisions of the Hungarian Bankruptcy Act. It is true that the part of the 'resolving insolvency' index which measures the quality of the insolvency framework is not the only element that determines Hungary's results, but this is where the fastest and easiest enhancements can be achieved. And it is clear from the rankings that many countries were able to swiftly improve their position of the 'resolving insolvency' index by focusing on the SIF indicator. The introduction of the SIF indicator in 2014 enabled even the already well-achieving economies like the US and Germany to jump ahead spectacularly in the rankings.

By observing our competitors, Hungary has the lowest rankings with respect to the 'resolving insolvency' index in the Doing Business report in the region. While all competitors have been able to improve their rankings by benefiting from the introduction of the SIF

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indicator, the data shows that Romania was able to capitalize on it the most, improving 50 places in the rankings, and getting well ahead of Hungary (see Figure 4.1.). If we consider that Poland has just introduced a whole new bankruptcy law in 2012, and by doing so managed to instantly improve from the position of 87. to 37[127]. it is clear that great results can be achieved by legal enhancements without the need to significantly alter the reality of the practice.

	Resolving insolvency rank in 2013[128]	**Resolving insolvency rank in 2016[129]**	**points in SIF in 2016 (0-16)**	**Difference in ranking**
Poland	37	27	14	-10
Czech Republic	29	26	13	-3
Slovakia	38	35	13	-3
Romania	99	49	13	-50
Hungary	70	63	9	-7

3. Table: Changes in the rankings in 'resolving insolvency' index and in the SIF indicator results of Central European Countries[130]

By simply following the well-trodden path of our competitors we can improve at least 25-30 places in our rankings in the 'resolving insolvency' index. If Hungary could achieve even 1 point more in the SIF indicator than the other countries in the region (that is, at least 15 points), the improvement could be even more significant. However, if the legislators intend to go even further, that is also possible, as currently the world leading US model is under reconstruction as well. After almost 40 years US legislators consider the US Bankruptcy Code to be increasingly outdated, and feel that the economic conditions have changed so significantly since 1978 that a new reform is needed.

Therefore, the American Bankruptcy Institute (ABI) was created in 2012 to work out recommendations to update the US Bankruptcy Code. At the end of 2014 the ABI has published its 'Final Report and Recommendations', a 395-page long work containing all of its findings

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[127] See *Supra* note 20.
[128] Contained in Doing Business report 2014.
[129] Contained in Doing Business report 2017.
[130] Source: The World Bank's Doing Business report website. Available at: http://www.doingbusiness.org/ Accessed on 6 April 2017.

in detail[131]. It contains 241 recommendations altogether, examining all aspects of the American reorganization procedure. As it is recommended by international legal scholars of bankruptcy[132], it is worthwhile for all developed countries that plan to reform their insolvency laws to examine the findings of this document, as simply catching up with the current rules of insolvency in the US might mean copying outdated solutions. The main reasons why a bankruptcy reform is needed in the US are the increase of use of secured credit, the increased complexity of companies with intricate debt structures, and also the general change from hard assets to intangible ones, such as intellectual property[133]. These developments could not be foreseen in 1978, so these new legal issues require new legislative answers, but not only in the US.

One of the biggest topics of ABI's recommendations is the need to focus on SMEs, as they are the main subjects of reorganizations (around 85 percent of all cases are SME cases in the US[134]). The main problems are that reorganizations are designed for large companies, which means that creditors are often not interested to get actively involved in the process of the small cases of SMEs, and the procedure itself is very cost-prohibitive as well[135]. The proposed solutions to these problems may not work in places less developed than the US but the problem itself is present everywhere, so each country has to consider finding individual answers for them.

Another key issue Hungary has to consider is paving the way for the efficient use of post-commencement credit. The World Bank echoes the importance of the access to post-

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[131] The whole document is available on ABI's website. https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h Accessed 2 April 2017.
[132] Bob Wessels, professor emeritus at the University of Leiden wrote in his summary of the ABI recommendations that „it is worthwhile for Europe and the rest of the world to understand the changes that are being proposed… since it would make little sense… to end up in a place where the United States no longer wants to be." For the whole chapter, see: B. Wessels, R J de Weijs, '*International contributions to the reform of Chapter 11 U.S. Bankruptcy code'* (Eleven international Publishing, 2015) pp. 3-43.
[133] B. Wessels, p. 8.
[134] *Ibid*. p. 7.
[135] *Ibid*. p. 36.

commencement finance for companies in distress, but such speculative ordeals require clear legal rules in order to make them available and affordable. As some of our competitors already have priority rules for this type of credit in the course of reorganization[136], they are getting ahead of us by creating a better chance for companies to survive. It is more important however, that some of the countries in the region also did not include this topic in their legal framework, which creates a great opportunity to get ahead of them – in the rankings, and in the overall economic performance as well.

It may be the most important objective for Hungary to create such conditions for reorganization that would change the outcome of a reorganization procedure, and instead of a likely piecemeal sale companies could continue operating as a going concern. This issue is examined under the 'outcome' indicator of the 'resolving insolvency' index in the Doing Business report[137]. Since it is such a complex issue that cannot be simply changed via legislative amendments[138], it is beyond the focus of this thesis. However, it is probably the most important aspect Hungary would have to focus its efforts – for which, the improvements in the SIF indicator recommended in this thesis might be the best first steps.

The ultimate benefit of going through with the amendments recommended in this thesis would not be the spectacular improvement in the Doing Business rankings, but a sensible increase in the rate of successful reorganizations in Hungary. Supporting reorganizations is the key trend[139] in current international legislation, as saving distressed companies instead of wiping them out has clear advantages, such as saving jobs and enabling entrepreneurs to keep on creating value. The creditors also would benefit greatly from such changes, as they would

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[136] See *Supra* note 125.
[137] For more details, see the methodology description of Doing Business. Available at: http://www.doingbusiness.org/Methodology/Resolving-Insolvency Accessed 6 April 2017.
[138] Unfortunately, the methodology description of the Doing Business report does not give any information about the exact way the 'outcome' indicator is measured, and it is most likely that its assessments is based only on the opinions of independent professionals, without any detailed calculation.
[139] See R. Stürner, p. 118.

be able to receive higher returns, which in turn would make credit less expensive. And credit is the lifeblood of any economy, as István Széchenyi has already recognized it almost two decades ago[140].

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[140] Count István Széchenyi was the greatest economist of XVIII. century Hungary, and probably his most influential work was titled Credit, which was published in 1830, and emphasized the importance of the availability of credit.

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