

## ADVANTAGES AND DISADVANTAGES OF PRE-BANKRUPTCY SETTLEMENT

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### Abstract

The Act on Financing and Pre-bankruptcy Settlement entered into force on October 2012. Government proposed Act as a response to fast growing illiquidity and insolvency. Years of irresponsible business operations brought many enterprises to the edge. There were two excuses for bringing Act. First one objected that most of enterprises are in situation where regular bankruptcy would lead to cessation of business. Second was connected to first one, stating that bankruptcy means loss of work places. Idea was to allow debtors to continue business by reprogramming and writing-off of part of debt with consent from majority of creditors.

Financial and operating restructuring plan, a key part of pre-bankruptcy settlement, sets how enterprise will operate and what is necessary for continuation of business. However, by accepting plan, creditors agree that some of their claims will not be settled. Therefore, Act approves non-payment of some of the debts, directly damaging creditors and other enterprises that pay on time. Reasonable question is: do saving enterprises and jobs justify unpaid debts? Moreover, there are no grants that enterprises who successfully settle will operate positive; and, if not – allowing them to continue business will only make new debts. Through three case studies paper shows how pre-bankruptcy settlement is conducted and what are advantages and disadvantages of settlement.

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## 1 Introduction

The Act on Financing and Pre-bankruptcy Settlement (later: the Act) was brought on October 2012. It was government response to growing problem of illiquidity and insolvency. Years of irresponsible business brought many companies to position where they could not operate. There were two excuses for the Act: wish to preserve companies and wish to preserve job places. Idea was to allow companies continuation of business with unblocking company's account and with write-off of part of debt. Everything should go with coordination between debtor and creditors. Therefore, idea where companies that are at the doors of bankruptcy – which would probably lead to cease of business – would be allowed to continue business operation, seemed as good solution and was welcomed in part of public. However, soon after the start of implementation of the Act, many problems came into light, and because of that Law had been changed four times in such a short period of time. Despite this fact, some of the major problems still exist: weak role of the Court, determination of claims, and legal relations after signing the settlement.

Paper is consisted from two parts. In first part is briefly explained pre-bankruptcy procedure: course of procedure, procedure authorities, and operating and financial restructuring plan. Second part offers critical review of pre-bankruptcy settlement in practice. Also, three case studies are used in paper. Paper aim is to critically evaluate pre-bankruptcy settlement, and to conclude can advantages of procedure overcome all disadvantages that are brought by it.

## 2 Pre-Bankruptcy settlement

Pre-bankruptcy settlement was imagined in the Act as a procedure which will allow entrepreneurs in financial problems to continue business operations. According to Act, entrepreneur is natural or legal person, who by itself manage economical or professional activity in order to gain income or other benefit. Aim is restitution of liquidity and solvency of debtor; the Act dictates that debtors who fulfil conditions from the Act are obliged to initiate the procedure. Key part of procedure is operating and financial restructuring plan. If creditors realise that proposed operating plan cannot guarantee positive business and income of additional money flows in future, and proposed financial restructuring plan is not supporting whole process of revitalization of company so that it can pay its debts on time, pre-bankruptcy settlement would be pointless, and for those companies bankruptcy would be better solution. (Garfulić, 2013, 28)

### **2.1. Pre-bankruptcy procedure**

Procedure can be conducted over legal person and over individual debtor (sole trader and artisan), and cannot be conducted over natural person. Procedure can be initiated only by debtor. He is obliged to initiate procedure in case of illiquidity and insolvency. Illiquidity appears when entrepreneur is not able to pay in time his liabilities. Entrepreneur is considered illiquid if in 60 days with financial restructuring outside of pre-bankruptcy settlement, is not able to reinstitute liquidity. Also he is illiquid if he is late more than 30 days with wages in amount from work contracts alongside with contributions.

Insolvency appears when entrepreneur becomes unable to pay or when he becomes overdue. He is overdue when he cannot in longer period of time respect his liabilities in period longer than 60 days. It is also considered that entrepreneur is overdue if value of his assets is lower than his debts.

There are two types of procedure: short procedure and regular procedure. Short procedure is conducted when liabilities do not cross amount of 2 million Kunas, and debtor do not employs more than 30 workers. In short procedure debtor is obliged to bring verification of signed agreements with creditors about their acceptance of operating and financial restructuring plan (<http://www.porezna-uprava.hr>). Regular procedure is conducted in all cases when two conditions for short procedure are not cumulative fulfilled. Pre-bankruptcy settlement procedure is urgent procedure and has to be over in 120 days, unless council allow to postpone it for maximum 90 days. Short procedure has to be over in 100 days. Proposal for pre-bankruptcy settlement debtor submits to Financial Agency (FINA). Procedure cannot be initiated over debtor who is in bankruptcy procedure. If there is negative outcome of settlement, ex officio is started bankruptcy procedure and which is aimed only on liquidation of debtor, end of his existence and erasing from register. Before bringing the Act in Bankruptcy Act were two possible solutions for companies who end up in bankruptcy. One was liquidation, and other was so called bankruptcy with restructuring. Other solution was for those companies who could survive on market, but was rarely used. Because of the Act Bankruptcy law had to be changed, where bankruptcy with restructuring has been abandoned (Barišić, 2013, 18)

### **2.2. Authorities in procedure**

Authorities in procedure are: Settlement Council and Pre-bankruptcy settlement Commissioner. Settlement council has a formal role, their task is to: lead pro-

cedure, bring solutions and conclusions, publish decisions and other documents on Financial agency's website, submit a proposal to institute bankruptcy procedure against debtor, name Commissioner, give instructions to Commissioner and supervise his work. As it was already mentioned Commissioner is named by Settlement council from bankruptcy trustee list. His tasks are: questioning the credibility of the documentation submitted by debtor, reviewing submitted claims, supervising debtor's financial business, notifying Council if debtor makes payments opposite to The Act, supervising payoff of costs of the procedure, supervising fulfillment of debtor's obligations towards creditors in contest of pre-bankruptcy settlement and performing other duties as requested by the presiding council.

When we speak about creditors, in order of deciding on a financial restructuring plan they are divided into three groups. One of the groups is consisted of public administrations and companies with majority state ownership. Second group is consisted from financial institutions and third group are other creditors. Creditors make decision by voting about the plan. They are allowed to vote in writing voting form which must be delivered to Settlement council, no later than beginning of hearing to vote. Creditors who's claims are determined have right to vote. Plan is considered accepted if is voted by creditors whose claims exceed half of value of established claims for each group of creditors, or if is voted by creditors whose claims exceed  $\frac{2}{3}$  of the value of all established claims.

### ***2.3. Operating and financial restructuring plan***

As it was already mentioned operating and financial restructuring plan is key part of settlement. It is responsible if there is going to be settlement or not. If creditors accept the plan, debtor is obliged to respect everything from it. Debtor's task is to convince creditors that pre-bankruptcy settlement is way better solution for them than the regular bankruptcy procedure. He needs to convince them that through settlement they will collect more than by selling all of his assets.

Nevertheless, in most cases value of assets is several times lower than liabilities; with regular sale of assets part of creditors would not be settled. In opposite case, where assets would cover majority of liabilities, creditors would not be ready to write-off debt, rather to collect from debtors assets. According to Article 43 of the Act, plan needs to incorporate facts from which can be red reason of deficiency of liquid fund. Also, there need to be calculation of deficiency of funds on day when financial report is presented. After that, there is description of measures for finan-

cial restructuring and calculation of their effect on profitability of business and elimination of insolvency. Those measures should ensure fresh capital for debtors and by that revitalization of business operation; often through inflow of new capital or from bank loans or by entrance of new owner.

Actually, whole plan goes around measures of operative restructuring and calculation of their effects on positive business, which should lead to revitalization of solvency. This measures should be sort of turnaround in business; while old way of business have brought company into problems. There should be strategically changes like change of targeted market, outsourcing, withdrawal from some services, wider range of service, change in number of employees, and all other measures for restructuring with which company can change temporally situation (Garfulić, 2013, 28). It is on debtor to offer creditors reduction of their claims. The Act holds some restrictions in this part. If debtor suggests reduction of liabilities, percentage that he offers to pay to creditors cannot be smaller than 30% – if he is to pay in period to maximum four years – or smaller than 40 % if period is longer than four years. What is noticeable in practice is that debtors usually use maximum reduction when it comes to debt towards state or state companies, but towards banks and bigger suppliers they are usually more careful, because those creditors in many cases cannot afford themselves to lose such big amount of claims, and would not vote for it. However, as it is to be shown later in paper, sometimes banks are against settlement but they do not have enough votes to stop it.

### **3 Pre-bankruptcy settlement in practice**

It can be said that none act can predict all cases in practice; however, when one act needs to be changed four times in less than year, it is clear that first solutions where deeply wrong. Exactly that happened to the Act, it has been changed two times in 2012 and two times in 2013. Nevertheless, act still have numerous problems, what will be shown in paper. There are few illogical regulations: role of the Court, procedure for determination of claims, and legal relations during and after signing the settlement.

#### **3.1. Role of the Court in Pre-bankruptcy settlement**

In Article 26 of the Act, pre-bankruptcy settlement procedure is conducted in regional centres of Financial Agency, whose territorial jurisdiction is in registered office of debtor. As it was already mentioned plan is considered accepted if is ac-

cepted by creditors with at least half of claims from every group or by creditors with 2/3 of claims. Until procedure is not over commercial court has no role. In Article 66 of the act stands that Court will with decision approve settlement if debtor and necessary number of creditors give their consent in hearing for conclusion of settlement, and if court approve that content of settlement is in accordance with general rules of court settlement, and its content is in essential manners adequately accepted plan on operating and financial restructuring plan. Therefore, we can say that judge is in position of Public Notary, he can only confirm settlement. What is not allowed for him is to question status of debtor and creditors, justification of certain claims and legality of whole procedure.

### **3.2. Pre-bankruptcy settlement case study**

With proposal for initiation of settlement, debtor is obliged to bring report on financial status and business. Therefore, he is obliged to report all his debts and claims. However, after proposal is accepted, FINA calls all creditors to deliver their claims. On tree case studies paper tries to show some advantages and disadvantages of institute of pre-bankruptcy settlement. All documentation used in this part of paper is available on Internet pages of Financial Agency (<http://predstecajnenagodbe.fina.hr>). On Internet page for public publication can be found all documents connected to certain pre-bankruptcy procedure. Basic criteria for searching documents are OIB or name of debtor. Software application usually shows primary results, like those brought by settlement council. (<http://www.fina.hr>)

First case is one of the most popular cases in media, case of company VOX. VOX has submitted proposal for initiation of pre-bankruptcy settlement, in which stands that VOX has one employee and debts which: “definitely goes above 10 million Kunas.” Than after request for amendment of proposal, VOX delivers documentation according to which debts are 12.3 million Kunas. Afterwards, proposal is accepted and creditors are called to deliver their claims. At the end, all claims were more than 77 million Kunas. Therefore, claims at the end of procedure were 60 million higher than in first proposal.

Second case is company METAL-COLOR. In proposal there is debt in amount of little less than 5.5 million Kunas. After call for creditors to deliver their claims amount rises above 28 million. Here we can also see that amount is 23 million Kunas higher than one in proposal.



Third case is company ENERGETIM. In its proposal debts are 3.3 million Kunas, and after call for creditors to deliver claims amount drops down to 2.4 million. In this case we see that debt is actually lower than debtor has applied.

From all these cases logical conclusion is that debtors usually do not know how big their debt is. Sometimes it is because of bad accountancy. However, it is possible, and what will be shown in this paper, that some of claims are not real, and that are applied only to gain necessary number of votes. Therefore we can say that there is serious question of fictive claims. Claims are not questioned in special procedure, it is only necessary to bring document proving that claim exists. Document itself is not questioned in any procedure. In Article 60/2 of the Act, existence and amount of claim for which there is consent of debtor and creditor, and claims for which there is writ of execution, are considered determined claims, unless debtor has public document that proves that claim does not exist anymore.

Therefore, it is enough that debtor accept debt and it is considered determined. This opens doors for various frauds, and what is directly connected with last chapter – inability of judge to indentify fraud. Consequently, it is possible that fictive claim appear only in order to ensure necessary majority for voting and for accepting settlement. How voting looks in practice we can see on case of VOX settlement where there were more than 53 million Kuna of debt written-off. From all claims that creditors held for acceptance of settlement voted 67.80 %, what is little more than 2/3. Against settlement were all creditors from second group of financial institutions with claims of more than 15 million Kunas, but that was not enough to change decision. In Plan for VOX it was proposed to write-off:

- All regular and penalty interests and 70% of principal for claims from group “companies in which state has major holdings”, “big suppliers”, “state budget” and “financial institutions”. Rest of debt would be paid with grace period of one year in equal monthly amount in four years,
- All regular and penalty interests and 60% of principal, with payment in 12 same monthly amounts for claims from group “small suppliers”,
- Workers claims will be paid at latest in 12 months from the day settlement is done,
- Interests (regular and penalty) for all groups of creditors are to be write off in whole amount.

Two more problems can be detected here. As it was said the Act was brought with idea of saving companies and work places. Question is if it is reasonable to save company which has only one employee? On the other hand, 1/3 of creditors' claims do not have any rights if majority decides to approve settlement. In VOX case that is 15 million Kunas. Nevertheless, considering possibility of fictive claims, it is clear that real creditors – because of whose protection the Act was brought in first place – can find themselves in situation where they cannot participate in making decisions.

In this part it is also important to note Article 60/8 where stands that if percentage of denied claims is more than 25% of amount of all claims, procedure of pre-bankruptcy settlement is dismissed. After dismiss, automatically starts bankruptcy procedure. Therefore, if there is some fictive claim – which court is not allowed to question – and debtor denies more than 25% of it, procedure is automatically dismissed. This Article allows third persons to fraudulently apply fictive claims and with that to stop settlement.

Second case METAL-COLOR suggested write-off:

- 40 % of liabilities to Ministry of Finance to amount of 1.044.724 Kuna, 40 % of liabilities towards suppliers to amount of 529.400 Kuna, and 40% of others short-term liabilities to amount of 500.981 Kuna. The income from depreciation allocated amounts total 2.075.105 Kuna.
- 60% of taxes and contributions is transferred to long-term debt (payment in installments), amount of which is 1.410.379 Kuna. Also 60 % of debt toward suppliers is transferred to long-term debts amount of which is 794.101 Kuna. Same way, 60 % of other short-term liabilities will result in amount of 751.471 Kuna. Total transfer towards long-term liabilities is 2.955.951 Kuna.

After conducting of financial restructuring plan short-term liabilities is reduced for 5.031.056 Kuna and now it amounts 405.692 Kuna. This amount could be covered by receivables dues from customers.

It is evident that in case of conducting financial restructuring plan company will become solvent and will be able to continue business operations. However, question is still if this plan is conductive, since it is based on predictions about positive business future.



#### 4 Post-settlement time

By pre-bankruptcy settlement debtor is exempt from paying to creditor amount that overgrows percentage agreed in settlement; deadlines are also determined in settlement. Nevertheless, all enforceable documents for claims inside of settlement lose their strength towards debtor in amount that is paid. (Cuveljak, 2012, 27). However if debtor pay any of these debts he was freed from he cannot ask for return of that amount.

In Article 82 it is explained what happens if settlement is not conducted entirely. In this case, creditors settled in amount from settlement do not have to return what they have been paid, but are considered as settled. Next, creditors who have been only partially settled can apply in bankruptcy procedure only rest of amount from settlement. At the end, creditors who did not get anything can apply in bankruptcy procedure only claims in amount from pre-bankruptcy settlement.

Possibly this is the biggest absurdity in whole Act. Creditors go into a pre-bankruptcy settlement mainly because it is considered that they can get more claims from settlement than from simple bankruptcy. After settlement is signed, nobody guaranties that it will be respected. Therefore, company who positively ended settlement is now allowed to continue business and also to create more debts and even to reduce its assets. If they do not respect settlement, and therefore comes to bankruptcy procedure, creditors do not get their rights before pre-bankruptcy settlement. And what is more, there is big possibility that they cannot collect any of their claims – what they might have been able to do if there was no settlement and just regular bankruptcy procedure. What is even worse, since there will be some creditors that got priority in settlement and succeeded to collect their claims, it is highly possible that others will not be able to collect even decreased amount from settlement.

Connecting fictive claims whit Article 82 it is not hard to imagine scenario where pre-bankruptcy settlement would be initiated only to pay some of creditors; and then after there is nothing left in company to start bankruptcy procedure. In regular bankruptcy procedure maybe those creditors would not have priority to collect their claims, and in pre-bankruptcy settlement it can be done by putting this in settlement.

Also, creditors with priority maybe would not be able to successfully vote against settlement because they would be in minority. Considering that there is no effective control over collecting claims and over operating and financial restructuring

plan, this scenario is possible. We need to wait year or two to see will this occur in practice, since there is small number of approved settlements which could already be breached.

## 5 Conclusion

The Act on Financing and Pre-bankruptcy Settlement is in force less than 20 months. For sure, it is too soon to see big positive or negative effects of it. The Act is brought with idea to allow entrepreneurs in problems clean start with fresh cash flow. Idea by itself is good and positive. What is not positive is way that this idea is implemented into the Act. In this paper we saw only few examples of Act's illogic solutions. Act that is currently in force allows several frauds, what can be seen from case studies. What is necessary is to increase role of court, so that it can stop fictive claims and fraudulent behaviour. Besides this, it is necessary to defend debtor from fictive claims which not exists and from which he will not be able to defend himself. It is obvious that legal effects in case of dismiss of pre-bankruptcy settlement and start of bankruptcy procedure, are not fair and needs to be changed. Whit those articles whole idea of settlement is automatically violated.

Advantage of this procedure is that some of companies will be saved from bankruptcy, mostly in cases where his liabilities are several time larger than assets. However, there should be some defined terms when it is possible for company to successfully continue with business, and that is something that cannot be left exclusively to debtor to decide – if he had know how to successfully run the business he would not be in position where he is. It must be noticed that there was sort of settlement in old Bankruptcy Act, called bankruptcy with restructuring, where creditors were those to decide should company continue to operate. However, there are only few cases where this possibility was exercised. It is obvious that creditors did not trust companies in bankruptcy and were not ready to take that risk. They did not trust that restructuring of company would help them to collect more of their claims. At present time situation is somehow completely changed. It should be mentioned one more time, that idea of settlement is not bad, but there must be some serious changes in the Act. Measures that should be added to settlement is necessity to do changes in management, easier entrance of creditors into ownership and choosing team of experts who would estimate can company effectively continue business or not, and who would create plan for that. It is in interest of everybody: owner, work-

ers, creditors, and state to allow business which can continue business operations to do so. However, that needs to be fair towards all of them.

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