

Deficiencies of the Hungarian Insolvency Act and Possible Remedies

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Radical reform overdue

- 2003-2004:
 - Working Group for the Re-Codification of Hungarian Insolvency Law
 - unitary approach with a common phase and 3 possible outcomes based on the creditors' decision: composition, reorganization or liquidation
- 2005:
 - revised Concept Paper by the Ministry of Justice
 - Government resolution on a new Insolvency Act
- 2006-2008:
 - only piecemeal amendments



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Improvements 2004-2008

- 2004:
 - transaction avoidance
 - interim (provisional) administrator
- 2006:
 - full priority of secured creditors
 - liability (?) for wrongful trading
- 2008:
 - on-line publication of winding-up orders (website of Companies Gazette)



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1. Company law creates incentive for owners and directors to attempt to avoid orderly closure of business activities



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Act on Public Company Information, Company Registration and Winding- Up Proceedings 2006

- Members' Voluntary Liquidation / Voluntary Winding-Up
- Termination of a company with unknown registered office



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Members' Voluntary Liquidation

- dissolution of a solvent company
- significant rise in the number of MVL proceedings in recent years
 - 2006: 5486 new MVL
 - 2007: 8836 new MVL
 - until 30 August 2008: 6200 new MVL
- the members of the company can appoint any person eligible for the office of director to be a liquidator
- no statutory order of priority
- often converted into insolvent liquidation
- misuse by insolvent companies to delay the opening of insolvency proceedings



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Termination of a company with unknown registered office I.

- a company can no longer be found at its registered office, place of business or branch
 - company directors cannot be located or their address is considered unknown (director residing abroad and having no registered agent for the service of documents)
- ↓
- public notice in the Companies Gazette to the company's members to restore lawful operations within 60 days
 - direct notice to members with more than 50 % of votes to restore lawful operations



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Termination of a company with unknown registered office II.

- if lawful operation not restored → order of the Companies Court for termination of the company
- search for assets:
 - public notice in the Companies Gazette
 - Companies Court contacts public registers
- if no assets discovered → the company is struck off the register without formal liquidation



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Registration of new companies I.

- considerably shortened registration times from 1 July 2008:
 - electronic registration within 1 hour in the simplified registration procedure (using template articles of association)
 - registration on the basis of paper documents: 15 days
- considerably reduced registration fee:
 - HUF 15,000 (€ 60) irrespective of the legal form of the company



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Registration of new companies II.

- considerably reduced minimum capital requirement from 1 September 2007
 - GmbH-style limited liability companies:
 - HUF 500,000 (€ 2,000)
 - private companies limited by shares:
 - HUF 5 million (€ 20,000)



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Directors' duty to apply for insolvency proceedings

1991-1993:

- directors under duty to apply for *bankruptcy* proceedings within 8 days from the company's becoming unable to pay a debt for 90 days after maturity
- failure to file for bankruptcy resulted in the civil liability (in tort) of directors

1993:

- abolition of duty to apply for bankruptcy



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Compare

- Germany:
 - duty to file without undue delay, but by the latest within 3 weeks from *Zahlungsunfähigkeit* or *Überschuldung*
- France:
 - duty to file for *redressement judiciaire* or *liquidation judiciaire* within 45 days of the cessation of payments [unless *conciliation*]
- Spain:
 - duty to file within 2 months from becoming aware of insolvency
- Czech R:
 - duty to file without undue delay after becoming aware of insolvency



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2. One-dimensional corporate insolvency law: lack of an effective and efficient rescue procedure



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Insolvency Act 1991

- applicable only to corporate debtors
- corporate insolvency: two-track approach
 - bankruptcy [csődeljárás] – purpose in theory: reorganization/composition
 - liquidation (winding-up) [felszámolási eljárás]



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“Bankruptcy proceedings”

- no substantive standard of insolvency to be satisfied
- no automatic stay of creditor action upon application
- the debtor has to
 - convene a meeting of creditors and
 - obtain the consent of a considerable proportion of the creditors to the stay
- practically out of use:
 - only 8 such proceedings commenced in 2006
 - only 1 in 2007
 - only 2 in Q1 of 2008



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Proposals for introduction of a rescue procedure

- Working Group for the Re-Codification of Hungarian Insolvency Law (2003-2004):
 - one route of entry into corporate insolvency procedures
 - common period of observation
 - different potential outcomes based on creditors' decision
- Ministry of Justice reform plans for 2009:
 - wholesale review of the provisions on bankruptcy proceeding, but separate legal avenues for reorganization and liquidation



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3. Lack of an efficient liquidation proceeding



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Commencement standards I.

- creditor application:
 - failure of a debtor to dispute or pay a debt within 15 days after maturity and failure to pay after a subsequent written demand of the creditor
 - failure of a debtor to pay a debt within the deadline set by a final court order
 - unsuccessful debt recovery action (judicial enforcement)
 - failure of the debtor to respect its obligations under the “bankruptcy settlement”



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Commencement standards II.

- debtor application (since 1 September 2007):
 - the debtor may make an application simply by declaring its state of insolvency or imminent insolvency
 - no requirement to satisfy some substantive standard of insolvency



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Debtors with insufficient assets

- 90 % of all liquidation proceedings
 - simplified liquidation proceedings
 - state liability for liquidators' remuneration (a total of approx. € 6,500,000 between 2002 and 2006)
- 2008: initiative to amend the Act on Company Registration
 - Company Court to strike the company off the companies register upon application from the tax authority following the latter's unsuccessful attempt to enforce tax claims (presumption of insufficiency of assets)
 - idea discarded for fear of fraud



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Compare

- France:
 - *clôture pour insuffisance d'actif*
 - *liquidation judiciaire simplifiée*
- Netherlands:
 - *opheffing wegens gebrek aan baten (90 %)*
 - *vereenvoudigde afwikkeling*
- Czech R.:
 - application can be dismissed on the grounds of insufficiency of assets (s. 144 of new Insolvency Act)
- Spain:
 - *inexistencia de bienes y derechos del concursado ni de terceros responsables con los que satisfacer a los acreedores (art. 176 LC)*



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Length of proceedings

- ECHR, *Bíró v. Hungary* (2006): liquidation still pending after 11 years, violation of creditor's right to a fair trial under the European Convention on Human Rights
- not even simplified liquidation proceedings can be concluded earlier than 1 year from the opening of the proceedings



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Insufficient creditor control over the process

- creditors' committee
 - formation not mandatory
 - lack of interest because of insufficiency of assets
 - rarely formed in the case of small and medium size companies
- lack of information
- creditors cannot nominate a liquidator or apply for the removal/replacement of the liquidator
- liquidator has much discretion e.g. decision to keep the debtor as a going concern



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Appointment of liquidator

- **Montenegro:** Initial appointment by the court. Court must change appointment and appoint office holder proposed by 60% of creditors at their first meeting.
- **Bulgaria:** The creditors nominate and the court appoints the liquidator.
- **Romania:** The court makes initial appointment. Appointment must be confirmed by assembly of creditors or, if the creditors propose a different office holder, the court must make a new appointment accordingly.



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Keeping the debtor as a going concern

- Dutch Voorontwerp-InsW:
 - subject to the approval of the creditors' committee or that of the *rechter-commissaris*, if for more than 1 month from the opening of the proceeding
- France:
 - *maintien provisoire d'activité* subject to court authorisation, maximum: 3 (+3) months, if sale as a going concern envisaged or justified by public interest



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Secured creditors

- before 1 January 2007: priority limited to 50 % of the proceeds
- since 2007:
 - full priority (~ *Absonderungsrecht*)
 - enterprise charge: priority limited to 50 % of the proceeds
- charges over all or substantially all of the assets of a company: which priority rule applies?

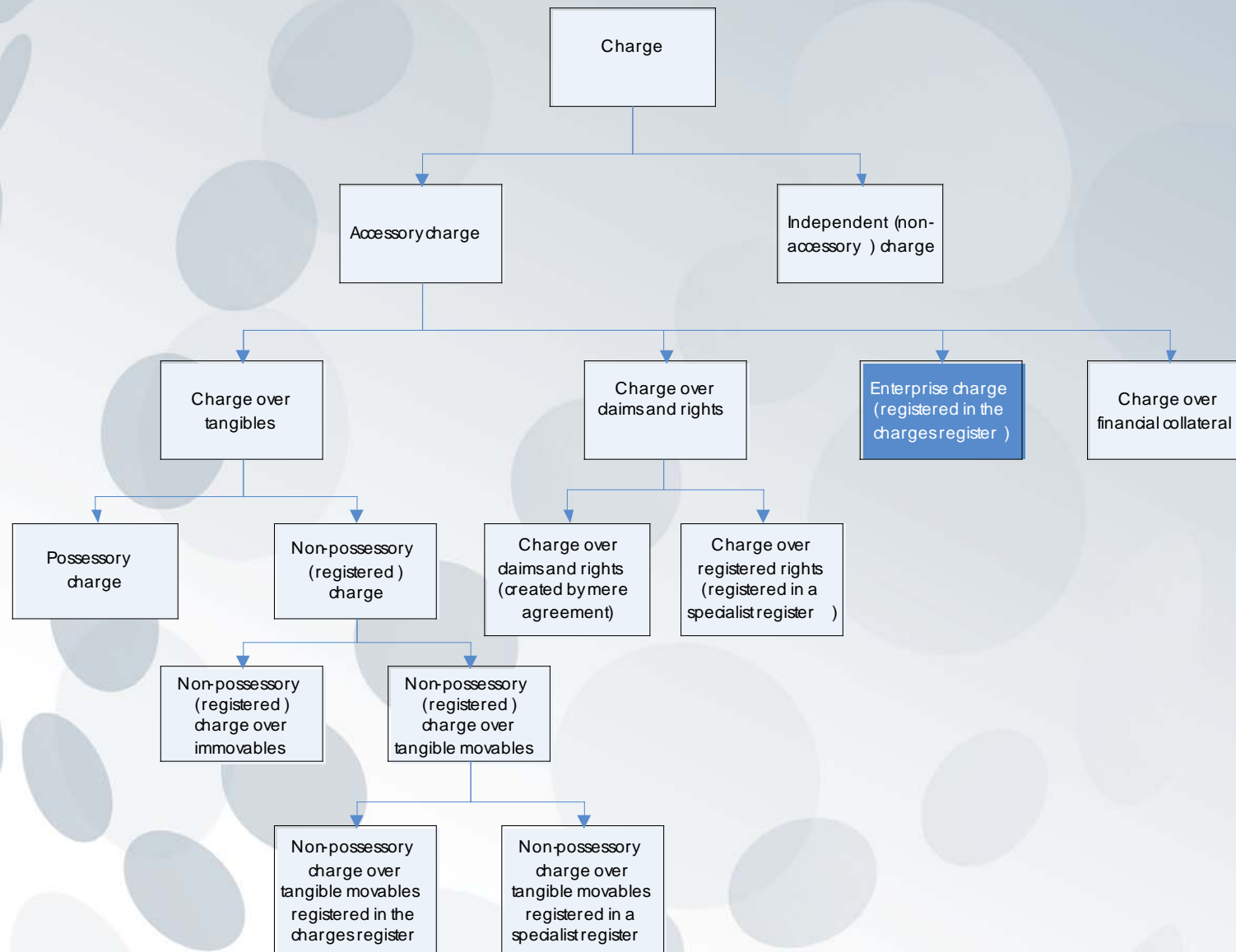


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Types and sub-types of charge



Quasi-security (title finance)

- genuine security:
 - encumbered assets included in the insolvency estate (but full priority of secured creditors since 2007)
- quasi-security:
 - third-party-owned assets outside the insolvency estate
- equal (functional) treatment of all security devices could contribute to wealth maximisation and transparency



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Compare

- InsO (Germany):
 - assimilation of security transfer of ownership and security assignment to genuine security rights (*Absonderungsrecht*)
- Ley concursal (Spain):
 - extension of the functional approach to retention of title and finance lease (*bienes muebles no consumibles e identificables*)



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Transaction avoidance I.

- 2004: reform along the lines of UNCITRAL Legislative Guide
- types of avoidable transactions and length of the suspect period:
 - fraudulent transactions (within 5 years of application)
 - undervalue transactions (within 2 years of application)
 - preferential transactions (within 90 days of application)
- parties entitled to commence avoidance proceedings:
 - liquidator
 - any creditor (on equal basis with the liquidator)



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Transaction avoidance II.

- funding:
 - liquidator (in the name of the debtor) → out of the insolvency estate
 - creditor → out of the creditor's own funds
- effect of avoidance:
 - not regulated
 - ambiguity in case law



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Liability for wrongful trading I.

2006:

- Companies Act: from the time of imminent insolvency directors must exercise their powers in the best interests of creditors
- Insolvency Act: 'wrongful trading' provisions introduced
 - applies to those who served as *de jure* directors or acted as *de facto* directors in the 3 years prior to commencement of liquidation



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Liability for wrongful trading II.

- ground of liability:
 - the director has not exercised his powers in the best interests of the creditors from the time when he knew or ought to have concluded that the company will be unable to pay its debts as they fall due (imminent insolvency)
- defence:
 - proof of having taken all the measures necessary to minimize the loss to creditors



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Liability for wrongful trading III.

- lack of clear guidance to directors as to what is expected of them
 - the only irrebuttable presumption of 'wrongful trading': if the director has not performed his obligations with respect to the publication of annual accounts
- directors cannot protect themselves by applying for a reorganization proceeding → wrongful trading provisions do not encourage timely application for an insolvency proceeding



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Enforcement of liability for wrongful trading I.

- two-stage proceeding:
 - during the liquidation proceeding, the creditors or the liquidator can apply to the court for a declaratory judgment
 - after the conclusion of the liquidation proceeding, creditors with unsatisfied claims have 90 days to apply to the court for an order requiring the directors to satisfy these claims



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Enforcement of liability for wrongful trading II.

- directors will not contribute to the insolvency estate → liquidator has no interest in making applications for declaratory judgments
- funding of wrongful trading actions unclear
 - as opposed to funding of avoidance proceedings, where the liquidator initiates proceedings on behalf of the corporate debtor
- creditors may not obtain the necessary information



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Compare

- England, Insolvency Act, s. 214
 - contribution to the company's assets, not payment directly to creditors
- Spain, Ley concursal:
 - *concurso culpable* → obligation to pay the *déficit concursal*
- France, Code de commerce:
 - *responsabilité pour insuffisance d'actif*
 - *obligation aux dettes sociales*
- Dutch Voorontwerp-InsW, Art. 8:
 - liability of directors for obligations incurred after *de facto* insolvency – towards creditors
 - liability for unpaid debts – towards the estate



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Disqualification of directors

- sole ground for disqualification: being *de jure* director of a company in the year prior to its termination (for unknown registered office)
- period of disqualification: 2 years from the company's removal from the companies register
- participation in wrongful trading does not result in disqualification
- no register of disqualified directors



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4. Lack of an adequate institutional framework for the regulation, licensing and oversight of the insolvency profession



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Authorisation/Licensing

- list of IPs maintained by the Ministry of Finance
 - Ministry decides when to issue call for new applications, no call for applications since 1997
 - period of authorisation: unlimited
- only firms can be licensed
 - either a limited liability company (~ GmbH)
 - or a private company limited by shares
- IP firms must employ (have a contract with) at least 2 lawyers, 2 economists, 2 auditors
- the firm designated by the court as liquidator appoints an individual to act on its behalf



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Ensuring appropriate qualification

- no requirement to attend a specialized training course or to pass an examination set by a professional body
- no monitoring of compliance with qualification requirements
- sale of shares of IP firms together with licences
- licences: transferable patrimonial rights?
- cross-ownership
 - multiple IP firms owned by the same person
 - between IP firms and factoring companies



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Licensing and oversight

- Insolvency Practitioners' Association
 - no power to authorise (license) insolvency practitioners
 - membership not a precondition of admittance to the list of insolvency practitioners
- no government agency comparable to
 - the Insolvency Service (England & Wales)
 - the Accountant in Bankruptcy (Scotland) or
 - the *Conseil national des administrateurs judiciaires et des mandataires judiciaires* (France)



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5. Incomprehensiveness: no insolvency regime for natural persons (consumers) and sole traders



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