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WHEN NONUSE IS USEFUL: BANKRUPTCY LAW IN POST-COMMUNIST CENTRAL AND EASTERN EUROPE

Michael Kim

INTRODUCTION

From the death of Communism in Central and Eastern Europe ("CEE")¹ arose the difficult task of developing market-based economies.² CEE nations faced a Communist legacy that posed the antithesis of a market economy. Prior to 1989, Communist ideology had dictated the social and economic policy of CEE nations, stressing a centralized government and socio-economic collectivism.³ Under Communism, the government owned all assets and planned the actions of most economic actors, such as banks, enterprise managers, and labor.⁴ Through centralized control, the state ensured an artificially stable economy: the state controlled the allocation of investment, credit, and wages,⁵ investing in and subsidizing banks and enterprises, even when they were not making profits;⁶ and the state

1. 1 Jonathan R. Macey & Enrico Colombatto, *Public Choice Theory and the Transition Market Economy in Eastern Europe: Currency Convertibility and Exchange Rates*, 28 Cornell Int'l L.J. 387, 387 (1995) [hereinafter Macey & Colombatto, *Public Choice*]. Although the term "Central and Eastern Europe" covers Hungary, Poland, the former Czechoslovakia, Bulgaria, Romania, Albania, the former Yugoslavia, and the former Soviet Union, this Note will focus on Hungary and the Czech Republic.

2. William C. Philbrick, *The Task of Regulating Investment Funds in the Formerly Centrally Planned Economies*, 8 Emory Int'l L. Rev. 539, 539 (1994) [hereinafter Philbrick, *The Task of Regulating*]; see Roman Frydman & Andrzej Rapaczynski, *Institutional Reform in Eastern Europe: Evolution or Design?*, 1992 B.Y.U. L. Rev. 1, 5-14 [hereinafter Frydman & Rapaczynski, *Institutional Reform*]. A market-based economy is "any economic system based on private ownership of all factors of production in which owners of capital act as entrepreneurs and coordinate their activity through use of the market." Carolyn Brzezinski, *Competition and Antitrust Law in Central Europe: Poland, the Czech Republic, Slovakia, and Hungary*, 15 Mich. J. Int'l L. 1129, 1129 n.1 (1994).

3. Macey & Colombatto, *supra* note 1, at 388; Sheila M. Puffer & Daniel J. McCarthy, *Finding the Common Ground in Russian and American Business Ethics*, Cal. Mgmt. Rev., Vol. 37, No. 2, Jan. 1995, at 29, available in LEXIS, Nexis Library, NEWS file, at *4. In Communist CEE, two types of centrally planned economies existed: the first controlled the quantity of production with fixed prices and market, evincing little regard for reforms to increase overall productive efficiency, e.g., Bulgaria and Romania; the second made attempts at limited reform to allow some market economy concepts to guide economic decisions, e.g., Hungary and the former Czechoslovakia. Macey & Colombatto, *Public Choice*, *supra* note 1, at 388; see Michele Balfour & Cameron Crise, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 Fordham Int'l L.J. 84, 87 n.5 (1993).

4. See Frydman & Rapaczynski, *Institutional Reform*, *supra* note 2, at 2 ("Eastern Europe has a very specific industrial infrastructure, a product of a command economy."); Macey & Colombatto, *Public Choice*, *supra* note 1, at 388.

5. Brzezinski, *supra* note 2, at 1130.

6. Fred Luthans et al., *Doing Business in Central and Eastern Europe: Political, Economic, and Cultural Diversity*, Bus. Horizons, Vol. 38, No. 5, Sept. 1995, at 9,

further distorted the statistics of the "financial health" of the economy.⁷ The "consistent" economy provided socio-economic stability⁸ and instilled such expectations in banks and state-owned enterprises⁹ ("SOEs"), as well as the general public.¹⁰ Two results of this planned economy were the absence of bankruptcies and full employment.¹¹

Consequently, economic actors living under Communism were not financially disciplined, but were indifferent about profits or economic success.¹² Investment decisions in the state sector were not driven by profit-motive.¹³ Under Communism, people ignored basic market principles, such as profit-maximization, and were insulated from competition;¹⁴ therefore, there was no need for basic market mechanisms, such as bankruptcy laws¹⁵ or competition laws.¹⁶

After the end of Communism, the CEE nations scrambled to begin their socio-economic transition toward market economies.¹⁷ Hence, the CEE transition economy was born. By its very definition, the

available in LEXIS, Nexis Library, NEWS file, at *5; Alisa Yamnarm, Note, *The Crisis of Unemployment and the Future of Reform in Central and Eastern Europe: Hungary as a Model*, 3 Cardozo J. Int'l & Comp. L. 181, 189-90 (1995).

7. See, e.g., Steve Campbell, Comment, *Brother, Can You Spare a Ruble? The Development of Bankruptcy Legislation in the New Russia*, 10 Bankr. Dev. J. 343, 354-55 (1994) (noting the former Soviet Russian practice of supporting inefficient firms).

8. Ronald Daniels & Robert Howse, *Reforming the Reform Process: A Critique of Proposals for Privatization in Central and Eastern Europe*, 25 N.Y.U. J. Int'l L. & Pol. 27, 67 (1992); see Luthans et al., *supra* note 6, at *5; see also Frydman & Rapaczynski, *Institutional Reform*, *supra* note 2, at 15 (commenting on the "long tradition of government paternalism").

9. Paul Marer, *Transformation of a Centrally-Directed Economy: Ownership and Privatization in Hungary During 1990*, in *Privatization and Entrepreneurship in Post-Socialist Countries* 173, 178 (Bruno Dallago et al. eds., 1992).

10. See, e.g., Balfour & Crise, *supra* note 3, at 85 ("[P]rivatization will impose economic hardships on the public which will demand the relief it is accustomed to receiving from political leadership.").

11. David C. Bangert, *Hungary: Exploring New European Management Challenges*, Int'l Stud. of Mgmt. & Org., Vol. 24, No. 1-2, Mar. 22, 1994, at 209, available in LEXIS, Nexis Library, NEWS file, at *2.

12. See Macey & Colomatto, *Public Choice*, *supra* note 1, at 389.

13. See, e.g., Márton Tardos, *Property Relations in the Period of Transition*, in *Privatization and Entrepreneurship in Post-Socialist Countries* 59, 59 (Bruno Dallago et al. eds., 1992).

14. Brzezinski, *supra* note 2, at 1129-30, 1129 n.3 (noting how Communist "non-competitive" economic systems created a need for competition law); see Stephen S. Cohen & Andrew Schwartz, *The Tunnel at the End of the Light: Privatization in Eastern Europe*, 7 Transnat'l Law. 7, 12-17 (1994); see also George Bogdan, *The Economic and Political Logic of Mass Privatization in Czechoslovakia and Poland*, 4 Cardozo J. Int'l & Comp. L. 43, 43-45 (1996) (noting that, as a result of an extensive history of centralized planning, post-Communist Eastern European countries "have to recreate private property and capital markets virtually from scratch"). For a definition of profit-maximization, see A. Mitchell Polinsky, *An Introduction to Law and Economics* 10 (2d ed. 1989).

15. See Brzezinski, *supra* note 2, at 1130; Campbell, *supra* note 7, at 346.

16. See Brzezinski, *supra* note 2, at 1130.

17. See Balfour & Crise, *supra* note 3, at 85; see, e.g., Pamela B. Sak & Henry N. Schiffman, *Bankruptcy Law Reform in Eastern Europe*, 28 Int'l Law. 927, 927 (1994)

transition economy simultaneously *pursued* the goals of a market economy and *subjected* itself to market economy rigors.¹⁸ Although a market economy was not firmly established, free market laws which were no longer completely restrained by the state began to impact economic actors.¹⁹

The first step in establishing a market economy is the creation of private owners by distributing former state-owned property to the public.²⁰ Private ownership forms the essence of a free market: without the liberty to own and control property, no voluntary buying and selling can occur.²¹ Therefore, by 1992, most CEE nations had either initiated the privatization of government-held assets or adopted such plans.²²

After privatization, however, additional steps are necessary²³ because countries still lack basic free-market mechanisms that constitute the market economy infrastructure.²⁴ Western theorists advised that, in CEE nations, one of these steps was the implementation of an effective bankruptcy law. Western theory counseled the enactment of two policies to help prepare for effective bankruptcy laws: first, CEE nations would release price controls and second, CEE nations would make their currencies convertible by establishing an exchange rate.²⁵ Western advisors, applying the logic of Western markets, then envisioned that CEE nations would need to use the bankruptcy law as the

(noting that CEE nations “formerly had centrally planned economies and decided in the past few years to adopt new economic systems”).

18. See Balfour & Crise, *supra* note 3, at 87.

19. *Id.*

20. Cohen & Schwartz, *supra* note 14, at 8-9; see Tardos, *supra* note 13, at 60 (stating that “property reform is needed” when establishing a market economy).

21. Tardos, *supra* note 13, at 64.

22. Ronald A. Cass, *The Optimal Pace of Privatization*, 13 B.U. Int’l L.J. 413, 415 (1995); *Chapter 3 - Progress in Reform (Part 3 of 5)*, EBRD Ann. Econ. Outlook, Sept. 1993, at 31, *7 [hereinafter *Chapter 3*]. Privatization commonly is defined as “the sale of a state-owned business to parties other than the state.” Cass, *supra* at 415.

23. See Cohen & Schwartz, *supra* note 14, at 7; *Stabilization, Reform, and the Role of External Financing in the Countries in Transition*, World Econ. Outlook, May 1994, at 67, available in LEXIS, Nexis Library, NEWS file, at *15 [hereinafter *Stabilization, Reform*] (“To reap the benefits of privatization, it will also be necessary to strengthen enterprise governance and market incentives in general [For example,] [fundamental aspects of commercial law, such as ownership and bankruptcy, must be clarified.]”).

24. See *infra* part I.A-B.

25. Macey & Colomatto, *Public Choice*, *supra* note 1, at 392-99; *The New Bohemians*, *Economist*, Oct. 22, 1994, at 23 [hereinafter *Bohemians*] (analyzing how the Czech Republic initiated the privatization process by freeing price controls and making the currency convertible for trade purposes); see Sanjay Dhar & Marcelo Selowsky, *Dealing with the Bad Debt Problem in Transition Economies*, *Fin. & Dev.*, Vol. 31, No. 2, June 1994, at 44, available in LEXIS, Nexis Library, NEWS file, at *1 (describing the legacy of nonperforming loans since there have been major shifts in relative prices due to a “breakdown of trading arrangements under the CMEA (the former socialist country trading bloc)” and a reduction of government subsidies).

primary market restructuring mechanism of their economies.²⁶ In theory, bankruptcy law would restructure markets²⁷ by taking assets from insolvent or near-insolvent ("nonviable") enterprises and funneling the assets to profit-making enterprises.²⁸

Many Western economists advocated, and continue to argue, that CEE nations should actively use bankruptcy laws.²⁹ In their view, such effectiveness implies a healthy market economy.³⁰ In an economy where market competition resounds, some enterprises must fail and then resort to the bankruptcy law.³¹ Jaromir Cekota of the European Bank for Reconstruction and Development stated, "[i]f you don't have bankruptcies, this is the economic equivalent of constipation [which] is bad for the whole organism."³² One commentator argued

26. Evan D. Flaschen & Timothy B. Desieno, *The Development of Insolvency Law as Part of the Transition from a Centrally Planned to a Market Economy*, 26 Int'l Law. 667, 668-69 (1992); David Fondler, *Seminar Focuses on Flaws in the Country's Bankruptcy Laws*, Prague Post, June 7, 1995, available in LEXIS, Nexis Library, NEWS file, at *1 ("[W]ithout bankruptcy, a market economy cannot exist. That's why more bankruptcies would not necessarily be a problem for the Czech economy."); see Sak & Schiffman, *supra* note 17, at 927-29; see also *Testimony July 15, 1994, John E. McLaughlin, Director of Slavic and Eurasian Analysis, Central Intelligence Agency Before the Technology and Nat'l Security Subcomm. of the Joint Economic Comm. of Congress*, Federal Document Clearing House Congressional Testimony, available in LEXIS, Nexis Library, NEWS file, at *3 (noting the lack of market mechanisms to better allocate funds, and thus help the restructuring process); Balfour & Crise, *supra* note 3, at 122 (discussing how bankruptcy law closely accompanied the Polish privatization program); Scott Horton, *The Death of Communism and Bankruptcy Reorganization*, 13 Am. Bankr. Inst. J., Apr. 1994, at 12, 12, available in Westlaw, TP-ALL Library (labelling bankruptcy, in the words of Russian First Deputy Prime Minister Gaidar, "as the ultimate corrective").

27. For purposes of this Note, the term "market" means a market economy, which includes specific markets such as a securities market and stock market. See William C. Philbrick, *The Paving of Wall Street in Eastern Europe: Establishing the Legal Infrastructure for Stock Markets in the Formerly Centrally Planned Economies*, 25 Law & Pol'y Int'l Bus. 565, 565-67 (1994) [hereinafter Philbrick, *The Paving*].

28. Balfour & Crise, *supra* note 3, at 85; Horton, *supra* note 26, at 12; Sak & Schiffman, *supra* note 17, at 927; Peggy Simpson, *O Easy Fix for Ineffective Bankruptcy Laws*, Warsaw Bus. J., May 5, 1995, at 7, available in LEXIS, Nexis Library, NEWS file, at *1-2; see also *Chapter 3, supra* note 22, at *8 (describing "efficient resource allocation" as a goal of bankruptcy law). Insolvency may be defined as the condition when debts exceed assets, but because balance sheets can be "notoriously inaccurate," a definition can also look at cash flow to see whether debts are paid as they come due. *Id.* at *2.

29. Sak & Schiffman, *supra* note 17, at 927 n.1.

30. See Fondler, *supra* note 26, at *1; *Bankruptcy Takes Hold in Central Europe*, Int'l Trade Fin., Dec. 15, 1995, available in LEXIS, Nexis Library, NEWS file, at *1 [hereinafter *Bankruptcy Takes*] ("In the west, bankruptcy plays a permanent but small role in the economy . . ."); Lidia Sosnowska-Smogorzewska, *Bankruptcy Proceedings Seminar, Unfreezing Liquidation Processes*, The Warsaw Voice, May 14, 1995, available in LEXIS, Nexis Library, NEWS file, at *1; *The Loveliness of Bankruptcy*, Economist, Feb. 18, 1995, at 66 [hereinafter *The Loveliness*] (describing bankruptcy as "one way of placing companies in the hands of more effective owners . . .").

31. See *The Loveliness, supra* note 30, at 66.

32. *Think About It*, Chi. Trib., Oct. 11, 1995, at 3 (citing undeveloped bankruptcy law as one of Slovakia's faults).

that bankruptcy law's restructuring function was as critical to the success of transition economies as other laws that focused more directly on market-defining financial institutions such as banking regulation, securities, and commodities laws.³³

The use of bankruptcy law, however, has not gone exactly as Western theories would have suggested.³⁴ At this time, CEE bankruptcy laws have not been utilized substantially on all levels. Governments, banks, and creditors have been reluctant to initiate bankruptcy proceedings, and debtors and nonviable enterprises have not sought bankruptcy law protection.³⁵ The underuse of bankruptcy law in CEE market restructuring has disturbed Western advisors who have attributed the underuse to procedural and personnel deficiencies rather than to substantive defects.³⁶ Although the West and CEE nations did not anticipate bankruptcy nonuse, this phenomenon should not be alarming.

Certain Western advisors have misunderstood the post-Communist context.³⁷ Western criticism of CEE bankruptcy nonuse is based on the erroneous, implicit assumption that a functional free market structure exists in the CEE region.³⁸ Until CEE nations create an environment conducive to capitalist behavior, bankruptcy law simply is not needed as a prominent economic mechanism. Other economic restructuring devices have played and will play the role traditionally played by bankruptcy law.³⁹

This Note argues that despite Western advice, the nonuse of bankruptcy law in CEE transition economies is a healthy phenomenon. Part I analyzes Western market economists' advocacy of functional bankruptcy laws in the post-Communist state. Part II describes, through case studies of the Czech Republic and Hungary, how differ-

33. Flaschen & Desieno, *supra* note 26, at 668.

34. *Chapter 3, supra* note 22, at *9-10 (recognizing that "there have been few major bankruptcy filings to date" and that "most countries have done little to utilise this [bankruptcy legal] framework"); Milan Zeleny, *Economies Cannot Be Shocked Into Reforms*, *The Prague Post*, Jan. 5, 1994, available in LEXIS, Nexis Library, NEWS file, at *1; see Anthony V. Raftopol, Note, *Russian Roulette: A Theoretical Analysis of Voucher Privatization in Russia*, 11 B.U. Int'l L.J. 435, 478 (1993) ("[In Russia,] the impact and viability of the new [bankruptcy] regulatory scheme remain untested."); *Bankruptcy Takes, supra* note 30, at *1; Dhar & Selowsky, *supra* note 25, at *5.

35. *Bankruptcy Proceedings Are Ineffective in Czech Republic, Say Foreign Experts*, *Hospodárske Noviny*, June 1, 1995, at *1 [hereinafter *Bankruptcy Proceedings*]; Enrico Colombatto & Jonathan Macey, *Exchange-Rate Management in Eastern Europe: A Public-Choice Perspective*, 16 Int'l Rev. L. & Econ. 195, 199 (1996); see Bernard Black & Reinier Kraakman, *A Self-Enforcing Model of Corporate Law*, 109 Harv. L. Rev. 1911, 1968 (1996).

36. *Bankruptcy Takes, supra* note 30, at *1-2.

37. Horton, *supra* note 26, at 12.

38. Roman Frydman & Andrzej Rapaczynski, *Privatization in Eastern Europe: Is the State Withering Away?* 14 (1994) ("The people . . . have a somewhat ambivalent attitude towards privatization and market economy as a whole.") [hereinafter *Frydman & Rapaczynski, Privatization*].

39. See *infra* part IV.

ent privatization paradigms gave rise to different kinds of bankruptcy law regimes.⁴⁰ These regimes fall into two general categories: liberal and stringent bankruptcy laws. Part III illustrates that neither liberal nor stringent bankruptcy laws have been used substantially. Specifically, part III determines that culturally, the Communist legacy has shaped the transition economy's hostile attitude toward bankruptcy law. Furthermore, part III focuses on the economic aspect of the Communist legacy which left the CEE region with a horrifying potential for mass bankruptcies,⁴¹ and presents difficulties specific to a transition economy that bankruptcy law cannot address. Finally, part IV explains that bankruptcy law is not necessary at this transitional stage because other restructuring mechanisms are fulfilling the role of bankruptcy law. Bankruptcy law nonuse does not indicate that a transition economy is in poor condition. Rather, its absence allows for the necessary gradual restructuring of CEE nations. This Note concludes that contrary to market theory, CEE nations, constantly moving toward a Western market economy, did not need to use bankruptcy law and instead employed other restructuring mechanisms.

I. THE THEORETICAL BASIS OF THE TRANSITION ECONOMY'S PURPORTED NEED FOR BANKRUPTCY LAW

Because CEE nations lacked market economy infrastructures after the demise of Communism, the West enthusiastically recommended that they immediately implement free market laws such as bankruptcy law.⁴² Western advisors, economists, and commentators theorized that bankruptcy law in the CEE region would serve the same function as it does in the West: the restructuring of markets through asset-allocation.⁴³ This part examines, first, how the Communist legacy left CEE nations in desperate need of market restructuring, and second, how in response to this need, Western specialists proposed bankruptcy laws to serve this role.

40. See *infra* part II.

41. See, e.g., Campbell, *supra* note 7, at 358 (describing how Russian legislators feared that a bankruptcy law would cause almost all firms to be declared bankrupt because of "the poor economic situation and the large amount of inter-enterprise debt.") Loss-making businesses are estimated to comprise one-third to one-half of inherited portfolios of large-scale state enterprises in the former eastern bloc. Stilson Nestor & Scott Thomas, *Privatization Through Liquidation; Economies in Transition; Industry Overview*, OECD Observer, No. 192, Feb. 1995, at 36, available in LEXIS, Nexis Library, NEWS file, at *1.

42. Paul H. Brietzke, *Designing the Legal Frameworks for Markets in Eastern Europe*, 7 *Transnat'l Law* 35, 38-40 (1994); Daniel T. Ostas & Burt A. Leete, *Economic Analysis of Law as a Guide to Post-Communist Legal Reforms: The Case of Hungarian Contract Law*, 32 *Am. Bus. L.J.* 355, 398 n.26 (1995); see Andrei A. Baev, *The Privatization of Land in Russia: Reforms and Impediments*, 17 *Loy. L.A. Int'l & Comp. L.J.* 1, 33 (1994). The author, a Western-educated professor of law in Russia, publishing in an American law school journal, urges the Russian government to implement bankruptcy laws. *Id.*

43. See *infra* notes 69-72 and accompanying text.

A. *The Need for Forced Structuring of the Market*

The Communist legacy created the need for a restructuring mechanism, such as bankruptcy law. Despite the fall of Communism, its negative impact lingers⁴⁴ in CEE economies, especially in the banking industries and among potential investors.

First, generally, post-Communist CEE nations need to establish cooperative market institutional links between government, labor, suppliers, manufacturers, and consumers.⁴⁵ These links did not exist because, under Communism, there was no need to improve economic efficiency.⁴⁶ Under Communism, CEE nations never suffered economic instability because the state, as the central macroeconomic actor, made impossible the very concept of market failure.⁴⁷ It avoided market failure by fixing currency and commodity prices to guarantee attainment of government-set production goals.⁴⁸ Further, the state served as the chief investor in, and subsidizer of, the economy, supporting inefficient firms and entire industries.⁴⁹ A Communist economy, particularly with respect to large firms, was integrated both horizontally and vertically "to facilitate top-down planning, rather than market competition."⁵⁰ In sum, the state imposed a central economic plan which siphoned off profits of successful businesses while also compensating for the losses of failing businesses.⁵¹

Second, as a result of Communism, the banking industry requires a serious overhaul. As the sole owner of all property and any assets of value, the government through its central plan controlled the banking system.⁵² The national banks provided investment capital to indus-

44. See Cohen & Schwartz, *supra* note 14, at 16-24; Stephen Denyer, *Introduction to the Privatisation in Eastern Europe*, in *Int'l Bus. Law.*, June 1995, at 242-43.

45. Cohen & Schwartz, *supra* note 14, at 21.

46. *Id.*

47. See *Eastern Metamorphosis Is Radical but Uneven*, *Investors Chron.*, available in LEXIS, Nexis Library, NEWS file, at *2 [hereinafter *Eastern Metamorphosis*] ("Czech banks are often unwilling to file bankruptcy suits against borrowers since they do not wish to appear responsible for mass company closures."); Luthans et al., *supra* note 6, at *5. The Communist era 1917-1991, is the second of three distinct eras of the former Soviet Union. The first era was pre-1917 traditional Russian society; the third era of post-Communism began in 1991. *Id.* at *1-2.

48. See Luthans et al., *supra* note 6, at *5.

49. Horton, *supra* note 26, at 12; Lin Shoukang, *A Monetary Model of a Shortage Economy*, *Int'l Monetary Fund Staff Papers*, Vol. 40, No. 2, June 1993, at 369, available in LEXIS, Nexis Library, NEWS file, at *2. Commentators note that a "[a] very large proportion of state enterprises simply could not survive without the explicit and implicit subsidies inherent to central planning." Nestor & Thomas, *supra* note 41, at *1.

50. Brzezinski, *supra* note 2, at 1129-30 n.7. Horizontal integration refers to the economic relationships, such as loans, between similar types of firms, such as all manufacturers or all wholesalers. Vertical integration refers to relationships between dissimilar groups, such as a manufacturer and a wholesaler. See *id.*

51. See Flaschen & Desieno, *supra* note 26, at 668.

52. Bangert, *supra* note 11, at *1; Paolo Miurin & Andrea Sommariva, *Financial and Technical Assistance to Central and Eastern Europe: A Critical Appraisal of the*

tries and firms by loaning to them on very favorable terms.⁵³ If a project financed by such loans failed, the banks simply forgave the bad loans and subsequently reloaned to the borrowers.⁵⁴ Such loans were part of the greater soft budget constraints that demanded no real economic bottom line.⁵⁵ For example, some enterprises, acting like banks, extended and forgave commercial credit to other enterprises, thus forming inter-enterprise credit.⁵⁶ "[T]he uncontrolled growth of inter-enterprise credit in Eastern Europe . . . and the tendency of banks to continue their lending to state enterprises regardless of their solvency"⁵⁷ protected debtor enterprises which otherwise would not have been able to make payments.⁵⁸

Third, post-Communist CEE economic actors are not familiar with basic market theory and have not voluntarily created an efficient free market.⁵⁹ In particular, CEE nations need to develop a "capitalist ethos" with "a stake in choosing the most efficient allocation of capital."⁶⁰ The operation of asset-allocation assumes certain understandings that are not established in CEE nations, such as property and equity ownership,⁶¹ profit-motive,⁶² asset valuation,⁶³ and more generally, acceptance of market failure.⁶⁴

Because of these factors, mere privatization cannot immediately transform a centrally-planned economy into a democratic free-market economy.⁶⁵ In the post-Communist states, private ownership is now possible, but a class of private owners acting as responsible management has not formed.⁶⁶ Furthermore, even though the government

Role of International Institutions, Washington Q., Vol. 17, No. 3, Summer 1994, at 91, available in LEXIS, Nexis Library, NEWS file, at *3.

53. Miurin & Sommariva, *supra* note 52, at *3.

54. *Making Bankruptcy Work in Central and Eastern Europe*, BCD News & Comment, Vol. 28, No. 15, Mar. 17, 1996, available in LEXIS, Nexis Library, NEWS file, at *2 [hereinafter *Making Bankruptcy Work*].

55. Macey & Colombatto, *supra* note 1, at 389.

56. Roman Frydman et al., *The Privatization Process in Central Europe 63* (1993) [hereinafter Frydman et al., *Central Europe*].

57. *Id.*

58. *Id.* at 48 ("As late payments [by debtor enterprises] increased and insolvency became widespread, enterprises resorted to the so-called inter-enterprise credits.")

59. See Cohen & Schwartz, *supra* note 14, at 12.

60. *Id.* at 12-13.

61. Prepared Statement of the Honorable Ralph R. Johnson Before the Subcomm. on Small Business, Federal News Service, May 12, 1994, at 92, available in LEXIS, Nexis Library, NEWS file, at *2; Raftopol, *supra* note 34, at 438 ("[P]rivate ownership of the means of industrial production remains a foreign concept in modern Russia.").

62. See Cohen & Schwartz, *supra* note 14, at 13.

63. Philbrick, *The Paving*, *supra* note 27, at 587.

64. See, e.g., Horton, *supra* note 26, at 31 (noting the Russian fear of bankruptcy and business failure).

65. Cohen & Schwartz, *supra* note 14, at 11-12. Stephen S. Cohen and Andrew Schwartz aver that "ownership structure is an important element in modern capitalism, but it is only one of many factors that influence corporate behavior." *Id.* at 15.

66. Zeleny, *supra* note 34, at *2.

lifted its price and currency controls, a free market has not arisen.⁶⁷ Simply, the end of Communism has not led automatically to a functional market economy and thus, CEE market restructuring is necessary.

B. *Configuring Bankruptcy Law in the Post-Communist Context*

In the view of Western advisors, bankruptcy law would play a significant role in restructuring CEE transition economies, and thus in rectifying the problems created by Communism.⁶⁸ These advisors believed that bankruptcy law would serve the same general asset-allocation function in the post-Communist state that it does in the West: reconciling market scarcity of available assets with the inefficient use of available assets.⁶⁹ Thus, asset re-allocation through bankruptcy laws would maximize market efficiency.⁷⁰ Consequently, by employing bankruptcy law, the post-Communist state would prepare the newly privatized firms for a market economy⁷¹ and facilitate the necessary restructuring of the market.⁷²

Western advisors recommended bankruptcy law for four basic reasons. First, bankruptcy law provides a legally predictable mechanism to deal with failed enterprises, which is necessary because in market economies enterprises inevitably fail.⁷³ Bankruptcy law prevents the creditors' race for the debtors' assets by providing equitable and predictable treatment to similarly situated creditors and employees of insolvent enterprises.⁷⁴ By ensuring predictability, bankruptcy law improves the amount of information available to investors regarding the recovery of capital invested in an enterprise that fails.⁷⁵ Equipped with this information, creditors are thus able to accurately determine

67. Alan S. Greenspan, *Thoughts About the Transitioning Market Economies of Eastern Europe and the Former Soviet Union*, 6 DePaul Bus. L.J. 1, 11 (1993); see Frydman & Rapaczynski, *Institutional Reform*, *supra* note 2, at 2.

68. Chris Aujard, *Central European*, Handbook Supplement, 1995 at 13, available in LEXIS, Nexis Library, NEWS file, at *1; Simpson, *supra* note 28, at *1 ("[B]ankruptcy 'can't be seen as an economic ill or a way to eliminate the weakest from the market . . . but it has to be seen as one of the tools that will lead to adjustment.'" (quoting Polish Justice Minister Jerzy Jaskiernia)).

69. Balfour & Crise, *supra* note 3, at 89-90; Julia M. Metzger & Samuel L. Bufford, *Exporting United States Bankruptcy Law: The Hungarian Experience*, 21 Cal. Bankr. J. 153, 153 (1993); see Horton, *supra* note 26, at 31.

70. See *Russia: Backs to the Wall*, Banker, July 1995, available in LEXIS, Nexis Library, NEWS file, at *1 [hereinafter *Russia*].

71. See Campbell, *supra* note 7, at 345-46.

72. See *Russia*, *supra* note 70, at *1.

73. Campbell, *supra* note 7, at 345. For a succinct discussion of Max Weber's sociological analysis of capitalism, analyzing how the Western concept of law paved certainty in an uncertain world, see *id.* at 347-52.

74. Flaschen & Desieno, *supra* note 26, at 669.

75. *Id.*

when the value of assets change,⁷⁶ and accurately compute credit agreement terms such as collateral requirements and interest rates.⁷⁷ In this way, bankruptcy law promotes more efficient investment decisions by arming creditors, such as banks and investors, with accurate financial information.

Second, bankruptcy law exerts pressure on insolvent and inefficient firms, and promotes the voluntary reallocation of assets.⁷⁸ Fearing either potential unemployment as a result of bankruptcy proceedings or aggressive interference by bank lenders, SOE and former SOE managers are forced to focus on the financial health of enterprises and restructure their operations accordingly.⁷⁹ To increase this pressure on managers, Western bankruptcy advisors recommended strict bankruptcy provisions that do not leave much discretion to either debtor or creditor.⁸⁰ By eliminating the debtor or creditor's ability to forestall such proceedings, a strict provision imposes a degree of certainty as to when bankruptcy proceedings will be initiated, and conveys this certainty to managers.⁸¹ One example, "involuntary bankruptcy," forces enterprises unwilling to act or acknowledge their financial troubles into bankruptcy proceedings after a limited grace period.⁸²

Third, bankruptcy law allows debtors to "start anew [and reenter the market] free of the albatross of debt."⁸³ Bankruptcy law enables the financially troubled but honest debtor to discharge his enterprise's obligations after a work-out is arranged.⁸⁴ No post-bankruptcy monies earned by the debtor will be subject to prior creditors' claims.⁸⁵ This allows a post-bankruptcy company to not worry about past debts, but rather gain new investments and start up a new business venture.⁸⁶

Fourth, bankruptcy law can facilitate privatization.⁸⁷ Many SOEs are heavily indebted or sustain severe losses.⁸⁸ The state could force these SOEs into immediate bankruptcy proceedings and privatize

76. "Asset value is determined by the present value of profits that the given assets may produce . . ." Tardos, *supra* note 13, at 59.

77. Flaschen & Desieno, *supra* note 26, at 669.

78. Campbell, *supra* note 7, at 352, 358.

79. Frydman & Rapaczynski, Privatization, *supra* note 38, at 127.

80. See Flaschen & Desieno, *supra* note 26, at 679-80.

81. See *id.*

82. See *id.* at 680.

83. Campbell, *supra* note 7, at 346.

84. Thomas E. Plank, *The Constitutional Limits of Bankruptcy*, 63 *Tenn. L. Rev.* 487, 497 (1996).

85. Carolyn Hochstadter Dicker, *Minimizing Risk: Securing a Loan with an Anticipated Tax Refund*, 13 *Bankr. Strategist* 3, 4 (1996), available in Westlaw, TP-ALL Library.

86. Mark A. Frankel, *Federal Taxation of Corporate Reorganizations*, 66 *Am. Bankr. L.J.* 55, 55 (1992); Sak & Schiffman, *supra* note 17, at 938.

87. Horton, *supra* note 26, at 12.

88. Nestor & Thomas, *supra* note 41, at 36.

them via the liquidation process.⁸⁹ Through a formal liquidation proceeding, the equity interest of the government is cancelled or diluted.⁹⁰ New ownership rights are then distributed to major creditors or the enterprise's work force.⁹¹

In reaction to the CEE's crucial need for market restructuring, Western economists and commentators looked to the theoretical justifications for Western-style bankruptcy law. These justifications led the West to strongly recommend bankruptcy law in the CEE regions because it would protect creditors who invest in enterprises, pressure SOE and former SOE managers to take part in the asset-allocation process, grant debtors a new life, and facilitate the privatization process.

II. DIFFERENT TYPES OF BANKRUPTCY LAWS IN PRACTICE

While all models of bankruptcy law ultimately seek to restructure markets, different models of bankruptcy law exist.⁹² In serving the broader goal of restructuring markets, different bankruptcy law models may address the specific, multitudinous socio-economic needs of each nation. A nation's legislature can tailor the bankruptcy law by carefully defining: (1) the event of insolvency/bankruptcy; (2) which parties can trigger a bankruptcy proceeding; and (3) once triggered, what protection should be afforded to creditors/debtors.⁹³

The creation of a particular bankruptcy law regime, as well as the specifically tailored provisions within such a regime, reflect which social policies a nation wishes to promote. If a nation wants to promote investment, particularly Western foreign investment, the bankruptcy law should be strict.⁹⁴ Going beyond a "well developed" bankruptcy law that seeks to establish predictability for investors, a *strict* bankruptcy law further bolsters predictability by forcing liquidations, thereby enabling creditors to quickly retrieve the assets of financially troubled businesses.⁹⁵ Further, a strict bankruptcy law allows investors to understand clearly the ramifications of enterprise failure, and

89. See Flaschen & Desieno, *supra* note 26, at 670 ("[A] business will be so threatened by financial difficulty that its creditors would prefer to have the business cease operations, liquidate its assets, and distribute the proceeds of the sales to the creditors . . .").

90. See Horton, *supra* note 26, at 12, 31. The process is done by "breaking a large business into viable components . . . as result of sale or debt-to-equity conversion." *Id.* at 31.

91. Horton, *supra* note 26, at 12, 31.

92. Campbell, *supra* note 7, at 369-70. A starting point in bankruptcy theory is the tension between a liberal bankruptcy code, which allows the debtor to avoid or postpone debt payments, and a strict bankruptcy code, which forces debtors to honor all pre-bankruptcy contracts. *Id.* at 370 n.203.

93. Flaschen & DeSineo, *supra* note 26, at 678-79.

94. *Id.* at 670-71.

95. Campbell, *supra* note 7, at 379.

thus encourages foreign investment.⁹⁶ If, however, a nation wishes to promote domestic stability and job security of enterprise employees, the bankruptcy law should be liberal.⁹⁷ A liberal bankruptcy law "permits the debtor to abandon or postpone payment on pre-bankruptcy" debt.⁹⁸ Further, a liberal law exhibits flexibility, favoring reorganizations before defaulting to liquidation.⁹⁹ A reorganization gives the debtor time to continue to manage the enterprise in the hope that the debtor can turn the business around.¹⁰⁰ During this period, the debtor can try to attract new investments and also move the assets from one company venture to another. This approach, however, does not provide investors with clear information about enterprise success, failure, or recovery, and thus discourages investment.¹⁰¹ As these contrasting policies demonstrate, different models of bankruptcy law reflect different national policies.

Despite this variability in potential bankruptcy laws, Western advisors did not suggest a specific bankruptcy model for each CEE nation.¹⁰² By the absence of different proposals, the West essentially proscribed a general bankruptcy law prototype. In practice, however, all bankruptcy laws that arose in CEE nations were not the same.¹⁰³ Instead, based on their chosen privatization scheme, CEE nations chose different types of bankruptcy law.¹⁰⁴

Because CEE nations experienced varying historical and socio-economic legacies, they are at varying levels of market economy development.¹⁰⁵ In response to their unique development levels, CEE nations varied in their approaches to privatization.¹⁰⁶ Two distinct privatization paradigms, the "speed" and "gradualist" paradigm, emerged.¹⁰⁷

96. Flaschen & Desieno, *supra* note 26, at 670.

97. *Id.* at 670-71.

98. Campbell, *supra* note 7, at 379.

99. See Flaschen & Desieno, *supra* note 26, at 670.

100. Horton, *supra* note 26, at 12. Because of the massive scale of bankruptcy in Russia, a liberal bankruptcy system is preferred. *Id.*

101. See Flaschen & DeSieno, *supra* note 26, at 669-70.

102. See *supra* notes 26-32, 69-72 and accompanying text.

103. Compare *infra* part II.A.1 (analyzing the "speed" paradigm of privatization in the Czech Republic) with *infra* part II.B.1 (analyzing the "gradual" paradigm of privatization in Hungary).

104. See Cass, *supra* note 22, at 418-19.

105. See Bogdan, *supra* note 14, at 45 (distinguishing the historically-influenced differences even between the similar mass privatizations between the Czech Republic and Poland); Cass, *supra* note 22, at 418-19 n.22.

106. Balfour & Crise, *supra* note 3, at 6; David Gordon, *Privatization in Eastern Europe: The Polish Experience; Special Section: Privatization*, 25 *Law & Pol'y Int'l Bus.* 517, 522 (1994) ("Each country in Eastern Europe has chosen to approach privatization differently.")

107. This Note uses the terms "speed" and "gradual" paradigm to describe the contrasting paces of privatization schemes. See Cass, *supra* note 22, at 433-34 (praising the benefits of a "rapid," "quick" privatization); Cohen & Schwartz, *supra* note 14, at 9-11 (comparing "gradualists and radical capitalists"); Frydman et al., *Central Europe*, *supra* note 56, at 71. According to Harvard Economist Jeffrey Sachs, the paramount

Each paradigm, along with each nation's very distinct history, engendered different models of bankruptcy law.

Thus, in order to understand why different bankruptcy laws arose among different CEE nations, one must first look to the varying privatization methods employed by these nations. In particular, this part examines an example of each of the two privatization paradigms—the “speed” paradigm’s use in the Czech Republic; and the “gradual” paradigm’s use in Hungary—and analyzes how each paradigm gave rise to a different bankruptcy law.

A. *The “Speed” Paradigm and the Czech Experience*

As its name suggests, the “speed” paradigm of privatization stresses the rapid transfer of state-owned assets to private hands.¹⁰⁸ The rationale of the speed paradigm was to first relocate all assets to the private sector as quickly as possible, and then allow the market to decide which assets, enterprises, and industries are market-worthy and which are inefficient.¹⁰⁹ Under this paradigm, the government does not restructure, but rather leaves “most restructuring to the new, private owners . . . [and n]ew legal frameworks and institutions [are developed] only when the need becomes pressing.”¹¹⁰ Some economists argue that the speed paradigm represents a “sink or swim” mentality that values assets most, and places little value on the shell enterprises or industries that actually hold the assets.¹¹¹

Under the speed paradigm, one method of privatization is the voucher system.¹¹² Under this system, the government makes available artificial currency to citizens in the form of voucher coupons.¹¹³ These voucher coupons may be utilized to transfer in one of two ways. Under the first method, private individuals redeem vouchers when bidding in auctions for shares of SOEs which are to be privatized by the government.¹¹⁴ The second method involves a financial intermediary—an investment fund or a holding company, which is managed either by private individuals or banks.¹¹⁵ Citizens tender their

policy issue in Eastern Europe is how fast to privatize. Jeffrey Sachs, *Accelerating Privatization in Eastern Europe: The Case of Poland*, Paper presented at the World Bank Annual Conference on Development Economics (Apr. 25-26, 1991), cited in Cohen & Schwartz, *supra* note 14, at 10.

108. Frydman et al., Central Europe, *supra* note 56, at 70.

109. See Flaschen & DeSieno, *supra* note 26, at 671-72.

110. Frydman et al., Central Europe, *supra* note 56, at 70.

111. Flaschen & DeSieno, *supra* note 26, at 671-72.

112. Bogdan, *supra* note 14, at 44 (noting that Russia, the Czech Republic, and Slovakia enacted voucher privatizations).

113. See Frydman et al., Central Europe, *supra* note 56, at 86; Philbrick, *The Task of Regulating*, *supra* note 2, at 554.

114. See Bogdan, *supra* note 14, at 44; Philbrick, *The Task of Regulating*, *supra* note 2, at 554.

115. Bogdan, *supra* note 14, at 44, 52-54; *East European Privatisation, Making It Work*, Economist, Mar. 13, 1993, at 90-93 [hereinafter *Making It Work*].

voucher coupons to the fund, thereby purchasing shares in the fund and authorizing fund managers to purchase SOE shares on the individual's behalf.¹¹⁶ The investment fund, in turn, uses the voucher coupons to bid on or trade in the shares of the former state-owned companies.¹¹⁷

1. The Czech Republic's Relaxed Application of Bankruptcy Law

The Czech Republic employed the speed paradigm, conducting a highly successful, rapid voucher coupon privatization.¹¹⁸ First, the government, in a series of actions, reduced public spending (including state subsidies), lifted price controls, made the Czech currency (*koruna*) convertible for trade purposes and pegged its exchange rate.¹¹⁹ Next, the crucial voucher system was implemented. The system allowed any citizen to purchase a book of vouchers for the equivalent of a week's wages.¹²⁰ In 1990, voucher privatization began with the auction of small businesses formerly owned by the state.¹²¹ This stage, aptly called the "small privatization" program, privatized 100,000 to 120,000 restaurants, shops, and small businesses.¹²² In April of 1991, the state then initiated the "large privatization" program, privatizing midsized and larger SOEs.¹²³

Under the Czech bankruptcy regime policy, "the issue of ownership [was] separable from the issue of restructuring," therefore even after privatization was completed, restructuring remained incomplete.¹²⁴ This exemplifies the correlation between the privatization pace and the bankruptcy law model: when CEE nations chose mass, rapid privatization, the application of effective insolvency procedures was left to the post-privatization stage, so as not to delay the transfer of ownership.¹²⁵ Mass-privatization proponents stressed that the issue of

116. See Bogdan, *supra* note 14, at 52; Philbrick, *The Task of Regulating*, *supra* note 2, at 554.

117. See *Making It Work*, *supra* note 115, at 90.

118. *Bohemians*, *supra* note 25, at 23-24 (recognizing Czech's privatization as a "big bang" and as a "fast and efficient privatisation programme"); *Making it Work*, *supra* note 115, at 93; Philbrick, *The Task of Regulating*, *supra* note 2, at 554; *Stabilization, Reform*, *supra* note 23, at 86.

119. *Bohemians*, *supra* note 25, at 23; Luthans et al., *supra* note 6, at 5. Still, important areas of the economy have not been liberalized; for example, rent and most utility prices remain under state control. *Bohemians*, *supra* note 25, at 24.

120. *Bohemians*, *supra* note 25, at 24. One commentator interestingly noted that the Czech voucher auctions were "designed to simulate a capital market for SOE shares." Bogdan, *supra* note 14, at 44.

121. Bogdan, *supra* note 14, at 44.

122. Frydman et al., Central Europe, *supra* note 56, at 77-78 (describing Act 427 of 1990, entitled About the Transfer of State Property and Some Things to Other Legal or Physical Persons).

123. *Id.* at 79-80.

124. Bogdan, *supra* note 14, at 47.

125. See Frydman et al., Central Europe, *supra* note 56, at 63.

ownership is clearly separable from the issue of restructuring.¹²⁶ In the Czech Republic, where most enterprises have been mass-privatized without regard to their profitability, liquidation procedures are “likely to become an increasingly important element of the post-privatization stage of enterprise reform.”¹²⁷ That is, bankruptcy law is needed, but at a later stage of market development.

Because this privatization-first, restructuring-second policy was followed, the Czech bankruptcy law that was eventually drafted did not confront specific post-Communist issues. Although the law was drafted in 1991, the Czech government delayed its application twice during the first half of the privatization.¹²⁸ Furthermore, the 1991 Czech bankruptcy law—the Act on Bankruptcy and Compositions of Czech and Slovak Republics—was quite routine in the Western sense.¹²⁹ The law provides for three kinds of insolvency proceedings: (1) liquidation (*konkurs*); (2) compulsory composition (*nuceny vyrovanani*), where the debtor can suggest the termination of the bankruptcy if distribution of the assets cannot be agreed upon; and (3) composition (*byrovanani*), which is a voluntary reorganization arrangement between debtors and creditors.¹³⁰ Consequently, the drafted law was generic and did not aggressively seek restructuring made necessary by the Communist economic legacy. Finally, the bankruptcy law has not been used in the post-suspension period, and only recently has the Czech government and its privatization agencies tried to amend the liberal bankruptcy law.¹³¹

The Czech Republic’s relaxed approach to bankruptcy law directly correlated to the speed paradigm of privatization. The privatization process contained “highly centralized aspects, such as the forced pace of the process and the concentrated power of [privatization] project approval in the Privatization and Finance Ministries.”¹³² The state es-

126. Bogdan, *supra* note 14, at 47.

127. Nestor & Thomas, *supra* note 41, at *5.

128. Balfour & Crise, *supra* note 3, at 101.

129. The bankruptcy law is known as Law Number 328/1991. Michael Steiner, *Czech and Slovak Republics: An Introduction to the New Insolvency Law, Turnarounds & Workouts Europe*, Vol. 4, No. 2, Apr. 1, 1993, at 1. This law predated the 1993 peaceful division of Czechoslovakia into the Czech Republic and the Slovak Republic. *Id.*; see Sak & Schiffman, *supra* note 17 (comparing Czech, Polish, and Hungarian bankruptcy laws; covering definitions, efficiency of administration of the insolvency proceedings, stay of collection proceedings against a debtor, degree of finality of the resolution of claims against debtors, enterprise rehabilitation, avoidance of pre-bankruptcy transfers, and priorities in distribution of assets); see also Daniel J. Arbes et al., *New Bankruptcy Laws: A Comparison of the Bankruptcy Laws of the Czech Republic, Poland, and Russia*, 1 Parker Sch. J. E. Euro. L. 128, 128-39 (1994) (comparing Czech, Polish, and Russian bankruptcy laws).

130. Steiner, *supra* note 129, at 6.

131. See Sak & Schiffman, *supra* note 17, at 944 (stating that, in 1993, the Czech law was amended to encourage more reorganizations by protecting the debtor for a period of three to six months after the filing).

132. Frydman et al., Central Europe, *supra* note 56, at 80.

established three newly created National Property Funds, which transformed SOEs into joint-stock companies, wholly owned by the state for a strictly limited period of time (whose shares were then sold to the Czech public in exchange for vouchers).¹³³ The Czech government exerted considerable control over the privatization. Given that the Czech government played such a dominant role in the speed privatization process, had it desired a more stringent bankruptcy law regime during the process, it would have likely taken steps to achieve one.

B. *The "Gradual" Paradigm and the Hungarian Experience*

The "gradual" paradigm posits that privatization must be moderately paced to thereby enable a post-Communist state to construct a market economy.¹³⁴ Thus, the gradual paradigm of privatization stands in direct opposition to the speed paradigm.¹³⁵ Gradual paradigm proponents believe that a privatization program like the Czech Republic's, which results in rapid mass ownership of enterprises, does not guarantee that enterprises will achieve market efficiency.¹³⁶ It is argued that the speed paradigm does not address the owner restructuring of newly-privatized firms, many of which remain heavily in debt. Finally, the speed paradigm fails to generate the new capital necessary to restructure the newly-privatized firms it creates.¹³⁷

In contrast, the gradual paradigm slows the speed of privatization and focuses on restructuring. A gradual privatization targets "enterprise restructuring, the creation of credible legal or tax systems, the rebuilding of a regional network of industrial and market linkages, and the creation of a functioning, reliable state administration."¹³⁸ In addition, by not fixating on privatizing, the state can work with owners of newly-privatized enterprises to coordinate business ventures and concentrate on improving long-term corporate governance.¹³⁹

1. Hungary's Aggressive Attempt to Apply Bankruptcy Law

Like the Czech Republic, Hungary achieved a high level of privatization success.¹⁴⁰ The state's goal was to find "real owners who

133. *Id.* at 74-75; see notes 112-17 and accompanying text.

134. Bogdan, *supra* note 14, at 46 (discussing the gradualist argument that capitalist economies "cannot be created through [mass privatization or "Big Bang"] revolutionary policies"); Cohen & Schwartz, *supra* note 14, at 9-10.

135. Cohen & Schwartz, *supra* note 14, at 10-11.

136. *Id.* at 11.

137. See Peter Rutland, *Privatization in East Europe: Another Case of Words that Succeed and Policies that Fail?*, 5 *Transnat'l L. & Contemp. Probs.* 1, 3 (1995).

138. Cohen & Schwartz, *supra* note 14, at 33.

139. *Id.* at 31-32.

140. Rachel Wood & Éva Talmácsi, *Privatisation in Hungary*, 23 *Int'l Bus. Law* 243, 250 (1995). One method of privatization was through ESOPs, employee share ownership programmes, whereby workers could purchase the relevant company's shares. *Id.*

[would] work hard to improve efficiency and obtain a decent rate of return on their investment."¹⁴¹ The emphasis was not on speed, but rather on finding "strategic investors."¹⁴² Prior to each privatization project, the Hungarian state transformed the applicable state-owned firms into new corporate entities.¹⁴³ After this "corporatization," Hungary employed direct sales¹⁴⁴ and liquidations, and established joint ventures between the state and private owners.¹⁴⁵ In contrast to the Czech experience, Hungarian vouchers were used solely as restitution to those who had owned private property before the Communist state had communized all land.¹⁴⁶ In addition, the privatization was aided by the early Hungarian economic reforms. In 1989, the Hungarian Parliament passed the Act on Transformation.¹⁴⁷ Pursuant to this act, in September 1990, Hungary launched the First Privatization Program designed to privatize twenty large companies either through competitive tenders or public offerings.¹⁴⁸

In contrast to the Czech Republic's speed paradigm/voucher system, the Hungarian privatization program has been a gradual, "spontaneous privatization." It was gradual in terms of *pace*,¹⁴⁹ because Hungary choose not to undergo a rapid, mass privatization.¹⁵⁰ It was spontaneous in terms of *control*, namely, whether the state exercised control over the privatization process.¹⁵¹ Overall, the state did not adopt a set of strict privatization rules and primarily left the process

at 248. "In Hungary, a US-assisted ESOPS program has resulted in over 100 major firms transferring ownership to employees—one of the most successful such programs in the world." Johnson, *supra* note 61, at *2.

141. Marer, *supra* note 9, at 182.

142. *Hungary: October 1996*, Bus. Intelligence Rep. World of Info., Oct. 1996, at 1, available in LEXIS, Nexis Library, NEWS File, at *19.

143. Marer, *supra* note 9, at 182-83. A precondition to privatizing a SOE is corporatization (also known as "full transformation" under the 1989 Transformation Law). "A part of the SOE may also be corporatized prior to privatization through a creation of a subsidiary" (known as "partial transformation" under the 1988 Company Law). Frydman et al., Central Europe, *supra* note 56, at 131.

144. Technically there are no "direct sales." First, a SOE must be transformed into a joint-stock company, creating shareowners (owners) and dividing ownership of the SOE into shares (stocks), whose sale or transfer is the vehicle for changing ownership. Frydman et al., Central Europe, *supra* note 56, at 131-33, 140-41.

145. Tardos, *supra* note 13, at 62-65. SOEs were remade partially or wholly into Western-style joint stock or limited liability companies. *Id.* at 62.

146. Cheryl W. Gray et al., *Hungarian Legal Reform for the Private Sector*, 26 Geo. Wash. J. Int'l L. & Econ. 293, 308-09 (1992).

147. Marer, *supra* note 9, at 179-80.

148. *Id.* at 182-83.

149. Wood & Talmácsi, *supra* note 140, at 245.

150. Philbrick, *The Task of Regulating*, *supra* note 2, at 550-51; see also Wood & Talmácsi, *supra* note 140, at 244 (discussing Hungary's resistance to mass privatization). The Association of Free Democrats, the opposition party to the ruling Socialist Party, urged a faster speed of privatization, believing that "it was counterproductive to attach too many conditions and constraints" of prices and sale or transfer terms. Marer, *supra* note 9, at 182.

151. See Marer, *supra* note 9, at 182-83.

de-centralized.¹⁵² The spontaneity has been described as a “case-by-case, market-driven approach to transactions.”¹⁵³ Similarly, one commentator stated that the Hungarian privatization rules and policies “must be understood as functioning only as a framework within which bargaining among individual actors takes place.”¹⁵⁴ This informal approach stems from the fact that “the initiative to transform and privatize” belonged completely to the head management or “enterprise councils,”¹⁵⁵ which could hold off their enterprise’s privatization.¹⁵⁶ In contrast, during the Czech speed privatization, the Czech government jump-started the privatization process by forcing firms to privatize.¹⁵⁷ Even after 1990, when the Hungarian state began to monitor and regulate privatizations,¹⁵⁸ the predominant pattern of “spontaneity” continued.

The gradual paradigm allows restructuring to begin immediately. Therefore, under this gradual paradigm of privatization, Hungary attempted to institute a more aggressive bankruptcy law regime. Aiming for greater bankruptcy law usage, Hungary changed its initial bankruptcy law (“First Amended Law”). In Hungary, bankruptcy laws generally were perceived as “important promoters of industrial restructuring.”¹⁵⁹ Specifically, the Hungarian government envisioned that the First Amended Law would be “the central mechanism of conflict resolution between banks and enterprises.”¹⁶⁰ Thus, the First Amended Law would perform “real as well as financial restructuring,” making surviving firms more competitive in the long run.¹⁶¹ Ultimately, however, this vision of restructuring through bankruptcy law did not materialize, however, and Hungary subsequently amended the law a second time (“Second Amended Law”).

Early in the privatization process, the amendment of the bankruptcy law was necessitated by the lenient features of the old bankruptcy law.¹⁶² The old bankruptcy law—the law that preceded the First Amended Law—was overly flexible; for example, it allowed a

152. Frydman et al., *Central Europe*, *supra* note 56, at 138.

153. Wood & Talmácsi, *supra* note 140, at 244.

154. Frydman et al., *Central Europe*, *supra* note 56, at 131. Thus “generalizing about the process [was] extremely difficult.” *Id.*

155. *See infra* notes 192-93 and accompanying text.

156. Frydman et al., *Central Europe*, *supra* note 56, at 130.

157. *See infra* notes 116-21.

158. Frydman et al., *Central Europe*, *supra* note 56, at 130. This regulation was achieved through the Law on Protection of State Property and the establishment of the State Property Agency. *Id.*

159. Gray et al., *supra* note 146, at 340.

160. Dhar & Selowsky, *supra* note 25, at *5.

161. Gray et al., *supra* note 146, at 343.

162. Metzger & Bufford, *supra* note 69, at 153. The Hungarian bankruptcy law consists of three substantive sections: (1) a reorganization section based on Chapter 11 of the U.S. Bankruptcy Code; (2) a liquidation section similar to our chapter 7; and (3) a corporate dissolution provision rather like that which we have in our state corporation laws. *Id.* at 154. Currently, only businesses are eligible. Because no signifi-

reorganization that had been converted into a liquidation to be easily converted back into a reorganization, thus giving "the debtor and creditors a second bite at the reorganization apple."¹⁶³ Further, bankruptcy proceedings could occur only if there was a prior agreement in the original lending contract between the creditor and debtor. Moreover, the law provided little guidance on how to develop a reorganization plan.¹⁶⁴ Finally, because creditors had lower priority claims than employee wage/severance payments under the bankruptcy law's creditor priority schedule, they had less incentive to bring bankruptcy suits.¹⁶⁵

In contrast, the revised law, the First Amended Law, was very rigid in its application of bankruptcy proceedings.¹⁶⁶ First, the First Amended Law established involuntary proceeding provisions which required the debtor to file for bankruptcy if it did not satisfy "a very narrow liquidity test."¹⁶⁷ The First Amended Law defined insolvency as the inability of the debtor "to pay a debt within 90 days of the debt being due."¹⁶⁸ Second, the First Amended Law encouraged enterprise managers to initiate bankruptcy proceedings by establishing penal sanctions for managers who failed to report insolvencies. Third, it strongly favored liquidation over reorganization by requiring unanimous creditor acceptance of any reorganization plan.¹⁶⁹ Finally, the First Amended Law offered creditors a strong incentive to initiate bankruptcy proceedings, by establishing "rigid time limits on the different stages of the bankruptcy and liquidation process."¹⁷⁰

Consequently, the gradual paradigm of privatization gave Hungary the opportunity to attempt to apply an aggressive bankruptcy law. Because the government and public resources were not devoted solely

cant consumer credit system exists in Hungary, there is no apparent need for a personal bankruptcy system. *Id.*

163. *Id.* at 156. Under Hungarian law, only a reorganization is deemed a "bankruptcy." *Id.* at 154. A reorganization occurs when "all or part of the business may remain economically viable, albeit after restructuring the operations or adjusting the capital structure, and the creditors may wish to have the business continue operations, agreeing to be repaid on terms somewhat different from the terms of their original credit contract." Flaschen & DeSieno, *supra* note 26, at 670.

164. Metzger & Bufford, *supra* note 69, at 155. The formation of a bankruptcy workout plan depends on negotiating a consensus among the creditors who may form one or more committees to deal with a debtor. *Id.*

165. Gray et al., *supra* note 146, at 344. This priority of employees over creditors was a political compromise and international deviation. *Id.*

166. *See id.* at 342-43. "The Hungarian bankruptcy law of 1992 was very strict, even by the standards of established market economies, and was definitely the strictest among post-communist economies." Nestor & Thomas, *supra* note 41, at *4. In accordance with bankruptcy law, the state adopted new banking laws that are more vigilant on debt collection. *Id.*

167. Nestor & Thomas, *supra* note 41, at *4; *see* Sak & Schiffman, *supra* note 17, at 934 (applying a "mandatory filing requirement").

168. Nestor & Thomas, *supra* note 41, at *4.

169. *Id.*

170. Gray et al., *supra* note 146, at 342.

to privatization, Hungary sought to begin their restructuring process simultaneously with privatization.

III. THE CEE NONUSE OF BANKRUPTCY LAW

As demonstrated in part II, because the Czech Republic and Hungary enacted contrasting privatization programs, they accordingly implemented contrasting bankruptcy laws.¹⁷¹ Both models of bankruptcy law had the common goal of restructuring post-Communist markets. Despite Western forecasts, however, in both cases the existing bankruptcy law has not been substantially used.¹⁷² This nonuse is attributable to both nation-specific reasons as well as general post-Communist concerns. First, the Czech Republic did not utilize bankruptcy law because of its speed paradigm of privatization, and Hungary, although it attempted to apply an aggressive bankruptcy law, eventually retracted its law due to the fear of mass bankruptcies. Second, more generally, the ideal objectives of a Western-style bankruptcy system conflicted with the practical reality of unforgiving CEE transition economy pressures.¹⁷³ In sum, neither model of bankruptcy law has been able to address the problem endemic to a transition economy—the gradual restructuring necessary for long-term benefits. This part discusses the substantial nonuse of bankruptcy law in the Czech Republic and Hungary.

A. *Specific Reasons for Czech Nonuse*

Since privatization began in the Czech Republic, very few bankruptcy proceedings have been filed or completed.¹⁷⁴ Both the speed paradigm and the Czech post-Communist legacy precluded the effective role of bankruptcy law.

First, under the speed paradigm, the success of privatization held priority over market restructuring mechanisms.¹⁷⁵ The government focused its resources on the privatization program and on involving available economic actors and citizens. The privatization process aimed toward wide dispersal of assets,¹⁷⁶ creating new classes of individual private owners and investment funds.¹⁷⁷ The government further ensured wide dispersion by distributing voucher coupons to

171. See *supra* parts II.A.1 and II.B.1.

172. See *Making Bankruptcy Work*, *supra* note 54, at *1; *infra* part III.C.

173. See Flaschen & Desieno, *supra* note 26, at 669.

174. *Bankruptcy Takes*, *supra* note 30, at *1; *Chapter 3*, *supra* note 22, at *9-10; *Making Bankruptcy Work*, *supra* note 54, at *1.

175. Nestor & Thomas, *supra* note 41, at *4; see also Bogdan, *supra* note 14, at 47 (remarking that the Czech government emphasized “speed and breadth over fiscal concerns and [restructuring] attention to individual firms”).

176. Balfour & Crise, *supra* note 3, at 94.

177. Rutland, *supra* note 137, at 11-12.

citizens.¹⁷⁸ In turn, heightened public interest ultimately resulted in the rapid purchase of SOE shares via coupons.¹⁷⁹

Second, the Czech Republic enjoyed "advantageous historical, geographical, and cultural proximities to Western Europe"¹⁸⁰ and thus, perhaps could afford to delay restructuring through bankruptcy law. The Czech Republic was not saddled with enormous foreign debts¹⁸¹ and had established far fewer state subsidies, with almost none in the industrial sector and only a small amount in the agricultural sector.¹⁸² Compared to the other CEE nations, the Czech Republic also had stronger political leadership supported by key economic elites charged with implementing government programs.¹⁸³

Lastly, the Czech bankruptcy law¹⁸⁴ did not encourage use by enterprises because it failed to encourage financial reorganizations, the form of bankruptcy law application that is preferred in a transition economy because of its flexibility.¹⁸⁵ In CEE nations, it has been difficult to distinguish truly bankrupt firms from struggling firms that have potential but need economic support at this time.¹⁸⁶ A reorganization allows the struggling debtor to continue to control its enterprise for a set period in the hope that the debtor will be able to turn the enterprise around. In stark contrast, a liquidation proceeding removes the debtor from any management position. In this respect, the Czech bankruptcy law favored liquidations "regardless of the enterprise's negative net worth and whether the situation may be remediable."¹⁸⁷

In sum, the Czech Republic did not use bankruptcy law to restructure because the Czech government was preoccupied with its speed

178. Bogdan, *supra* note 14, at 44-45; *Bohemians*, *supra* note 25, at 24.

179. At first, there was very little public response, but interest grew with the implementation of private investment funds. The funds solidified public support for the privatization campaign by giving people an individual stake in the process. See Rutland, *supra* note 137, at 12.

180. Luthans et al., *supra* note 6, at *6. The Czech Republic appears to be furthest along in privatization of "the private sector, from less than 1% of GDP in 1989 to 22% by the beginning of 1993, and to 44% by the beginning of 1994." Rutland, *supra* note 137, at 11.

181. *Bohemians*, *supra* note 25, at 23; *Star Czech; Interview with Czech Prime Minister Vaclav Klaus*, Chief Executive (U.S.), Sept. 1994, at 26, available in LEXIS, Nexis Library, NEWS file, at *1 [hereinafter *Star Czech*]; see Bogdan, *supra* note 14, at 45 ("Czechoslovakia had a stable economy.").

182. *Star Czech*, *supra* note 181, at *4.

183. *Id.* at *1, *5 (discussing the education and experience of the Czech economic leaders). The Czech market-economy has had a committed elected government with popular support. *Id.* at *1.

184. See Sak & Schiffman, *supra* note 17, at 933-34 (remarking on the similarity between the Czech and Polish bankruptcy laws).

185. *Id.* at 941; Samuel L. Bufford, *What Is Right About Bankruptcy Law and Wrong About Its Critics*, 72 Wash. U. L.Q. 829, 836-38 (1994).

186. *Instituting Bankruptcy in the Post-Communist Economies of East-Central Europe*, A Colloquium Sponsored by the Institute for EastWest Studies and the Ministry of Finance of Hungary, Oct. 26-27, 1992, at 3 [hereinafter *Instituting Bankruptcy*].

187. Sak & Schiffman, *supra* note 17, at 934.

privatization program, could suspend such restructuring as a result of its "strong" CEE economy, and because the bankruptcy law did not encourage the preferred restructuring method of reorganization.

B. *Hungarian Nonuse*

Despite its aggressiveness, the Hungarian bankruptcy law, like the Czech Republic's, has not been substantially used to the degree Western policy-advisors predicted. The Hungarian government believed that an environment favorable to restructuring through bankruptcy law existed, and tried unsuccessfully to utilize a bankruptcy law.

Hungary attempted to apply an aggressive bankruptcy law that would perform a restructuring function. First, because of its gradual privatization program, Hungary was able to focus on restructuring more than the Czech Republic.¹⁸⁸ Second, just as its liberal market policies that existed during Communism encouraged Hungary to privatize, such policies encouraged post-Communist Hungary to begin restructuring.¹⁸⁹ For example, the development of some state-owned partnerships under Communism forced the state to make Western-style calculations of the market value of capital as well as dividends to be paid on shares.¹⁹⁰

In addition, as early as 1984, with the passage of the Law on Enterprise Councils,¹⁹¹ Hungary began to implement Western-style, self-management systems in most socialist enterprises.¹⁹² The law established "enterprise councils"—for each SOE, a specific group of management was appointed—for "2000 of the 2800 SOEs and transferred . . . ownership rights [in enterprises] to them."¹⁹³ The enterprise councils in turn encouraged profit-driven behavior. In 1988, Hungary passed the Company Act which allowed persons to enter into partnerships with existing SOEs and with foreign entities, "including businesses with limited liability whose sole purpose was to make financial investments."¹⁹⁴ In addition, the 1990 Law on Entrepreneurship "abolished most of the remaining restrictions [left over from the Communist era] on operating a small business."¹⁹⁵

Working on the assumption that restructuring through bankruptcy law was feasible, Hungary amended their initial bankruptcy law. Dur-

188. *Bankruptcy Takes*, *supra* note 30, at *1.

189. Yamnarm, *supra* note 6, at 185; see Wood & Talmácsi, *supra* note 140, at 243; Blaise Szolgyemy, *Hungary Still Seen Foreign Capital's Darling in East*, Reuter Eur. Bus. Rep., Jan. 10, 1995, available in LEXIS, Nexis Library, NEWS file, at *2.

190. Tardos, *supra* note 13, at 63.

191. Frydman & Rapaczynski, *Privatization*, *supra* note 38, at 103.

192. It has been argued that Hungary actually began privatization in the 1980s. *Chapter 3*, *supra* note 22, at *6.

193. Marer, *supra* note 9, at 178. The rest of the firms remained in state ownership exercised by ministry or local municipal capital. *Id.*

194. *Id.* at 175.

195. *Id.*

ing the subsequent period of the First Amended Law, Hungary saw an enormous increase in initial bankruptcy filings and also privatized some SOEs through bankruptcy proceedings.¹⁹⁶ Although not the preferred option of many CEE nations, Hungary privatized substantially by forcing enterprises into liquidation.¹⁹⁷ Through this process, the enterprises were split into smaller, more viable pieces available for purchase by private investors or funds.¹⁹⁸ Because of these early results, some over-optimistic commentators called it the only effective bankruptcy law in the region.¹⁹⁹

Ultimately, however, Hungary realized that it had to amend the First Amended Law because the Hungarian economy was not ready for a fully effective bankruptcy law. As demonstrated in the next section, Hungary saw firsthand the horrifying potential of mass bankruptcies. The First Amended Law was overzealous in its formulation;²⁰⁰ it imposed excessively rigorous financial requirements on debtors,²⁰¹ causing an enormous rise in the number of bankruptcy filings.²⁰² The First Amended law was subsequently amended to "soften the quasi-automatic triggering of bankruptcy procedures and the liquidation bias."²⁰³ As a result of the Second Amended Law, the number of bankruptcy filings significantly dropped.²⁰⁴ Thereafter, the degree to which Hungary utilized bankruptcy law failed to meet the expectations of Western advisors.

C. *Reasons Common to All CEE Nations*

Czech and Hungarian bankruptcy nonuse also was due to three fundamental reasons shared by all CEE nations. First, the dreadful, economic consequences of strictly following bankruptcy law contributed to bankruptcy law nonuse. Second, legally speaking, a bankruptcy infrastructure did not exist. Third, and most importantly, CEE nations culturally did not understand the concept of bankruptcy law.

196. See Johnson, *supra* note 61, at *2.

197. *Id.*

198. *Id.*

199. See, e.g., Szolgyemy, *supra* note 189, at *2 (stating conclusion of economist Laszlo Csaba).

200. *Instituting Bankruptcy*, *supra* note 186, at 5.

201. *Id.*

202. Sak & Schiffman, *supra* note 17, at 934 n.19; Nestor & Thomas, *supra* note 41, at *4. Since the new 1992 bankruptcy legislation, enterprises with aggregate production representing close to 10% of GDP have entered insolvency proceedings. *Id.* The number of bankruptcies erupted from 528 in 1991 to 14,300 in 1993. Gray et al., *supra* note 146, at 349.

203. Nestor & Thomas, *supra* note 41, at *4.

204. *Hungary: October 1996*, *supra* note 142, at *24.

1. CEE Economic and Legal Reasons for Nonuse

First, a policy of strict adherence to bankruptcy law by CEE countries failed to address the special needs of the region and threatened to bring too many enterprises into bankruptcy without giving them a chance to succeed.²⁰⁵ Thus, the general fear of mass or inter-enterprise insolvency within CEE nations remained.²⁰⁶ Mass insolvency was feared especially in the Czech Republic with its many newly-privatized market enterprises and in Hungary, where the Communist era left many bad loans. In Hungary, the systemic problems of enterprise insolvency posed the potential to affect thirty to fifty percent of the economy.²⁰⁷ Notably, since 1990, Hungary attempted three times to bail out debt-ridden banks, “[b]ut this has not brought stability.”²⁰⁸ Furthermore, the Hungarian government remained reluctantly in control of the big banks and the majority of their assets.²⁰⁹ Because of these links, the same debt affected multiple enterprises and banks, thus forming inter-enterprise debt²¹⁰ and posing a potential crisis if an overly aggressive bankruptcy law forced liquidations.²¹¹ The consequences of mass enterprise bankruptcies in both CEE nations would be disastrous, resulting in extensive unemployment,²¹² and potentially, social unrest.²¹³

Second, bankruptcy infrastructure was lacking in CEE nations. In both the public and private sectors, the administrative system was ill-equipped to deal with the volume of insolvent enterprises.²¹⁴ In addition, the judicial system lacked experienced judges and qualified liquidation or reorganization trustees who would administer the bankruptcy proceedings.²¹⁵ Judges and trustees lacked market experi-

205. Dhar & Selowsky, *supra* note 25, at *5.

206. *Bankruptcy Takes*, *supra* note 30, at *1. The massive filing following the first amendment of the Hungarian Law was the most important single reason for the fall in GDP by three percent to five percent in 1992. *Instituting Bankruptcy*, *supra* note 186, at 5.

207. Gray et al., *supra* note 146, at 345.

208. *Eastern Metamorphosis*, *supra* note 47, at *2.

209. *Id.*

210. *See supra* notes 56-58 and accompanying text.

211. *See* Richard W. Stevenson, *In New Economy, Russians Cannot Rely on Their Banks*, N.Y. Times, Sept. 12, 1995, at A1, A10 (discussing how in August of 1995, the entire Russian banking industry underwent a crisis as banks halted the inter-bank market, which banks rely on to keep their operations going).

212. Campbell, *supra* note 7, at 391 (“[I]t is possible that mass unemployment due to a strict bankruptcy code may result in a popular uprising sufficient to end the Yeltsin government’s reforms”); Flaschen & DeSieno, *supra* note 26, at 672.

213. Campbell, *supra* note 7, at 391; Flaschen & DeSieno, *supra* note 26, at 672. The Russian government feared “mass layoffs and the political fallout that could result from the closing of insolvent enterprises.” Mikhail Dubik, *State Prepares Major Bankrupt List*, Moscow Times, June 7, 1994, available in LEXIS, Nexis Library, NEWS file, at *1.

214. Dubik, *supra* note 213, at *1.

215. Sak & Schiffman, *supra* note 17, at 944-45; *Bankruptcy Proceedings*, *supra* note 35, at *1.

ence and a sense of social responsibility, and often were not motivated to protect debtors and satisfy creditors to the extent necessary to instill confidence.²¹⁶ Thus, CEE countries were unable, even if they so desired, to effectively use the bankruptcy system.

2. Cultural-Economic Bankruptcy

Most importantly, CEE nations did not understand the concept of bankruptcy law.²¹⁷ In order to understand bankruptcy law, nations must understand market failure, and CEE nations did not.²¹⁸ A socio-cultural fear of bankruptcy pervaded the CEE region, with a bankrupt party likened to a criminal.²¹⁹ Thus, although bankruptcy law is, in theory, a necessary partner of market restructuring, in CEE practice, bankruptcy law represents Western cultural norms and policies that CEE nations are unwilling to embrace.²²⁰

First, because post-Communist economic actors did not aggressively seek profits,²²¹ they were not motivated to recognize market inefficiency.²²² An ability to recognize market inefficiency and incentives to economize resources is imperative to the use of bankruptcy law.²²³ This inability in CEE nations also formed a vicious cycle: transition economy enterprises generally were unable to collect adequate market information because of the "accumulation of outstanding unpaid, non-performing credit;"²²⁴ this inability severely distorted information about the market;²²⁵ and completing the cycle, the distortion further hampered enterprises in their efforts to collect data.

Second, creditors and debtors viewed bankruptcy law in a negative light, disbelieving its purpose, and thus did not seek to use it. Creditors, including banks, did not "have an interest in seeing the enterprises go bankrupt, because if the companies [were] still around, they [would] at least pay some interest on their loans."²²⁶ Bankruptcy proceedings failed to procure for banks any return on their investments.

216. *Bankruptcy Proceedings*, *supra* note 35, at *1.

217. *See* Aujard, *supra* note 68, at *1.

218. *See* Steven L. Seebach, *Bankruptcy Behind the Great Wall: Should U.S. Businesses Seeking to Invest in the Emerging Chinese Market Be Wary?*, 8 *Transnat'l Law.* 351, 354 (1995).

219. *Bankruptcy Proceedings*, *supra* note 35, at *2.

220. *See infra* part III.C.2.

221. Tardos, *supra* note 13, at 59 ("[D]uring the transition from the socialist economy to a market economy there are no true proprietors behind real assets and firms who would have any vital interest in expected profit.").

222. Mary M. Shirley, *The What, Why, and How of Privatization: A World Bank Perspective*, 60 *Fordham L. Rev.* S23, S27 (1992).

223. *See* Cass, *supra* note 22, at 420-21.

224. *Russia*, *supra* note 70, at *1.

225. *Id.*

226. David Rocks, *Czechs Spared the Bite of Unemployment*, *S.F. Chron.*, Feb. 22, 1995, at 2, available in LEXIS, Nexis Library, NEWS file, at *1 (quoting Richard Falbr, chairman of the Czech-Moravian Chamber of Trades Union, the Czech Republic's largest labor organization).

This lax attitude toward enforcing bankruptcy was reinforced by the absence of liquid stock markets which would have enabled the ownership of privatized firms to change hands.²²⁷ On the debtor end, employees and management in debtor or nonviable enterprises did not understand bankruptcy protection. Instead, such salaried parties tried "to get as much out of the company as they [could] before it [went] out of business."²²⁸ In the Czech Republic, this threat translated into increased wages and perks.²²⁹ Thus, both creditors and debtors delayed filings for bankruptcy. The state "support[ed] bail-outs for large companies in trouble and . . . discourag[ed] the calling in of debts."²³⁰

Third, the state feared the political and social consequences of bankruptcy, and because they controlled many of the largest banks and companies, they were able to avoid bankruptcy. The state owned fifty percent or more of many of the largest banks and companies, with the remaining share distributed to many small shareholders.²³¹ The state viewed bankruptcies as leading to unemployment. The exploding economic effect of an enterprise's bankruptcy would be especially catastrophic on the local level, with the loss of several thousand jobs.²³² Retraining and relocating such a group would be extremely difficult from the state's perspective.²³³

Such attitudes continue to dissuade CEE actors from using bankruptcy law. Economic actors are unable to discern market inefficiency, creditors and debtors are not encouraged to resort to bankruptcy protection, and the state still in control of too much of the "private" market sphere fears the unemployment consequences of bankruptcy.

IV. FILLING BANKRUPTCY LAW'S VOID

Predictions that bankruptcy law would play a major role in CEE nations' shift to a market economy led to the inverse idea that bankruptcy nonuse is a warning sign of macroeconomic problems.²³⁴ This assumption, which may hold true in Western market economies,²³⁵ does not explain the post-Communist situation. In CEE nations, a trade-off resulted between the type of bankruptcy law that was implemented and the adoption of a mass, rapid privatization or a gradualist program.²³⁶

227. *Stabilization, Reform*, *supra* note 23, at *7.

228. *Zeleny*, *supra* note 34, at *2.

229. *Id.*

230. *See Bohemians*, *supra* note 25, at *4.

231. *Rocks*, *supra* note 226, at *3.

232. *Flaschen & Desieno*, *supra* note 26, at 672.

233. *Id.*

234. *See supra* notes 29-32 and accompanying text.

235. *Id.*

236. *Nestor & Thomas*, *supra* note 41, at *5.

Aggressive use of bankruptcy law is not necessary in CEE transition economies because other devices, peculiar to this environment, have assumed the restructuring role traditionally played by bankruptcy law. The result appears to be that most companies can be effectively restructured without bankruptcy law application.²³⁷ This part will analyze how domestic restructuring mechanisms and foreign investment have played the restructuring role of bankruptcy law.

A. *Domestic Restructuring Mechanisms*

To avoid bankruptcy proceedings, CEE governments have turned to various devices. Specifically, CEE governments have improved creditworthiness and contained inflation, thereby avoiding the need for bankruptcy use, through the use of three principal debt-restructuring methods. All three methods work as an incentive to restructure and maximize capital-use efficiency.

Under the first method, CEE nations attempted a traditional "systemic" approach—encourage bankers and borrowers to work out as much bad debt—where payment was unlikely—as possible.²³⁸ Once bad debt was identified, it was cut out of banks' portfolios or recapitalized²³⁹ through an autonomous public entity set up to accept the non-performing loans.²⁴⁰ These loans were then settled through direct negotiations or eventually through the use of bankruptcy proceedings. This systemic approach assumes that the risk of the collapse in the financial sector far outweighs banks growing accustomed to being bailed out in this manner.²⁴¹

Instead of aggressive bankruptcy use, both the Czech Republic and Hungarian governments have implemented this traditional systemic approach.²⁴² In the Czech Republic, consolidation banks were established in 1991. Using these consolidation banks, the government assumed the bulk of bad loans from the nation's quasi-public commercial banks, and re-capitalized the bad loans with five-year government bonds. In 1992, the second round of Czech bank re-capitalization occurred, with the National Property Fund ("NPF") assuming the bad loans.²⁴³ In Hungary, the Hungarian Investment and Devel-

237. See generally *Stabilization, Reform*, *supra* note 23, at 90, 99.

238. Nestor & Thomas, *supra* note 41, at *3.

239. For a concise explanation of programs that seek to write off bad debts or to recapitalize debts, see *Chapter 3*, *supra* note 22, at *12.

240. Nestor & Thomas, *supra* note 41, at *3.

241. *Id.*

242. *Id.* The problem of the traditional approach is that it leaves large portfolios of bad loans in public or recently privatize enterprises in the hands of public entities who effectively are in charge of pushing for financial restructuring or bankruptcy. *Id.*

243. Several schemes also were enacted to work out inter-enterprise debts with very little success due to the lack of clear incentives—the plan was voluntary. *Id.*

opment Bank assumed most of the bad debt from commercial banks' balance sheets, replacing it with twenty-year treasury bonds.²⁴⁴

Under the second method, "centralization," the CEE government channelled aid to certain SOEs, thereby preparing these enterprises for privatization and for a competitive market environment.²⁴⁵ By first evaluating enterprises' business plans and competitive strategies,²⁴⁶ the state selected SOEs which were most likely to advance national economic development and were therefore most deserving of scarce government funds.²⁴⁷ Under a modified centralization method, the government also established liquidation or restructuring agencies to manage a preselected number of the most distressed, insolvent post-privatization enterprises.²⁴⁸

Under this approach, bankruptcy law purposely was circumvented. Some whole industry sectors were exempt from bankruptcy to achieve financial stability and ensure social stabilization.²⁴⁹ For example, monopolized and essential industries were principal sources of employment,²⁵⁰ particularly in areas outside the capital cities.²⁵¹ The state also did not want to get "rid of"—i.e., privatize—all enterprises because certain, valuable enterprises provided a source of revenues.²⁵²

The third method was "pre-privatization" restructuring, which was minimally used in the Czech Republic and Hungary. In the Czech Republic, the NPF carried out pre-privatization restructuring of some large enterprises, reworking their balance sheets²⁵³ that had been distorted under Communism. In Hungary, "apart from the 100 companies participating in a debt consolidation programme, another 160 very large companies (with a value of more than \$10 billion) have been transferred to the State Holding Company which is responsible

244. *Id.*

245. See Campbell, *supra* note 7, at 381 (discussing how the Russian bankruptcy law explicitly allows for state subsidies to shield certain firms "from the realities of a market economy").

246. Alice H. Amsden, *Eastern Europe: Putting Some Government Back in Manufacturing*, 98 *Mass. Inst. of Technology Alumni Assoc. Technology Rev.*, No. 5, July 1995, available in LEXIS, Nexis Library, NEWS file, at *5. The government can favor enterprises that are willing to devote a certain percentage of their output to a particular product line or meeting a quality level by a specified year, or export given qualities of goods to selected countries. *Id.* at *5-6.

247. See Flaschen & Desieno, *supra* note 26, at 672. Evan Flaschen and Timothy B. Desieno examine the legacy of the socialist system and advises which aspects of it are worthy of preservation.

248. Dhar & Selowsky, *supra* note 25, at *3.

249. *Bankruptcy Takes*, *supra* note 30, at *2.

250. Campbell, *supra* note 7, at 389-90.

251. Amsden, *supra* note 246, at *1.

252. Cf. Frydman & Rapaczynski, *Institutional Reform*, *supra* note 2, at *6 (stating that preservation of valuable enterprises is an important goal for policymakers considering privatization).

253. Nestor & Thomas, *supra* note 41, at *2.

for their pre-privatisation restructuring (which includes financial support)."²⁵⁴

Planting the socio-cultural seeds of a native capitalist class is necessary,²⁵⁵ each of these three methods have helped restructure by encouraging capitalist behavior. After four decades of Communist mismanagement, certain ingrained attitudes remained.²⁵⁶ There has been a need to create a driving force of private ownership, and to develop "the informal codes of behavior—including managerial and business practices—which underpin the working of all effective [market economy] institutions."²⁵⁷ The government, private investors, managers, and the general citizenry must learn to utilize assets in the most efficient way and steer these assets towards profit-generating entities.²⁵⁸

For example, to motivate labor, some CEE governments have sold state enterprises to enterprise workers.²⁵⁹ Further, CEE governments established management programs which financially disciplined managers by linking their compensation to their enterprise's value.²⁶⁰ In addition, in Hungary, to foster capitalist entrepreneurship, financial recommendations have been made to construct a network of small financial intermediaries, such as commercial banks, to provide small businesses with special bonds or credit pools for start-up capital and credit.²⁶¹ The government would support this network by acting as a guarantor for commercial loans.²⁶²

254. *Id.* at *3; see *Star Czech*, *supra* note 181, at *5.

255. See Cohen & Schwartz, *supra* note 14, at 16-22 (noting the ability of state institutions and policies to address the shortage of entrepreneurial experience and poor work habits of labor). Some argue that to privatize firms "without first restructuring them may undermine the creation of a competitive environment, since questions of competitive structure and effective corporate governance need to be settled before privatization takes place. Otherwise, the new private owners will resist any belated attempt to correct for market failures." Zeleny, *supra* note 34, at *2.

256. See Burton Bollag, *Walking the Line . . . ; Western Business Concepts and Communism in the Czech Republic*, Across the Board, July 1995, at 37, available in LEXIS, Nexis Library, NEWS file, at *1, *3.

257. Zeleny, *supra* note 34, at *2.

258. See Flaschen & Desieno, *supra* note 26, at 671 (noting the theory that "assets themselves, rather than the particular business that utilizes the assets, produce economic value and employment").

259. Kent Klaudt, *Hungary After the Revolution: Privatization, Economic Ideology and the False Promise of the Free Market*, 13 *Law & Ineq. J.* 303, 362-64 (1995); see also Masahiko Aoki & Hyung-Ki Kim, *Corporate Governance in Transition Economies*, 32 *Fin. & Dev.* 20, Sept. 1995, available in LEXIS, Nexis Library, NEWS file, at *1 (noting that "the privatization process has resulted in strong insider control—by managers in some cases, and by managers and workers in others").

260. Dhar & Selowsky, *supra* note 25, at *4; see Tardos, *supra* note 13, at 63 (drawing up an incentive program where the firm would pay bonuses for carefully specified tasks).

261. Marer, *supra* note 9, at 177.

262. *Id.*

B. *Foreign Investment*

Foreign investment also helped to provide both the investment capital and impetus to begin the restructuring of the private sector.²⁶³ Industrial shares in insider-controlled enterprises were unattractive to potential domestic investors²⁶⁴ because of low dividends and the virtual impossibility of obtaining a large block of shares in a particular enterprise. Consequently, the domestic equity market tended to be weak and incapable of providing adequate finance for enterprise restructuring.²⁶⁵ Foreign investment in CEE nations, acquired through sales by tender and international private placements of shares with a domestic public offering,²⁶⁶ helped to bring in needed capital—both equity and liquid capital. Further, foreign investment assists in organizing capital, technology, and management skills.²⁶⁷

The restructuring process in CEE nations through foreign investment has been underway. All of the CEE nations have made their economies more receptive to foreign investment and moreover, improved their framework of laws regarding foreign investment.²⁶⁸ By the end of 1993, the amount of foreign investment had risen to almost \$10 billion.²⁶⁹ In both the Czech Republic and Hungary, foreign investment has helped to begin the long restructuring process in their economies. The Czech government has relied on investments from foreign institutions for debt financing and for capital improvements.²⁷⁰ Hungary has made foreign investment “a basic element of its economic growth and privatization strategy” and has successfully attracted foreign investment.²⁷¹ It has received an enormous amount of foreign investment, with “[f]oreign direct investment beg[inning] to flow into Hungary in amounts equal to, and sometimes greater than, the rest of the region put together.”²⁷² In 1993, Hungarian firms with

263. See Zeleny, *supra* note 34, at *2. “New wealth is imperative. Redistribution of the old wealth is insufficient.” *Id.*; see also Donald J. Hasfurther, *Prospects for Business with East Europe*, 549 *PLUComm.* 189, 196 (1990), available in Westlaw, TP-ALL Library (“All of the countries . . . have placed a heavy emphasis of foreign investment as a mechanism for stimulating economic growth . . .”). *Contra* Tardos, *supra* note 13, at 66 (warning CEE nations against sales to foreign investors unless such sales reduce the foreign debt).

264. Amsden, *supra* note 246, at 2.

265. See *id.*

266. Wood & Talmácsi, *supra* note 140, at 244-45.

267. See Cheryl W. Gray & William W. Jarosz, *Law and the Regulation of Foreign Direct Investment: The Experience from Central and Eastern Europe*, 33 *Colum. J. Transnat'l L.* 1, 5 (1995).

268. *Id.* at 3.

269. *Id.*

270. *Id.* at 6.

271. Hasfurther, *supra* note 263, at 193.

272. *The Knife is Turned*, *Banker*, Vol. 146, No. 839, Jan. 1996, at 42, available in LEXIS, Nexis Library, NEWS file, at *1.

over ten percent foreign ownership accounted for half of all new investment.²⁷³

CONCLUSION

CEE nations are not ready for bankruptcy law restructuring. Market economy infrastructure as well as incentives—to recognize the need for correcting market inefficiency and distortion through bankruptcy law application, and to understand the bankruptcy law's rehabilitative impact as well as its sense of equitable justice—do not exist.

At this point, CEE nations cannot afford to comply strictly with Western-style bankruptcy laws. Because of their post-Communist legacies, it is difficult to differentiate between a temporary, short-term financial crisis and a doomed business.²⁷⁴ Insolvency law should only allow the former, a presumably viable firm, to continue in business.²⁷⁵ CEE transition economies need extensive economic restructuring, particularly of the equity and capital markets, and must actively seek to inculcate new "market" attitudes in potential domestic investors. Western predictions of pervasive bankruptcy law use in CEE rested on market assumptions that did not exist.

As evidenced in the Czech Republic and Hungary, bankruptcy non-use, at this time, is a positive sign of gradual restructuring. When the economy is ready for a fully-effective bankruptcy law, part of the learning process then will be to teach CEE nations that bankruptcy is a positive tool to salvage businesses and jobs.²⁷⁶

273. *Id.* at *4.

274. *Instituting Bankruptcy*, *supra* note 186, at 3.

275. Sak & Schiffman, *supra* note 17, at 931.

276. *See, e.g.*, Horton, *supra* note 26, at *12 (focusing on Russia as an example of post-Communist nations).

