CRAMDOWN IN U.S. BANKRUPTCY LAW: LESSONS FOR HUNGARY

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LL.M. SHORT THESIS

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Budapest, 1 April 2016

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dr. Kovács Krisztián
Abstract

European countries and even the European Union are amending their bankruptcy laws continuously to increase the likelihood of the companies’ continuation in an insolvency situation. This thesis is dealing with problems that are well-known by European insolvency experts: the difficulties surrounding the acceptance of a reorganization plan by the creditors. Reorganization preserves the value of the company as a going concern while helps to the employees’ to keep their job and to the state to maintain the existence of a tax payer.

The central issue of this paper is what the Hungarian legislators could learn from the experience of the more advanced US bankruptcy system.
1. Introduction

The creditors, or some of the creditors, may not find the reorganization plan as successful as the debtor or other creditors, therefore, using their voting rights they vote against the reorganization plan which then normally results in liquidation of the debtor. For the survival of companies in an insolvent situation U.S. bankruptcy law introduced a new concept to the system of insolvency law which is a solution offered by the legislator to impose a reorganization plan over the creditors. This power is called cramdown in the United States.

In a bankruptcy procedure which is federal law governed today, the bankruptcy court may give its approval to the reorganization plan which then becomes binding for all the concerned parties. For a confirmation the court must find that the requirements which are stated in Section 1129 of the Bankruptcy Code are met. Without the confirmation of the court according to Chapter 11 of the Bankruptcy Code, only those plan proposals are having binding effect on the creditors that are accepted by each class of impaired claimants or interest holders, the presumption that those deals are consensually formulated and satisfied the impaired parties. For a cramdown it is also necessary to have at least one impaired creditor who votes in favor of the reorganization plan – the presumption that the ‘yes’ vote is based on calculation or other advantage of the plan. If the plan is fair and equitable and also not discriminating any parties unfairly, the court may impose it on the parties, despite those rejection of the plan. Parties usually receive at least the same amount as they would receive in a liquidation proceeding. Secured creditors may not be negatively affected by the cramdown, due to the so called absolute priority rule which is giving the full satisfaction based on the value of their collaterals.

In Hungary – and also in Europe – the most problematic part of an insolvency procedure is to get the creditors involved in the negotiations, most of the creditors are just not attend to the meetings, therefore accepting a reorganization plan is almost impossible. Therefore the first
objective – if we think the reorganization is a better solution than liquidation, if a company become insolvent – is to encourage the participation of the parties in the reorganization negotiations.

In the realm of business some enterprises will be successful, some will be less successful and some will fail. The best way to not fail is to not start anything, but business entities are designed to gain profit. People set up a new legal entities to achieve profit, but sometimes a good idea, a good product does not result in financial success. When a legal entity can’t pay a debt when it’s become due, it would be considered insolvent and insolvency proceeding could be brought against it – voluntarily or involuntarily. In Europe – and especially in Hungary – the most common way to solve the problems of an insolvent company is liquidation,¹ in which the company is wound up and deleted from the company register, the assets are sold and at the end of the day creditors may receive a small amount of their claims. But this is not a good solution. With respect to the fact that more than 99% of the Hungarian insolvency proceedings end up in a form of liquidation and only less than 1% ends in reorganization I think that reorganization could be a better scenario.²

Liquidation is a cheap and fast solution to satisfy the creditors’ claims partially, but the side effects of the procedure are – in my opinion – sometimes overcome the advantages of this kind of procedure. The main problem is that the company is removed from the commercial register, stops its activities, therefore employees are losing their job, and the government lose a taxpayer and has to pay unemployment benefit and other support for unemployed workers.

It is important to state that my presumption that the reorganization is at least as good for the creditors as the liquidation would – without the relatively short timeframe of the liquidation.

² From 29 March 2006 to 2016 March 2016 only 829 reorganizations took place in Hungary, compare to 160,123 liquidations.
The major difference that the reorganization allows the company to run its business, saves people’s work, and also gives a second chance to the company to restructure its business and be profitable again. If there is no possibility to reorganize the company, then liquidation would be better. When is reorganization better to the society?

To answer the question it is important to highlight that most of the systems set up the following voting mechanism according to the acceptance/rejection of the reorganization plan: the reorganization plan must achieve the (simple or qualified) majority of the creditors voting in favor of the plan, while creditors who are not impaired according to the plan, considered as non-voters or as voted in favor of the plan. The non-impaired distinction is very important: if a party does not lose anything regardless of the form of the procedure, the party has no real interest to change the circumstances. In the realm of liquidation versus reorganization the status quo is different: both ways result in impairment, the creditors receive only partial satisfaction, therefore only the amount is in question. In my opinion if the creditor in a reorganization procedure receive at least that would receive in a liquidation, the creditor should be considered as a neutral party that has no preference to choose either liquidation or reorganization. If it is neutral for the party to choose between the two we shall take into account the interest of the society. The interest of the society is the following: if the company survives while creditors receive the same amount (or more) that they would in a liquidation, choosing reorganization will save a tax-payer, an employer, a part of the supply chain. Therefore we shall conclude that the promotion of reorganizations – where it is possible – could have very positive effects on the economy of a state.
2. Chapter 11 reorganization

This chapter will describe the purpose, procedure and outcome of the Chapter 11 BC.

In the US businessmen regularly more familiar with terms of bankruptcy and willing to use and to cooperate in reorganization proceedings, the number of Chapter 11 (reorganization) filings compare to Chapter 7 (liquidation) filings is very telling: in 2015 business entities filed 6,130 Chapter 11 reorganizations while filed 15,917 Chapter 7 liquidations which shows that in 38% of the cases creditors and/or debtors decided to try reorganization instead of liquidation.³ As we seen the numbers in Hungary are radically different. Both system offers almost the same solutions for reorganization, but in the US the courts have the power to impose the reorganization plan over the objecting creditors which solution does not exist in Hungary.

2.1 Purpose of Chapter 11

“For a business debtor in the throes of financial difficulties, the most important statutory mechanism for rehabilitation is found in Chapter 11 of the Bankruptcy Code.”⁴ Chapter 11 reorganization is aimed primarily to avoid social costs of liquidation and secondarily to the retention of the corporation’s operation as a going concern.⁵ As long as there is a chance for the debtor to produce positive net income its more efficient the reorganize the business.⁶ The US experience shown that the Chapter 11 reorganization is a very efficient and comprehensive mechanism which allows the company to avoid liquidation. The companies are able to file for protection regardless of whether it can show that the company is insolvent or close to be

⁴ MALLORY, KATHRYN C. & PHelan, ROBIN E., To impair or not to impair – that is the question in Chapter 11 reorganization, 17 St. Mary's Law Journal 869 (1985-1986)
insolvent, therefore managers have much broader discretion whether it is necessary to restructure the debts of the company.\textsuperscript{7}

2.2. The procedure

The procedure itself starts with a filing of a petition to the bankruptcy court. As we stated above, insolvency is not necessarily a requirement to file a petition. After a company filed its petition for reorganization “\textit{there is an automatic moratorium or stay on enforcement of claims against the company and its property}”\textsuperscript{8}. The automatic stay remain active until the end of the reorganization procedure, but can be revoked by the bankruptcy court. One advantage for the debtor in a Chapter 11 scenario compare to a liquidation is the debtor remain in possession and continue to maintain its business activities during the procedure.\textsuperscript{9} If the debtor fails to maintain its obligations during the negotiation period or commence fraud, other prohibited actions, such as wasting the money of the company or it is the best interest of the company,\textsuperscript{10} the court may be replaced by a trustee.\textsuperscript{11}

During the automatic stay the debtor has 120 days\textsuperscript{12} to file a reorganization plan if it’s committed a so called “free-fall” bankruptcy. If the debtor started a so called pre-packaged proceeding it is obvious that there is no need for that 120 days period. If a debtor fails to fulfil its duties and not submitting a plan within 120 days, the interested parties, such as the trustee, the creditor’s committee, etc. are having the right to file a reorganization plan.\textsuperscript{13} It is a known business in the US to participate in reorganization procedures to raise profit by buying strategic block of debts issued by the bankrupt company. These investors are called as “vulture” or “debt

\begin{footnotes}
\item[9] Bankruptcy Code § 1107 (a)
\item[11] Bankruptcy Code § 1104 (a)
\item[12] Bankruptcy Code § 1121 (a)
\item[13] Bankruptcy Code § 1121 (c) (c) Any party in interest, including the debtor, the trustee, a creditors’ committee, an equity security holders’ committee, a creditor, an equity security holder, or any indenture trustee, may file a plan if and only if— (2) the debtor has not filed a plan before 120 days after the date of the order for relief under this chapter;
\end{footnotes}
raider” investors. The investors may buy debt claims to acquire cash and securities valued at more than that invested, or to exchange the purchased claims for particular assets of the debtor, or to acquire strategically important part of the claims and exchange it for equity of the bankrupt company.

2.3. The reorganization plan

The insolvent company could either choose to file a conventional bankruptcy petition or a prepackaged one. In the first scenario the debtor voluntarily files the petition to the bankruptcy court and during the automatic stay starts negotiations with the creditors. In the case of prepackaged bankruptcy the debtor approaches its creditors before actually filing the petition to the court. If the parties agreed on the terms of the reorganization, the debtor “files for bankruptcy protection with the votes for a plan for reorganization having already been solicited by the debtor and agreed to by the requisite number of creditors before the filing of the bankruptcy petition” [16]. If the debtor turns to the court without a prepackaged plan [so called “free-fall”], a negotiation takes place between the debtor and its creditors. The Bankruptcy Code § 1126 requires positive votes of two-thirds in amount and majority in numbers. The court is allowed “to disqualify votes that are not procured and exercised in good faith” [17]. Altogether there are sixteen requirements listed in Bankruptcy Code § 1129 (a).

There are additional requirements which must be satisfied. The four additional requirements are the following: (i) the plan must meet a statutory best-interest-of-creditors test,

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14 Like in an asset deal on discount price.
15 AFRICK, ANDREW, Trading claims in Chapter 11: How much influence can be purchased in good faith under Section 1126?, 139 University of Pennsylvania Law Review 1393-1394 (1991)
(ii) each priority claim must receive special treatment, (iii) at least one class of claims must accept the plan, (iv) the plan must be feasible.¹⁸

(i) The best interest test is requiring each member to receive at least as it would receive in liquidation. This rule protects the dissenting members of the class – there is a presumption that if the creditor receive the same amount or more there is no real reason to object.

(ii) States generally have huge discretion when deciding the type of claims shall be considered as prioritized claims, these claims generally include: administrative fees, taxes, sometimes wage claims, claims of consumer creditors.

(iii) This requirement can be satisfied in two ways: one way to achieve majority in an impaired class, the other way is to create a class of claims that are not impaired, because non-impaired claimants considered as who vote in favor of the plan.¹⁹ The rule also excludes the votes of so called “insiders” – claims of equity holders, etc. While the best interest test protects the dissenting creditors of the class, the majority requirement and the cramdown power protects the dissenting class(es).

(iv) “Prior to emerging from Chapter 11, a U.S. debtor company is required to provide financial and operational projections, as part of its reorganization plan, to the U.S. Bankruptcy Court. These projections are to demonstrate that the company is not likely to liquidate or reenter Chapter 11.”²⁰ The last precondition means that the company has real chance to survive, the acceptance of the plan is not like followed by liquidation or reorganization.²¹

¹⁸ KLEE, KENNETH N., All you ever wanted to know about cram down under the new Bankruptcy Code, 53 American Bankruptcy Law Journal 137-138 (1979)
²¹ KLEE, KENNETH N., All you ever wanted to know about cram down under the new Bankruptcy Code, 53 American Bankruptcy Law Journal 138 (1979)
If all the above mentioned criterions are met, the plan shall be confirmed and in the majority of the cases this is the common scenario. Sometimes all of the above mentioned preconditions are met but the confirmation by the majority of impaired creditors is missing.

The plan must designate different classes, based on the claims and interests that they have. Bankruptcy Act § 1122 specifies that substantially similar claims and interests should be in the same class.

For the acceptance of the reorganization plan the majority of the claims has to vote in favor of the plan. The majority is not simple: a class of claims has to hold “at least two-thirds in amount and more than one-half in number of the allowed claims”\(^\text{22}\). This double-majority requirement ensure the balance between the claimants: if the only requirement would be the amount threshold it would be favorable for the major creditors with big amount of claims, while the number-based requirement in itself would be favorable for the small creditors.

The acceptance of the plan is required during the procedure, but in itself not enough for a successful reorganization. After the acceptance of the plan the bankruptcy court shall confirm the reorganization plan. For the confirmation the parties shall prove that they fulfilled the criterions listed in the Bankruptcy Code § 1129. The plan is only be confirmed by the court if the impaired classes accepted it, this statement is not true for cramdown scenarios.

2.4. Types of claims and creditors

Many transactions are based on a form of credit: this form can be either secured or unsecured. Securing a claim could be essential for a creditor if he would like to obtain the due payment come hell or high water. In the realm of business many transactions are based on unsecured credit. “The unsecured credit transaction involves a maximum of risk to the creditor – the person who extends the credit.”\(^\text{23}\) According to the Black’s Law Dictionary, the term

\(^{22}\) Bankruptcy Code § 1126 (c)

“credit” has several meanings: “1. Belief; trust. 2. One’s ability to borrow money; the faith in one’s ability to pay debts. 3. The time that a seller gives the buyer to make payment that is due. 4. The availability of funds either from a financial institution or under a letter of credit.”

The problem or the risk arises from the fact that the unsecured creditor has no priority over other creditors’ of the debtor, therefore in a scenario whereas the debtor has no sufficient amount of money to pay every claims that become due, the unsecured creditor remain junior to the secured creditors and other priority claims and may receive nothing at the end of the day. Secured creditors also receive special treatment is cramdown procedures. Before 2006 it seemed possible for the secured creditors to subordinate their claims to the junior classes to convince them to accept the reorganization plan or achieve majority at least in one junior class in favor of the plan, but the district court in the decision of In re Armstrong World Industries stated – and the appellant court affirmed the verdict - that this type of subordination violates the absolute priority rule and violating the Bankruptcy Code § 1129 (b) (2) (B) (ii) standard therefore the court cannot confirm it.

The absolute priority rule is something more and something different than the fair and equitable requirement according to the case law of the Supreme Court: the rule mandated that the plan had to satisfy in full the claims of the senior class before junior classes receive anything. According to the rule if the bankruptcy estate is not enough to satisfy all the claims of the class, the junior classes shall receive nothing and all creditors had to be paid in full, before equity holders receive anything. The sequence therefore is the following: secured creditors from senior to junior, unsecured creditors from senior to junior, equity holders from senior to junior.

25 In re Armstrong World Industries, INC. United States District Court, Delaware, 2005, 320 Bankr. 523
However the *Armstrong decision* had been criticized by commentators: “*Armstrong would prevent one class of creditors from giving up value to equity if another class of creditors (whether pari passu or junior to the senior class) was not paid in full and such class did not vote to accept the plan.*” With this restriction it could be hard sometimes to convince junior classes to vote in favor of the plan.

Creditors’ decision making involves a lot of calculation whether to lend and – if so – under what conditions. One possible solution could be to secure a debt; become secured creditor. The secured creditor has priority rights over the collateral and with these rights become senior to other (unsecured) creditors. “Lenders take the collateral for one reason: to secure repayment of the loan.” In the event of bankruptcy, these debts are repaid to the secured creditors before other creditors receive their payments. Regulating the rights of the secured creditors could be a key element of credit-friendliness, but the secured creditor must not overcompensated for its security right. The protections must remain as strong as it would in non-bankruptcy; additionally the secured creditor must be protected from bankruptcy risks and hazards. To have priority it is essential for the creditor to perfect its security interest. Forms of perfection are possession, control or filing – also, some security interests are subject to automatic perfection. The “delay in one of the attachment or perfection requirements can arise either in bankruptcy or in non-bankruptcy situations if subsequent parties claim the same collateral. The risk arises when either the trustee in bankruptcy or the subsequent parties claim that the security interest is invalid because filing does not comply with the requirements of the

27 FRIEDMAN, SCOTT J. & DOUGLAS, MARK G., *You just can’t give it away: Senior Class give-up to equity violates absolute priority rule*, 1 Pratt’s Journal of Bankruptcy Law 436 (2005-2006)
31 HILL, PATRICK H., *“The Twain Shall Meet”: A Real Property Approach To Article 9 Perfection*, 64 Emory Law Journal 1103, 1110 (2015)
Uniform Commercial Code.” Different rules apply to secured creditors in bankruptcy: “At a minimum, the cramdown plan must provide that secured creditors will retain their liens on the collateral and receive deferred cash payments with a present value at least equal to the creditors’ interest in the property.” According to the collateral, the secured creditors claim is only as strong as the collateral: “an undersecured claim is bifurcated by section 506(a) to yield two claims: a secured claim equal to the value of the collateral and an unsecured claim for the remainder.” For attachment three requirements must be fulfilled: (i) value must be given, (ii) the debtor has rights or the power to transfer rights in the collateral, (iii) the debtor has authenticated the security agreement.

32 WALLACH, GEORGE, Perfecting and Reperfecting Security Interests Under the Uniform Commercial Code, 30 The Business Lawyer 447, 448 (1975)
35 UCC § 9-203(b)
3. The cramdown power

This chapter will describe the rules on cramdown, which is the opportunity to impose the reorganization plan over the objecting creditors.

“Every class of creditor must approve the plan unless the court can override the objection of an opposing class; this is referred to as the ‘cramdown’ of creditors. Secured creditors may be forced to agree if they receive at least the value of their security. Unsecured creditors cannot be overridden unless claimants below them in priority receive nothing.” In European legal systems equivalent provisions do not exist, the absence of these rules “adds an onerous layer of complexity and transaction risk.” The impaired status is very important in the procedure: cramdown provisions may only be used against impaired classes. Therefore “if the debtor believes for some reason that a class might vote against a plan, the debtor may propose to leave that class unimpaired.” This feature of the Bankruptcy Code gives important discretion to the maker of the reorganization plan to choose the best way of voting mechanisms, including the forming of different classes and the designation of impairment status. Sometimes it could be advantageous to exclude the objecting parties per se, therefore they have no opportunity to convince other creditors to vote against the plan.

If all the criterions what listed in Bankruptcy Code § 1129 are met – except the majority of votes in favor - the bankruptcy court shall inspect whether the reorganization plan satisfies the requirements of cramdown: the plan must not discriminate unfairly and must be fair and equitable.

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37 The case for unifying the EU’s insolvency laws, 24 International Financial Law Review 49 2005
38 MALLORY, KATHRYN C. & ROBIN E. PHELAN, To impair or not to impair – that is the question in Chapter 11 reorganization, 17 St. Mary's Law Journal 874 (1985-1986)
39 But at least one impaired class always has to accept the plan to have the opportunity to cramdown.
40 Bankruptcy Code § 1129 (b) (1)
We are talking about discrimination when similar situations threatened differently or
different situation threatened as the same. In insolvency law mostly occurs when we are talking
about distribution policies: creditors of equal rank are entitled to equal distribution. Discrimination in itself not prohibited, but it should be based on a distinction which is not unfair: “the pertinent inquiry is not whether the plan discriminates, but whether the proposed discrimination is `unfair”42 The term of unfair discrimination is not defined in the Bankruptcy Code, If there is a rational basis for discrimination/different treatment, the plan does not discriminate unfairly. In case In re TCI 2 Holdings, LLC case43 the court stated that there is no unfair discrimination if: “(a) the discrimination is supported by a reasonable basis, (b) the discrimination is necessary for reorganization, (c) the discrimination is proposed in good faith, and (d) the degree of the discrimination is directly related to the basis or rationale for the discrimination”.

The fair and equitable requirement is something that the Congress has given very little guidance to the courts for how to determine. In the Hardzog case the court stated: “While the cases considering the issue are fairly uniform in agreeing that a market rate of interest is appropriate, the cases differ drastically in their interpretation of how a ‘market rate’ is to be determined”44.

3.1. Reverse cramdown

Reverse cramdown is the “give up” of the secured creditors to the junior unsecured creditors to convince them to vote in favor of the reorganization plan. This subordination violates the fair and equitable standard, as well as the absolute priority rule. Prior the bankruptcy a secured creditor may receive benefit from a subordination: “Under most

41 See In re Combustion Engineering, Inc 391 F.3d 190 (3d Cir 2004)
42 In re Armstrong World Industries, INC. United States District Court, Delaware, 2005, 320 Bankr. 523
43 Bankr. D.N.J. Apr. 12, 2010
44 Hardzog v Federal Land Bank (In re Hardzog), 901 F.2d 858, 859 (10th Cir. 1990)
subordination agreements, the junior or subordinated creditor is required to turn over all payments allocable to its claim against the debtor to the senior creditor until the senior creditor’s claim is satisfied in full. Thus is the debtor files for bankruptcy, the senior creditor has a right to distributions allocable to the claim held by the junior creditor until its senior claim is satisfied in full.”

In theory the reorganization plan is a contractual relationship between the debtor and its creditors therefore parties are enjoying the traditional freedoms of contract formation. However, this special type of contract is subject to bankruptcy regulations and these regulations are protecting the interests of every affected party, not just the ones who are participating in the reverse scenario. The basic idea of reverse cramdown is that – according to the Bankruptcy Code – the secured creditor is entitled to no less than the nominal value of its secured claim. Since the secured creditor would receive that amount (i) after enforcement, (ii) in a liquidation procedure, (iii) in a reorganization, the creditor’s position there is strong. The secured creditor after the initiated procedure has done is entitled to do anything with the acquired asset, cash, etc. The reverse cramdown is nothing more, but the disposal of the collateral not after, but before the end of the procedure.

The barrier against reverse cramdown is the fair and equitable rule and the prohibition of unfair discrimination. So as the court ruled in the Windsor on the River Associates v Balcor Real Estate Finance case: “[...] one of the primary functions of bankruptcy law: to discourage "side dealing" between the shareholders of a corporation and some creditors to the detriment of other creditors.” The problem with this type of side dealing that it is often concluded

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46 Till the value of the collateral.
47 In re Windsor on the River Associates, Ltd. 7 F.3d 127, 132 (8th Cir. 1993)
See: http://openjurist.org/7/f3d/127/windsor-v-balcor
between the secured creditors and equity holders over the objection of the intermediate creditors.

“Permitting the practice of “give ups” and “tips” creates the perverse incentive for secured creditors and old equity interest holders to collude to achieve a valuation indicating that the secured lender is undersecured in order to squeeze out other parties who may in reality be in the money” \(^{48}\).

Most of the US court rely on provisions laid down in the SPM case. In the case a creditor (Citizens Savings Bank) held a perfected security interest in substantially all of the debtor’s assets, the Internal Revenue Service (IRS) was a junior creditor with unsecured, but prioritized claims and the 3\(^{rd}\) party in the deal was the Unsecured Creditors Committee.\(^{49}\) The Bank and the Committee reached an arrangement whereas the Bank would give a small portion of its claims to the Committee to convince them to vote in favor of the plan to have a possibility to cramdown. Two creditors who would have been personally liable for the tax claims owned by the IRS if its not paid by the estate are contested the deal. The bankruptcy court shared their point of view that these agreement violates the absolute priority rule, because the Committee receive something from the bankruptcy estate while the IRS remain totally unsatisfied.\(^{50}\)

One possible way to overcome the consequences of the prohibition of “gifting” is the pre-bankruptcy planning. These workouts are allow the debtor to negotiate with the creditors, settle or modify the obligations without the barriers of the Bankruptcy Act. This may lead to a pre-packaged filing or there will be no filing at all.

“Pre-bankruptcy planning is certainly not without drawbacks, though. Unlike in bankruptcy, a pre-petition workout is only binding upon creditors that are party to the


\(^{49}\) MCDIVITT, LAUREN E., What do you mean there won’t be gifts this year?: Why practitioners cannot rely upon gifting provisions in Chapter 11 reorganization plans in the Fifth Circuit, 44 Texas Tech Law Review 1029 (2012)

\(^{50}\) Id. at 1030.
agreement. Thus, creditors that choose not to consent to the agreement are not bound and may still pursue state court remedies such as initiating foreclosure or pursuing a judgment lien. Similarly, a rogue creditor may prematurely disrupt pre-petition negotiations by filing an involuntary petition of bankruptcy. Finally, pre-petition workouts may do little for a business that already has minimal resources and is teetering on the verge of financial ruin."51

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51 Id. at 1049-1050.
4. Reorganization in Hungary

This chapter will describe the history of Hungarian insolvency laws, then the statutory and procedural aspects of the reorganization procedure.

The bankruptcy law in Hungary for centuries was only a customary law. The first laws are adopted in the late 18\textsuperscript{th} century, but the procedures are weren’t similar in the state. In 1807 the Parliament adopted the Act XII. of 1807 on the punishment of fraudulent falls, and considered fraudulent insolvencies as a crime (theft). The German-type insolvency model is adopted in 1840\textsuperscript{52}, the model basically remained the same till the Second World War. After the war in the communist era there was no need of bankruptcy: companies are owned by the state, this basically meant that the state just put the money from one pocket to another. The minister of finance was responsible for the “reorganization” of the insolvent companies – but most of the time the government maintained the insolvent companies’ activities and paid their debts.\textsuperscript{53}

4.1. The Hungarian Bankruptcy Act

The modern Hungarian Bankruptcy Act\textsuperscript{54} entered into force in 1992. Hungarian acts adopted by the parliament generally use Roman numerals which is an elegant way of numbering, but sometimes hard to follow or recognize the numbers if the person has no knowledge about the methodology. The HB Act had been published in the Official Gazette\textsuperscript{55} with wrong numbers: the act was the 49\textsuperscript{th} adopted act in 1991 and it is published as “Act IL” which number basically doesn’t exists in the realm of Roman numerals. It took 15 years to amend (correct) the title of the act. The HB Act contains 85 sections in 6 six chapters as the

\textsuperscript{52} Act XXII. of 1840 on Bankruptcy
\textsuperscript{54} Act XLIX of 1991 on reorganization and liquidation (hereinafter: HB Act)
\textsuperscript{55} In Hungarian: Magyar Közlöny – the official gazette whereas the new legislative instruments are published before entering into force.

Chapter 1 is containing the aims, definitions and basic procedural rules as well as the outline of the creditors’ committee. Chapter 2 is laying down the rules on reorganization, Chapter 3 contains the outline of a liquidation.

In 2010 a new government elected which acquired qualified majority in the Parliament, then with the given power the government introduced new rules the strengthen the economy of Hungary, the concept of Strategically Important Business Organization (hereinafter: SIBO) comes from this idea. The government in a governmental decree could qualify a business entity as SIBO if the reorganization (survival) of the company is qualified interest of the national economy or private interest of many people. The decision of the government is discretion, therefore the SIBO-qualification is a pleasure from the government for the creditors or to the debtor – depending on the case.

Chapter 5 contains only one section that allow the state- and governmental organs to surrender their claims if there is no possibility to enforce it in a bankruptcy proceeding.56

The last Chapter of the Act regulates the temporal scope and the delegation of law-making powers to the ministers of the cabinet.

56 HB Act 80. §
4.2. Reorganization

The ministerial motivations to the HB Act stated the following: “In the realm of economy it is natural that a part of companies are could not comply with the requirements of the market and go bankrupt. These companies shall be liquidated as fast as possible or reorganized in a way to comply with the requirements of the market.”

In 2009 and 2011 the parliament amended the HB Act – resulted in almost a new act to facilitate the use of reorganization: decreased the required consent of debtors (the voting power based on the value of their claims) to the reorganization from 2/3 to 50% and introduced a concept which is more or less the same as automatic stay in the US system, in the Hungarian regime the debtor receive a 90 days long moratorium after the filing of the petition for reorganization. However, businessmen prefer the use of liquidation instead of reorganization if they have claims against a company which is insolvent: in 2014 only 88 reorganizations took place, in 2013 there were 128; which is basically nothing if we compare to the liquidations; in 2014 more than 16 000 liquidation procedures started.

As László Juhász, former head of the civil division of the Regional Court (Ítélőtábla) of Pécs said: “In Hungary it is so easy to found a new company, therefore not worth to reorganize an existing one. It is not surprising that 90% of the finished cases are only the simplified cleanup of ruins.”

For simplifying the – with the words of Juhász - cleanup, a new procedure introduced in 2012, what is called forced cancellation (kényszertörlés) to the Company Registration Act. The new procedure takes place when the company has not enough

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57 Ministerial motivations to the HB Act, General Part. Translated by the author. Original text: „A gazdaság működésében természetszerű, hogy a vállalkozások egy része nem tud megfelelni a piaci követelményeknek és tönkrejegye. Ezért ezeket a vállalkozásokat minél előbb fel kell számolni, vagy úgy kell újítsa készíteni, hogy beilleszsekhezennak az üzleti élet rendjébe.”

58 HALMOS, KÁROLY, A csőd intézményének rövid története, LIX. Közgazdasági Szemle, 540-557. 554 (2012)


61 Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings
property even to pay the costs of the liquidation, therefore the Company Court is deleting the company from the Commercial Registry in a simplified, fast and cheap way.\textsuperscript{62}

In 2013 the parliament has adopted a new Civil Code\textsuperscript{63}, which changed the minimum credit requirements of limited liability companies (Korlátolt Felelösségű Társaság – Kft.) from 500 000 HUF to 3 000 000 (1 660 EUR \textrightarrow 10 000 EUR). Before the new law entered into force it was relatively easy to found a new company if the existing one become or was close to become insolvent. Huge amount of companies are only made for the purpose of being a so called “invoice factory” (“számlagyár”)\textsuperscript{64} due to the very high amount of the Hungarian value added tax (27%). One possible answer to fight against these frauds to ban shareholders and managers from the competitive market for a limited amount of time whose company became insolvent– the real owners used puppets to maintain their business, most of the time poor or even homeless persons, who are not able to understand what they are doing. This measure again resulted in the strengthening of the so called bankruptcy stigma\textsuperscript{65}, it also affected honest managers who had undertook some risks to achieve higher rates of profit.

4.3. Procedural steps

The insolvent company has the right to file a voluntary petition for reorganization to the Bankruptcy Court. Since 1 January 2015 the petition can be submitted only as an electronic copy. After the filing the Court decides whether there is a room for reorganization and if there is no incompliance with the requirements of the filing publish the decision in the Company Gazette and award the temporal moratorium to the debtor.\textsuperscript{66}

\textsuperscript{62}Ibid. 116-118, §§
\textsuperscript{63}Act V of 2013 on the Civil Code of Hungary (hereinafter: Civil Code)
\textsuperscript{64}These companies are designed for VAT frauds, issued invoices on non-existing transactions and recovered the VAT from the tax authorities.
\textsuperscript{66}HB Act 8. §
There are some restrictions on the reorganization, according to the insolvent company, e.g.: fiduciary asset management companies (the Hungarian trusts) cannot file for reorganization, according to the Fiduciary Asset Management Companies Act § 46 (3).  

4.4. The bankruptcy trustee

The same time the Bankruptcy Court appoints a kind of bankruptcy trustee (vagyonfelügyelő) who is responsible to the preservation of the debtor’s assets and the registration of the claims against the debtor. Every creditor has 30 days to inform the trustee about the claims against the debtor and in the same time the creditor has to pay a registration fee, which is now 1% of the claim, but minimum 5 000 HUF, maximum 100 000 HUF. The fee is used to pay the expenses of the trustee. Privileged claims, such as taxes and employee wages are not subject to registration.

After the bankruptcy proceeding opened, the debtors lose the right to solely dispose of its property. Every disposal requires the countersignature of the trustee. If a debtor fails to acquire the countersignature of the trustee, before the disposal of assets the trustee has the right to commence proceedings against the parties and declare the disposal null and void.

The trustee is entitled to remuneration for its actions. The amount of the remuneration is based on the value of the debtor’s assets. The commission scale is regressive, for example if the asset’s value is below 100 000 000 HUF which is normally the case in Hungary, the trustee is entitled to a 2% commission, but minimum 250 000 HUF. If the asset’s value exceeds 1 000 000 000 HUF, the trustee is entitled for 7 500 000 HUF for the 1 000 000 000 HUF asset value and additional 0.25% commission for the value above the 1 000 000 000 HUF. If a

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67 2014. évi XV. törvény a bizalmi vagyonkezelőkről és tevékenységük szabályairól 46. § (3) Bizalmi vagyonkezelő vállalkozással szemben csődeljárásnak és kényszertörlési eljárás lefolytatásának nincs helye. Translation: Act XV. of 2014 on the fiduciary asset management companies and their activities 46. § (3) The reorganization or forced cancellation of fiduciary asset management companies is not possible.  
68 HB Act 12. § (1)  
69 HB Act 13. § (3) e)  
70 HB Act 16. § (3)
reorganization deal is concluded and approved by the court, the trustee is entitled another 15% of its commission, but minimum 300 000 HUF. We can see that the bankruptcy trustee is more interested to be appointed to big insolvent firms, where they earn much more money than preserving small entrepreneurs.

Before 2009 the trustees were appointed by the decision of the bankruptcy judge, the judge choose the trustee from a list. This cause some controversies and may sometimes resulted in corruption, or in favoring the judge’s favorite trustee for good cases and the unknown ones for the non-prosperous cases. The parliament changed the procedure of the appointment of trustees to an electronic mechanism in 2009. Several arguments came against the new system before it is even adopted, mostly from trustees, liquidators, bankruptcy lawyers and their organizations. The Minister of Justice also adopted a new decree about the rules of electronic appointment in bankruptcy. The electronic system is monitoring the case numbers of the trustee’s and based on the number of cases randomly selects a trustee. Trustees are having less cases than the average are having more chance to be appointed by the program.

The program itself is not perfect. First of all, it is only differentiates between trustees based on the number of ongoing cases. Other considerations, such as the experience of the trustee are remain out of scope. This may led to a scenario whereas a rookie trustee is appointed to a relatively complicated case with huge amount of assets, which would be a hard task even for an experienced one. The amendments are also challenged by a judge as a constitutional complaint, but the Constitutional Court in its verdict found that there is no violation of fundamental rights or principles.

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71 Act L. of 2009 on the amendment of Act XLIX. of 1991 on reorganization and liquidation, and the amendment of associated acts
72 36/2010. (V. 13.) Minister of Justice Decree on the rules of electronic appointment of liquidators, bankruptcy trustees and interim trustees
4.5. Problems with the nature of the claims

The trustee has the responsibility to decide whether a claim is recognized or undisputed. If a claim evidenced in notarial deed, the trustee previously had no right to decide, the claim automatically considered as an undisputed claim, based on a decision of the Budapest-Capital Regional Court of Appeal (Fővárosi Ítéltábla). In the mentioned case the debtor issued an acknowledgment of its debts at a notary public, but the trustee wanted to challenge the existence of that claim. The court held that according to 12. § (4) of the HB Act the trustee has no such power to do so. This opinion however become a bit more sophisticated after a decision of the Supreme Court, whereas the court ruled that if the debtor challenged the deed before the insolvency procedure started, the claim shall be considered as a disputed one with all of the consequences that arise from this nature.

The debtor may extrude a creditor from the creditor’s meeting/creditor’s committee by refusing to accept its claim or by commencing a dispute on that particular claim. In my personal practice I saw scenarios whereas the preparation of a voluntary started with the planning of which creditor should not participate during the negotiations, therefore its claim must have been eliminated in a way, such as with the commencement of a claim for invalidity – before opening the bankruptcy. Challenging the claims before the bankruptcy could be a tool therefore to exclude the biggest creditor from the creditor’s meeting.

The controversies arise from the fact that for example if a loan agreement evidenced in a notarial deed and there is a bank transfer note about the transfer of the money, the debtor could only challenge the interest rates, costs and other fees of the loan, but not the transferred value. The challenged amount in these cases is minimal compared to the whole claim, only a few percent. The courts therefore had to decide whether the creditor has undisputed claims against

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73 Case Cspkf.44.214/2011/2. – Fővárosi Ítéltábla
74 Case Gfv.X.30.174/2012/7. – Kúria
the debtor – no matter that the debtor challenged the notarial deed. The Supreme Court in the case Gfv.VII.30.275/2014/4. ruled the following: if the claim has a substantial part that is undisputed based on the petition of the claimant or by law, only the separated part shall be considered as a disputed claim, even if the two claims are basically arise from the same legal basis. The courts are in these cases are only making a distinction between the claims to decide the voting rights of each debtor and each claim, and its not the basis of a final judgment for invalidity or other claims. Also, these decisions in the bankruptcy procedures don’t constitute res judicata effect.

4.6. The creditor’s meeting

Within 60 days the creditor shall organize a creditor’s meeting to accept the reorganization plan – a draft plan must have been sent to them prior to the meeting. There are some requirements or rules that are may result in the rejection of the plan even if the plan is fair to the creditors. The creditors are having 1 vote for every 50 000 HUF recognized or undisputed claim, creditors who are having less than 50 000 HUF as claim shall have 1 vote. For the acceptance of the plan the creditors shall have majority in favor of the plan in every class. If a creditor who (i) filed its claim in time to the trustee, (ii) paid the registration fee, (iii) the claim is recognized or undisputed, but doesn’t present in person or by a representative at the meeting is considered – by law - as voted to the rejection of the plan.75

4.7. The reorganization plan

The reorganization plan aims to restore the solvency of the debtor. “The debtor shall explore what caused the financial difficulties, the insolvency or the situation what may result

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75 HB Act 18. § (5)
The restoration can be achieved via the reduction of the debts, the remission of the debts, acquisition of shares of the debtor, the acceptance of the reorganization plan, etc.\textsuperscript{76} If the debtor fails to prove that the measures provided in the reorganization plan are sufficient to achieve that result, the procedure ends up in liquidation, where the debtor’s assets were sold and the income is distributed among the creditors. The reorganization in Hungary not a tool to exit from the market and from responsibilities, the debtor must prove that after the deal he is willing to continue its business in the future.\textsuperscript{78} The court therefore have to inspect the reorganization plan on the merits, but this is not including the economic rationality of the plan. The judge refuse to approve the reorganization deal if the deal obviously violates the basic principles of law.\textsuperscript{79}

From the court’s point of view the most important question is that the plan is enforceable or not, if the debtor fails to perform the obligations in the later stages. This may seems obvious, but several cases it could be very hard to decide. In basic scenarios the court only has to take care about the (i) amount payable, (ii) when the claim become due.\textsuperscript{80}

For the acceptance of the plan at least 50% of the creditors in every class – have to vote in favor of the plan. As I mentioned before, if a creditor is not present at the creditors’ meeting, considered as voted for the rejection of the plan. Compare to the US it seems easier to accept

\textsuperscript{76} Case Gfv.VII.30.413/2014/10. – Kúria
\textsuperscript{77} HB Act 19. §
\textsuperscript{78} Case BH2014. 118
\textsuperscript{79} See Case BH2015. 75. § 29: „The debtor obviously had knowledge about the concentration between him and the S. A. Kft. [Limited Liability Company]. Because the debtor achieved majority to the acceptance of the reorganization plan from an unlawful act, the argument contained in the binding decision of the bankruptcy court is correct, the reorganization deal consisting the abuse of rights which is prohibited by law, therefore the court shall not have the power to approve it.”
\textsuperscript{80} Case BDT2012. 2643 – Pécsi Ítéltábla
the plan, because it only requires simple majority of the votes. The big difference according to the acceptance of the plans therefore not based on the percentage requirements during the vote.

One more thing that worth mentioning that the bankruptcy judge in Hungary has no cramdown power to impose the reorganization plan to the creditors. In the US even that there is no qualified majority achieved at the creditors’ meeting, the court shall have the power to impose the reorganization plan to the creditors, if at least one impaired creditor voted in favor of the plan, the creditors will receive at least that amount that they would in a liquidation and the deal considered as fair and equitable. The Hungarian reorganization deal is a so called “pressure deal” (kényszeregyezség), which means if the majority threshold met, the non-voting or voting for the rejection creditors are affected as well as other creditors. The plan become binding for them.

4.7.1. Challenging the reorganization deal after acceptance

There was a long debate about the nature of the reorganization deal, whether it is subject to further revision after conclusion. Some scholars said that like every agreement a reorganization deal could be the subject of an invalidity claim based on manifest error, deceit or fraud, while other scholars don’t share this argumentation. The Supreme Court ruled against the first approach when stated the following in case Gfv. 30.171/2013/13:

“ […] Before the amendments of Act LI. of 2009 entered into force on 1 September 2009 the rule was that in reorganization proceedings – whereas the bankruptcy court haven’t decided on the approval of the deal – were considered as amendments of the original contracts. […] With the amendments entered into force on 1 September 2009 the legislator considered the deal between the debtor and the creditors a deal approved by the court [and not an amendment of the original contracts]. “

The court also held in the same decision that the approved deal has the same effect as a judgment, therefore constitutes res judicata. Because of this, there is no possibility to appeal
against the decision. The only extraordinary measure which may be used is the revision process. Since 1 March 2012 there is no revision possibility in reorganization: “If the agreement comply with the rules of law, the court shall approve it in a binding order and declares the reorganization completed. No revision possible against the approving order.”81.

81 HB Act 21/A. § (3)
5. Hungarian versus US reorganization

This chapter will compare some basic features of the Hungarian and the US bankruptcy regimes.

<table>
<thead>
<tr>
<th></th>
<th>Hungary</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Who can initiate the procedure?</td>
<td>Debtor(^{82})</td>
<td>Debtor, creditors</td>
</tr>
<tr>
<td>Insolvency required for the procedure?</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td><strong>Moratorium?</strong></td>
<td>Automatic stay if not obviously unfounded</td>
<td>Automatic stay after filing</td>
</tr>
<tr>
<td>Length of the moratorium?</td>
<td>122 days(^{83}) (can be prolonged to max. 240 days)</td>
<td>120 days (can be prolonged to max. 180 days)</td>
</tr>
<tr>
<td>Who can submit reorganization plan?</td>
<td>Debtor</td>
<td>Primarily the debtor, after 120 days any other interested party</td>
</tr>
<tr>
<td>Mandatory to attend the creditors’ meeting?</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Is the confirmed reorganization plan binding to everyone?</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Required majority for the acceptance of the reorganization plan?</td>
<td>50% (simple majority) vote in every class, based on the amount of claims (secured creditors, unsecured creditors)</td>
<td>2/3 (qualified majority) in amount of the claims AND 50% (simple majority) based on the number of creditors</td>
</tr>
<tr>
<td>Cramdown possibility?</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Based on this comparison table and on the text of the first four chapters we can see some of the similarities and the differences between the Hungarian and the US regimes. In the first chapter we saw that the percentage of reorganizations among all of the insolvency proceedings is very different in the two states. In this chapter we are trying to decide whether the regulatory differences are the reason of the big difference in the percentage of reorganizations among the different procedures offered by the system.

\(^82\) Till the amendments of 2011 on the HB Act it was possible for the creditors to initiate reorganization, but the amendment deleted this section from the HB Act as of 1 March 2012.

\(^83\) The moratorium ends on the second working day after the 120 days period. Before 1 March 2012 it was a 90 days period.
In Hungary the reorganization procedure can only be initiated by the executive manager of the debtor while in the US either the debtor or the creditors can initiate this kind of procedure. In the US regime insolvency itself is not a pre-requisite for the opening of the procedure, therefore reorganization can be used as a tool to restructure the debtor’s business. It is also true that US-type reorganization can be initiated when there is no actual proof of insolvency, but the management see signs of possible insolvency, this feature does not exists in Hungary. The Hungarian-type reorganization’s aim is to restore the solvency of the debtor and cannot be used for different purpose.

After the amendments of 2008 of the HB Act the legislator introduced the automatic moratorium of 120 (122) days, prior to that amendment the decision on the award of the moratorium based on the discretion of the bankruptcy judge. After the filing of the request the petition is subject to preliminary review whereas the bankruptcy judge decides if the requesting party submitted all the necessary documents and if the answer is yes, furthermore the application is not manifestly unfounded, issues an injunction on the moratorium. The moratorium in the US is called “automatic stay” and the debtor is automatically entitled for it from the filing of the request.

In the US regime everything is aiming towards to reach a deal between the debtor and its creditors: if the debtor fails to provide an acceptable reorganization plan for the creditors everyone who has legal interest (including the trustee) could present its own reorganization plan which will be subject to voting. In Hungary only the debtor can submit reorganization proposal/plan. Debtors are sometimes using the moratorium as an abuse of right: not for preparing a reorganization proposal or to reach an agreement with the creditors, but to have time to hide the assets of the company.84

84 While the reorganization (moratorium) is in progress the creditors are not entitled to initiate liquidation proceedings against the debtor.
Both systems are sharing the opinion that the creditors are not obliged to attend the creditors meeting, the attendance is based on their own policy.

Systems are also sharing the idea that a confirmed reorganization deal is binding to everyone, even for the objecting or not participating creditors.

The required majority for the acceptance of the reorganization plan is different is the two systems. The HB Act requires simple majority in all classes according to the positive votes. The act specify creditors that are not attending to the creditors meeting as objecting creditors, their votes are considered as voted for the rejection of the plan. If the majority of the votes are in favor of the plan, the plan is accepted and only requires a formal confirmation of the court.

The Bankruptcy Code (US) is using a double-threshold mechanism, therefore achieving the required majority could be harder for the interested parties. Firstly, according to the amount of claims 2/3 majority must be achieved. Secondly, at least half of the creditors have to accept the plan. It is clear that in the US regime the thresholds are higher than in Hungary, therefore it should be harder to accept the reorganization plan – if we are talking only about numbers.

What happens if the plan is good, but there are not enough votes for the acceptance of the plan? In Hungary the answer is simple, most of the times the reorganization ends up in a liquidation immediately after the end of the moratorium. In the US there is a possibility to impose the reorganization plan over the objecting creditors which is called cramdown. Again, a feature which is heading towards the acceptance of the reorganization deal. Several preconditions must have been met in order to get the confirmation of the court – except the majority of the votes. If an impaired party is willing to accept the plan the court could impose it over the objecting creditors. The rational of this measure is the following: if there is an impaired class which votes in favor of the plan there is a presumption that the decision made by this class is based on calculation of the feasibility of the proposed plan. There are several checks and balances in the
system; e.g.: the deal must be fair and equitable, unfair discrimination is prohibited. With these barriers the bankruptcy court can prevent the abusive use of rights in the realm of bankruptcy. If the proposed plan violates any of the provisions of the Bankruptcy Code, the court refuses to confirm it.
6. Conclusion

The research has discussed the differences between the US-type and Hungarian reorganization regimes, while focused the very distinct feature of the more advanced bankruptcy system: the possibility to impose the reorganization plan on the objecting creditors – without the majority of votes in the creditors’ committee.

The purpose of this thesis was to present a brief overview about the problems of the two systems with a little historical and regulatory background. The scope of this research was very limited and only discussed the basics of the Hungarian and US-type reorganization, including the procedural aspects.

Bankruptcy is not a hot topic in Hungary. The government introduced a new constitution (2011), new civil code (2013), criminal code (2012), civil procedure code (planned in 2016), criminal procedure code (planned in 2016) in the past few years, the Bankruptcy Act remained basically the one which entered into force in the beginning of the 1990s. The first free elections after the socialist regime took place in 1990, therefore that decade was the period of consolidation to market economy: new companies and new concepts came into Hungary these years, but the laws on insolvency are based on the experience of the socialist times. The law amended several time, by this fact the Bankruptcy Act nowadays is not a coherent one, contains self-contradictions, unclear rules which is a strong barrier on the efficiency of the system.

In the socialist era bankruptcy wasn’t a living concept: the owner of the estates was the state itself, the aim was to give work to all adult who can work, therefore factories weren’t efficient and/or profitable ones with some exceptions. After this climate the transition to market
economy was grievous for most of the people: managers who seemed to be successful in the past became incompetent ones in the market economy without knowledge of the new system. The lack of knowledge lead many entrepreneurs to bankruptcy and it is considered as a shame on the previously successful managers. If a manager participated in an insolvent company’s life, later it become harder to find a job for him, its called the bankruptcy stigma.

The bankruptcy stigma not a new “invention”: in the ancient times bankruptcy was a crime, officers and owners of the bankrupt companies are forced to sit in the central place of the village and place baskets on their head, while humiliated by the crowd. In the ancient Rome they used a special lawsuit (*Legis actio per manus iniectionem*) if the debtor failed to pay its debts the creditor had the right to imprison it, after 60 days the creditor was entitled to sell the debtor as a slave. This continued till the modern times, these people often considered as cheater, squanders and their conduct as a fraud or crime. The stigma remained active in the late 1990s as well.

The most important effect of the bankruptcy stigma is that managers became too careful, refused to take risks and on the other hand if a problem occurred the managers tried to hide the problems and did not start negotiations with the creditors, therefore the small problems became even bigger ones and may resulted in the fall of the companies.

It is a struggle even in nowadays as well, that managers are not familiar with terms and features of bankruptcy: in their point of view bankruptcy equals to liquidation. In Hungarian the common words for a bankrupt company is “csődbe ment” and the phrase imply that there will

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be a liquidation. However in Hungarian legal terms “csőd” or “csődeljárás” means reorganization. Reorganization is very rarely used in Hungary, even the government amend the Bankruptcy Act in every 7-8 years. In the late 1990s the number of (filed, but not completed) reorganizations were higher due to a mistake: businessmen taught that filing for reorganization is a pre-requisite for liquidation, but after the Supreme Court issued a guidance about the procedures the number of filed reorganizations dramatically dropped.

The main problems of the Hungarian insolvency regime that businessmen: (i) not willing to participate in a bankruptcy procedure, (ii) according to the first one, they know that most of the managers will not participate, therefore it is not worth to open the procedure as a debtor.

In my point of view both problems could be solved in one way: in a liquidation procedure the creditors are obliged to notify the liquidator about their claims, the amount of claims and the legal basis of their claims. If they fail to notify the liquidator they lose their claim and can not commence a lawsuit in the future for that claim.

The Bankruptcy Code should be modified in a way the requires the debtor to name all of its creditors – with personal liability of the managers if they fail to comply with this requirement -, then the bankruptcy trustee would have to send a notification to the debtors about the insolvency of the debtor and a warning that they have “x” days to notify the trustee about their claims. The notification should contain a warning about that they lose their claim if they fail to submit it to the trustee in time. It would solve both problems, but definitely create new ones.

One possible problem is that even the creditors notify the trustee about their claims, the latter stages they would not cooperate with the trustee and the debtor, and according to the rules of the Bankruptcy Act if they are not present in the creditors committee’s meeting they are
considered as they vote against the reorganization plan. This is a huge problem in nowadays as well. The Bankruptcy Act therefore should amended and state the following that the lack of presence at the creditors committee’s meeting in itself does not constitute a negative vote. The negative vote shall be an independent action of the creditor, not just negligence and the lack of presence – but voting opportunity by mail shall be ensured.

With reference to the title of this thesis one basic question of the procedure is that the concept of cramdown should be introduced to the Hungarian system. One problem that we saw in the recent past that bankruptcy judges may make mistakes or the applicable law itself is not perfect\(^\text{87}\) – so long as it drafted by humans. The confirmation of the reorganization plan in itself is often contested by the objecting parties as an extraordinary appeal to the Supreme Court. The scope of discretion in the case of cramdown is much broader, therefore it could be the source of other complaints.

The US-type cramdown is based on the normal requirement of the reorganization procedure and on a few additional principles. These principles are the key elements according to the confirmation of the reorganization plans. Even all of the criterions are met the bankruptcy judge may refuse the confirmation of the reorganization plan on the basis of breaching the fair and equitable standard or for unfair discrimination.

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\(^{87}\) See ICSID case No. ARB/12/9 Dan Cake (Portugal) S. A. v Hungary: in the case an investment of Dan Cake was liquidated in Hungary, however an agreement almost concluded between the debtor and its creditors. On 24 August 2015 the tribunal rendered a decision on jurisdiction and liability, according to the latter Hungary lost the case. The problem discussed by few authors is that the bankruptcy judge (or the liquidator) did something which is not comply with the standards or the breach stemmed from the domestic law per se. For discussion see: Gábor Kökényesi, ‘Denial of Justice’ as a Basis for the ICSID Ruling against Hungary, Kluwer Arbitration Blog, 1 March 2016. [http://goo.gl/xD1Uaz](http://goo.gl/xD1Uaz)
The fair and equitable standard – or something similar – exist in the Hungarian legal system. One of the basic principles in the first book of the Civil Code is the principle of good faith and fair dealing (Civil Code Book 1 § 3). The rule is the following: “*In exercising rights and in fulfilling obligations the requirements of good faith and fair dealing shall be observed.*” This guiding principle existed even in the 20th century, therefore courts have case law to search for guidance on application. Good faith and fair dealing principle however is something different than the fair and equitable standard: it’s a very general term which is applicable in all legal relationship, therefore it should be very broad – and in the realm of insolvency it is not sufficiently precise.

For the introduction of cramdown we need a new guiding principle designed exclusively for bankruptcy purposes, which has sufficiently precise substance – while keeping the good faith and fair dealing principles as a tool of interpretation. But how to define this principle? It is essential to discover the possible abuses on cramdown to prevent them. Even in the US it is a common problem that equity holders are acting in bad faith and are having private (secret) deals with the senior creditors to exclude the intermediaries from satisfaction of their claims. Knowing the business attitude in Hungary it would be the problem there as well.

Since the new Civil Code abolished the existence of fiduciary securities, such as fiduciary call option, fiduciary assignment, the creditors could have only liens on the assets of the debtor, the so called over-collateralization is no longer possible. This means that a creditor shall not have more property of the debtor or security interest on the debtor’s assets which is necessary to satisfy its claims. The absolute priority rule shall be maintained in this new regime like in the

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88 Note: there might be a change in the future according to fiduciary securities, the rules on securities are subject to change maybe in this year. The statement here however is true on 1 April 2016.
US. So long as the senior class has unsatisfied claims, the junior class(es) shall receive nothing from the bankruptcy estate. “Gifting” shall be prohibited as well, it should not be a tool for convincing the junior classes/equity holders to accept reorganization deals made in bad faith.

Regardless of what will be the decision of the legislator according the renewal of the Bankruptcy Act, especially the rules on reorganization there are some important obligations that must be fulfilled. It would be advantageous for the country if people would know about that insolvency is not necessarily means the cancellation from the market for the companies, there are other solutions, especially bankruptcy. The biggest barrier so far – since the regulation is more or less the same in the US and in Hungary – the lack of information, which lead to too many liquidations and very few reorganizations irrespective of that the company worth a fresh start or not.

And – finally – the lesson to be learnt from the US:

“In the mid-1970’s Congress began to debate and redraft the bankruptcy laws. The result was the Bankruptcy Code of 1979. Much of the Congressional debate revolved around the “fair and equitable” standards which had been cast in the form of the “absolute priority rule”:

“Early in the process, most of the knowledgeable commentators on bankruptcy concluded that if not abandoned completely, the absolute priority rule should be modified in major respects. The importance of deal-making in the reorganization process was recognized.”89

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