



Vlasic, 26th and 27th 2005

Status of Preferred Creditors in Bankruptcy Procedure

Who Has the Status of Preferred Creditor?

- According to article 38 of the BL, creditors with preferential right are:
 - mortgagee and land charge creditor (doesn't exist in our legal system)
 - creditors with collateral against moveable property, acquired on the basis of this law, legal transaction, agreement before court, and seizure (other court collateral omitted?)
 - Fiduciary creditors (don't exist in our legal system)
 - Retainers (retention according to art. 286 of the ZOO – Law on obligations)
- What about the right to settlement (article 72, par. 2 of LEP), is its title holder preferred creditor? (In theory – YES – the re is priority right and succession right)

Occurrence of Preferential Right (Collateral) Against Real Property

- According to article 69 of ZOVPO/ 64 ZOSPO the moment when mortgage against real property occurs, on the basis of legal transaction and court decision, is registration in the LR
- By the same article, legal collateral occurs regardless of the moment of registration in the LR
- However, according to the new Law on Land Registry, for institution of any right over real property, the moment of registration in the LR is constitutive (art. 5, par. 1), thus, by the “**Lex posterior derogat legi priori**” principle, this provision of the Law on Land Registry puts out of effect the respective provision of art. 69 of ZOVPO/ 64ZOSPO
- According to the provisions of earlier LEP, mortgage against real property not registered in the LR could be acquired by seizure inventory list (art. 186), as if it was moveable property, on the basis of agreement between parties before court (art. 251a, b, c, d, e, f)

The Issue of Statutory Collateral of Tax Administration in FBIH

- Article 2 prescribes that the Law on Tax Administration has priority over other laws (Law on Land Registry)
- No article of the Law on Land Registry has the character of “supremacy” clause
- The result is that the Tax Administration in FBIH acquires mortgage against real property regardless whether that right is registered in the LR or not
- According to the Law on Tax Administration of RS, art. 67, legal mortgage is instituted by registration of that mortgage in the LR

General Conclusions on Collateral Rights Over Real Property

- In order to prove having the status of mortgage (preferred creditor), there must be an excerpt from the LR with registered collateral, or seizure inventory list for the real property that is not registered in the LR
- The above conclusion on constitutionality of registration of collateral in the LR is not applicable to the Tax Administration FBiH, they have the collateral without registration in the LR, for them the proof of institution of collateral is the order for payment of taxes (art. 50)
- When is collateral considered registered in the LR, when the DN decision on registration is issued, or when this right is actually and technically registered in the LR file?
- Is collateral instituted if there is only a “filling” in the LR file?

Types of Collateral Against Moveable Property

- There are two types of collateral against moveable property, possessing (pledged item in possession of creditor) and non-possessing (pledged item not in possession of creditor)
- On the basis of its institution, collateral against moveable items can be statutory, court, and based on legal transaction (article 61. ZOSPO/ 66. ZOSVO).
- The statutory mostly occurs according to the provisions of the LEP (seizure inventory list) and the Provisions of the Law on Tax Administration of FBiH/RS, and it can be possessing and non-possessing
- The court one is instituted by an agreement before the court (by seizure inventory list), and it is mostly non-possessing
- On the basis of legal transaction it is instituted by transfer into possession (possessing), or in accordance with the provisions of the BiH Framework Pledge Law (OG BiH 28/04) (non-possessing)

Institution of Collateral Against Moveable Items I

- The statutory, according to the provisions of the LEP, occurs the moment the seizure inventory list is composed (art. 124 of LEP), or by issuance of order for payment of taxes (Law on Tax Administration FBiH art. 50), i.e. decision establishing tax debt (Law on Tax Administration RS art. 67), and as proof of this institution, it is necessary to provide this seizure list, or these two documents from Tax Administration
- The court one also occurs in the moment of seizure list on the basis of agreement between parties before court (article 251d and 251f of LEP of SFRJ), and as proof, it is necessary to submit the seizure list of moveable items (the whole system for such institution of collateral against moveable property has been put out of effect by the BiH Framework Pledge Law).

Institution of Collateral Against Moveable Items II

- In contractual collateral instituted in accordance with the Framework Pledge Law (OG BIH 28/04), it is necessary to satisfy 4 conditions for institution (collateral agreement, registration in pledge registry, loan disbursement, and debtor's ownership over the subject of collateral (art. 4 of the Law).
- For contractual collateral, pledge is instituted by transfer of moveable item into possession of creditor (968 LO), and for status of preferred creditor it is necessary to prove existence of legal basis and the fact that there was transfer of items into possession of creditor

Rights of Preferred Creditors

- Preferred creditors have the right to satisfaction from pledged items before other creditors of bankruptcy debtor, for its principal, interest, and expenses (art. 38, par. 1 of the BL)
- Bankruptcy creditors can be preferred creditors if the debtor is personally liable to them (art. 39 related to article 120, par. 2 of the BL), and not if a third party is liable to them for fulfillment of obligation (arg. contrario art. 39 of the BL)
- Preferred creditors with an enforceable document cannot initiate bankruptcy because they don't have the legal interest from article 4, par. 1 of the BL, since they can exercise their rights in easier and more efficient way in enforcement procedure (unless they waive their collateral for the entire or partial amount of their claim) – motion rejected as inadmissible
- Preferred creditors without an enforceable document can initiate bankruptcy procedure, because they exercise their rights in faster and more efficient way in bankruptcy than to file a civil case, and enforcement thereafter

Report of Preferred Creditors I

- Preferred creditors must report their claims just like all other creditors (art. 46 BL part. 1 does not differentiate between bankruptcy, preferred, or extraction creditors, and art. 56)
- In their report, preferred creditors indicate property which is the subject of their collateral, and the amount they expect to remain uncompensated from the pledged items (art. 110 par. 6 BL)
- Preferred creditors can report their claims to bankruptcy court only as preferred creditors, and they can report those claims (in part or whole) as bankruptcy creditors, under condition they waive their preferred right, or prove they will not be satisfied from pledged items (art. 39 related to art. 114 par. 1)
- In this case, if bankruptcy trustee admits that preferred creditor does not have coverage for the entire claim (or that it waived the collateral), it (preferred creditor) will appear as bankruptcy creditor in bankruptcy proceeding with the remaining part (not covered by the collateral).

Report of Preferred Creditors II

- Failure to report, or untimely report of preferred creditor's claim as secured claim to bankruptcy court, however, has no legal consequence regarding its right to separate satisfaction from pledged item, out of bankruptcy, by the rules of enforcement procedure (art. 58. par. 4 ZSP)
- The only legal consequence of failure or untimely report by preferred creditor in bankruptcy proceedings is its inability, due to that (art. 113. par. 4 related to article 56. BL), to appear as bankruptcy creditor for satisfaction from the remaining bankruptcy estate for the amount of claim not settled in preferential right case

Investigation of Preferred Creditors' Claims

- If a preferred creditor has reported its claim on time in bankruptcy proceeding, either as preferred or bankruptcy creditor, trustee must declare him/her self on it in investigation hearing (art. 114)
- Statement of bankruptcy trustee should only be reduced to statement on existence of that claim, its basis, amount, and repayment rank of that claim, and in no way statement on the preferred right itself (whether it exists or not)
- Art. 112. par. 1. and 114. par. 1 of BL say that only claims are investigated in investigation hearing, and not property rights, which is the case with collateral.

Investigation of Existence of Preferential Rights

- Discussion whether some collateral exists or not should not be conducted in investigation hearing, and it cannot be disputed in investigation hearing
- Existence of preferential right is of interest only for distribution of bankruptcy estate, and in articles 118, 123, and 124 there is a mechanism, based on which existence of collateral will be discussed before bankruptcy judge and second instance court (appeal right), before bankruptcy estate is distributed.
- Discussion on existence of collateral in reorganization of bankruptcy debtor takes place when discussing the plan (art. 163), denial of confirmation of the plan ex officio by the court (art. 175), protection of creditors (art. 176), and appeals against decision on confirmation of the plan (art. 178)
- In case a mortgagee chooses enforcement procedure for satisfaction of its claim from pledged items (art. 58. par. 2), as legal representative of bankruptcy debtor, trustee can contest the existence of collateral before enforcement court (and generally the possibility of enforcement during bankruptcy), and other bankruptcy creditor can exercise the same right in the same procedure as a third party (art. 51. of LEP)

Disputed Preferential Rights

- In case some creditor appears as preferred creditor, not claiming that it will not be satisfied from pledged property (art. 110 par. 5) , and its preferential right is doubtful to bankruptcy trustee or to bankruptcy creditors, there will be no discussion on that preferred right in investigation hearing.
- Legal consequence of this situation is that this creditor should not have the right of vote in the assembly of creditors, or the right to dispute other claims in investigation hearing (art. 114 par. 2, 28 st.2)
- Its disputed preferred right will be discussed only in distribution of bankruptcy estate (art. 123 BL), discussion on bankruptcy plan and its confirmation (art. 175 and 176), and enforcement procedure, if initiated
- What if a creditor appears only as preferred creditor, and later, according to articles 123, 175, 176 of BL and in enforcement procedure, discovers that it really is not preferred creditor. Since it failed to apply as bankruptcy creditor, it loses the right to satisfaction from the bankruptcy estate!?
- How do you treat preferred creditor whose preferred right exists, but it is disputed, especially in reorganization procedure? Is it preferred or bankruptcy creditor? Such preferred right must be treated as existing until it is finally denied!

Treatment of Amounts not Covered from the Collateral

- If bankruptcy trustee in investigation hearing disputes reported amount for which the preferred creditor will not be satisfied from pledged property, because he/she thinks that that amount will be settled from the pledged property, then civil suit must be brought for that amount (trustee or preferred creditor, depending on enforceable document - art. 115)
- Under such circumstances, it will be planned for the disputed amount in distribution list (reserved amount) if, in accordance with article 119, it proves to the trustee that it filed a civil case for the disputed amount.
- Bankruptcy trustee can recognize the reported amount for which preferred creditor will not be satisfied from pledged property, with its subsequent obligation to prove that the pledge is insufficient to settle the entire claim (article 114 par. 1 related to article 120)
- Preferred creditor's claim it reported as bankruptcy creditor, despite being recognized by the bankruptcy trustee, will be included in the distribution list only if the preferred creditor proves that it was not satisfied for that amount, or that it waived the collateral for that amount (art. 120)

Realization of Right to Separate Settlement I

- Preferred creditor can decide to initiate separate enforcement procedure for exercising its right (art. 58. par. 4), or to stay within bankruptcy and to de facto leave the sale of the pledge to bankruptcy trustee
- Unless it “leaves” the bankruptcy, the entire property of bankruptcy debtor will be sold in bankruptcy, regardless whether it is pledged or not, since the pledge belongs to the bankruptcy estate, and the trustee is authorized to sell all items belonging to bankruptcy estate (art. 101 par. 1 related to article 38. par. 1)
- Preferred creditor cannot prevent the sale in bankruptcy proceedings, unless it wants to initiate enforcement procedure (art. 101 par. 1 related to article 38. par. 1)
- In bankruptcy procedure, as well as in enforcement, it can settle the principal, interests, and expenses from the pledge before all other creditors (art. 38. par. 1)

Realization of Right to Separate Settlement II

- This property is sold in bankruptcy according to the rules of enforcement procedure, and its sale cannot be decided by the assembly of creditors (art. 38 par.1)
- The sale is performed by bankruptcy trustee (art. 101)
- In case pledge property is sold in bankruptcy procedure, the trustee must include the repayment in distribution list for the preferred creditor from its pledge, according to conditions from article 38. par. 1, regardless whether the preferred creditor appeared as such in bankruptcy proceedings
- For the amount reported as bankruptcy creditor, the preferred creditor will be included in distribution list, if it proves, in accordance with article 120, par. 1, that the amount is not settled, or that the collateral was waived
- If the trustee is authorized for sale of pledged items, preferred creditor does not have to prove that it is not satisfied, or to have waived the collateral, in order to be included in the distribution list for the amount reported as bankruptcy creditor (120. par. 2)

Right to Initiate Enforcement Procedure

- Preferred creditor can initiate separate enforcement procedure for realization of its right to separate settlement until the sale in bankruptcy proceedings commences, because one item cannot be sold in two procedures (analogous application of article 73. par.1 of LEP)
- Sale in bankruptcy is commenced by bankruptcy trustee (by making the sale public – ad foe example, analogy to registration of enforcement from article 73 of the LEP)
- Problem of establishing this moment in sale through direct or free deal

Right of Preferred Creditors to Participate in Bankruptcy

- Preferred creditor only has rights in assembly of creditors equivalent to its report as bankruptcy creditor (art. 28. par. 2)
- In the assembly of creditors, they do not have right of vote for their secured part, or in investigation hearing for disputed unsecured part, unless judges allows it for the that part (art. 28. par. 3)
- Preferred creditors cannot dispute claims of other creditors, unless they participate as bankruptcy creditors in bankruptcy proceedings (art. 28. par. 2, 39, 114. par. 2)

Rights of Preferred Creditors in Reorganization of Bankruptcy Debtor

- If the plan does not prescribe anything with regard to rights of preferred creditors, they are considered to have unchanged rights (art. 148. par. 1.)
- Plan can change rights of preferred creditors (art. 148. par. 2)
- According to article 147, special group of creditors will always have to be formed with preferred creditors (different legal position compared to others) and often there will be several groups of preferred creditors, since there can be different economic interests among them (repayment of principal only, repayment of principal in 2, 3, or 5 years, debt for equity swap etc)
- Within a group, there can be one or more preferred creditors, depending on their economic interests

Groups of Preferred Creditors and Voting

- Within group(s) of preferred creditors, decision on acceptance of plan is made in accordance with the general rules (majority of claims and number of creditors within a group – art. 169)
- If the majority from article 169 is achieved within a group, and if the plan is accepted by all groups, that plan also binds preferred creditor who voted against the decision on acceptance of the plan (different in Croatia)
- Although theoretically there is possibility to apply article 170 (considered that the group accepted the plan although required majorities from article 169 have not been achieved) to group(s) of preferred creditors also, in practice it will be rare due to conditions from article 170. par. 2 t. 2 (that, if there was no plan, no one could be satisfied who is, in regular order of events, satisfied after the preferred creditor – general repayment rank)
- Right to vote on the plan is given only to those preferred creditors whose preferential right was not disputed in the discussion hearing (163. par. 1 and 164)
- Still, even such preferred creditor will have the right to vote on the plan, according to general rules on voting by creditors whose rights have been disputed (art. 163. related to article 28. par. 2. and 3.)

Legal Means of Preferred Creditor in the Procedure of Acceptance of Reorganization Plan

- Preferred creditor discontent with the plan can vote within its group against acceptance
- According to article 175 it can warn the judge that the plan has not been accepted as prescribed by the provisions of the law (the same treatment within a group, forming of groups etc)
- According to article 176, preferred creditor can propose denial of the plan acceptance, because it is in worse position than it would be if there was no plan
- It can file an appeal against the decision confirming the plan, in accordance with article 178. of the BL