SOLUTION MODELS
FOR

COMMON ISSUES ARISING

May 15, 2006

SOLUTION MODELS (FRAMEWORK)

Introduction

This resource material, developed by USAID's Fostering an Investment and Lender-Friendly Environment Project (FILE), is the result of 32 months of regular interaction and exchange of ideas and experiences with judges, trustees, and others involved in the successful implementation of the new Federation and RS bankruptcy laws (collectively, the "Bankruptcy Law"). This document summarizes a large sampling of frequently asked questions and issues raised by key stakeholders (judges, trustees, debtors, creditors, investors, experts, and other parties) active in the bankruptcy process. It compiles different experiences from different phases in the bankruptcy proceeding and thereby promotes not only the benefits of working in this new bankruptcy system, but also identifies the main roadblocks and obstacles that might be encountered and how to circumvent them.

Through regular training sessions, roundtables, and day-to-day contacts, bankruptcy practitioners have been sharing various issues and problems that FILE describes on the following pages, offering solutions that represent both theoretical and practical knowledge and experience of the Bankruptcy Law. In the final analysis, these Solution Models will help key practitioners and participants to build confidence and standardize practice in the implementation of the new bankruptcy system. This material may be used as a learning tool addressed to a wider audience because the identified issues and solutions contain straightforward explanations and references to the law that will help a public audience to learn more about overcoming obstacles in bankruptcy proceedings and be better informed about the possibilities for resolving difficulties faced in the application of the bankruptcy system.

This document is but one example of a tool that can be used to address these problems and to offer solutions for properly conducting bankruptcy proceedings. We thank our partners in bankruptcy practice for their considerable interest and assistance in developing this document and for their commitment to effectively implementing the Bankruptcy Law.

A FILING BANKRUPTCY

A.1 Guiding Bankruptcy Solution Principles (the main purpose of bankruptcy)

Issue: What can motivate employees to file a petition to open the bankruptcy proceeding when they could lose their jobs?

Description: According to our stakeholders (trustees, trade union representatives, judges, etc.), there are over 4,000 companies in BiH in financial trouble with no prospect of reviving the business from internal resources and no investors or banks interested in investing in such companies. These enterprises have failed or are failing; businesses are registered that have been defunct for many years; they suffer from lost market-share and customers, accumulated debts to workers and social funds, frozen banks accounts; *etc.* How is it possible in this economic environment to convince workers that the bankruptcy of such failing enterprises may create benefits for them?

Solution: Misunderstanding and misplaced hostility from workers and their representatives could be a major hindrance to bankruptcy implementation. Public education on bankruptcy is a priority task not only for FILE, but also for key bankruptcy practitioners (judges, trustees, lawyers, government representatives and media). There is no doubt that implementing a modern and efficient bankruptcy system is a major and necessary step on the path to enterprise regeneration in BiH. Bankruptcy specifically addresses the problems which occur when enterprises fail or begin to fail.

Workers and other creditors should be educated about bankruptcy and reorganization as a key element in improving the BiH economy. For example, workers should understand why their interests are best protected when a bankruptcy is filed as soon as debtor company meets the filing criteria, as it will best preserve their existing claims and limit future losses that lessen the company's prospects for revitalization.

Bankruptcy is the surest way to revive businesses, foster investment, and privatize state-owned assets. Restructured business operations and assets returned to productive use for companies emerging from reorganization or liquidation proceedings preserve and create jobs, generate new orders for raw materials, equipment, and services, and infuse money into the local community. The goal of bankruptcy is to distinguish those companies that are viable from those that are not and, in both cases, to distribute as much as possible to an insolvent debtor's creditors. The critical question, in the particular circumstances of each case, then, is what the best way to pay these creditors will be: immediately, through the orderly liquidation of the debtor's assets and distribution of the proceeds, or instead over time, through reorganization and restoration of the debtor's solvency. In a bankruptcy proceeding, decisions about the fate of the business are made by the creditors. A majority of the participating creditors makes this decision after a certified and experienced trustee, who may himself employ other experts, completes a comprehensive analysis of the business operation and recommends whether to liquidate or reorganize. In either event, the trustee will implement the creditors' decision under the supervision of the court and in keeping with the Bankruptcy Law.

A.2 Financial discipline as a Solution Principle

Issue: How to deal with companies that lack financial discipline?

Description: Because of difficulties in a company as described in Description 1, it often happens that the preliminary trustee and trustee encounter difficulties in identifying the debtor's assets and liabilities. In practice, a lack of proper bookkeeping and the absence of any cost-management system are contributing reasons for the helplessness of some companies in determining how to save the business from further deterioration. But how is it possible to save the company when the business has failed or begun to fail?

Solution: Bankruptcy prevents a rush to cannibalize a failing business and ensures an equitable distribution to the creditors. An experienced and certified trustee manages the process and the company under the supervision of the Court and the creditors, and in companies where additional investment, better management, and relief from burdensome liabilities or hazards can restore an enterprise's financial health, such companies may be "reorganized." The failure to address these problems in a properly conducted bankruptcy proceeding compounds them and contributes to a culture lacking essential financial discipline. This is one of the main motives for reorganization through bankruptcy, for reorganization enforces economic discipline on the process and compels the parties to be realistic about their options. Thus, it is important for a trustee to quickly the past business operations, books, records and other data available to determine the nature and scope of assets and liabilities of the company.

B PRELIMINARY PROCEEDING MODEL SOLUTIONS

B.1 Dealing with claims:

B.1.a. Enforcement of claims

Issue: Creditor has a claim against a bankruptcy debtor who does not want to satisfy the debt.

Description: The creditor has an enforceable document establishing its claim (a judgment or decision of another body with jurisdiction). Despite the Court's or other authorized body's order to pay the debt within a certain time, and despite negotiations between the debtor and the creditor, the debt has not been paid. What are the options at the creditor's disposal?

Solution: At the creditor's disposal, in such circumstances, are two options: Either to initiate a Court enforcement procedure and forcibly enforce his claim by liquidating part of the debtor's property, or to initiate a bankruptcy proceeding, as a mechanism for the collective settlement of all claims against the bankruptcy debtor, in which case all the debtor's property would be available for the satisfaction of these claims. The criterion for taking one or the other of these options is the insolvency of the debtor. Specifically, to open the bankruptcy proceeding, the Bankruptcy Law requires the petitioner to establish the insolvency of the bankruptcy debtor, *i.e.*, a situation in which bankruptcy the debtor is unable to pay all his debts within 30 continuous days (see Article 6 of the Bankruptcy Law). If this requirement is not met, the Bankruptcy Judge cannot decide to open the bankruptcy, but may only decide to reject the petition for opening the bankruptcy. Thus, in such a situation, the creditor could only resort to a Court enforcement procedure in which he could enforce his claim through forcible liquidation of part of the debtor's property.

When the debtor is insolvent, the creditor seeking enforcement of its claim could initiate either an enforcement or bankruptcy proceeding, as solvency does not prevent any creditor from initiating an enforcement procedure, "attacking" part of the debtor's property. On the other hand, the creditor should be aware that, for initiation of the bankruptcy proceeding, it has to show the probability of the bankruptcy debtor's insolvency. Thus, taking into account all the requirements both for initiation of proceedings and the consequences, a creditor could choose whichever one of these options better advances its rights and interests.

B.1.b. Dealing with uncertain claims

Issue: A creditor who has a claim against the bankruptcy debtor does not have official documentation proving its claim.

Description: A creditor has a claim against the debtor, but has no enforceable document that might serve as proof that the claim definitely exists. In such circumstances, we find workers who have not received their salaries, but who do not have a Court judgment; persons claiming redress for damages without a Court judgment; and contracting parties asserting a breach of contract and claiming damages. Is it necessary in all of these situations that petitioners who file a bankruptcy prove their claims only through an enforceable document (judgment, decision of administrative body, mediation and arbitration decision, notary document)? In other words, can the bankruptcy be initiated without these types of documents?

Solution: According to the provisions of the Bankruptcy Law (see Art. 4), there is no requirement that a creditor submit with his petition an enforceable document proving his claim beyond any doubt, but only that the creditor produce a document by which he could establish the probability of his claim against the debtor. Thus, there is an obligation for the creditor to submit some document showing that its claim is probable, but the threshold of the possible existence of a claim is much lower than if the creditor must prove this claim with an enforceable document.

B.1.c. Dealing with claims not yet due

Issue: Protection of creditors' rights when the debt has not come due.

Description: A creditor has a claim that comes due in several months. Based on information received by this creditor, however, it is obvious that the debtor has ceased to pay its regular obligations towards his creditors. As a result, some of these creditors have begun enforcement proceedings against some of the debtor's property. The creditor whose claim is not yet due is concerned to protect its right to collect be this claim. The creditor might therefore wish to file the bankruptcy because of the threat of insolvency. Is he authorized to do so?

Solution: According to Article 4 to the Bankruptcy Law, the creditor with a claim not yet due and owing cannot initiate bankruptcy because such a claim is not ripe. Furthermore, such a creditor would not be able to file a bankruptcy based on future insolvency, since on this ground a bankruptcy can be filed *only* by the debtor (Article 6.4). Therefore, under such circumstances, the creditor would not be authorized to initiate a bankruptcy proceeding before his claim is due. As regards the right of other creditors to initiate an enforcement procedure before the bankruptcy is filed, such actions by creditors with claims not yet due could only be avoided according to the general rules for voiding preferences in bankruptcy (Articles 80-87 of the Law).

B.1.d. Claim has been paid (accord and satisfaction)

Issue: Paying the debt to the petitioner who filed the bankruptcy.

Description: After the bankruptcy has been filed, in the preliminary phase, the debtor has paid off the petitioning creditor or managed to reach an out-of-Court settlement. The debtor, according to the preliminary Trustee's report, is insolvent, but the creditor has decided to withdraw its petition for opening a bankruptcy proceeding. Is the Court in a position to resume or continue the proceedings by itself, *ex officio*, regardless of the withdrawal of the petition, based on the fact that the preliminary Trustee has established the debtor's insolvency?

Solution: According to Article 4, par. 5 of the Bankruptcy Law, the petitioner may withdraw its petition for opening the bankruptcy until the moment the decision is handed down on opening the bankruptcy. In this case, the Court would render a decision on terminating the proceeding. Accordingly, the Court lacks the authority to resume proceedings *ex officio*, in the absence of an interested party serving as the as petitioner (Article 2.q of the Civil Procedure Law). Unless some other petitioner lodges its own petition for opening the bankruptcy, and provides for the resumption of the preliminary proceedings in this case, withdrawal of the petition must result in the dismissal of the case.

B.2 Providing proof of a debtor's insolvency

B.2.a. Probability of debtor's insolvency.

Issue: Proving that the debtor's insolvency is probable.

Description: Article 4 of the Law provides that a creditor who files a bankruptcy must show the probability of his claim and of the debtor's insolvency. How can the creditor establish that the claim is "probable"?

Solution: The most common way of proving the debtor's insolvency in practice is by providing a certificate that all the debtor's bank accounts are frozen for a period longer than 30-60 days. Banks are obliged to issue such certificates to the creditor on his request; the creditor can learn of the existence of all of the debtor's accounts from the Central Register of Legal Persons' Accounts at the BiH Central Bank. Another way of collecting data on a debtor's accounts that have been frozen for more then 30 days is through reports from each bank, which must publish this information in the entities' Official Gazette, pursuant to the Law on the Payment System in the Federation and RS.

Issue: Different ways of establishing the probability of a debtor's insolvency

Description: A creditor who wants to file a bankruptcy against a debtor can prove the probability of its claim but may encounter difficulties in proving the probability of the debtor's insolvency. For example, of the debtor's four bank accounts, three are blocked, and the debtor conducts the transfer of funds only through the fourth account. Through this account, the debtor pays his debts from time to time to certain creditors, but avoids paying his obligations to the largest principal creditor. Worse still, the debtor pays some of his debts through the bank account system. The principal creditor is fed up with this situation and is prepared to file a bankruptcy case against the debtor. How will the principal creditor prove the probability of the debtor's insolvency if the debtor pays from time to time part of his obligations to selected creditors (according to his own

criteria)?

Solution: Although the certificate that all the debtor's bank accounts have been frozen would without doubt support the conclusion that the debtor is insolvent, this is not the only possible proof available. Specifically, Article 6.2 provides that a debtor could be insolvent even if he pays his debts to some of his creditors. Thus, a creditor in such circumstances should provide proof to the Bankruptcy Court that its claim came due and was not paid for a period of 30-60 days from the moment it was due.

B.2.b. Cash flow analysis

Issue: What is the purpose of a cash flow analysis in the bankruptcy context?

Description: In a majority of state-owned or private companies in BiH, it is common that management does not prepare a cash flow analysis or, in the worst case, does not keep adequate financial records. There are also companies that ceased operations and no longer have any financial records.

Solution: According to the Bankruptcy Law, the justification for opening a bankruptcy proceeding is the inability of the debtor to make payments as due. Specifically, such "inability" to make payments is present when the debtor is no longer able to meet its accrued and outstanding payment liabilities (Article 6). Obviously, "lack of cash" is the most common reason that companies fail to pay their outstanding liabilities. Besides the balance sheet and income statement, cash flow is the third critical financial statement to be analyzed. As the name implies, this statement of the company's business operations shows how a company obtains and uses its cash resources. The data to construct a statement of cash flows comes from the income statement and the balance sheet. Since debt is repaid with cash, the cash flow statement helps the analyst to determine both the company's funding needs and its sources of repayment. The cash flow statement shows inflows and outflows of cash categorized as: operating funds flows, and investing activities and financing activities. There are two methods used to develop cash flow analyses (indirect and direct method) and both, in the context of bankruptcy, serve the same purpose -- to verify if generated cash would be sufficient to pay debts. This is crucial not only for identifying the grounds for bankruptcy but also for monitoring the company's ongoing activities. It also enables the Trustee to confirm if the debtor can continue its operations without incurring additional losses and provide enough cash to cover other expenses related to the bankruptcy proceeding.

B.2.c. Ratio analyses

Issue: Which ratios should be used in determining the debtor's insolvency?

Description: As mentioned above (A.2.a), the most common way of proving the debtor's insolvency in practice is providing a certificate that all the debtor's bank accounts are frozen for a period longer than 30-60 days. There are, however, also many companies that do not have frozen bank accounts but nevertheless meet the criteria for a bankruptcy because they cannot service their accrued and outstanding liabilities or because of the imminent threat of an inability to make payments. How can a Trustee reliably conclude that a particular company is or will shortly be insolvent?

Solution: After receiving an acceptable petition to open a bankruptcy proceeding, the Bankruptcy Judge is required to determine whether there are grounds for opening a bankruptcy and whether

the petition is justified (Article 14). For this purpose, the Judge may appoint an interim Trustee (or an appropriate expert) who is required to conduct a full review of the business records in order to draw conclusions about the company's payment ability. Ratios are the best known and most widely used of all financial statement analysis tools because ratios allow the analyst to study the relationship and trends over time among various components of a financial statement. In the bankruptcy context we can use the most widely accepted ratios that help in analyzing a company's liquidity, activity, leverage, coverage, and profitability. The first and the most important task, however, must be to identify the company's liquidity, profitability, and prospects for paying current and future debts.

Liquidity Ratios -- in finance, liquidity means the ability to convert an asset into cash in a timely manner without the loss of market value. The assets must be converted in time to meet debt obligations as they come due. Although it is not a ratio, *working capital* does indicate a company's liquidity (net working capital = current assets – current liabilities). The two ratios commonly used to obtain a rough indication of liquidity are the current ratio and the quick ratio:

- *Current Ratio* compares the absolute quantity of the company's current assets to its current liabilities at a certain point of time. Generally, the higher the current ratio, the more comfortable the cushion against the effects of reduced inventory levels, uncollected receivables, and unanticipated cash needs. But a large current ratio may signify idle cash, too much inventory, or a slow collection of accounts receivable.
- *Quick Ratio* is a more stringent measure of liquidity than the current ratio because it includes only the most theoretically liquid current assets (those assets that a company should be able to convert to cash quickly to pay obligations). Historically, a quick ratio of 1:1 has been regarded as an indication of good liquidity.

Activity Ratios use a mix of income statement and balance sheet variables. Generally, these ratios compare the company's sales with three balance sheet accounts -- accounts receivable, inventory, and accounts payable (accounts receivable turnover ratio and days receivable ratio; inventory turnover ratio and days inventory ratio; accounts payable turnover ratio and days payable ratio). It is also important to draw comparisons between similar companies or to look at trends over time.

Leverage Ratios show how much protection the company's assets provide for a creditor's debt, for assets must be financed either by the owner's equity (net worth) or creditors' liabilities (debt). The higher the proportion of borrowed funds to owner-contributed funds, the greater the assumed risk to lenders. The debt-to-value ratio indicates how well the shareholders' investment in the company provides a cushion for asset shrinkage. Like the current ratio, this ratio measures a company's ability to liquidate its assets in order to satisfy debt (total liabilities / net worth = debt-to-value ratio). Most manufacturers depended heavily on financing fixed assets, resulting in a higher debt-to-value ratio.

Coverage Ratios are another type of leverage ratio commonly used in financial statement analyses. These ratios measure the extent to which a company's fixed charges from debt obligations are met or exceeded by the flow of funds from the company's operations. A company's ability to cover principal and interest payments is a key indicator of financial health, which is of crucial concern to lenders (*i.e.*, the *Debt Service Coverage Ratio* measures the proportion of a company's net profit and non-cash expenses that will be needed to pay the principal portion of long-term debt in the coming year).

Profitability Ratios usually relate the company's profits to various standards, such as the level of sales, assets, and equity. Taken together, they give a good indication of a company's viability and its ability to survive and continue to attract new equity or debt funding in the future. For example,

a *return-on-sales* ratio is a reflection of management's ability to properly price its product or service, control cost of goods sold, and control operating expenses (profit before taxes/net sales = return-on-sales ratio[1]).

B.3 Solving problems with Court fees when filing

Issue: The initiator of the bankruptcy (petitioner) has no money to pay the required Court fees in advance.

Description: In practice, the creditor (usually, workers) has no money to pay the fees in advance that the Bankruptcy Judge has set and ordered (pursuant to Article 4.4 of the Bankruptcy Law). There may be a third party, however, among the other creditors (not the initiator) who is willing to pay such fees in order to have bankruptcy opened. Is this possible?

Solution: Court practice in BiH has already adopted a solution according to which any person or entity (not only creditors) can pay the Court fees for initiating a bankruptcy. Note that, it is important that the person actually paying the Court fees denote in his payment the order number of the Court case and the name of the creditor on whose behalf these fees are paid.

B.4 Solving problems with the appointment of Trustees

B.4.a. Trustees' conflicts of interest

Issue: Whether a Trustee employed by one of the creditors can be appointed in a particular case.

Description: A Trustee from the available list is employed by one of the creditors. He is not holding any position in the creditor's company through which he could affect the creditor's policy in bankruptcy, nor is he assuming any position by which he could represent the creditor's company before third parties. Should such a person be appointed as a Trustee in the particular case?

Solution: According to Article 23 of the Bankruptcy Law, such a person could not be appointed as Trustee because of the potential conflict of interest. Beside the Judge, the Trustee and the board of creditors should pay particular attention to such potential conflicts. Even if the Judge were to appoint such a person as Trustee, each creditor has standing to object to this appointment by motion submitted to the Judge asking for this Trustee's dismissal for conflict of interest.

B.4.b. Lack of qualified or available Trustees in the relevant region.

Issue: How to proceed with the case when there is a lack of qualified or available Trustees.

Description: In certain regions, Bankruptcy Judges do not have enough qualified Trustees available to appoint in bankruptcy cases in their Courts, or there is no Trustee who is specialized in certain industries (especially in bankruptcy of banks). In other regions of BiH, however, there are sufficient numbers of competent Trustees or available specialists for particular industries. Can these persons be appointed as Trustees for cases in other regions or entities?

Solution: There is no clear answer to this question in the Bankruptcy Law. However, BiH

[1] The various ratio definitions included herein are taken from "Analyzing Financial Statements" by George E. Ruth.

bankruptcy practice has already adopted an approach according to which Judges appoint the Trustee from another region or entity in particular cases because of the lack of qualified or available Trustees. This practice is based on an interpretation of the Bankruptcy Law, *i.e.*, that such practice is allowable because it is not explicitly prohibited by the law.

B.5 Solutions to problems arising from the automatic stay in the preliminary proceeding

B.5.a. Refusal of Enforcement Judges to honor automatic stay

Issue: Whether enforcement Judges are obliged to honor the automatic stay issued by the Bankruptcy Judge on the basis of the Bankruptcy Law?

Description: According to Article 15 of the Bankruptcy Law, the Bankruptcy Judge is authorized to render a decision on the imposition of security measures. A stay against enforcement proceedings affecting the debtor's assets in preliminary bankruptcy proceeding is among these measures. An enforcement Judge, however, pursuant to Article 228 of the Law on Enforcement, may not wish to respect any stay of enforcement proceedings provided by other laws, including the Bankruptcy Law. In this event, there arises a classic conflict of two laws, and enforcement Judges quite often prefer to follow only the Law on Enforcement, disregarding the explicit stay during the preliminary proceeding provided by the Bankruptcy Law.

Solution: Although the provisions of the Law on Enforcement and the Bankruptcy Law conflict with each other, the Bankruptcy Law should prevail because, according to well established practice, this law is considered *lex specialis*, being more specific and particular than the Law on Enforcement. Only by this interpretation is it possible to overcome this legal stalemate. Any other interpretation, which some enforcement Judges apply, would not only endanger equal, collective settlement of all creditors of the bankruptcy debtor (a fundamental purpose and at the core of the bankruptcy proceeding), but undermine an effective system of bankruptcy in this country as a whole. Each enforcement Judge should be provided with this explanation by the preliminary Trustee in the case so that he will not refuse to honor the stay of enforcement proceedings in the particular case ordered by the Bankruptcy Judge.

B.5.b. Effect of automatic stay on great number of Court proceedings

Issue: How would each enforcement Judge in all enforcement cases against the debtor's assets know that the bankruptcy Judge had ordered a stay of all proceedings against the debtor while the preliminary bankruptcy proceeding is pending?

Description: Usually, in a majority of the bankruptcy cases in BiH, petitions are filed against companies which have been in financial distress for a long period of time. As a rule, against each bankruptcy debtor, at the moment of filing the bankruptcy, there are ongoing enforcement procedures against its property. At the time of filing the bankruptcy, the Bankruptcy Judge has no information about any of these enforcement procedures pending against the debtor, and therefore there is a question about how the ordered stay will be applied. In other words, how would an enforcement Judge learn of the stay in his proceeding, bearing in mind that the debtor could have property against which an enforcement procedure has been initiated, not only in the location of the Court, but also throughout BiH?

Solution: According to Article 15 of the Bankruptcy Law, the Bankruptcy Judge has the power to impose security measures, including a stay of all proceedings while the preliminary bankruptcy

proceeding is ongoing. Article 15.7 provides that a decision on security measures may be appealed. Therefore, it appears that the stay of all proceedings in the preliminary proceeding has to be issued by the Bankruptcy Judge in the form of a decision. The Bankruptcy Judge is obliged to deliver this decision to the debtor and the preliminary Trustee, who both have a right to appeal it. However, as the preliminary Trustee's obligation is to secure the debtor's property by a decision on the opening of the bankruptcy proceeding (Article 16.1), he is the one that must distribute the Bankruptcy Judge's decision to stay the proceedings to all enforcement Judges involved in cases affecting the debtor's assets. This is a logical solution as well, as the preliminary Trustee has access to all of the debtor's documentation from which all information regarding ongoing enforcement procedures should be available.

B.6 Model solutions for introducing security measures

B.6.a. Consent of the Judge

Issue: What is the effect of the security measure according to which the Judge has to consent to any disposal of a debtor's property?

Description: In an operating company, the Judge may impose a security measure pursuant to which any disposal of the debtor's property would require the Judge's prior consent. Since an operating business has to order its supplies, sell finished products, and receive proceeds for goods sold, there is uncertainty whether all such operations require the Judge's consent under this imposed security measure. According to the opinion of some Judges, such an interpretation would lead to inefficient and burdensome work for the Bankruptcy Judge.

Solution: In BiH a bankruptcy practice has now been established interpreting this security measure to mean only that the consent of the Judge is required for disposal of the debtor's property out of the normal course of the debtor's business operation. Thus, according to these Judges' views, in an operating company on which the security measure prohibiting disposal of property without the Judge's consent has been imposed, such measure is not related to the debtor's everyday activity by which it continues to operate (selling finished products, collecting receivables, ordering raw materials, *etc.*), but only to the debtor's acts out of the ordinary course of business.

B.6.b. Consent of the preliminary Trustee

Issue: How to effectuate a security measure according to which there is no disposal of the debtor's property without consent of the preliminary Trustee?

Description: Although a security measure should, according to Article 18 of the Bankruptcy Law, be recorded in the company register to warn any interested third parties of the measure, it is not unusual for the measure not to be appropriately recorded. In this event, it is possible for a debtor to enter into contractual relations with third parties without notification to such third parties of the Court-imposed security measure (or even informing them that a bankruptcy against the company has been filed). In such a situation, there is an important practical question about how to effectuate the Court-ordered security measure.

Solution: In order to avoid the foregoing situation, a bankruptcy practice in BiH has already developed according to which the Trustee is authorized to take under his control of all of the debtor's corporate stamps, which he must use in his correspondence. In this way, all correspondence of the debtor with the outside world and all documents will need to be stamped by

the preliminary Trustee.

B.6.c. Rights of debtor's management in relation to security measures

Issue: If the Judge imposes a security measure requiring consent of the Judge or preliminary Trustee for any disposal of the debtor's assets during the preliminary bankruptcy proceeding, what is the authority of management in this period?

Description: In some of cases, the Judge imposes a security measure requiring the consent of the Judge or preliminary Trustee for any disposal of debtor's assets during the preliminary bankruptcy proceeding. Management, however, continues to operate the company and steer the board, dismissing the director of the company. In other cases, the director of the company dismisses some of the workers who caused problems for the company's operations, or orders cessation of production and operation. In many such cases, management, Trustees, and Bankruptcy Judges were not clear whether the foregoing actions by management were legally valid and binding.

Solution: The time-honored legal principle that "everything is permitted that is not prohibited by Law" is also applicable in the case of security measures during the preliminary proceeding in bankruptcy. In sum, this means that management of the bankruptcy debtor is allowed to perform all its functions that are not specifically prohibited by the decision on security measures. In our example, where a measure imposed deals with prior or subsequent consent of a Judge or Trustee to all acts of disposal of the debtor's property, management of the debtor would retain all its other prerogatives, except the free disposal of the debtor's property (selling, encumbering, or otherwise alienating current property). Consequently, under such circumstances, management may operate the company as it would outside bankruptcy, dismiss directors and workers, cease operations, enter into various contracts, *etc.* All of these acts are legally valid and binding, although some acts (entering into unfavorable contracts, for example) could be subject to avoidance or "right to reject contract" proceedings after the bankruptcy case is opened.

B.7 Model solutions for treatment of the debtor during the preliminary proceeding

B.7.a. Representative of the bankruptcy debtor

Issue: Who represents the debtor during the preliminary bankruptcy proceeding?

Description: During the preliminary proceedings, despite some security measures by which only disposal of the debtor's property is subject to consent of the preliminary Trustee, the board of directors dismissed one and appointed another person as the managing director of the company. This decision was not, however, appropriately recorded in the company register, which still names the old director as the person authorized to represent the company. The new director wants to appeal the decision on imposing the security measure. Does he have standing to appeal?

Solution: According to Article 23n of the Federation Law on Companies, a company is represented by the director or other person as determined by the Internal Company Act. Furthermore, according to the new Federation Law on Company Register, Article 4.1.6, the legal effect of all facts regarding a company comes into force the day of entering such fact in the Register of Companies. Therefore, if the decision of the board of directors has not been appropriately registered, the new managing director of the company can not represent the company, and so cannot appeal the decision on security. The only person that could appeal this decision on behalf of the debtor is the managing director or other person authorized by the

Internal Company Act, whose name(s) and authority for representation is duly entered into the Register of Companies.

B.7.b. Objection to the appointment of the preliminary Trustee

Issue: The Debtor's right to object to the appointment of the preliminary Trustee for the preliminary bankruptcy proceeding.

Description: The Judge has appointed a preliminary Trustee in order to assess whether the preconditions for opening the bankruptcy are satisfied. However, the debtor has information that this Trustee is related to some of the creditors, and has concerns about his or her impartiality in performing the duties of a preliminary Trustee. The question arises how the debtor might move the Court to remove this Trustee.

Solution: According to Article 11.1 in connection with Article 14.1, of the Bankruptcy Law, a decision on appointing a preliminary Trustee is not appealable. Once appointed, neither the debtor nor any other person can appeal this decision, which is effective as of the date of rendering. Any party with a legally cognizable interest, including the debtor, could move the Court separately to reconsider the appointment, explaining the factual background for this conclusion about the partiality of this Trustee. The Court could, having considered all stated allegations, decide to remove the existing and appoint another preliminary Trustee.

B.7.c. Dissatisfaction with opening of the bankruptcy case

Issue: Possibility of an objection to the decision on opening of the bankruptcy.

Description: The bankruptcy against the debtor has been filed and the preliminary Trustee has submitted his report on whether the preconditions for opening the bankruptcy have been met. Although the preliminary Trustee's report stated that some of the obligations have been paid during last 60-30 days, the preliminary Trustee ascertained that all preconditions for opening a bankruptcy are present. At the hearing on opening the bankruptcy, the debtor objected to the probability of the existence of the petitioner's claim, stating that the creditor's claim ceased to exist because it had been satisfied (accord and satisfaction). In spite of the debtor's arguments at the hearing, the Judge decided that the conditions for opening the bankruptcy were otherwise met and opened the bankruptcy. The Debtor is sure that the Bankruptcy Judge made a mistake.

Solution: According to Article 50 to the Bankruptcy Law, a decision on opening the bankruptcy is appealable. The debtor under these circumstances could appeal the decision on opening the bankruptcy, and in Federation (but not the RS) this appeal would stay any further action of the Court or Trustee (Article 11.5 of the Bankruptcy Law). However, regardless of the staying effect of the appeal, all legal consequences of the opened case provided by the law (Articles from 51-88) would still come into effect. The appellate Court must decide the appeal within 15 days of its submission.

C INVESTIGATION HEARING MODEL SOLUTIONS

C.1 Solving multiple problems when challenging claims

C.1.a. Whether claimant is secured or not

Issue: Challenging the secured status of the creditor at the Investigation Hearing

Description: The creditor has filed its claim with the bankruptcy Judge within the deadline provided in the decision on opening the bankruptcy. In its submission, the creditor stated that six months before filing the bankruptcy, it acquired the status of a secured creditor, and submitted all documents supporting this claim. Several other creditors, however, consider that this creditor acquired its secured right owing to a special relationship with the debtor. They believe that in this case all the preconditions for avoiding this security interest have been met, and they do not recognize this creditor as secured. Can the bankruptcy Judge make a decision on whether the creditor is secured at the Investigation Hearing?

Solution: According to Article 112 and 114.3 of the Bankruptcy Law, the Investigation Hearing can only deal with the grounds, amount of the claim, and its priority rank within the bankruptcy scheme, not the status of a secured claim. Eventually, such status can be determined only in a separate civil proceeding, initiated as the result of the exercise of the avoidance power of the Trustee or some of the creditors. Thus, the secured status of a creditor can not be decided at an Investigation Hearing, and the Judge and Trustee should not address this issue at the hearing.

C.1.b. Termination of the status of a secured creditor

Issue: Status of a secured creditor who acquired its security within two months before filing the bankruptcy.

Description: A creditor acquired security for a claim two months before the filing. Although the creditor began enforcement proceedings to obtain security eight months before the bankruptcy was filed, its right to security was entered into the Public Register only 50 days before the bankruptcy was filed because of delays in applicable Court procedures. The creditor asserts that it is a secured creditor, while the Trustee contends that its security right ceased to exist due to Article 57 of the Bankruptcy Law, which declares that security interests obtained with 60 days of filing are void. Can the Judge determine whether this creditor retains its security interest?

Solution: The Bankruptcy Judge, as stated earlier, has no authority to decide at the Investigation Hearing whether a creditor is secured or not. However, the status of a creditor (secured or not) is relevant to its voting rights in the assembly of creditors, where secured creditors have no right to vote to the extent their claim is secured (Article 28). Furthermore, at the Reporting Hearing, as well as the hearing for voting on a bankruptcy plan, the Judge should determine whether such a creditor has a right to vote as a general or secured creditor (see Articles 28.2 and 28.3, 163, and 164). Such a determination would also be relevant in the proposal for distribution of the proceeds from liquidation of the debtor, to which each creditor has a right to object and to appeal an adverse ruling (Article 123). Nevertheless, such a determination is not relevant to an Investigation Hearing.

C.1.c. Challenges by the Trustee

Issue: What are the claims that a Trustee could challenge?

Description: In actual Court practice, it is quite often the case that some of the claims are supported by Court judgments or by decisions of some administrative body. Some of the Trustees are uncertain if it is possible to challenge such claims and on what basis.

Solution: According to Articles 114 and 115 of the Bankruptcy Law, a Trustee can challenge any claim regardless of whether the creditor proves its claim by an enforceable document or other type of proof. The only difference in this respect is who is obliged to initiate the civil proceeding in order to prove that the claim is valid. According to Article 115 of the Bankruptcy Law, if a claim is not established by an enforceable document, a civil proceeding proving its existence is the obligation of the creditor holding such claim. However, if the Trustee challenges a claim that is supported by an enforceable document, then the obligation to initiate an appropriate civil proceeding falls on the Trustee.

C.1.d. Challenges by creditors

Issue: Role of the creditors at the Investigation Hearing.

Description: At the Investigation Hearing, the Trustee allowed certain claims. But some of the creditors do not agree with the Trustee and would like to object to claims that the Trustee allowed. Can any of the creditors object to the validity of claims that the Trustee already allowed?

Solution: According to Articles 114 and 115 of the Bankruptcy Law, claims can be challenged by a Trustee or by any creditor. This right of a creditor is not affected by the fact that the Trustee allowed the claim at issue. In such circumstances, a creditor who objects to the claim would assume the position of the Trustee in a civil proceeding, and would in effect represent the debtor company in the dispute for the benefit of the entire bankruptcy estate as a whole.

C.1.e. Role of the Judge at the Investigation Hearing

Issue: Right of the Bankruptcy Judge to allow a disputed claim

Description: At the Investigation Hearing, the Trustee objected to the validity of a claim. The claimant, however, is not satisfied with the Trustee's action and insists that the Bankruptcy Judge nevertheless allow the claim by Court decision. Can a claim that is objected to at the Investigation Hearing be allowed by the Bankruptcy Judge at that hearing?

Solution: According to the Article 115 to the Bankruptcy Law, the role of the Bankruptcy Judge is not to review or discuss objected claims, nor to resolve disputes between creditors, but only to note that the Trustee or other creditors have decided to object to a claim and direct the interested parties to initiate a civil proceeding, as provided by Article 115.

C.1.f. Techniques for challenging claims

Issue: What is a basis for challenging a claim?

Description: At the Investigation Hearing, the Trustee challenged a claim without stating the

reasons for challenging it. The creditor whose claim was challenged is in a dilemma -- what is the basis of future litigation over the claim in the civil proceeding?

Solution: Any objection to a filed claim is cognizable and has to be noted by the Judge. This includes objections to the validity or existence of the claim, the amount, and its priority rank. As for the validity or existence of the claim, an objection can be based on the fact that the claim has no legal basis (e.g., there is no contract or the service has not been performed), that it has ceased to exist (by satisfaction of the obligation, compensation, waiver, inability of the debtor to perform the contract due to *force majeure*, novation, *etc.*) or the period of enforceability of the contract has lapsed (statute of limitations). As regards the amount of the claim, usually it includes a disputed amount of interest and questions about how it was calculated. The priority of the claim (higher, general, or lower priority) can also be a matter of dispute and a civil proceeding can be initiated to establish this issue.

All these reasons to object to a claim must be precisely articulated (elementary due process and a general rule of non-litigation law), and the party directed to initiate the civil dispute may file the petition only on the same basis on which the claim was challenged at the Investigation Hearing. If the Trustee or creditor does not state the reason for the objection, the affected creditor could move the Court at the hearing to remind the Trustee or objecting creditor what his or her obligations are in this respect.

C.2 Civil disputes after the Investigation Hearing

C.2.a. Informal resolution with Trustee

Issue: Right of Trustee to allow a disputed claim after the Investigation Hearing.

Description: A creditor fails to provide the Court with documentation establishing its claim. For that reason, the Trustee objected to the validity of the claim. The creditor, however, does have valid documentation, and would like to know how to rectify the situation.

Solution: In such circumstances, the creditor could provide the Trustee with all relevant documentation requiring him to allow the claim subsequently in writing, or at the subsequent Investigation Hearing (see Article 114.5 of the Bankruptcy Law).

C.2.b. Filing suit and proving the claim

Issue: From what moment does the deadline of 30 days for filing a civil proceeding begin to run?

Description: After the Investigation Hearing has been concluded, the Bankruptcy Judge issues a decision noting which claims have been allowed and which are subject to objections. The decision is posted at the Court's board of announcement for two days and delivered to each creditor whose claim was challenged after seven days from the date of the Investigation Hearing. When does the deadline in Article 115 begin to run?

Solution: Article 115 of the Bankruptcy Law clearly sets a 30-day deadline that runs from the moment of commencement of the Investigation Hearing. Despite the provisions of the law that do not require a Bankruptcy Judge to note objected claims in a separate decision, many Judges are nonetheless doing so, relying on the practice under the old law. Such a decision, however, has no effect on the prescribed deadline in Article 115; regardless of the time when such a decision noting the list of challenged claims has been posted on the board or delivered to the relevant

creditors, the deadline begins to run from the moment of the hearing at which the creditor's claim was challenged.

C.2.c. Basis of civil litigation arising from bankruptcy

Issue: What is the basis of a dispute in a civil proceeding instituted after the claim was challenged at the Investigation Hearing?

Description: The Trustee or creditor who objected to a claim stated one reason for the objection (*e.g.*, termination of obligation). The holder of the disputed claim has appropriately initiated a civil proceeding in order to prove the validity of its claim. But the Trustee or objecting creditor now wants to assert that there is another issue related to the statute of limitations. Can the objecting parties change the basis for disputing a claim in the civil proceeding?

Solution: Only the grounds stated by objecting creditors or the Trustee at the Investigation Hearing may be the subject of a civil proceeding initiated after the claim has been challenged. If a dispute begins to move in a direction other than the stated grounds of objection, the holder of the disputed claim (the plaintiff in the civil proceeding) should insist that the civil Judge limit the discussion strictly to the allegations of the plaintiff, not matters raised by the Trustee or an objecting creditor.

C.2.d. Continuance of interrupted litigation

Issue: Continuation of litigation interrupted by the decision on opening the bankruptcy.

Description: Before filling the bankruptcy, the creditor initiated litigation to prove its claim against the debtor. With the decision on opening the bankruptcy, this litigation was stayed. Afterwards, at the Investigation Hearing, the creditor's claim was subject to an objection. Is the creditor obliged to initiate a new civil proceeding or may it continue the earlier stayed proceeding?

Solution: According to Article 55.4 of the Bankruptcy Law, the creditor would be allowed to continue the stayed civil proceeding if its claim is challenged at the Investigation Hearing. If its claim was challenged on different grounds than in the original litigation, however, the creditor must amend its complaint for which, in some cases, the consent of the debtor is required (Article 57 of the Civil Procedure Law). If such consent has not been granted, it appears that initiation of new litigation would be necessary.

C.3 Determining the status of secured creditors

C.3.a. What secured creditors must establish when filing their claims

Issue: Treatment of claims filed by purportedly secured creditors.

Description: After the bankruptcy has been opened, a secured creditor timely filed its claim, asserting that it has a secured claim, and providing the Court with appropriate documentation. In its filing, however, this secured creditor moved the Court to treat it as secured only up to the value of the collateral, and to treat it as unsecured for the remainder (the unsecured portion) of its claim. How should the Trustee and the Judge handle this secured creditor's motion?

Solution: According to Article 110.5. of the Bankruptcy Law, the secured creditor in its filing

with the Bankruptcy Court must identify the property that serves as collateral and disclose the alleged amount of the debt to be recovered from this property. Furthermore, according to Article 114.1, the Trustee at the Investigation Hearing may require that the secured creditor provide him with proof that the value of the collateral is not sufficient to satisfy its claim. Thus, from these two provisions it is clear what the obligations of a secured creditor who wants to participate in the distribution from the bankruptcy estate are. If the provisions of Article 115 are not honored, as in our example, the Trustee and Bankruptcy Judge should treat this creditor only as a secured creditor, without any right to participate in a distribution from the bankruptcy estate, except with reference to the property that serves as collateral for the debt (see Article 39 of the Bankruptcy Law).

C.3.b. Challenging secured claims

Issue: Techniques for challenging secured claims.

Description: At the Investigation Hearing, the Trustee challenged the amount of the secured creditor's claim, as well as its status as a secured creditor. The Judge directed the Trustee to initiate civil litigation in order to establish his allegations pursuant to Article 115 of the Bankruptcy Law. Did the Judge make the correct decision?

Solution: According to Articles 112 and 114, the purpose of the Investigation Hearing can only be to deal with those claims that were filed in the Bankruptcy Court, *i.e.*, rights arising from obligatory relations (contract, tort, and so on). The lien claimed by the secured creditor in its filing with the Court is a real property right and as such is not properly a subject of investigation at the Investigation Hearing. Consequently, in this situation, the Judge correctly directed the Trustee to initiate civil litigation on the amount of the secured creditor's alleged claim. Whether the creditor is actually secured or not, on the other hand, must be established in a different (enforcement) proceeding, as discussed below.

C.3.c. Challenging the rights of secured creditors

Issue: Procedure for disputing the allegedly secured status of a creditor.

Description: The creditor filed his claim in the Bankruptcy Court as a secured creditor. At the Investigation Hearing, the Trustee agreed with the basis and amount of this creditor's claim, but disputed his status as a creditor secured by any property. The Bankruptcy Judge, applying Articles 112 and 114 of the Law, declined to examine the secured status of the creditor at the Investigation Hearing. When should the secured status of a creditor be examined?

Solution: If in such circumstances a secured creditor is dissatisfied with the ruling of the Trustee, regardless of the fact that the Judge did not allow examination of the issue at the Investigation Hearing, the creditor, in order to exercise its right as a secured creditor, could initiate enforcement proceedings pursuant to Article 58.3 of the Bankruptcy Law. If the creditor initiates enforcement proceedings, the Trustee would be in a position try to prove that the purportedly "secured" creditor is not actually secured and therefore has no authority to exercise the rights provided by Article 58.3 of the law. Furthermore, if the "secured" creditor decided to exercise its right to the presumed collateral in the bankruptcy proceeding, then this examination of the status of its secured claim would be raised in connection with the distribution of the proceeds in accordance with Article 123 or the voting on the reorganization plan in accordance with Article 163 of the Bankruptcy Law.

D REPORTING HEARING MODEL SOLUTIONS

D.1 Trustee's model report for the Reporting Hearing

Issue: What should a Trustee include in his or her report for the Reporting Hearing?

Description: In BiH bankruptcy practice various models of a Trustee's report are being used. Some reports might not cover all topics required, or information and conclusions are not presented in the most logical and comprehensible way. It is difficult for the Judge and the institutional creditors to orient quickly in such reports and additional time is lost on hearings for explaining the basics. The obvious solution is standardizing the form of the report.

Solution: Reviewing the various activities and analyses that the Trustee should report to the assembly of creditors at the Reporting Hearing, we recommend the following tentative structure of this report to be used as a guideline:

Report for the Reporting Hearing

1. Debtor's Legal Status (establishment, historical transformation, last registration details, representative organs);
2. Description of Debtor's Activities (list of activities as per registration, actual main production activities and/or services);
3. Management, Organizational Structure, Structure of Personnel by position;
4. Debtor's Current Status (operational status, obligations/debts, receivables, *etc*.);
5. Debtor's Financial Analysis for the period before bankruptcy (analysis of the financial trends for past three years);
6. Analysis of what has caused Debtor's insolvency and led up to the bankruptcy;
7. Analysis of all Debtor's obligations as of the day that bankruptcy is opened (submitted and examined claims, percentage of individual claim to total claims);
8. Report on the Trustee's activities since the opening of the bankruptcy (securitization of the bankruptcy estate, informational meetings held, negotiations with contracting parties, released workers, reviewed or collected accounts receivable, bookkeeping, *etc*.);
9. Assessment of the possibilities for continuation of the Debtor's business activities (assumptions, concrete activities conducted);
10. List of Debtor's Assets (appointment of committee to prepare the list of assets, methods of inspection used, groups and categories of assets: registered in books, registered and dully depreciated, assets not evidenced on business books);
11. Appraised value of Debtor's assets (value date, appraiser, value standard: expected liquidation value of assets);
12. Summary of appraised value of assets by category and group of assets (compared to book value);
13. Determination of the sufficiency of funds to continue the bankruptcy proceeding;
14. Bankruptcy Trustee's report on prospects for reorganization (supported with evidence); and
15. Appendices (full list of assets with their book values and appraised values, monthly cash-flows, contracts, orders, accounts receivable, expressions of interest, pending litigation, *etc*.)

D.1.a. Establishing title to the debtor's property

Issue: The Bankruptcy Trustee should prepare a list of the assets forming the bankruptcy estate where Debtor possesses property without clear title of ownership.

Description: Owing to various transformations in the ownership of property in BiH over the past 50 years, many titles to real estate are limited to the right to manage, use, or dispose, but not to own or alienate. In some instances, certain plots of land are still held in common social ownership or by the municipality. In addition, subdivision of huge industrial and trade holdings may not have been properly conducted and title still belongs to non-existent legal entities. How should the Trustee handle such situations?

Solution: First, the Bankruptcy Trustee should thoroughly investigate all real estate of the Debtor beginning with the land books register and cadastre and, where appropriate, uncover additional information in the archives. For buildings, all building permits and urban-planning decisions and approvals should be collected and analyzed. The property ought to be analyzed in several categories, depending on the differing rights to title. Each category should be studied and assessed in regard to its market value and possibility of conversion into an ownership right. The latter requires assessment of the time and cost to be expended in order to gain an ownership right through the various costly and time-consuming available legal procedures.

D.1.b. Valuation of the debtor's property

Issue: Who can perform a credible valuation and what standards of valuation should be applied?

Description: Valuation of a Debtor's property is a fundamental prerequisite for a bankruptcy proceeding and has a direct impact on the most critical decisions in the bankruptcy, *e.g.*, liquidation or reorganization, timely and efficient or prolonged and costly liquidation, secured status, required payments in a reorganization, the prospect of a cram-down, *etc.* A decisive element in valuation is the applicable standard of value. In BiH, Court expert witnesses are employed to accomplish this task are not appraisers and the Depreciated Replacement Cost New (DRCN) is widely accepted as the standard of value. By definition, the DRCN standard of value is a market value that does not assume sale of the property and is conducted based on the market prices of the basic elements of each asset. The requisite of all market standards of value is that there is a willing buyer and a willing seller and both are well informed about the object to be sold and accept the estimated price. Bankruptcy is an involuntary type of enforcement proceeding where the seller is not willing to sell, but creditors have taken over his property and now will force a sale, *i.e.*, it creates a distressed-sale context.

Solution: In this case the most appropriate and applicable valuation tool is the Standard of Liquidation Value. The bankruptcy law itself refers to the individual sale of properties as bankruptcy liquidation or involuntary liquidation. Such a standard assumes that the assets are not being used and therefore usually the salvage value is the best estimate when an efficient liquidation proceeding requires a fire sale. When the majority of the bankruptcy creditors have voted for a planned liquidation, this assumes achievement of a higher price than salvage value, but still the value estimation should be less than the net asset value of an asset used in ongoing operations. The difference is in the liquidation cost (announcement of sale, organizational expenses, dismantling or disassembling machines and equipment, minor repairs and refurbishing, *etc.*), applicable tax discount, second-hand price discount, and other potential market demand discount factors (such as uniqueness, utility, technological perceptivity, *etc*.). The valuation should be done by a professional appraiser; the Court's usual expert witnesses are not trained for such work and in the overwhelming majority of the cases significantly over-value the assets of the bankruptcy estate for these reasons, creating unreasonable expectations and undermining the bankruptcy itself. When appraisers are not available, then the Court's expert witnesses should be required to adhere to the Liquidation Value Standard, for it is this test that underlies the

bankruptcy system. The production managers, the machine engineers, and the technologists in the debtor's company could be a valuable source of information on the price of new and second-hand machines and should be used whenever possible as a second verification.

D.1.c. Varieties of Debtor's property (real and personal (immovable and movable) property, claims, *etc.*)

Issue: The Bankruptcy Trustee has to deal with a variety of Debtor's properties, which should be classified and grouped by similar characteristics. The main concern is the correct analysis of the secured property of the Debtor.

Description: The value of property that is secured may not equal or exceed the claim of the secured creditor. The Bankruptcy Trustee should be able to identify the amount of the secured claims and also to analyze what would be the rate of recovery (percentage) for the rest of the payment priority ranks and report this to the creditors at the Reporting Hearing.

Solution: A prerequisite for conducting the analysis of the secured property of the Debtor is the appropriate valuation of all assets forming the bankruptcy estate. Furthermore, the Bankruptcy Trustee should get all excerpts from the land books and cadastral office and from the public pledge registry and determine the priority of the secured claims in the same property. Then the amounts of the secured claims should be compared to the value of the underlying collateral. Finally, the analysis should show which claims are secured and which are not and those that are partly secured (under-secured). Secured creditors have a right to file the unsecured portion of their claim as bankruptcy creditors and participate in the distribution of the estate. If they do not file within the three-month period of time after the first Investigation Hearing as provided by the Bankruptcy Law, such an under-secured claim will not be considered an allowable claim.

D.2 Trustee's model recommendations for the assembly of creditors

Issue: The Bankruptcy Trustee should formulate recommendations on whether the Debtor has realistic prospects for reorganization, which the assembled creditors will vote to determine.

Description: The Reporting Hearing is concluded by a vote on the pivotal decisions for the bankruptcy proceeding. If the Debtor has a real possibility of being reorganized in bankruptcy, the creditors' assembly should vote with a majority (in number and amount of claim) that they would like to direct the Trustee to explore this option and require him or her to prepare and present a potential bankruptcy reorganization plan. The Bankruptcy Trustee should be able to formulate and make a compelling recommendation on this decision from the materials he has studied.

Solution: The main conclusions from the report of the Bankruptcy Trustee should be presented in the form of proposals. A tentative list of possible proposals to the Creditors Assembly is provided here in the text. The draft of the decision should be adjusted for each individual case.

Debtor: XXXX Municipal Court XXXX
Subject: Proposal for decision

Based on the Report presented, the Bankruptcy Trustee proposes that the Creditor's Assembly at the Reporting Hearing vote the following:

DECISIONS

1. The Creditors Assembly accepts in full the report of the bankruptcy Trustee on the economic condition of the Debtor, the stated reasons that have caused this condition, and all activities conducted by the Trustee during the period from the opening of the bankruptcy XXX until the Reporting Hearing XXX.

Variant on exploring reorganization option

2. The Bankruptcy Trustee is authorized to continue (resume) production on condition that this would not result in losses in any individual case or decrease the value of the bankruptcy estate.

3. The Bankruptcy Trustee is required within a period of 30 days to submit to the Bankruptcy Court a proposal for a bankruptcy reorganization plan for this Debtor, based on which the Creditors' Assembly will decide whether to accept the proposed measures.

Variant Liquidation

2. The Bankruptcy Trustee is authorized to continue certain operations such as lease contracts and others until the assets that are the subject of these contracts are scheduled for sale.

3. The bankruptcy Trustee should engage guards, bookkeepers, appraisers, auctioneers, and such other professionals as are needed for the organization of the total sale of the assets of the debtor.

4. The Creditors' Assembly decides that the assets forming the bankruptcy estate of the Debtor should be sold the following way:
Var. a. Dutch Auction with starting price set at the current balance of book value
Var. b. As per Var. a and reserved price of XX% from the Book/appraised asset value
Var. c. Public silent auction with closed bids
Var. d. Var. a, b, c, with option allowing for absentee bids
Var. e. Multiple assets sale at a single auction as per combination of Var. a, b, c, d
Var. f. In case of a single monopoly buyer, direct negotiations (company roads, bridges, power lines, kindergartens, parks, Church, Mosque, and other elements belonging to the public infrastructure or to non-profit or religious and other charitable organizations)
Var. g. Public Auction Assets Sale as per the procedure provided by the enforcement law

The Bankruptcy Trustee is authorized to execute all sales. If needed, the Bankruptcy Trustee may require the Creditors' Committee to resolve specific issues that do not fall within the competence of the Bankruptcy Trustee (such as the sale of the company as a whole -- total assets sale or planned liquidation resulting in higher cash proceeds than would otherwise be collected from fire sales).

5. The fire sale of all assets should be completed by XXX. In case of a possibility for a planned liquidation, the Creditors' Committee should specify the deadlines for the sale of these assets.

D.3 Model for impaneling a Creditors' Committee

Issue: Who decides whether Creditors' Committee should be formed, who makes the proposal,

and when is a creditors' committee most needed?

Description: At different stages of the bankruptcy proceeding, the Bankruptcy Trustee may need an operating body that can speak for and replace the Assembly of Creditors and make the necessary decisions that are beyond his authority and might have a decisive impact on the outcome of the bankruptcy.

Solution: After the bankruptcy has been opened, if the Bankruptcy Trustee needs a Creditors' Committee to assist him in making strategic decisions such as ensuring the assets of the bankruptcy estate, signing of significant contracts that impact the bankruptcy estate, *etc.*, the Trustee could ask the Judge to appoint such an interim Creditors' Committee to defend the creditors' collective interests (Art. 29.2). Otherwise, the general intention of the law is that the Creditors' Committee be elected by the assembled creditors at the creditors' meeting (Art. 29.1). The Committee can supervise (Art. 29.5) the work of the Trustee and approve the sale of assets and decide where and in what form to hold the proceedings (Art. 91.1). The interim Creditors' Committee can also terminate the business operations of the company, if this is appropriate, before the Reporting Hearing takes place (Art. 100.2). All legally binding acts of special importance require the consent of the Creditors' Committee, such as: disposal of workshops or real-estate and share participations; intention to take a loan for financing current activities; or intention to assume or file a lawsuit (Art. 108). Furthermore, if the Bankruptcy Trustee would like to make a partial distribution, he should secure the consent of the Creditors' Committee in the same way as in the main distribution process (Art. 117.3).
In case a reorganization plan is developed by the Bankruptcy Trustee, he should follow the advice of the Creditors' Committee (Art. 143.2) and should take their views into consideration (Art. 157.1) if they are justified. The Bankruptcy Judge must first hear from the Creditors' Committee and the Trustee when deciding on the confirmation of the plan (Art. 173.2). Upon confirmation of the plan, its implementation is supervised by the Trustee and the Creditors' Committee (Art. 186).

D.3.a. Number of members

Issue: Most creditors would like to have their own representative on the impaneled Creditors' Committee. Obviously, so high a number is unmanageable.

Description: In some cases, the representatives of the different subgroups of creditors within the main groups (workers, general trade creditors) would each insist on having their own representative on the impaneled Creditors' Committee. This would certainly lead to an unmanageable committee. The purpose of the Creditors' Committee is effectively and timely to fulfill the tasks suggested above. In order for this to be possible, a limited number of creditors is required.

Solution: In the vast majority of cases, it is recommended that the number of creditors impaneled be three; the maximum allowed by law is 7. Their number must always be odd to avoid a deadlock (Art. 29.4).

D.3.b. Conflicts of interest

Issue: Could any creditor potentially be impaneled on the committee?

Description: Unfortunately, the bankruptcy law does not specifically address the conflict of interest of the members of a Creditors' Committee. The Trustee might confront a situation where a creditor is appointed to the creditors' committee whose claim is disputable or voidable or even

related to some criminal activity. All of the legally binding acts that the Trustee should undertake might be hampered by creditors who have a conflict of interest and thus be inclined to block the bankruptcy proceeding in general.

Solution: Carefully select the creditors to be impaneled, ensuring that they have no potential conflict of interest, that their claims are solid, and that they are not related to or associated with other creditors that might have such conflicts of interest.

D.3.c. Recommending members

Issue: Who can be impaneled on the Creditors' Committee and who makes the recommendations?

Description: This issue is closely related to the number of creditors that can be impaneled (3-7). Often workers want to have more than one representative on the Creditors' Committee because they have already split up into several antagonistic groups that do not trust one another. In some cases there is uncertainty about who can recommend whom to be impaneled. What is the resolution of this uncertainty?

Solution: The law specifies the following representatives of the classes of creditors that must be represented on the Creditors' Committee (Art. 29.3):

- bankruptcy creditors with the highest claims,
- bankruptcy creditors with small claims,
- representatives of the debtor's employees, and
- secured creditors.

Persons who are not creditors may also be appointed as members of the committee if they can contribute to the work of the board through their professional knowledge.

In many cases one class of creditors may qualify for two seats. For example, if the workers hold the majority in number of claims, they would qualify for the place of the creditors with the highest claims and for the place of the employees' representative. If this happens, it is advisable that either both classes of creditors take only one place or that the committee include five or seven members. This applies to workers and secured creditors only because these two classes of creditors by law have reserved places on the Creditors' Committee based on their payment priority rank, whereas the other classes are selected based on the amount of their claim, regardless of whether they are workers or secured claimants.

The Bankruptcy Trustee is the party most interested in an effective Creditors' Committee. If this is not the case, then there is little use of a Creditors' Committee that gathers with the same frequency as the Assembly of Creditors. This explains why Trustees proactively propose to the Judges (before the Reporting Hearing) and to the Assembly of Creditors those who in their judgment should be on the Creditors' Committee, assuming all the other legal preconditions have been met (number and class of creditors as per the law). The Judge may also propose particular creditors to be on the interim Creditors' Committee (Art. 29.2).

D.3.d. Replacing members

Issue: A group of creditors does not like a certain member named to the Creditors' Committee or considers that their representative is misrepresenting them.

Description: In practice it may turn out for various reasons that the first choice selected or appointed by the Judge misrepresents the class of creditors to which the member belongs or simply cannot exercise the obligations of a member of the committee (always absent, frequent business travels abroad, ill, indifferent, *etc.*). What can be done in such a situation? Who can replace members of the Creditors' Committee?

Solution: The law allows changes in the composition of the creditors who are on the interim Creditors' Committee by the Judge in the interests of all the creditors (Art. 29.2). In all other cases, it is the Assembly of Creditors that can replace the members of the Creditors' Committee (Art. 29.1). It might be fairer and more effective, however, if each class of creditors were to select its own representative. Otherwise, a simple majority of one class of creditors could override the others in the voting and thereby acquire greater representative and operating rights in controlling the bankruptcy proceeding.

D.4 Voting model solutions

Issue: Who can vote on the Report presented at the Reporting Hearing?

Description: At the Reporting Hearing, the Creditors' Assembly must make certain decisions as described in Point 2 above. The vote is reached by a simple majority, but who can actually vote and how are the votes counted?

Solution: Decisions taken by the Assembly are made by an absolute majority of the creditors present, taking into account that the total amount of the claims of the creditors who have voted for a decision has to be greater than half of the total amount of the claims of all the creditors present (Art. 28.4).

D.4.a. Bankruptcy creditors

Issue: Do all bankruptcy creditors vote?

Description: The Reporting Hearing is open to the public and all bankruptcy creditors can appear. Should the Judge allow all of them to vote?

Solution: The law requires that the right to vote in the creditors' assembly be granted to those creditors who have properly filed their claims, which were not contested by the Bankruptcy Trustee or by other creditors who have the right to vote. The creditors in lower payment priorities do not have the right to vote (Art. 28.2).

D.4.b. Secured creditors

Issue: Secured creditors would to like to vote for the liquidation of the Debtor at the Reporting Hearing. Can they cast such a vote?

Description: The Trustee might find himself or herself in a situation where the secured creditors are quite active at the Reporting Hearing, asking frequent questions, making comments, and manipulating other creditors into voting for liquidation.

Solution: The law requires that the right to vote of the secured creditors be limited to the amount for which they appear as bankruptcy creditors (Art.28.2), *i.e.*, to the extent they have an under-secured claim. Secured creditors do not have a right to vote at the Reporting Hearing - only

bankruptcy creditors have such right. For creditors to be recognized as bankruptcy creditors, they should have registered their claims, which were not contested by the bankruptcy Trustee or by other creditors who have the right to vote (art. 28.2).

D.4.c. Exceptions to the general rules

Issue: Under what circumstances might creditors vote who otherwise are not allowed to vote at the Reporting Hearing?

Description: At the Reporting Hearing, creditors whose claims have been contested might consider this as a circumvention action of the Trustee who would like to prevent them from voting and affecting the outcome in deciding whether to liquidate or reorganize the debtor.

Solution: The law makes certain exceptions in regard to who can be allowed by the Judge to vote in the Reporting Hearing if a contested claim seems probable. At the hearing, the present creditors, the debtor, and the bankruptcy Trustee may request an urgent reconsideration of a decision on the right to vote. The Bankruptcy Judge must make a decision immediately, on the basis of the existing circumstances, and the creditors do not have the right to appeal this decision (Art. 28.3).

E SECURED CREDITORS' MODEL SOLUTIONS

E.1 How to establish the status of a secured creditor

Issue: Proving the secured status of a claim.

Description: The creditor timely filed its claim in the Bankruptcy Court, asserting that the claim was secured. The creditor has not, however, submitted any supporting excerpt from the Land Book in which its lien over specified property of the debtor's has been recorded in this creditor's name. Should the Trustee recognize this creditor's claim as secured?

Solution: As noted earlier, according to Articles 112 and 114 of the Bankruptcy Law, determining the secured status of a creditor is not a proper matter for the Investigation Hearing. The Trustee at this hearing should deal only with the grounds and amount of the claims and their priority rank of payment according to the scheme in the Bankruptcy Law (higher, general, or lower priority rank of payment), and if the Trustee discovers that either the amount or basis are questionable, then he must challenge the claim on these grounds. But as regards the status of the claim, whether it is secured or not, this question would be addressed and resolved in a later phase of the proceeding (see section B.3.c of this document).

E.2 Terminating the status of secured creditors (waiver, abandonment)

Issue: Transformation of a secured creditor into an unsecured creditor.

Description: The creditor filed its claim as a secured claim in the bankruptcy proceeding. Through informal contacts with the bankruptcy creditors, it learned that the majority of creditors would vote at the Reporting Hearing for this Debtor's liquidation. But the secured creditor has an interest in trying to reorganize the debtor, for it expects through a successful reorganization to obtain more than it might in liquidation of the Debtor, with whom this creditor has had a long

relationship. At the Investigation Hearing, the creditors learn that this secured creditor (as a secured creditor) has no right to vote in the Creditors' Assembly (see Article 28.2 and 39 of the Bankruptcy Law) and that it would not have any opportunity to interfere in the decision on liquidation or reorganization of the debtor. Is there any mechanism in the Bankruptcy Law that provides a secured creditor with a possibility of participating in the voting at the Reporting Hearing?

Solution: According to Article 39 of the Bankruptcy Law, a secured creditor has a right to participate in bankruptcy proceedings only if it has waived or abandoned its security right or has proved to the Trustee at the Reporting Hearing that part of its claim could not be recovered from the sale of the property that is collateral for the claim (Art. 114.1), in which case the claim is bifurcated into a secured and an unsecured claim. Consequently, the right of a secured creditor to vote at the Creditors' Assembly is limited (Art. 28.2). If the secured creditor is interested in actively participating in the bankruptcy, however, and is eager to advocate for the reorganization of the debtor, this creditor may waive or abandon its secured right for all or part of its claim, or may prove to the Trustee that part of its claim will not be satisfied from the expected proceeds of the sale of the collateral. In either case, the secured creditor would be in a position to participate in the bankruptcy as a bankruptcy creditor only for that part of his claim that is not secured.

E.3 Rights of secured creditors in the bankruptcy generally

Issue: Status of the secured creditor in a bankruptcy.

Description: The secured creditor timely filed its claim in the Bankruptcy Court. The creditor is aware that its collateral for this claim would not be sufficient to cover the claim in full, but has not indicated this fact in its filing, nor precisely determined to what extent it is under-secured. Through its filing in the Bankruptcy Court, the secured creditor would like to participate in the distribution of the bankruptcy estate. Does this creditor have the right to share in the distribution of the bankruptcy estate?

Solution: According to Article 39 of the Bankruptcy Law, a secured creditor has the right to participate in the distribution of bankruptcy estate only if the creditor waives or abandons its security interest or proves that it has cannot recover its claim in full from the property that secures the claim. Furthermore, the right of a secured creditor to participate in the decision-making process through the Creditors' Assembly (the highest authority in the bankruptcy proceeding) is also limited to the amount of the secured creditor's claim that, owing to waiver or inability to recover the debt, becomes unsecured.

E.4 Rights of secured creditors at the Investigation Hearing

Issue: Right of secured creditor to challenge someone's claim (secured or bankruptcy creditor).

Description: At the Investigation Hearing, the Trustee allowed the claim of a bankruptcy creditor, which a secured creditor knows is groundless. Bearing in mind that the Trustee earlier allowed this claim, is the secured creditor now in a position to challenge the dubious claim of this bankruptcy creditor?

Solution: A secured creditor can only exercise the right to dispute a claim if the Trustee earlier allowed part of the secured creditor's claim as unsecured (see Art. 39). According to Article 114.2, only a Trustee and a bankruptcy creditor can challenge another creditor's claim.

E.5 Rights of secured creditors at the Reporting Hearing

Issue: Right of a secured creditor to interrogate Trustee at the Reporting Hearing.

Description: At the Reporting Hearing, the Trustee submitted his report with a recommendation on the further course of the bankruptcy (reorganization or liquidation). Some of the creditors asked the Trustee for explanations, and a secured creditor insisted on an explanation concerning the appraised value of the debtor's property. Keeping in mind Articles 39 and 28.2 of the Bankruptcy Law, can the secured creditor question the Trustee's Report?

Solution: According to Articles 39 and 28.2, the rights of secured creditors to influence the bankruptcy proceeding are limited to the amount of its claim that would be unsecured (under-secured). Accordingly, a secured creditor who has not filed part of his claim as unsecured has none of the rights that belong to a bankruptcy creditor. To the extent that a secured creditor has waived its claim, it has the same rights as other bankruptcy creditors. With reference to the status of the collateral, however, a secured creditor has the right to demand an explanation from the Trustee, and may request of the Trustee an opportunity to verify the condition and maintenance of this property during the bankruptcy proceeding.

E.6 Rights of secured creditor in the distribution of proceeds

E.6.a. Right of secured creditor to participate in partial distribution of bankruptcy estate

Issue: Whether a secured creditor has the right to participate in a partial distribution of the bankruptcy estate, regardless of his secured rights.

Description: The secured creditor has not exercised its right to recover its claim from property in a separate enforcement proceeding, outside bankruptcy. Instead, the creditor timely filed its claim and left the property that serves as collateral to be liquidated in the bankruptcy proceeding by the Trustee. The Trustee sold part of the debtor's property, but not the secured creditor's collateral. The Trustee has proposed a partial distribution according to which this secured creditor would not receive anything. Is such a proposal correct?

Solution: The secured creditor was invited to file its claim after the bankruptcy was opened pursuant to Article 46 to the Bankruptcy Law. By filing such a claim, the creditor would become a bankruptcy creditor with the right to be paid in the first instance from the liquidated value of the property that secures its debt (see Article 39). If this property has not been liquidated, though the Trustee was authorized to do so in the bankruptcy, a proposal of partial distribution should contain a percentage of recovery for the secured creditor's claim if the general priority rank of creditors is expected to be paid in the partial distribution (see Article 163).

E.6.b. Secured creditor's appeal of the distribution process

Issue: Options of a secured creditor in the distribution of proceeds.

Description: The secured creditor did not exercise its right to initiate a separate enforcement proceeding after the bankruptcy was opened (see Article 58). Instead, the creditor left to the Trustee the authority to sell its collateral in the bankruptcy proceeding. After liquidation of all the debtor's property, the Trustee made a proposal for distribution according to which the secured creditor would receive less money then it had expected. What are the options at the secured

creditor's disposal to address this unexpected shortfall?

Solution: According to Article 123 of the Bankruptcy Law, the secured creditor could file an objection with the Bankruptcy Judge concerning the proposal of distribution. If the creditor is not satisfied with the decision of the Bankruptcy Judge, it would still have a right to appeal the decision before a second-level Appellate Court. Such an appeal would have the effect of staying the distribution. These two legal remedies should be lodged only for the reasons that do not relate to the liquidation value of the attached property. Namely, secured creditor that do not use his right to sell attached property in separate, enforcement procedure, would not have any argument that liquidation value of that property is too low, under conditions that Trustee's liquidation procedure was fair and transparent.

E.7 Rights of secured creditors in a reorganization

E.7.a. Rights under the Plan

Issue: Is it necessary to provide for each secured creditor in a Plan of Reorganization?

Description: In a plan of reorganization, the Trustee has not provided for some of the secured creditors, nor placed them in any of the five voting classes. The secured creditors that were not provided for in the proposed Reorganization Plan are not satisfied and have moved the Court to reject the plan for this reason. Do they have this right?

Solution: According to Article 163.2, like other unimpaired creditors, secured creditors whose rights are not affected by the Plan in any way have no right to vote on the Plan. Consequently, settlement of the claims of such creditors would not be any part of the Plan. A secured creditor nevertheless would have the right to raise its concerns at the hearing to discuss and vote on the Plan, regardless of the fact that settlement of its claim is not contemplated by the Plan. In addition, if the secured creditor is not satisfied with his treatment or lack of reference under the Plan, the creditor would have an opportunity to challenge the entire plan pursuant to Article 176 of the Law. On the other hand, the Bankruptcy Judge *ex officio* should take care to protect the established procedure for reorganization in a bankruptcy (see Articles 156, 173, and 175 of the Law) and any creditor is free to move the Court to assert its grievances.

E.7.b. Right to object

Issue: Whether a secured creditor is bound by a Reorganization Plan that the creditor voted against?

Description: According to the Reorganization Plan as filed, one of the creditors was placed in a class of three secured creditors. For this class of creditors, the Plan provided for payment only of the principal on their claims within two years, beginning from the date of confirmation of the Plan. One of these three secured creditors is not satisfied with such treatment and wishes to vote against this proposal. Under such circumstances, if he is outvoted, would the Plan still bind him?

Solution: According to Article 169 of the Bankruptcy Law, a class has voted in favor of the Plan if at least 51% of the creditors of that class holding at least 51% of the claims of that class voted for confirmation of the Plan. Furthermore, the same provision states that a Plan will be considered confirmed if each class votes in favor of the Plan. Article 179.1 provides that a confirmed plan binds the creditors who objected to the plan along with all others. Therefore, it is quite clear that once each of the classes of creditors votes to confirm a Plan, this Plan binds even

dissenting creditors who voted against the Plan within their class.

F RIGHTS OF CREDITORS WITH THE RIGHT TO SEPARATE RECOVERY

F.1 Basic right of creditor with right to separate recovery

Issue: Is property subject to separate recovery included in the bankruptcy estate?

Description: Several years before filing the bankruptcy, the debtor entered into a contract to lease certain machinery. It used this machinery in its production. After the bankruptcy was opened, the owner of the leased machinery wanted to repossess its machinery. Would this owner be permitted to recover its property despite the bankruptcy?

Solution: The right of a creditor with the right to separate recovery (a creditor who owns property held or used by the debtor) is regulated by Article 37 of the Bankruptcy Law. Paragraph 1 clearly prescribes that such a "creditor" is not a bankruptcy creditor at all and that its right to repossess its property is subject to other law rather than the Bankruptcy Law. In addition, in article 30 of the Law, the limits of the bankruptcy estate are set forth in detail. From these provisions, it is evident that the bankruptcy estate does not encompass all property that is in the possession of the bankruptcy debtor but only the property that belongs to it. Thus, a creditor with the right to separate recovery would indeed have the right to repossess its property, regardless of the pending bankruptcy proceeding over this debtor's property.

F.2 Technique for realization of the right to separate recovery

F.2.a. Submission of the claim in bankruptcy

Issue: Is the creditor with the right to separate recovery obliged to file its claim with the Bankruptcy Court within the deadline prescribed by the decision on opening the bankruptcy proceeding?

Description: The Bankruptcy Judge opened the bankruptcy over the debtor's property. The creditor with right to separate recovery has not filed a claim pursuant to Articles 46 and 110.6 of the Bankruptcy Law. Has this creditor lost the right to recover its property?

Solution: According to Article 56, such a bankruptcy creditor can realize its right only within the bankruptcy proceeding. Article 37, however, explicitly provides that creditors with a right to separate recovery are not bankruptcy creditors. Thus, even if a creditor with separate recovery did not timely file its claim in the bankruptcy, it does not follow that the creditor has lost the right to recover its property. As the owner of certain property, the creditor has the right to repossess its property in accordance with the general rules of Property Law.

F.2.b. Realization of the right to separate recovery

Issue: Whether a creditor with the right to separate recovery can realize its right without approaching the Bankruptcy Court.

Description: The creditor with the right to separate recovery has not filed any claim in the bankruptcy. Yet the creditor is aware that, owing to this failure, it has still not lost its right to repossess its property. How would it realize this right?

Solution: Under these circumstances, the creditor with the right to separate recovery should directly approach the Trustee with its request for repossession of the property. Since the relationship between a creditor with the right to separate recovery and the debtor has not been specifically prescribed by Bankruptcy Law, the general rules of Property Law should be applicable to this relationship. Disregarding the existence of the bankruptcy, in normal circumstances, a third party who would like to repossess its property would first approach the debtor who is in possession of the property. In our situation, the debtor is represented by the Trustee. If the Trustee refuses to accede to the request of the creditor with a right to separate recovery, civil litigation to assert the rights granted by the Property Law should be initiated by the creditor.

F.2.c. Trustee's right to forestall repossession by a creditor with the right of separate recover.

Issue: Whether a Trustee can prevent a creditor with the right to separate recovery from seizing its property?

Description: The creditor with the right to separate recovery seeks to repossess property (equipment, say) that is essential for the debtor, an operating company, to continue to produce goods and operate. Without this equipment, the debtor has little chance of implementing a successful plan of reorganization. The creditor who owns this equipment nevertheless insists on taking possession of its property immediately once the bankruptcy case has been filed. Will the creditor succeed?

Solution: The rights of a creditor with a right to separate recovery may not, in any event, be exercised before the Reporting Hearing, though such creditors are entitled to claim against the bankruptcy estate for any loss in value resulting from excessive wear of their property up through the Reporting Hearing. After the Reporting Hearing, they are entitled to receive their property back, although the Trustee has the right to seek the Judge's permission to continue to use the property in ongoing business activities. In this case, the creditor with the right to separate recovery may claim both lost value and compensation for the use of its property. Therefore, under Article 37, if the creditor is compensated for the use and depreciation of the property, the Trustee who needs this property for continued operations may be able to prevent separate recover.

G SOLUTION MODELS FOR LIQUIDATION OF THE DEBTOR'S PROPERTY

G.1 Decision on liquidation

Issue: The Assembly of Creditors is divided between creditors who prefer a reorganization of the debtor and creditors who want an immediate liquidation.

Description: Typically, such an impasse describes a situation where the bankruptcy Trustee has prepared a Report that did not provide enough information or in which the information was misrepresented or misinterpreted, causing the creditors to divide into two adversarial groups. How to reconcile these creditors?

Solution: In this situation where no decision has been reached, the Bankruptcy Judge may close the hearing and let the creditors think it over, and may instruct the Trustee to prepare an

additional report, create amendments to the report, and perform specific marketing and assessment of the feasibility of the reorganization and liquidation options. If no decision is made at two consecutive sessions of the creditors' committee or at two consecutive convened sessions of the assembly of creditors, the Bankruptcy Judge may issue such approval for liquidation *sua sponte* (Art. 29.6). Then the Trustee must immediately set about liquidating the assets belonging to the bankruptcy estate (Art. 101.1).

G.2 Recommendation of Trustee

Issue: The assembly of creditors cannot decide on how the bankruptcy estate should be liquidated. The Judge suggests recourse to enforcement proceedings, but this is time-consuming, costly, and at the end results in a sale for next to nothing.

Description: This describes a situation where creditors would like to achieve a maximum recovery from the sale of the bankruptcy estate. How do they achieve this goal?

Solution: The Trustee should be proactive and explore different ways for maximizing the value from the sale of the bankruptcy estate. He might contact professional auctioneers and other intermediaries who have knowledge and experience in achieving good results. If this is not possible, the Trustee can always explore the possibility of soliciting closed bid offers, a Dutch auction with reserved price, or various other selling techniques.

G.3 Different ways of liquidating assets

Issue: The Trustee has identified different selling techniques but does not know which to use.

Description: This occurs when several alternatives exist but the Trustee cannot decide which selling strategy to develop. How to decide?

Solution: The Trustee should determine which of the assets buyers have showed the greatest interest in. Of these, he should select the ones that are non-core (not crucial to any prospect of continued operation) and have clean title, and propose to the Creditors' Assembly the most competitive selling technique. Following this pattern, the Trustee might categorize assets in different groups and propose for each group the most appropriate method of sale depending on the level of interest and market factors. If possible it would be good that any such proposal be supported by a cost-benefit analysis. Finally, though, it is the Assembly of Creditors or Creditors' Committee that will decide finally on the terms and the method of sale, which the Trustee is obligated to abide by (Art. 101.2).

H BANKRUPTCY REORGANIZATION MODEL SOLUTIONS

H.1 Who has the right to file a proposed plan of reorganization?

Issue: The creditors and the Debtor might have the same (to save the business and jobs for workers) or quite opposite interests in the bankruptcy (creditors want to recover their money quickly, however this goal is to be achieved, through reorganization or liquidation; while the debtor wishes to continue with the operation and save the company by implementing a reorganization plan). Who is allowed to draft and to file the bankruptcy plan – the creditors or the debtor or some third party?

Description: The creditor had tried to negotiate a schedule of debt repayment with the debtor but all negotiations failed because the debtor could not meet even the newly restructured payment deadlines. Still, the creditor has been working with the debtor for a dozen years and has established very close relations because the debtor has well-experienced workers, good quality products, and used to satisfy all the customers' demands in the past. The market situation has changed owing to strong competition from abroad and the debtor lost a significant share of the market. Sales decreased, collection of accounts receivables slowed, payroll included more workers than needed for current level of operations, *etc.* All these changes jeopardized the debtor's business and affected its ability to pay its debt on a regular basis. Despite continual delay in paying its debts to this particular creditor, and despite all previous failed attempts to restructure and extend the repayment schedule, the creditor is still willing to offer the company a new chance to save the business by implementing a reorganization plan through the bankruptcy proceeding. This will result in mutual benefit: the creditor will collect part of its money and will continue cooperation with the debtor, while any unpaid amounts would be discharged. Can this friendly creditor file the plan of reorganization?

Solution: According to the Bankruptcy Law, only a debtor may file a reorganization plan with a petition to open a bankruptcy proceeding (Article 143). So, in these circumstances, it would not be permissible for a creditor to submit a plan. In addition, after the opening of the bankruptcy proceeding, there are only two parties that are authorized by law to file a reorganization plan -- the Trustee and the debtor.

H.2 Deadlines and their extension in filing the plan of reorganization

Issue: When is too late for a debtor or Trustee to file the reorganization plan and under what circumstances could the deadline for filing the plan be extended?

Description: Management was aware of all the financial difficulties in the company, but for their own reasons did not want to file the petition to open a bankruptcy proceeding. At the same time, the workers were not familiar with the possibility of filing a reorganization plan reflecting their own plan for how the company could be saved, together with the petition to open a bankruptcy proceeding, but they missed their chance because they are not major creditors in the company. In the meantime, another creditor filed the petition and the proceeding has just been opened. Is it too late for the debtor itself to file a reorganization plan now?

Solution: No, the debtor still has an opportunity to file a plan. According to Article 143, both the debtor and the Trustee could submit a plan after the opening of the bankruptcy proceeding, but the timing is relevant in this case because a reorganization plan filed with the Court after the final hearing cannot be considered. It is also necessary to mention that creditors could instruct the Trustee to prepare a reorganization plan within 30 days of the assembly of creditors. Because of the fact that this is a complex task and a demanding activity, as well as requiring many assumptions that should be verified first, the deadline for filing the plan may be extended by the Court for an additional 30 days. It is recommended to all relevant parties in the bankruptcy proceeding (debtor's management, workers, and other creditors) to assist the Trustee to create the most realistic plan that will satisfy the creditor's interests and provide an efficient and transparent mechanism for revitalizing the business and increasing the assets.

H.3 Consent to drafting the plan

Issue: May a plan be drafted without consent of the Bankruptcy Judge or some other party?

Description: One creditor filed the petition and the bankruptcy proceeding was opened because the debtor had met all the criteria for opening a bankruptcy proceeding. After the opening of the bankruptcy proceeding, the debtor began to prepare a reorganization plan that would be filed with the Court before the Investigation and Reporting Hearings, which were scheduled to be held on the same day. The debtor does not wish to miss its chance to save the business because a serious investor from abroad has expressed and confirmed its interest in financing the business. The first effort to privatize the debtor's business through the regular privatization process failed several years ago because the buyer was not interested in a company burdened with debts. There is consent of the workers who are major creditors, as well as consent of the debtor's management team, the investor, and the company's consultant to the preparation and filing of such a plan before these two hearings and to a discussion of its contents with the other creditors on the same day. This will significantly shorten the procedure. Does the debtor need the Court's consent to draft the plan?

Solution: The debtor does not need the Court's approval to draft the proposed plan, but the debtor must take care that the Judge not refuse to confirm the reorganization plan because the terms of the proposed plan place certain creditors in a more favorable position than they would otherwise find themselves in, violating express provisions of the Law (see Article 175). The timing is crucial, however, because the hearing on consideration and voting on the bankruptcy plan may not be held before the examination hearing. Therefore, in this situation, it is possible to have all three hearings on the same day (Investigation, Reporting, and Plan Hearing). The question remains whether the debtor could file the plan on time because of the provision in the Bankruptcy Law requiring that the day of the hearing to consider and vote on the plan must be noticed and that the proposed plan and the responses received must be available for inspection by all parties in the administrative office of the Court. If the reorganization plan has not been rejected, the Court must also grant the parties to the bankruptcy 30 days to respond to the proposed plan (see Article 157). Article 160 provides that the 30 days runs from the day of the decision setting the hearing until it is actually held. Theoretically, it would be possible to hold a hearing to consider the plan before the examination hearing (when debtor files the petition together with the plan), but when merged with the examination hearing, it is not realistic to prepare for the examination hearing before 30 days from the announcement in the Official Gazette because creditors have 30 days to submit their claims to the Court. The conclusion, then, is that only the Trustee requires the consent of the creditor's assembly and is not allowed to draft the plan without specific instruction from the creditors' assembly (Article 143).

H.4 Classifying the creditors

Issue: How is it possible that two creditors (both secured) have different treatment in classification of creditors in the bankruptcy plan?

Description: In this particular reorganization plan developed by the Trustee there are five classes of creditors. They are classified in separate classes: I (Bank A, Bank B); II (Supplier A); III (Employees of the general payment rank); IV (Other suppliers) and V (Employees and Funds of the higher payment rank). Banks A and B, as well as Supplier A, are secured creditors. Each bank will be fully repaid within two years after this plan comes into force and each bank is waiving regular and late interest on their principal. Supplier A, in turn, is classified separately from other suppliers and has agreed to convert its claims into shares in the new company (together with employees for their claims of the general payment priority rank). Is this classification legally correct and which criteria were used for classification of creditors in this particular bankruptcy plan?

Solution: Yes, despite the fact that there are three secured creditors, it is possible to classify them in two separate classes because of their different legal status, as well as because of the similarity of their economic interests (see Article 147). In the description above, the banks were in the same class due to the fact that both were secured creditors and based on the fact that their debts would be fully repaid within a certain period and forgiveness of all late and regular interest. Despite there being three secured creditors, the Trustee had to classify Supplier A into a separate class because it was the only supplier willing to convert its claim into shares in the new company. Other suppliers constitute Class IV because these are creditors from the general payment priority rank with no security for their claims. All creditors of this priority rank will be provided with the same rights (payment of a certain percentage of their claims over an agreed period of time).

H.5 Treating similarly situated creditors the same

Issue: What could happen in practice if similarly situated creditors were not treated the same?

Description: Banks A and B are not secured creditors. In the proposed bankruptcy plan, the Trustee offers to repay Bank A (the major creditor) 80% over five years and to repay Bank B only 50% within the same period. Bank B objects to such treatment because the Trustee appears to prefer Bank A, although both banks should be classified in the same class for the following reasons: identity of their legal status and the same economic interest. What could Bank B do to protect its rights according to the Bankruptcy Law (see Article 146.2).

Solution: Unfortunately, Bank B is not a secured creditor and could not take the decision to collect its claims through an enforcement proceeding (outside the bankruptcy proceeding). Moreover, if Bank B receives more money in the reorganization than in a straightforward liquidation of the bankruptcy debtor, in that case the voting class is deemed to have accepted the bankruptcy plan if the creditors in the same class are in no worse a position than without the plan. This conclusion refers also to the Prohibition of Obstruction (Article 170). Even if Bank B rejects the plan, the bank will be bound by its terms if the Plan gives the bank at least as much as it would receive in a liquidation (*i.e.*, in five years Bank B will collect more on its claim than through a present liquidation). The principle of equal treatment of all participants assumes that any different treatment of participants that constitute one class requires the consent of all interested participants and in such event declarations of consent of all participants for this different treatment must be attached to the reorganization plan (see Article 151).

H.6 Solutions provided by the plan

Issue: Lack of knowledge among bankruptcy practitioners about potential solutions provided by a bankruptcy reorganization plan.

Description: Although the bankruptcy law imposes few limitations on the contents of a plan of reorganization, Trustees, Judges, employees, managers, and other bankruptcy practitioners do not take advantage of the new Chapter Five of the bankruptcy law. Reorganization through bankruptcy is a novel institution in BiH, and allows the proponent of a plan to be creative in approaching the task of rehabilitating the debtor, specifically tailoring the solutions to the problems.

Solution: More education of all relevant parties in the bankruptcy will hopefully result in more confidence in the bankruptcy law. A bankruptcy reorganization can include such measures as the creation of new, independent legal entities for discrete components of the business or for the business in its entirety; down-sizing the debtor by liquidating or closing unprofitable aspects of

the business; issuing new stock to raise capital; collecting debts; incurring additional secured or unsecured debt; pledging unencumbered property as collateral, including accounts receivable; modifying the rights of secured creditors; satisfying creditors through the surrender or sale of property; converting debt to equity; paying creditors' claims over time; and any other structural or financial measures not prohibited by law (see Article 142). At the conclusion of the reorganization, the company will emerge with manageable debts, improved financial and operational management, and perhaps fresh investment.

H.7 Cram-down

Issue: The majority of creditors in the same class do not accept the proposed bankruptcy plan.

Description: It might happen that the necessary majority in a class has not been achieved during the voting, and therefore according to Article 167 the reorganization plan shall be deemed accepted only if in each class of the creditors the majority creditors and the sum of their claims is greater than the sum of the claims of the creditors that voted against the plan. Very often there are situations when creditors from the same class would object to the proposed reorganization plan either because of the amount that would be repaid, the dynamic of the repayment schedule, or because of some other reasons. This is a question concerning the prohibition against obstruction of a plan.

Solution: Fortunately, the Bankruptcy Law has foreseen the possibility of such a situation when the majority in a class would not be achieved and, nevertheless, provides for confirmation despite a dissenting class under certain conditions (Article 170). The prerequisites for cramming down a dissenting class are: 1) the creditors from the same class would not be in a worse position than without the plan; 2) the majority of voting classes has voted for the plan; 3) none of the other creditors will receive a benefit or other accommodation that exceeds the full amount of their claims; 4) no benefit is received by a creditor that would, if there were no plan, be of lower priority that the creditors in this class; 5) none of the creditors that would have the same priority, if there were no plan, is placed in a better position than the creditors in this class. Based on this provision in the new bankruptcy law in BiH there are more realistic prospects for bankruptcy debtors in BiH than for the debtors from neighboring countries (*e.g.*, Croatia) where it could happen that only one dissenting creditor bank could obstruct the confirmation of a plan. At bottom, this cram-down provision of the Bankruptcy Law recognizes that if a class of creditors is clearly better off as treated by the plan than this class would be if the debtor were liquidated and if no other class that is not higher in priority is treated more favorably, then it is irrational for this class to reject the plan.

H.8 Voting on the plan

Issue: When does a secured creditor have the right to vote and what are the basic rules related to voting on a bankruptcy plan?

Description: See description of the reorganization plan on page 42 (Paragraph 4: Classifying the creditors). Do these secured banks have voting rights and if not, how do they acquire the right to vote?

Solution: The Bankruptcy Law imposes the same voting rules for creditors who are supposed to vote for a plan, as for bankruptcy creditors who are supposed to vote at other stages of the bankruptcy proceeding. In this event, banks typically do not have voting rights because they are secured creditors, unless they abandon their collateral or their claims are not fully satisfied from

the property securing their claim (see Article 163). As secured creditors, they may vote only if their legal status as secured creditors is affected by the reorganization plan; otherwise at the hearing their votes will not be considered. Creditors whose claims and legal status are not affected by the bankruptcy plan have no right to vote since they are unimpaired. The creditors may also vote in written form once a separate hearing to vote on the plan is set. In such case, only the votes that the Court has received at least three days before the hearing on the vote takes place shall be counted (Article 167). Finally, the reorganization plan shall be deemed accepted if a majority of eligible creditors by class and if the sum of the claims of the creditors who voted for the plan exceeds the sum of claims of creditors who voted against. (Article 169).

H.9 Amending the plan

Issue: What is the deadline for exercising the right to amend the content of particular provisions in the plan and who can take advantage of this right?

Description: A proposed bankruptcy plan with all the relevant attachments and responses received must be available for inspection by all parties in the administrative office of the Court and the responses must be received within 30 days. Moreover, the Court may invite management bodies responsible for the activities of the debtor (such as relevant Ministries) and the Chamber of Commerce to respond to the proposed plan. To whom and when would all these responses be submitted and when would the plan be amended accordingly?

Solution: The day of the hearing to consider and to vote on the plan must be noticed and this hearing may not be held before the examination hearing, though the two hearings may be combined. On the basis of the deliberations at the hearing, the Bankruptcy Judge shall compile a list of creditors and indicate their voting rights. According to Article 165, the same hearing may include voting on an amended plan because the same party that filed the plan has the right to amend the plan to take into account the deliberations at the hearing. There is also, however, the possibility of holding a separate hearing for voting, but in that event the Bankruptcy Law does not allow more than 30 days time between the hearing to consider the plan and the hearing for voting. The answer is therefore that all responses must be filed in the administrative office of the Court for inspection by the parties and after the confirmation hearing the plan should be amended and re-submitted for voting within 30 days. The party that has filed the plan should amend it accordingly.

H.10 Supervising the implementation of the plan

Issue: Who will be responsible for the results of the implementation of the plan and for how long should such supervision remain in place?

Description: Lack of previous experience with this monitoring measure provided by the Bankruptcy Law raises a lot of questions for Trustees, the debtor, creditors, and Judges. Some time will be needed to identify all the issues that might arise in practice, but for the time being all the key bankruptcy practitioners should carefully follow the plain language of the provisions in the law related to the effect of the confirmed plan and supervision of the implementation of the plan.

Solution: The Court announces the two decisions together: the closing of the bankruptcy proceeding and the supervision of the implementation of the plan (see Article 192). According to Article 185, supervision over the implementation of the reorganization plan is usually provided after the closing of the bankruptcy proceeding. In that case the bankruptcy debtor would be

supervised because of the extended satisfaction of the debtor's liabilities according to the plan and its relations with new creditors who have claims against the legal entity created after the opening of the bankruptcy proceeding. Supervision is exercised by the Trustee and Creditors' Committee. At least once a year the Trustee is obliged to submit a report on the implementation of the plan to the Court and to the Creditors' Committee. If the Trustee finds that some claims have not been paid or cannot be paid, he or she is required to inform the foregoing parties immediately. In addition, it is possible to restrict the debtor's freedom in taking certain legally binding actions without the Trustee's prior authorization. All expenses related to the supervision of the implementation of the plan are assumed by the successor of the debtor's business activity and the Court must render a decision to terminate supervision only when all claims are fully paid or appropriately guaranteed; or three years have elapsed after the closing of the bankruptcy proceeding and there has not been a petition to open a new bankruptcy proceeding (see Article 193.)

H.11 Debt – Equity Swap

Issue: converting creditor debt into equity during reorganization of the bankruptcy debtor

Description: Bankruptcy debtors and trustees often propose debt for equity swaps in their reorganization plans. The bankruptcy law allows for debt-equity swaps, but does not provide guidance on how to effectuate such swaps. Consequently, some reorganization plans that utilize debt-equity swaps do not comply with existing law.

Solution: Since the bankruptcy law does not provide guidance on how to effectuate debt-equity swaps, other law must be applied. The Law on Companies regulates the actions required to become a shareholder of a company. Accordingly, any reorganization plan proposing a debt-equity swap should comply with the Law on Companies.

H.12 Representation of Bankruptcy Debtor in Reorganization

Issue: Representation of the bankruptcy debtor during reorganization

Description: Several provisions of the bankruptcy law provide the debtor with the right to object to or comment on the reorganization plan. This raises the question of who represents the debtor in bankruptcy reorganization - its shareholders or the pre-bankruptcy director (whose name was registered in the Register of Companies).

Solution: Someone must be empowered to exercise the rights afforded to the bankruptcy debtor under the law's reorganization provisions. Since the bankruptcy law does not specify the person (or persons) designated to act on behalf of the debtor company in such circumstance, other substantive law must be applied. The Law on Companies and Law on Registration of Companies, as general acts, provide that the company is represented by the director or such other representative as may be registered in the Register of Companies. The bankruptcy law does not require the pre-bankruptcy representative to be deleted from the register, but severely limits the representative's powers (see Article 51). Given the law's acknowledgement of the representative's role and powers, even though limited in scope, one can conclude that the pre-bankruptcy representative registered in Register of Companies is the appropriate person to exercise the debtor's rights in reorganization. Consequently, the debtor's shareholders have no direct right to represent the debtor's interests.

H.13 Foundation act of the new company established by the plan of reorganization

Issue: What is foundation act of the new company established by the plan of reorganization

Description: In some of the first confirmed plans of reorganization in BiH, creditors chose a debt-equity swap as the preferred reorganization option. In this method, the entire property of the bankruptcy debtor is conveyed to a newly established company, in which the former creditors are the new shareholders and which then becomes responsible for the liabilities established by the plan itself (clean balance sheet). When such plans have been implemented, the registry court has required all shareholders (former creditors in the bankruptcy case) to establish the new company in accordance with the general law on registration of companies. That Law requires all shareholders (a) to enter into a new contract as a foundation act of the new company, and (b) to adopt the new company bylaws. However, some of the new shareholders have refused to comply with these requirements, thereby blocking implementation of the confirmed plan of reorganization.

In this situation, the implementation of the plan of reorganization is frustrated. Without the consent of all shareholders, there will not be any founding contract for the new company. Without the new company, it is not possible to start operating the business. Without the new business operation, the obligations established by the plan will not be paid. In such situations, under pressure of the possibility that the whole transaction would fail, some of the shareholders have blackmailed the rest, although all of them voted for the plan of reorganization.

Solution: In order to avoid such a development, some courts have treated the confirmed plan of reorganization alone as a sufficient foundation act of the new company. However, despite persuasive arguments supporting this practice, other courts have not accepted it. The Law needs to be amended to give the court clear authority to enter an order to this effect.

I CONCLUSION OF BANKRUPTCY MODEL SOLUTIONS

Solution Models listed on these pages present only a sampling of various issues that could appear while implementing the Bankruptcy Law. We have tried to collect findings on different roadblocks identified at different stages of the bankruptcy proceeding, to describe each particular situation, and to offer solutions provided by the law or recommendations that will assist bankruptcy practitioners to build a functional modern bankruptcy system, which is a precondition to establish financial rationality in the BiH economic culture. For this reason we have grouped all issues together, despite their diversity, and presented them according to the sequence of bankruptcy proceedings:

- issues related to Judges' implementation of the Bankruptcy Law;
- issues related to Trustees' implementation of the Bankruptcy Law;
- issues related to other laws; standards, and methods relevant to the bankruptcy proceeding;
- issues related to debtor's status over the bankruptcy proceeding; and
- issues related to creditors' status in the bankruptcy proceeding.

Undoubtedly there are additional issues encountered during bankruptcy proceedings and more effective solutions available owing to changes in the bankruptcy and other related laws. We encourage all our local partners to develop their own Solution Models discovered during a particular bankruptcy proceeding and to share their positive and negative experience with their

colleagues.

In addition, it is always important to remember that business is a basic human activity and that outcomes of bankruptcy cases directly affect many individuals and their communities. Although the financial failure of business enterprises causes great disruption for them, the effective use of reorganization can reduce or reverse such disruption, even restore stability and discipline in operations, employment, and the discharge of public responsibilities such as payment of taxes and social welfare benefits. As the public comes to see such results from the successful administration of reorganization cases, it will repose greater trust in the courts as an institution and in bankruptcy as a legal procedure for amelioration of the results of financial failure and the rehabilitation of viable businesses.