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Community Interests: An Insolvency Objective in Transition Economies?

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This paper is an extract out of the author's doctorial thesis to issues on *insolvency law reform in transition economies*. The dissertation entails an analysis of core insolvency standards and related principles, which are highly significant when (re-) designing or reforming the insolvency regime of a country in the transition process.

There, the author intends to examine those issues from a potential legislator's point of view, whereby the benefits and repercussions associated with such standards are analysed in the context of the particular economical, social and political needs of the jurisdictions in question.

The aim of the thesis is to discuss the policy objectives facing a potential legislator in a country seeking to reform its insolvency regime and to offer guidelines that support good practise standards in the countries in question. Furthermore, the paper attempts to articulate a comprehensive statement about the various and competing goals that underlie the insolvency system, particularly in a transition economy.

As a result the paper identifies several key principles that should form the basis of any insolvency regime. Furthermore, the outcome of the research points out, certain issues will be of more importance for transition economies than for developed countries, and vice versa.

Some of the issues, characteristic particularly to transition economies, are attempted to reflect in this paper. What does the term *transition economy* mean in the context of insolvency law? Who has which interests in the outcome of an insolvency scenario? Do general objectives of insolvency regimes differ in transition economies from those in highly developed countries? Are there any objectives to consider other than the pure economical outcome for the concerned creditor? How do *community interests* influence policy decisions regarding the insolvency regime in transition economies?

I. Transition economies

Before examining some characteristic features of the insolvency process in transition economies one has to identify a definition of a transition economy in that context.

1. General

The term *"transition economy"* is frequently used to refer to the countries of Central and Eastern Europe after the fall of the communist or socialist regimes in the end of the 1980's. Thereby, transition means the status of those countries during

the evolution from a command economy to a market-based economy (Lowitzsch/ Pacherowa, 1998: 211). This movement is usually characterised by the changing and creating of institutions, particularly private enterprises; changes in the role of the state, thereby, the creation of fundamentally different governmental institutions; and the promotion of private-owned enterprises, markets and independent financial institutions.

The transformation process in Central and Eastern European countries was and still is a fundamental socio-economical change, mainly based on the creation and promotion of private property rights (Lowitzsch/ Pacherova, 1998: 211; Roggemann, 1997: 189; Will, 1996). Thereby, property rights are the essential and most basic elements of any type of market-based economy and define fundamental terms like interest, money and credit but also value, price, profit and market (Roggemann, 1997: 225).

However, both, the starting point and the current stage of the transition process may vary from country to country. A transition in that sense is not a simple, linear, one-dimensional progression to a “standard” market economy.

Nevertheless, there exist some key features, which are basic and essential for the functioning of a market economy.

As mentioned before, the existence of private property rights may be the most basic element of a market economy (Lowitzsch/ Pacherova, 1998: 211). A market economy is driven by the profit seeking of the owners of privately owned enterprises.

Therefore, the privatisation of state-owned enterprises (SOE’s) became a central element of the transition process not only in the countries of Central and Eastern Europe.

A further essential component of a market economy is the necessity of markets as the key arena in which enterprises and households interact. Well functioning markets are trading platforms, a source for the exchange of information, and above all, the main creators of competition.

Moreover, financial institutions are central players in a market economy. They are responsible for the allocation of resources over time, for the distribution and assessment of risks, for payment mechanisms, and for the enforcement of financial discipline. They are typically the main capital investors and have therefore a strong influence on the productive enterprise sector. Thereby it is most important, that financial institutions are free from extensive governmental interference in order to make independent investment decisions based on economically sound risk assessments. On the other hand, they are the main capital suppliers; their failure to provide the market with needed capital may affect the macro economic situation of

the whole economy. Banks and other financial institutions in transition economies carry frequently a heavy burden of non-performing loans on their balance sheets. The "cleaning up" of those balance sheets becomes a key task in an early transition stage.

The state in a market economy, on the other hand, is not eliminated but is charged with relatively distinctive tasks as in other economical systems. Instead directing output and resources, as typically in a command economy, the role of the state is to set, supervise and enforce the basic market principles and rules; provide for certain goods, services and facilities; and ensure different rights and guarantees. The degree of governmental involvement in market decisions varies widely among developed market economies and may be more intense in transition economies. Furthermore, the state must resist the temptation and incentives to interfere and protect on behalf of special interests. That may be particularly difficult, since the state under other systems was frequently overloaded with responsibilities and corresponding rights to interfere. Many of those functions and obligations rest in a market economy with independent and self-sustainable or self-regulatory institutions and organisations. The building up of such an institutional infrastructure may take a reasonable period of time and therefore may be a considerable obstacle in the transition period.

The task of redefining and creating a strong but limited state is fundamental to the transition process (Stern, 1997: 20).

2. The scope of "transition economies"

According to these observations it might be possible to use the term "transition economy" also in a wider context, covering a wider range of countries than merely the jurisdictions in Central and Eastern Europe.

Firstly, there are countries outside of Central and Eastern Europe, emerging from a socialist-type command economy towards a market-based economy.[1]

Moreover, it might be justifiable to categorise several other types of economies as in transition as well (Lowitzsch/ Pacherova, 1998: 211). One has only to remember the key elements of a market economy and the typical facets of the economical, social and political transition process.

Economies, which attempt to change their basic constitutional elements towards market-style fundamentals, undertake a transition in a wider sense. Their origin could be also in a post-colonial situation, in a heavily regulated Asian-style

[1] The most important example therefore provide surely the reform efforts of the Peoples Republic of China, see generally Hamer, (1996); Lam/ Kan, (1999: 351).

economy, in a Latin American post-dictatorship or even in a somehow economically underdeveloped country in Africa.

Another more historical example, which provides for the contrary transition, is the economical and political process followed the Bolshevik revolution in 1917 in Russia. The new rulers initiated a transformation from a market-based to a command economy, including a change from private ownership to public or collective ownership rights (nationalisation). Similar developments took place in other socialist or communist countries (Stern, 1997: 3).

3. Key features of transition economies

However, transition economies are usually characterised by one or more of the following features.

In transition economies prevails commonly a strong governmental interference in markets and related activities of participants.

They have frequently developed a system of weak private-ownership rights, which is complemented by some form of extensive public or state ownership rights.

Additionally, domestic markets are regularly shielded from international competition combined with a low level of competition among national participants.

Finally, they lack habitually the institutional infrastructure, essential to support a market economy.

Consequently, the mere economical development does not provide a valid criterion to identify a transition economy. According to the above-mentioned criteria, a country may be highly developed but in a phase of a transition in order to apply more market-based structures and principles.

A good example therefore provides South Korea. Before the Asian crisis, South Korea was the eleventh largest economy in the world, the world's third largest automobile exporter and one of the largest steel producers and shipbuilders (Ehrlich, 1998: 9).

Nevertheless, the Korean economy was heavily affected by structures and elements incompatible with principles of a well-functioning market economy.[2] After a serious decline of economical development in the Asian crisis the Korean

[2] See Ehrlich (1998: 9): E.g. extensive cross-guaranteeing among members of Chaebols, government-directed lending, close ties among government, banks and the Chaebols, weak corporate governance structures, insufficient debt-equity ratios, extensive short-term borrowing for long-term investments

government realised and recognised the shortcomings and failures and proposed extensive changes in their economical and institutional environment. Currently, South Korea is in a transition process to more market-based principles and structures and thus became temporarily a transition economy.

4. Types of transition economies

Post-socialist transition economy

The thesis mainly focuses on jurisdictions from Central and Eastern Europe. These jurisdictions have in common that they emerged from a communist or socialist regime mainly dominated by the former Union of Soviet Socialist Republics (USSR). However, even with this common background are they quite different and might be therefore divided broadly into 4 groups.

The first group[3] consists of countries west of the former USSR, which were never formally part of the USSR but came under Russian domination after the 2nd World War. In all of those countries the socialist government were abolished in 1989.

A second group[4] consists of countries that were part of the USSR since its foundation in 1922, and which gained their independence in 1991, shortly after the aborted military coup in Moscow.

The third group[5] are countries that were formally part of the USSR after its occupation in 2nd WW. These countries gained their independence in 1989[6] or after the military coup in 1991.[7]

To the last group belong the countries of the Balkan region, which are Albania and the successor states of former Yugoslavia.[8] Generally, these countries have a quite different and unique historical development in comparison to the countries of group 1-3. Yugoslavia, for example, was under a socialist or communist government but not dominated by the USSR. Albania, on the other hand, closed itself to the East as well as to the West for decades and is currently centuries behind in development. After the changes in whole Europe, Yugoslavia fell into an ethnic war from which it is still suffering (Bufford, 1996: 459, 461). Because of the unique situation in the Balkan region, it will be only a secondary focus of this paper.

It might be even possible and appropriate to further distinguish among the different

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[3] Poland, Czech Republic, Slovakia, Hungary, Romania, Bulgaria
[4] Ukraine, Belarus, Russia
[5] Baltic Republics: Latvia, Lithuania, Estonia; Moldova
[6] Baltic Republics
[7] Moldova
[8] Slovenia, Croatia, Serbia, Macedonia and Bosnia-Herzegovina

jurisdictions emerging from a socio-economic collectivism. Some countries[9] in Central and Eastern Europe for example, controlled the quantity of production with fixed prices and markets, evincing little regard for reforms to increase overall productive efficiency. Other socialist countries[10] made some attempts to allow a few market-economy concepts to guide economic decisions.

Additionally, we may differentiate between economies that had already some experiences with a market-style economy prior to the 2nd WW and on the contrary, transition economies, which did not have such experiences.

In several Central European Countries[11] western-style legal system and market economies existed already prior to World War II. In most of those countries remained substantial parts of the legal system intact but were simply not used during the communist era. For our purposes, a great advantage was that insolvency and other commercial laws have existed already and did not need to be drafted newly. However, those pre-war laws were not used and amended for almost half a century and thus were in urgent need of substantial changes and amendments in order to cope with the challenges of the modern commercial and business reality.

Poland, for example, is still using its Bankruptcy Law, which was promulgated as presidential order in 1934 but was recently amended many times (Bickford/ Schiffman, 1994: 927, 928).

Other countries, mainly states of the former USSR, did not have that tradition and consequently, commercial, especially insolvency laws had to be newly drafted and enacted (Bufford, 1996: 477).

For our purposes the common features of those countries are from more importance. All of them were economically ruled by a type of planned economy. Characteristic measures of a planned economy are that production requirements were determined annually by the government; that costs and revenues were determined pursuant to a central plan; that production assets are owned by state or government as “public property”; that no competition among enterprises was existing and market-shares were determined by plan; that those economies had only limited access to “world markets” due to the lack of freely convertible currency; that enterprises were generally agents of the governments without independence and their own decision making competence; that in order to avoid unemployment, the workforce was kept too high without consideration for efficiency; and finally, enterprises were usually charged with a variety of social functions.

However, the two characteristics prevalent in those economies most important for

[9] E.g. Romania, Bulgaria
[10] E.g. Hungary, former Yugoslavia
[11] E.g. Poland, Hungary, Romania

the purpose of this paper are the absence of insolvencies and full employment.

Post-colonial transition economy

Another type of a transition economy is formed by countries, formerly dominated and governed by colonial powers. These countries[12] have usually a number of features in common and may be therefore grouped under one heading.

Usually, the colonial powers have imposed their administrative and legal system on their colonies without adjusting the structures to the cultural, traditional, economical or social needs and realities existing in these countries. Frequently, they exported even their commercial laws including insolvency and company legislation. Experiences with those imported insolvency laws have been quite different, but they were generally not often used by local businesses. Consequently, the colonial powers and the successor governments of the independent colonies have been paying little attention to the development and adjustment of those laws. After independence from its colonial powers, many of those former colonies have turned or turning towards the development of market-based economies.

Generally, basic legal structures did exist but were outdated and therefore insufficient to cope with the challenges of a modern market economy. The reform of basic commercial laws became an important issue on those government's agenda.

Other types of transition economies

As mentioned above, one may think on several other situations, where an economy tends to open itself to market-based principles.

Conceivable, could be, for example, a heavily regulated Asian-style economy, which may reform the economy in general and the insolvency law regime in particular.

Furthermore, some economically less-developed economies may still function without workable insolvency law – as soon as their development reach a certain level they may need to adjust it or in other cases enact one at all.

Nevertheless, the discussed different types of economies in transition are not necessarily separately assigned to particularly one jurisdiction. Several types may somehow apply to one economy and may therefore overlap respectively.

[12] Typical former colonies in that sense are mainly found in Asia, Latin America and Africa

5. Differing stages of economic development and their practical implications

As a matter of fact, there exist a varying degree of economical development among emerging or transition economies. Some of them belong economically to the highest developed countries in the world[13]; others have advanced their economy successfully in the last few years and are almost on the way to a developed country[14] whilst other nations are still struggling with the establishment of basic market concepts.

However, the stage of economic development is in direct relation to the demands on the prevailing insolvency regime. Especially the different phases of the transition process may require respective response from the insolvency law.

Right at the beginning of the transition course, for example, it might be necessary to protect failing SOE's from liquidation and associated plant closures. It might be a central policy to prevent mass unemployment, along going mass poverty or even social unrest. Under this aspect, the insolvency law may be a mechanism for social stability.

Additionally in this early transition stage, the insolvency regime might become an important tool to reorganise the state-owned sector and thereby adjust the structure of the economy to market principles.

On the other hand, a country's insolvency system should be viewed as part of its law and policy of economic development, but it does not necessarily mean that a country's stage of economical development is or should be the only or predominant concern when designing the corporate insolvency system (Braucher, 1997: 473).

Policy decisions regarding the insolvency law should be made in harmony with the prevailing political, social, historical, cultural and economical realities in that society (Braucher, 1997: 475).

II. Interest groups in insolvency

Designing and redesigning an insolvency system, in today's complex and rapidly changing commercial environment, is a process of making and balancing difficult policy choices.

As it becomes apparent in the thesis, particularly transition economies may utilize the insolvency system to correct overwhelming social needs of the society (Bufford, 1994: 829, 838; Smid, 2000: 393), a function, which is frequently criticised in modern market economies.[15]

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[13] E.g. South Korea
[14] E.g. the prospective new member countries of the EU
[15] E.g. for the US see: Baird/ Jackson (1984: 97, 102); for Germany see: Balz (1997: 167, 171).

1. Debtor and Creditor views

According to the respective attitude of the law, insolvency laws might be seen from a more debtor or from a more creditor perspective. Legislators are charged with balancing the different interests of debtors and creditors.

Oversimplified, a debtor may wish to overcome the burden insolvency measures are able to impose. In economic terms, a debtor may mainly wish to protect its assets from the action of creditors, may wish to remain existing management and control over its activities, or may wish to continue the business without further creditor interference.

A creditor, on the other hand, may wish to recover outstanding debts as soon as possible.

However, reality is more complex and interests of debtors and creditors are regularly more diverse.[16]

On the debtor side, there might be different interests between management and shareholders.

On the creditors side, interests may be even more diverse. Secured creditors, for example, are frequently interested in the quick realisation of their collateral, unsecured finance creditors may be interested in the liquidation or realisation of the going concern value of the debtor and trade creditors may be more in favour of a continuing business relationship with the debtor (Baird/ Jackson, 1984: 106). Similar views might have the employees since the debtor may be the (only) source for their future income.

Therefore, interests of those creditors could be much closer to some debtor interests than to the concern of some other classes of creditors.

2. Adding interests of community

But insolvency affects not only debtor and creditors– a two dimensional approach to the problem is insufficient (Frost, 1995: 75, 78). There is yet another perspective to consider: the interests of community[17]. Community is not a self-defining term and therefore needs some elaboration. Although in some respects it may overlap with the interests of either debtors or creditors or both, it brings a markedly different perspective in the insolvency discussion.

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[16] See for the discussion on the different interests among participants in insolvency also: Flessner (1982: 195)

[17] See Gross (1997) with instructive examples; Flessner (1982: 194).

Community interest

Community interests have generally in common, that they represent a non-legal but societal accepted interest of a certain community surrounding the debtor. Insolvency may touch on many communities, which simultaneously co-exist, much like co-centric and interlocking circles. By way of example, one imagines a situation where the main employer of a town or region gets into financial difficulties. Firstly, there are several types of creditors, which are usually recognised by the insolvency law in a prescribed manner. They might be employees, suppliers, lenders, or the fisc with valid legal claims.

But there are, on the other hand, other parties with a valid "moral/ societal claim" on the debtor.[18] People depending on the performance or future existence of the debtor may be the family of creditors, the whole community of that town or region since the insolvency of the debtor may diminish the tax base, in the case of knock-on insolvencies the creditors of the creditors of the debtor, customers which may depend on the supply of the products of the debtor or any other affected communities (Gross, 1997: 20).

Others (Flessner, 1982: 196) suggest, that particularly big businesses have developed to social and political centres, not only functioning as mere employer but also as "public institutions" within the society. The value they represent for the society cannot only be measured in economic terms. Stating only a few examples: they may provide a platform for communication and interconnection among people; may financially support varying cultural activities through sponsoring and other means; or may be accountable for education, training or elderly care of people.

Those aspects have to be considered when shaping the insolvency regime and thus deciding about the treatment of these enterprises under financial distress.

One could possibly argue, that such non-legal claims do not matter in insolvency proceedings since the debtor would generally also have the right to close or relocate its business when he would have been solvent – without granting anybody a valid right in the future existence of the debtor. That might be correct under a pure legal perspective – but definitely comes too short in a wider context. Bringing a humanistic element in the discussion of insolvency may provide a means to consider and balance broader society goals.

As we will see in the forthcoming discussion that applies particularly to transition economies, where societies traditionally depend and rely more intensively on social interrelations among participants rather than on legal claims.

Recognising interests of the community in transition economies

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[18] See Frost (1995: 79): Frost distinguishes between investors and non-investors

As mentioned before and discussed in more detail later, many western scholars[19] criticise the employment of the insolvency law to promote social stability and other "non-insolvency policy goals", which are here summarised as interests of community. However, even though those critics may be valuable and in their result acceptable for the situation of modern and developed market economies (see Frost, 1995) they might be not correct for many transition economies.

Contrary to many Western economies, where individualism dominates societal relations, the concept of and the philosophical orientation towards community is society rooted and well accepted in many transition economies.

In the former communist states of Central and Eastern Europe for example, has developed a strong belief in communities, deriving from the communist ideology but also from legal institutions, as for example the dominating public ownership rights.

Other transition economies in Asia or Latin America may be more relying on family and similar community values.

The most significant difference to Western societies is that transition societies function to a considerable degree on a non-legal interdependence among its inhabitants. Western societies, on the contrary, are broadly based on the rule of law and thereby function mainly through the reliance on legal entitlements.

In Western cultures predominates the conception of individualism, which provides the individual with relative freedom supported by a great variety of legally enforceable rights. In that way, the legal entitlement has replaced moral and societal obligations.

But even in Western societies are community interests currently integrated in the legal discussion (Taibi, 1994: 1463; Eckstein, 1991: 843) in general and the insolvency debate (Gross, 1997: 193-235; Frost, 1995: 81-91; Warren, 1993: 336, 354-361; Carlson, 1992: 453, 475-478; Flessner, 1982: 185-196) in particular.

Consequently, one should attempt to view insolvency issues in a three dimensional way from a debtor, the creditors and a respective community perspective (Gross, 1997: 19). In doing so, one should consider the existing interrelations between the three angles. What is good for debtors might be negative for some creditors, what is favourable to creditors might be the contrary to a community. A legislator has to analyse the different perspectives and interests and accordingly balance them in the final policy decision.

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[19] Baird (1986: 127, 134); Baird/ Jackson (1984: 102); Bebchuk (1988: 775, 776); Schermer, (1994: 1049, 1052); generally for the discussion under the US-Bankruptcy Code: Frost (1995: 81-91).

III. Protection of community interests as objective of insolvency proceedings in transition economies

A in the ongoing discussion[20] frequently ignored or underestimated objective of insolvency is concerned with the impact of insolvency laws on communities, which are not directly legally connected with the struggling debtor. Since those issues seem to be of significant relevance to the here examined transition economies, the thesis intends to look at the related questions in more depth.

As pointed out before, the insolvency regime is concerned with parties with formal legal rights. It organises and structures the conflict between the debtor and several types of creditors. As described by the well-accepted creditors bargaining model[21], insolvency law is mainly concerned with the debt collection process under the common pool situation.

However, the business failure of a debtor may also impact on parties who are not creditors and who have no formal legal rights to the assets of the business.

This impact might be from particular weight in transition economies, since there enterprises are often accountable for a varying degree of social functions.

Therefore, the final economical outcome for creditors should be not the only means when considering insolvency precepts and policies. A pure economical analysis focused solely on the debtor/creditor relationship is fraught with problems. Community interests must also be considered and rebalanced in a modern insolvency law (Averch, 2000: 77, 79).

1. Methods to protect community interests

The protection an insolvency regime can provide to parties without formal legal rights is usually derivative in nature and limited in scope. Their interests are commonly only indirectly considered, mainly through provisions that forestall liquidation to permit the business to remain in operation and to reorganise, instead of being shut down by a few anxious creditors (Warren, 1993: 354).

Communities or other affected non-insolvency parties have frequently no substantive rights under the respective insolvency code (Frost, 1995: 101).

Often, the mere existence of reorganisation provisions may have a redistributive effect from creditors to shareholders, managers, employees and other related

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[20] Neither the respective paper of the IMF (International Monetary Fund, 1999) nor the study of the World Bank (World Bank) mentioned the issue expressly.

[21] See generally for the creditors bargaining model: Baird/ Jackson (1984: 100); Jackson (1982: 857).

communities. The delays, along going with the reorganisation process lead frequently to a shift of wealth from creditors to other (non-investor) communities (Frost, 1995: 93).

A similar result may also be reached by provisions, which limit or extend rights and obligations of participants in insolvency when these are contrary or consistent with "public interests or public policy" (Gross, 1997: 219). By way of example, the court may only confirm a reorganisation plan when its outcome is in the interest of the public or with other words in the interest of community.[22] An example therefore provides the Polish Bankruptcy Code[23], where the court may refuse to approve an arrangement, when it conflicts with decency or public order.

Nevertheless, it might be problematic to grant the necessary wide discretions to courts and other participants in order to determine "public policy or order" in a highly sensitive field as insolvency. That is from particular importance in transition economies, where the judiciary and other official participants are commonly un-experienced in insolvency issues and economical-based decision-making.

Another technique to recognise potential community interests would be a general clause, which grants the court wide discretions to consider such interests and to balance them with interests of other participants, namely the debtors and creditors. But similarly as with "public-policy clauses" may such provisions create non-uniformity and unpredictability among participants (Gross, 1997: 227).

Moreover, community interests could be recognised in the plan confirmation process. The law could compel the court to consider and balance not only debtor and creditors interest but also community interests before confirming a proposed reorganisation plan (Gross, 1997: 228). But that again, requires from the involved authority economical-based wide-reaching decision-making.

Another way to consider interests of particular vulnerable claimants directly through the legislative process would be the explicit granting of distributive priorities for such claims. This important issue is discussed in more depth in the dissertation.

Likewise, the insolvency could consider the varying interests in the insolvency process by granting the different interest groups participation rights (Flessner, 1982: 197). Several insolvency laws follow this path when they grant employee representatives[24], representatives of councils or local governments respective participation rights.

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[22] E.g. the railroad reorganisation provisions of Chapter 11 of the US-Bankruptcy Code (US-Bankruptcy Code §§ 1161-74

[23] Polish Bankruptcy Code, Art.191 (3)

[24] The Hungarian Bankruptcy Code, Section 8 (1), for example, grants trade unions and employee councils (employee delegates) a information right prior to the filing of the bankruptcy petition

2. Examples

A practical example for the legislative implementation of community matters offers the Russian Bankruptcy Code (1998) in its Chapter VIII §2, dealing with the insolvency of *town-forming organisations*.

According to these provisions, town-forming organisations are legal entities, which employ half of the population of a region or town or a minimum of 5000 employees.[25] As discussed more profoundly in the thesis, such dominating industries are a common feature of transition economies and one of their major impediments. Those SOE's have usually wide-reaching social responsibilities and functions, with the consequence that their piecemeal liquidation may result in a social downturn combined with the deterioration of the living conditions of the local community. The Russian legislator has responded to this dilemma in its new bankruptcy code and consequently included provisions, which deal explicitly with the situation of those industries.

In the case of the insolvency of a town-forming organisation obtains the affected body of local self-government a formal right to participate in the proceedings.[26] Other authorities, like federal executive bodies or executive bodies of the corresponding constituent region of the Russian Federation may be allowed to participate by the respective Arbitration Court.[27]

On request of one of these authorities or on its own discretion may the court order the institution of external administration even if the creditor committee voted for liquidation of the debtor.[28] To protect the creditor interests in such a case, the respective governmental body has to furnish a guarantee for the obligations of the debtor.[29] Additionally, the body of local self-government may apply for an extension of the external administration.[30] Moreover, the Russian Federation, a constituent region of the Russian Federation, or a municipality, represented by their authorised bodies, have at any time the right to settle with all creditors of the debtor.[31] Is the sale of the enterprise necessary, shall that be done under a competition with the conditions that the enterprise is sold as a single property complex[32] and retains at least 70 percent of the employees working at the enterprise at the time of its sale.[33]

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[25] Russian-Bankruptcy Code (1998), Article 132
[26] Russian-Bankruptcy Code (1998), Article 133 (1)
[27] Russian-Bankruptcy Code (1998), Article 133 (2)
[28] Russian-Bankruptcy Code (1998), Article 134 (1)
[29] Russian-Bankruptcy Code (1998), Article 134 (1)
[30] Russian-Bankruptcy Code (1998), Article 135 (1)
[31] Russian-Bankruptcy Code (1998), Article 136 (1)
[32] Russian-Bankruptcy Code (1998), Article 138 (1)
[33] Russian-Bankruptcy Code (1998), Article 137 (1)

Another example presents the Bulgarian Commercial Code[34], which grants the consideration of the interests of employees explicitly a priority objective in bankruptcy proceedings.

These provisions offer a good example how transition economies may react to their unique problems and thereby are contrary to widespread Western insolvency theories and policies. The decision whether to liquidate or reorganise is determined not only by the expected outcome for creditors but also by the interests of the affected communities. At the same time creditor interests are protected by a mandatory guarantee from part taking governmental bodies. The legislator has attempted to consider affected community interests at one hand and to preserve creditors valid claims on the other hand.

Furthermore, the attempt to protect community interests corresponds with a more profound economic reality: the parties with formal legal rights never internalise the full costs of a business failure. Hence, any measures to avoid rash liquidations helps offset the losses imposed on parties to whom the costs have been externalised as well (Warren, 1993: 356).

Consequently, insolvency laws should endeavour to minimise losses to the general public when a business fails and to force parties dealing with the failing debtor to bear the burden of the failure. The benefits of such a policy are obvious. If creditors have the opportunity to externalise losses significantly, they will be less cautious when making their credit decision or monitoring the debtor to assure repayment. Conversely, if lenders know that they must bear a reasonable bulk of the losses, they are more likely to develop appropriate levels of investigation and monitoring ex ante. In that way, the insolvency law will avoid or reduce moral hazard (Warren, 1993: 361).

3. Considering community interests

That leads consequently to the question, what constitutes a right or interest that is worth being protected or supported in an insolvency scenario and what forms a community in that sense?

Generally, insolvency laws recognise not only contractual rights but also other legal entitlements as tort claims, unjust enrichment or administrative obligations. However, these claims can be normally characterised as legal claims, also recognised and enforceable under the relevant (individual) compulsory execution regime.

Nevertheless, the underlying situation in insolvency and in an individual

[34] Bulgarian Commercial Code, Art.607 (2)

enforcement situation might be quite different. If a creditor tries to enforce a valid claim against a debtor he may or may not succeed with its action with the consequence, that the debtor has to pay or has not to pay. Affected from the outcome of such an individual action are usually only the two parties of the underlying obligation.

As mentioned before, in an insolvency scenario are not only the debtor and all formal creditors involved, but also other parties with a unique interest in the future existence of the debtor.

That in turn raises the question, whether the insolvency law should generally consider similar interests and rights as the individual enforcement system or rather go beyond it? What are the criteria, which determine whether a non-legal interest is worth being considered in insolvency?

Social interrelation among people is not only defined by legal terms but on a variety of levels. Generally, any interconnectedness has value and is worth being protected; even it cannot be measured in economic terms (Gross, 1997: 195). Necessary is a shift away from right-based thinking towards responsibility-based thinking (Gross, 1997: 210).

People are usually interconnected with and integrated in very different communities. There are communities, which are closer, as the family for example; and others, which are further remote, as the inhabitants of a city or a region. The workplace is another frequently close community. For a business, the shareholders form a community as the suppliers and the neighbours in the commercial district or the whole local population do. The amount of communities may be uncountable as the variety of human interaction. Consequently, every insolvency case affects varying communities (Gross, 1997: 197). However, for a workable insolvency system, designed to function in a market economy, not all communities and their respective interests can be considered.

In order to take rights and interests into account, the respective community should have a nexus to the insolvent debtor; should be palpably injured by the insolvency; and the injury should be redressable. Thereby, the community interest in question can take a variety of forms; the injury does not need to be economic but cannot be solely conjectural or hypothetical (Gross, 1997: 212).

As a consequence, insolvency law may protect and support wider community interests. It may protect the economy from mass unemployment, may stabilise social welfare, may protect interests and rights of local creditors (e.g. trade creditors), preserves markets for suppliers, encourages private sector development and gives failing debtors a second chance (Flessner, 1982: 196).

These features may be from significant importance in transition economies

(Bufford, 1994: 838) since other protective devices for these interests (e.g. social safety systems) are often not or only insufficiently available.

However, one should consider, that any unnecessary interference with market rules by instruments of the insolvency law should be avoided. Nevertheless, it might be necessary to support the transition process by such intervention where the appropriate market-conform techniques and institutions have not been established yet. Insolvency laws provide an opportunity to deal with social problems – not in the sense of creating a global long-term solution but in terms of resolving a current crisis immediately (Gross, 1997: 249). This view may make respective policy decisions in transition economies more understandable.

4. Criticism

On the contrary, some commentators[35] believe that the welfare of communities, the continuity of existing businesses, and the preservation of human dignity should not be considered in the insolvency process.

But the inability to measure those impacts in strict and immediate monetary units does not consequently mean that those considerations should be excluded but rather that the prevailing neoclassical economic approach to insolvency is too narrow (Gross, 1994: 1031, 1046; 1997: 88). However, it does not mean that interests of community are necessarily always non-economic nor are they, per se, economically inefficient (Gross, 1994: 1033). Neither are community interests always consistent with the interests of the debtor – recognising and considering community interests indicates only a different approach to the problem and adds another, independent value to the balancing process.[36]

Advocates of the creditor value-maximisation theory[37] argue further, that the inclusion of non-investor or non-insolvency interests in the process may provide incentives that cause over- or under-utilisation of insolvency proceedings. This in turn reduces the economical outcome for creditors and shifts thus the burden unjustifiable to investors (Frost, 1995: 89).

Moreover, critics put forward, that any judicial interference with legal entitlements by non-legal entitlements or moral/ societal obligations may create politicised court decisions and would step on the toes of elected legislators who are usually charged with developing public policy by identifying and responding to the interests of the

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[35] See, e.g., Schermer (1994: 1049); Baird/ Jackson (1984: 102); in its consequences also (but only for the US Bankruptcy System): Frost (1995: 138)

[36] See the discussion on a three dimensional approach to insolvency

[37] World Bank (1999: 2); Baird/ Jackson (1984: 109); Aghion/ Hart/ Moore (1994: 849, 851); Balz (1986: 24); see also the discussion at Flessner (1982: 185), with a critical analyse of the economical foundation of that theory by Buchanan, The Economics of Corporate Enterprise.

public (Schermer, 1994: 1052; Frost, 1995: 123). The judicial process might be the inappropriate means to implement social policy considerations (Frost, 1995: 123).

Furthermore, one should admit that under market conditions some firms will always fail, and postponing the inevitable or keeping marginal firms alive may do more harm than good (White, 1994: 1319, 1339). Keeping a firm in one town from closing, for example, may have the indirect effect of keeping a new one in another town from opening (Baird/ Jackson, 1984: 102).

Additionally, insolvency-related problems as along going unemployment, knock-on insolvencies and other social hardship are not unique insolvency problems. The insolvency law should not be the place to implement a policy that the society is unable to enforce outside insolvency. Social reform should be brought about through broad changes in policy by changing the respective substantive law rather than through ad hoc modifications of rights in insolvency (Baird/ Jackson, 1984: 103).

A redistributive effect and thereby a protection of from insolvency affected communities or other non-investors could be reached through progressive taxation and a respective design of social welfare systems (Frost, 1995: 136).

Moreover appears unclear, who should bear the costs of the redistributive effects, created by a protective insolvency regime. Any redistribution from creditors to communities or non-investors will affect a shift of wealth from creditors to the communities since costs are not externalised (Frost, 1995: 113).

But the capital providers will not finally bear the costs but price the new risk and further distribute it. That in turn will lead to the increase of the costs of capital and may negatively affect macro-economical developments (Frost, 1995: 115).

Competitors of the debtor may be negatively affected when the debtor enterprise is artificially kept in business in order to protect respective employee or community interests. Such debtor enterprises have a comparative advantage to their competitors since their operations are directly or indirectly subsidised and capital providers are forced to extend further credit below market terms (Frost, 1995: 120).

Additionally, one has to admit that the insolvency process may not have the institutional capacity to extensively deal with non-insolvency interests and is generally not designed to achieve redistributive goals (Baird/ Jackson, 1984: 101; Frost, 1995: 91).

5. Effects for transition economies

As we have seen, there exist valuable arguments to generally minimise the impact

of communities as well as convincing policy goals to consider the interests of affected communities in formal insolvency proceedings.

However, we have to acknowledge that the discussion reflected above is mainly lead by scholars from the US[38] and some other highly developed countries. The proponents as well as the critics base their arguments on the legal and social environment of their home jurisdictions.

Since this paper is primarily concerned with the situation in transition economies, it will not enter in a respective discussion focusing on the relevance of the topic for high-developed market economies but rather consider a conclusion for transition economies. In doing so, one should not adequately apply the above-mentioned pros and cons for the transition process. As mentioned before and will in more detail in the thesis, circumstances in transition economies may greatly vary from situations prevalent in highly developed market economies.

Including some measures to protect affected communities may, at least for the transition process, be a legitimate instrument to reach varying social goals in a society.

Considering community interests in insolvency, is historically not unprecedented - insolvency policy was always dominated by economical developments.

In the 1930`s in the US, for example, prevailed a pro-reorganisation approach to insolvency policy towards the prioritisation of enterprise reorganisation out of the fear of mass unemployment and economical downfall. Insolvency policy in general and the relation between liquidation and reorganisation in particular, have been always depending on the economical situation. In times of economical downturns has insolvency policy been concentrated on the promotion of enterprise reorganisation along going with the protection from mass-unemployment and general social disorder, whilst in times of a boom more liquidation-favoured policies prevailed (Flessner, 1982: 192).

Applying a similar measure to contemporary transition economies may justify a more intense recognition of community interests and general social matters in the insolvency regime.

Furthermore, such a result may be the only solution available to deal with varying problems on a short-term basis. As mentioned before, legislative remedies to the underlying social hardship in transition economies are far away or at least insufficient to cope with the dimension of those problems.

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[38] See for example the excellent article by Frost (1995) focused only on the situation under the US-Bankruptcy Code

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