As a result of past low financing costs, over-leveraging of businesses, excessive securitization activity and relaxed lending standards, as well as the current scarcity of new financing, the level of bad debts in Hungary has been growing. These developments have forced the government, lenders and other creditors to address the problem.

From a policy perspective, it is generally accepted that an effective insolvency law and a well-functioning, market-friendly regulatory regime have a major positive impact on the economy, as they are capable of saving companies experiencing temporary financial difficulties, and thereby saving businesses and jobs or – in the worse case – facilitating the quick liquidation of insolvent businesses and reducing the overall level of bad debt.

The three entries in this series will review the basic features of the Hungarian insolvency law, namely bankruptcy and liquidation proceedings, the two insolvency proceedings regulated by Act XLIX of 1991 on Bankruptcy Proceedings and the Liquidation Proceedings (the Hungarian Bankruptcy Code), as well as certain considerations for viable and workable re-organizations and work-outs under the current Hungarian legislation.

As discussed in more detail below, because of certain existing constraints in the Hungarian bankruptcy system, there have been very few cases in which a bankrupt Hungarian debtor successfully reorganized through an in-court bankruptcy proceeding, emerged from bankruptcy, and continued its operations. Nearly all bankruptcies in Hungary end in liquidation. This leaves private, negotiated work-outs of insolvent debtors as the only practical approach available to avoid liquidation in most cases.

The first entry in this series describes reorganization proceedings under Hungarian law.

Hungarian Bankruptcy

What is bankruptcy under the Hungarian Bankruptcy Code?

The Hungarian Bankruptcy Code defines bankruptcy as a proceeding in which a debtor is granted a temporary stay and is allowed to attempt to reach a composition agreement with its creditors in order to preserve or restore the debtor’s solvency. A stay of 90 days is immediately and automatically granted to the debtor upon its application, provided that the application meets the formal requirements prescribed by the law.

Owner’s prior approval

Because one of the requirements for a successful application for a stay is proof that the members’ or shareholders’ meeting of the debtor has approved the initiation of the proceedings, creditors could be
in a position to learn of the intended request for bankruptcy protection and may initiate liquidation proceedings before the prior approval at the members’ or shareholders’ meeting is obtained, thereby frustrating the commencement of bankruptcy proceedings and the granting of the stay. This practical problem can arise, especially in the case of public companies limited by shares, where the invitation to the shareholders’ meeting, together with the agenda (which includes the proposal to approve the initiation of the bankruptcy), must be published prior to the meeting. However, it may also arise in the case of closed companies limited by shares or limited liability companies with several owners because the articles of these companies typically provide for the publication of the invitation and the agenda of the owners’ meeting. Even if the agenda of the meeting is not required to be published, one or more of the owners may initiate liquidation proceedings or disclose the information to a third party who, in turn, may initiate liquidation proceedings before the prior approval at the owners’ meeting is obtained.

A creditor is also entitled to initiate the bankruptcy of a debtor pursuant to the Hungarian Bankruptcy Code. However, because – among other things – the prior approval at the owners’ meeting of the debtor also needs to be submitted together with a creditor’s application, in practice creditors cannot force a debtor into a bankruptcy proceeding against its will and without the cooperation of the owners of the debtor.

Once the stay is granted, the bankruptcy court issues a decision declaring the commencement of bankruptcy proceedings in respect of the debtor, which includes the appointment of the bankruptcy administrator and an invitation to the creditors to register their claims with the administrator within 30 days of the publication of the court’s decision.

**The role of the bankruptcy administrator**

The role of the bankruptcy administrator is to monitor the debtor’s business activities during the stay, with due regard to the creditors’ interests and with the objective of facilitating the conclusion of a composition agreement. The administrator reviews the financial position of the debtor and its books, accounts and assets, assists the debtor in enforcing its claims vis-à-vis third parties, and registers the creditors’ claims. Following the commencement of bankruptcy proceedings, the debtor may not undertake new obligations and make payments unless the administrator has previously approved them. In the absence of such prior approval, the administrator may challenge such undertakings and payments.

During the stay, therefore, the rights and obligations of the debtor’s management are not suspended, but they may only be exercised and performed in cooperation with the bankruptcy administrator.

**The purpose of the stay**

The purpose of the stay is to suspend enforcement proceedings by creditors and preserve the assets of the debtor in bankruptcy until a composition agreement can be reached (or the stay expires). During the stay, the debtor may not perform payment obligations that become due (other than salary-type payments and taxes), and creditors may not enforce their monetary claims and security interests
(other than security deposits) or otherwise initiate or continue enforcement proceedings, and no set-off can be applied (with certain exceptions, including close-out netting).

**Creditors’ meeting**

Within 45 days of the start of the bankruptcy proceedings (i.e., the publication of the court’s decree ordering the commencement of the proceedings), the debtor will call a creditors’ meeting in order to attempt to agree on a composition agreement and/or extend the duration of the stay. The stay may be extended to 180 days from the start of the proceedings by a simple majority of votes of both secured and unsecured creditors, and to 365 days by a two-thirds majority of such votes. As a condition to extend the duration of the stay, the creditors may request that the administrator be granted a joint signatory right on behalf of the debtor, including the joint right of disposal over the bank accounts of the debtor.

In general, each creditor who has duly registered its claim with the administrator (i.e., within 30 days of the publication of the court’s decision declaring the commencement of the bankruptcy proceeding), paid the registration fee, and whose claim is recognized and uncontested will have one vote for each HUF 100,000 (approximately €330 or $430) of the claim at the creditors’ meeting. Claims of controlling shareholders or controlled subsidiaries of the debtor (and certain other claims resulting from a guaranteed assignment by the debtor) have 1/4 of a vote for each HUF 100,000 of the claim.

**Composition agreement**

The composition agreement typically includes a reorganization plan aimed at restoring or preserving the debtor’s solvency, a rescheduling and/or forbearance of debt, as well as a conversion of debt into equity, provision of security by the debtor, and the implementation of the foregoing. The agreement is reached if the simple majority of both secured and unsecured creditors vote for it and if, upon the application of the debtor, the bankruptcy court approves it. The court will approve the composition agreement if it complies with the applicable statutory requirements (including that the composition agreement does not discriminate against non-participating or participating, but non-consenting, creditors), thereby concluding the bankruptcy proceedings. The court-approved composition agreement is also binding on those creditors who did not vote for it (provided that they were properly notified of the bankruptcy proceedings) and also on those creditors whose claims were contested by the debtor.

A recent amendment to the Hungarian Bankruptcy Code appears to have clarified the position of creditors who did not register their claim within the 30-day deadline from the publication of the court’s decision opening the bankruptcy proceedings. According to the new rules, the composition agreement is not binding upon such creditors; however, they cannot enforce their claims against the debtor unless a third party subsequently initiates liquidation proceedings against the debtor and the creditor’s claim is not yet time-barred.

Before this amendment, a composition agreement approved by a majority of creditors and the court did not prevent the non-participating creditors or creditors of contested claims from initiating a
lawsuit subsequent to the composition agreement and claiming the award of the entire claim; such a rule weakened the binding nature of the composition agreement. Obviously, if these creditors could sue after the approved composition agreement is entered into and realize a higher percentage of their claims than creditors of the same class that participated in the composition, then the bankruptcy proceedings and the implementation of the composition agreement could on occasion be successful.

Finally, if no composition agreement is reached with the creditors and approved by the court during the stay, then the court shall *ex officio* declare the debtor insolvent and initiate its liquidation.

*New money problem – no DIP-type financing*

A significant deterrent to successful bankruptcy reorganizations in Hungary is the so-called “new money problem.” Financially troubled companies usually need liquidity. However, the applicable rules in Hungary do not provide for DIP-type (i.e., debtor in possession) financing. Exceptions to the “challengeable transactions” rules, discussed below, are needed to enable the providers of “new money” to benefit from additional, newly created security with “superpriority” in terms of satisfaction, without running the risk that such transactions and security will later be voided or not given the priority that the parties to the composition agreement and the reorganization plan intended.

*Practically no successful bankruptcy reorganizations*

Due to the constraints described above, there have been practically no bankruptcy proceedings in Hungary that did not eventually result in a liquidation.

One recent exception is the case of Vértesi Erőmű Zrt., a major Hungarian power generation company belonging to the group of the Hungarian state-owned electricity works, MVM Zrt. In February of 2011, it managed to agree with its creditors on a reorganization plan in a bankruptcy proceeding. and the bankruptcy court eventually approved the related composition agreement.

This outcome resulted from a unique set of circumstances. All secured creditors of Vértesi approved the composition agreement, as did 90% of unsecured creditors. However, MVM Zrt. was the only secured creditor, and the Hungarian State was also a significant debt holder among the unsecured creditors. Vértesi, which owed a total of HUF 20 billion (approximately €67 million or $87 million) to creditors, agreed to pay 30% of its unsecured debt. Also, as part of the reorganization plan, MVM Zrt. will provide a three-year, HUF 4 billion (approximately €13.3 million or $17.3 million) loan to Vértesi in order to facilitate debt payments. The availability of such financing was an essential element of the plan and was exceptional in that it is being provided by a state-owned parent company.

As mentioned above, DIP-type financing is generally not available in Hungary.

The Vértesi bankruptcy procedure should also be distinguished from other more ordinary procedures, as the largest creditor is a state-owned company with the capability of using its political influence to persuade other creditors. Further, the survival of the debtor company’s core business largely depends on state subsidies.
The next entry in this series will discuss liquidations under Hungarian law.

Read more: http://business-finance-restructuring.weil.com/cross-border-update/dead-or-alive-liquidation-or-restructuring-under-the-hungarian-insolvency-law/#ixzz1mIGyuZVX

Dead or Alive – Liquidation or Restructuring under the Hungarian Insolvency Law? Part 2 — Liquidations

Siegler Konrád and Simon Tamas on February 3, 2012 ·

Posted in Cross-Border Update

Hungarian Liquidation

What is liquidation?

The purpose of liquidation proceedings under Hungarian law is to terminate the business activities of an insolvent debtor and distribute its assets in accordance with the priority order set out in the Hungarian Bankruptcy Code.

Initiation and commencement of liquidation

Liquidation proceedings may be initiated by the debtor, any creditor or the bankruptcy administrator, as well as the bankruptcy court (in case of unsuccessful bankruptcy), the company court of registration (in case of non-compliance with certain corporate law provisions), or the criminal court (if a criminal sanction of liquidating the company has been imposed). Typically, liquidation proceedings are initiated by a creditor due to the failure of the debtor to pay an uncontested or recognized debt within 15 days of its due date and following a separate written notice requesting payment issued by the creditor after the expiry of such 15-day period.

Once the court establishes the insolvency of the debtor, it will pass a decision commencing the liquidation proceedings and, among other things, appoint a liquidator and invite the creditors to register their claims with the liquidator. Claims should be registered within 40 days of the publication of the court’s decision. In the event that a creditor does not register its claim within 40 days, but does so within 180 days of the publication of the decision, such creditor’s claim will be satisfied only if there are distributable liquidation proceeds following the application of the priority order set by the Hungarian Bankruptcy Code (i.e., such claims – regardless of whether the claim is secured or not – are last to be satisfied). If the claim is not registered with the liquidator within 180 days, it may not be enforced by the creditor.

The liquidator

In the course of liquidation proceedings, the debtor’s management is taken over by a liquidator appointed by the bankruptcy court, and the debtor’s management and shareholders cease to have
control over the debtor. The liquidator has the statutory right to terminate and to challenge certain agreements entered into by the debtor prior to the commencement of the liquidation proceedings.

**Challengeable transactions**

Based on the relevant provisions of the Hungarian Bankruptcy Code, a transaction can be challenged within 90 days of the applicant creditor or liquidator first becoming aware of it, but latest within one year from the publication of the court’s decree ordering the commencement of the liquidation proceedings, if the purpose of such transaction was to:

(i) conceal the debtor’s assets or defraud any of the creditors, and the other party had or should have had knowledge of such intent – in each case, if such transaction was entered into within five years of the application to commence the liquidation proceedings;

(ii) transfer the debtor’s assets or to undertake any commitment for the encumbrance of any part of the debtor’s assets without any compensation, or if the stipulated consideration provides unreasonable and excessive benefits to a third party – in each case, if such transaction was entered into within two years of the application to commence the liquidation proceedings; or

(iii) give preference and privileges to any of the creditors, such as the amendment of an existing contract to the benefit of a creditor, or to provide security interest to a creditor that has none – in each case, if such transaction was entered into within 90 days of the application to commence the liquidation proceedings.

In the event of a successful challenge, the above transactions are declared void, and any affected assets will have to be returned to the debtor and become part of the distributable liquidation proceeds.

**Priority order**

The liquidator registers the creditors’ claims and satisfies them pursuant to the priority order set by the Hungarian Bankruptcy Code.

The claims of secured creditors have priority over unsecured claims and are satisfied as follows:

(i) First, claims secured by security deposit (over shares and other securities, cash and bank account receivables) created before the commencement date of the insolvency proceedings are first to be satisfied. These can be directly enforced against the subject of the security deposit. Any excess must be returned to the liquidator and becomes part of the distributable liquidation proceeds. However, if a creditor holding a security deposit fails to exercise its right of direct enforcement within three months of the publication of the commencement of the insolvency proceedings, it will rank at the same level as secured creditors holding mortgages, pledges and floating charges as described in point (ii) below.
(ii) Second, assets that are subject to mortgages, pledges, and floating charges created before the commencement date of the insolvency proceedings are sold, and the proceeds (less the costs of the sale and a proportional part of the liquidator’s fees) are distributed to the creditors holding such security interests. In the case of a floating charge, only 50% of the proceeds from the sale of the charged assets (less the costs of the sale) are distributed directly to the floating charge holders. The remaining 50% becomes part of the liquidation proceeds, and is distributed as described in point (iii) below.

(iii) Third, claims secured by floating charges created before the commencement date of the insolvency proceedings are satisfied from the remaining 50% of the proceeds of the sale of the assets so encumbered, following payment of the expenses of the insolvency proceedings (which include salary-type payments and taxes payable by the debtor, costs incurred in connection with the termination of the debtor’s operations, sale of its assets and enforcement of its claims, protection and preservation of assets, placement and safeguarding of the debtor’s documents and the liquidator’s fee).

The Hungarian Bankruptcy Code also details the order of satisfaction of unsecured claims. Claims of controlling shareholders, controlled entities and certain other related parties have the lowest priority.

*Equitable subordination*

The Hungarian Bankruptcy Code recognizes the principle of “equitable subordination,” pursuant to which controlling shareholders and claims held by certain other related parties or the executives of the debtor are satisfied last. This is the case regardless of whether such parties held any perfected mortgages, pledges or floating charges over the assets of the debtor. In the case of security deposits held by such parties, the application of the principle is (unusually) somewhat restricted, although – as described above – such transactions are also challengeable before the court controlling the liquidation proceedings.

The last entry in this series will discuss out-of-court workouts under Hungarian law.

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Hungarian Work-Outs

What is work-out?

Instead of initiating enforcement proceedings, foreclosing on the security, or conducting judicially controlled insolvency proceedings, an alternative way to deal with financially troubled companies is a privately agreed reorganization, often referred to as work-out.

The main benefit of such procedure is that the debtor avoids (or at least deters) being labeled insolvent, formally bankrupt or in liquidation, and at the same time it enables the debtor to engage in negotiating a way out of its financial difficulties with its main creditors.

Also, because of the constraints on the effectiveness of Hungarian bankruptcy proceedings described in this series, almost all successful insolvency reorganizations in Hungary are carried out as private work-outs.

One of the notable successful out-of-court insolvency reorganizations in Hungary involved NABI Rt., a Hungarian bus maker with subsidiaries in the UK and the US. The restructuring was implemented in several stages over a period of approximately two years and was completed in 2006. The creditors included a number of banks, financial institutions and trade creditors, and their aggregate claims exceeded $100 million. The restructuring was in part facilitated because the lenders and the noteholders agreed to apply the principles of the London Approach (and not take unilateral enforcement actions), and, following the sale of the UK subsidiary and the subsequent sale of the US subsidiary and the assets in the Hungarian entity to a private equity investor, the restructuring resulted in a relatively favorable return of the claims of the creditors.

The risk of a private deal

Although the Hungarian Bankruptcy Code does not recognize (or regulate) such procedures, there are, in principle, no legal obstacles to the debtor and its main creditors (e.g., banks and bondholders) negotiating and agreeing in a private contract the details of a reorganization plan that aims to rescue the debtor from insolvency. At the same time, it should be noted that, as with any private contract, it binds only the contracting creditors. Accordingly, privately agreed reorganizations may be frustrated if the non-participating or non-consenting creditors formally initiate liquidation proceedings.

Further, workouts have a similar “new money problem” as debtors attempting to reorganize in bankruptcy. Financing generally is not made available by creditors due to risks of equitable subordination and the lack of exceptions to the “challengeable transactions” rules.

Need for further legislative developments

The authors believe that the Hungarian insolvency regime should facilitate and encourage more effective bankruptcy reorganizations and out-of-court work-outs, as well as reduce incentives to initiate judicial procedures. Further, the Hungarian Bankruptcy Code – which has been in force, albeit with countless amendments, for 20 years – is ripe for a legislative overhaul. Although there are rumors that a
new code is being prepared, no official proposal has been announced yet. Before such code is enacted, unfortunately, bankruptcy practitioners will have to live with, and navigate in, the existing difficult framework.

The only notable recent developments in this area have been (i) the adoption by the Hungarian Banking Association of a recommendation for a self-regulating model for dealing with companies in financial distress in May 2010 and (ii) an amendment to the Hungarian Bankruptcy Code which became effective in August 2011.

The recommendations, commonly referred to as the “Budapest Principles” (corresponding to the London Approach), is a voluntary code of conduct – banks signing up to the code agree to consider on a case-by-case basis whether the principles could be applied to a debtor in a specific case. If the affected banks agree to apply the principles, then the debtor is given a reasonable standstill period, during which the consenting creditors refrain from taking action against the debtor in order to facilitate reaching an out-of-court restructuring agreement during the work-out process. The application of the principles, which are based on voluntary cooperation between the creditors and the debtor, is aimed at avoiding bankruptcy, liquidation or foreclosure proceedings. So far, nine Hungarian banks (including the three largest) have signed up to the code.

Although the adoption of the Budapest Principles is a useful initiative, it would be desirable that more banks sign up. Also, because the application of the principles should be approved by the creditors in each specific case (i.e., the principles are not binding), it will be important that legislation further strengthens the incentives to avoid judicial procedures (which so far have very rarely been successful) and rules that facilitate the preservation of debtors and business that experience only temporary financial difficulties.

As mentioned in this series, the amendment to the Hungarian Bankruptcy Code seems to have clarified the previously unclear position of those creditors who do not register their claims with the bankruptcy administrator within the statutory deadline, in that they cannot enforce their claims subsequently unless liquidation proceedings are opened against the debtor.

In addition, the amendment implemented certain special rules applicable to the bankruptcy and liquidation proceedings of the companies which the Hungarian Government declares, on a case-by-case basis, to be exceptionally significant from the perspective of the national economy. The bankruptcy administrator or liquidator of such companies is a special, state-owned entity – the Hitelintézeti Felszámoló Nonprofit Kft., which was originally set up to administer the insolvency proceedings of banks and other financial institutions – and the stated purpose of the new rules is to ensure that the proceedings against such companies are quicker, more transparent and conducted in a more unified manner.

Although no proceedings conducted under these special rules by Hitelintézeti Felszámoló Nonprofit Kft. have been reported to date, it would certainly be a welcome development if the transparency and integrity of the insolvency proceedings were strengthened.
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