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## CONSOLIDATED BANKRUPTCY OF RELATED PERSONS

**ABSTRACT:** Amendment to the Act on Bankruptcy from August 2014 has significantly worsened the procedural position of persons connected with the debtor through the limitation or exclusion of their rights. The introduction of the restrictive regime for related persons was explained by the need to eliminate the causes which enabled abuses and corruption. It is provided that the persons connected to the debtor are paid off in the newly established last – fourth order of payment and cannot be elected to the committee of creditors in order to prevent outvoting of other bankruptcy creditors by the related persons. An important novelty is that persons connected with the debtor (except those who are dealing with provisions and credit loans within their ordinary course of activities) represent a special class of creditors and do not vote on the reorganization plan which disables abuse by the related parties. Changing position of affiliated entities is also reflected in the exclusion of the appointment of a bankruptcy trustee or an independent expert who monitors implementation of the reorganization plan. It also facilitates the refutation of legal transactions concluded with related parties.

**Key words:** *related persons, bankruptcy, payment order, committee of creditors, reorganization.*

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## I About Related Persons

Exploring the impact of the economic crisis in the domestic micro and macro business environment in terms of a legal framework and reform legislation aimed at strengthening the domestic economy has been conceived in a way to give a synergistic response to several questions which occur daily in domestic economic environment such as how to improve legislation and allow the economy efficient legal mechanism for solving business problems and how to be competitive in a market where fluctuations occur at the basic laws of supply and demand. The essential result of the study which the authors presented in this document is certainly a value judgment whether the current national legislation in the field of bankruptcy is an adequate platform for the improvement of the domestic investment environment.<sup>1</sup>

Amendments of the Act on Bankruptcy from August 2014<sup>2</sup> have been changed and amended, and as many as 62 articles of the basic legal text<sup>3</sup> and new articles were added: 117a, 174a, 174b and 204a. Bankruptcy proceedings until the entry into force of the Law on Amendments to the Law on Bankruptcy not being completed shall be completed in accordance with the regulations that were in force before the entry into force of this law.<sup>4</sup> Since novelties from 2014 have no “retroactive” application, all bankruptcy proceedings in which the bankruptcy petition was submitted before 13th August 2014, shall be completed in accordance with the provisions of the basic text of the Bankruptcy Act of 2009 or previous bankruptcy laws. This means that the courts will parallelly apply different procedural rules, depending on when the procedure was initiated.

The New Bankruptcy Act makes a distinction between “*interrelated entities*” that are determined as defined in the Law on Enterprises,<sup>5</sup> for instance, when more interrelated creditors appear as creditors of the same bankruptcy debtor which are in no way connected with the debtor, from “*persons connected with the debtor*” referred to in the definition of related persons from the

<sup>1</sup> Dukic-Mijatovic, M. Veselinovic, J., (2015), The effect of subsidies and incentives to create a better investment environment in the Republic of Serbia, Law - theory and practice, no. 1, p.1

<sup>2</sup> The Law on Amendments to the Law of Bankruptcy was published in the “Official Gazette of RS” no. 83/2014, which came into force on 13<sup>th</sup> August 2014 except for the provisions on the publication of all submissions and participants in the proceedings, which apply from 1<sup>st</sup> January 2015, and the provisions on reporting and publication of the report of the bankruptcy trustee, which will be implemented from 1<sup>st</sup> October 2014.

<sup>3</sup> Basic legal text published in the “Official Gazette of RS”, no. 104/2009.

<sup>4</sup> Article 68 of the Law on Amendments to the Law on Bankruptcy

<sup>5</sup> The “Official Gazette of RS”, no. 36/11 and 99/11

Article 125 of the Bankruptcy Law. In a legal theory, preference of the legislator to define the term of related entities in different ways in the Law on Commercial Companies as a general regulation,<sup>6</sup> as well as in the Law of Bankruptcy<sup>7</sup> is exposed to criticism.<sup>8</sup> It was pointed to certain differences between definitions of related persons referred to in Article 62 of the Law on Enterprises in relation to the definition of Article 125 of the Bankruptcy Law which refers to blood relatives, i.e. the degree of kinship. Also, unlike the Law on Enterprises, the Law on Bankruptcy considers the related entity only a legal entity that is under control of the debtor in terms of the Law on Enterprises and not the other legal entity that is, altogether with bankruptcy debtor under control of the third party. It is outstanding opinion that it is a legislator's mistake or intention to dismiss these persons from a special restrictive regime proscribed for related persons, to allow them the participation in the creditors' committee and voting on the reorganization plan which has been assessed as an unfair decision, opposite to the interest of all creditors.<sup>9</sup>

However, there is another – the third category of related persons in bankruptcy which the law does not regulate. These are interrelated debtors. For example, when a creditor blocks all solidary debtors who are also entities related to capital, bankruptcy reason is realized for the entire group of related parties for the same debt.<sup>10</sup> Bankruptcy of the group of interrelated entities is called a consolidated bankruptcy. In preparing a proposal of novelties from 2014, it was discussed about the introduction of consolidated bankruptcy which was receded after a detailed analysis and consultations.<sup>11</sup> In the Bankruptcy Law from 2009, related persons are mentioned only in four places, e.g. in four articles. The Amended Bankruptcy Law regulates related persons by provisions contained in articles 21, 36, 38, 54, 120, 123, 125, 156 and 165.<sup>12</sup>

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<sup>6</sup> Jovanovic - Zattila M., V. Colovic, (2007), Bankruptcy Law, Belgrade, 2007, p. 172

<sup>7</sup> Čolović V. Milijević N.,(2004), Bankruptcy Proceedings, Banja Luka, 2004, p. 114

<sup>8</sup> Tanasković Z., (2014), Related Parties According to Amendments in the Law on Bankruptcy, Law informant, no. 10, p. 9

<sup>9</sup> Ibidem, page 10

<sup>10</sup> Kozar V., (2014), The effect of the bankruptcy proceedings on loans and the provision of related persons, Lege Artis, no. 26, p. 30th

<sup>11</sup> Dukic-Mijatovic, M., Veselinovic, J., (2014), The Reform of Legislation as a *conditio sine qua non* for creating a better investment environment in the Autonomous Province of Vojvodina - commercial law aspect, Proceedings of XI traditional scientific meeting of the University of Business Academy, The Faculty of Law for Commerce and Judiciary, Novi Sad, pp. 37-54

<sup>12</sup> See more: Dukic-Mijatovic, M.,(2010), Bankruptcy Law, The University of Business Academy, The Faculty of Law for Commerce and Judiciary, Novi Sad, p.18

These novelties have significantly worsened the procedural position of persons related with the debtor through the limitation or exclusion of their rights.<sup>13</sup> The introduction of the restrictive regime for related persons was explained by the need to eliminate the causes which allowed abuses and corruption.<sup>14</sup> It was provided that persons related to the debtor pay off in the newly established – the fourth order of payments and cannot be elected to the committee of creditors, in order to prevent outvoting of other bankruptcy creditors by the related parties. An important novelty is that persons associated with the debtor (except those who in the ordinary course of their activities deal with the provision of credits or loans) are a special class of creditors and they do not vote on the reorganization plan, which disables abuse by the related parties. Changing the position of related entities is reflected in the exclusion of the appointment of a bankruptcy trustee or an independent expert to monitor the implementation of the reorganization plan. It also facilitates the refutation of legal transactions concluded with related parties.

In the explanation of the proposed new opinion was the opinion that a change of treatment of related entities can lead to a significant reduction in lending within the group of related entities and loans of the owner.<sup>15</sup> In a situation where a debtor has no access to other sources of funding, the new provisions may demotivate the owners to carry out further investments. However, regardless of the restrictions, changes were adopted on the grounds that it is a more equitable solution which should reduce the perceived abuse in practice. In addition, the draft of the novelties was proposed to prevent related parties to participate in the creditors' assembly, but in the course of discussions at the oral hearing prevailed the opinion that this way was a violation of fundamental rights, and it was held that such a solution is not acceptable. The definition of the related parties was not changed by the novelties in the Bankruptcy Law from August 2014, but its scope was narrowed, and in period from 23<sup>rd</sup> January 2010 to 13<sup>th</sup> August 2014 referred only to the assumption of unconscientiousness from the Article 120, paragraph 4 because it was used only to determine related persons who were supposed to know that the debtor was insolvent which facilitated contesting of legal transactions and other legal proceedings normally undertaken in behalf of related parties.

<sup>13</sup> Kozar V., (2015), Changing the position of related parties in the bankruptcy proceedings, Law and Commerce, no. 1- 3, pp. 43 - 57

<sup>14</sup> See more: Dukic-Mijatovic, M.,(2010), Guide to the bankruptcy proceedings - A review of the bankruptcy legislation of the former Yugoslav republics, the copyright issue, Novi Sad, 2010, p.33

<sup>15</sup> [http://www.srbija.gov.rs/vesti/dokumenti\\_pregled.php?id=208453](http://www.srbija.gov.rs/vesti/dokumenti_pregled.php?id=208453), pristup 02.05.2015

## **II Consolidated bankruptcy and multiple application claims arising on the basis of joint liability of related persons**

In preparing the proposal of novelties from 2014, the introduction of a consolidated bankruptcy was dropped after a detailed analysis and consultations.<sup>16</sup> The discussion was focused on various concrete solutions. In the case of bankruptcy over two or more related persons, among which is a parent company, the procedure would be conducted by the following rules: 1) one bankruptcy trustee is appointed, there is one creditors' assembly, one committee of creditors is elected; 2) bankruptcy procedure is initiated and implemented by the bankruptcy judge competent according to the headquarters of the parent company; 3) one bankruptcy estate is formed; 4) preparing and voting on the reorganization plan is done once for all related persons; 5) the principle of equal settlement of creditors applies to the bankruptcy creditors of all related persons; 6) mutual claims of related persons are deleted. If the security is mortgage or pledge, such a creditor in a bankruptcy has the status of a lien creditor. Amended law defines lien creditors<sup>17</sup> who occurred in the cases of related persons so far; when one person uses the property of another person in a bank loan (who later becomes a debtor) as collateral which guarantees repayment of the loan.<sup>18</sup> In a legal theory this new type of a creditor is called a "lien creditor with claims against the third party."<sup>19</sup> The question of a consolidated bankruptcy is especially actual in the case of solidary debtors, for example with guarantees for liabilities of commercial contracts, giving a corporate guarantee or accessing debt, considering that these collaterals are usually given

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<sup>16</sup> [http://www.srbija.gov.rs/vesti/dokumenti\\_pregled.php?id=208453](http://www.srbija.gov.rs/vesti/dokumenti_pregled.php?id=208453), visited on 11<sup>th</sup> 2015.

<sup>17</sup> In the amended article 49, pages 5-7, lien creditors are defined as creditors who have a lien on the property or rights of the debtor that are recorded in public registers and have no monetary claim towards the debtor which is secured by that lien right. Lien creditors are not bankruptcy creditors and are not secured creditors. Lien creditors are bound to the deadline for submitting claims to give notice of lien with submitting evidence of the existence of a lien and a statement of the amount of monetary claim against a third party that these rights are provided on the opening day of the bankruptcy proceedings, by which they shall become parties. Lien creditors cannot elect and be elected to the assembly and the committee of creditors.

<sup>18</sup> Radulovic B.,(2014), "Bankruptcy in Serbia - facts, misconceptions and the intended consequences," Economic Policy of Serbia in 2014: Possibilities of economic growth in terms of reforms and fiscal consolidation in: B. Atmospheric Environment Arsic (ed.), University of Belgrade, The Faculty of Economics, Belgrade, 2014, pp. 144 and 145, etc.

<sup>19</sup> Radovic M., (2014), The position of mortgages ("mortgage") of creditors in bankruptcy proceedings, Law and Commerce, no. 4-6, p. 256

to banks and other creditors, i.e. each of them “shares” related persons.<sup>20</sup> In this case it may happen that a creditor blocks all solidary debtors, thus creating a securing reason for bankruptcy for the entire group of related parties for the same debt. The problem of the multiple application claims arising from a joint liability of related entities in all bankruptcy proceedings which should be resolved by adequate legal novelties was pointed out in a legal theory.<sup>21</sup>

Then the creditor may either condition or block a vote on the reorganization plan for each of the related entities, joint and several co-debtors with the same claim; therefore with both principal debtor and guarantors. In this way one claim is “multiplied” in a specific way, which should be prevented or limited by adequate legal amendments, or in the absence thereof, by an appropriate interpretation in the jurisprudence, and creating rules consolidated bankruptcy or reorganization, for example, such a creditor should be ranked in a class of creditors with the terms of the claims (resolutely condition), which does not vote on the reorganization plan in affiliated entities - guarantors, but only when deciding on a plan of reorganization with the principal debtor, or with the person who received the benefit, for which the creditor claims compensation.<sup>22</sup>

## Conclusion

The Amended Bankruptcy Law makes a difference between “interrelated entities” that are determined according to definitions in the Law on Companies from “persons related to the debtor”, referred to in the definition of related persons in Article 125 of the Bankruptcy Law. More categories of related parties occur in bankruptcy which the law does not regulate. They are interrelated debtors and insolvency group of interrelated legal entities is called consolidated bankruptcy. Novelties have significantly worsened the procedural position of the persons related to the debtor through the limitation or exclusion of their rights. Persons who are related with the debtor pay off in the newly established last - the fourth order of payments of claims resulting two years before the opening of bankruptcy proceedings on loans, as well

<sup>20</sup> Kozar V., (2014), The effect of the bankruptcy proceedings on loans and the provision of related entities, Legal informant, no. 10, p. 4

<sup>21</sup> Radulovic B., (2014), “Bankruptcy in Serbia - facts, misconceptions and the intended consequences,” Economic Policy of Serbia in 2014: Possibilities of economic growth in terms of reforms and fiscal consolidation in: B. Soskic, M. Arsic (ed.), The University of Belgrade, The Faculty of Economics, Belgrade, pp. 145 - 146

<sup>22</sup> Kozar V., (2014), Commentary on the Law on Bankruptcy, with novelties in 2014 and jurisprudence, Belgrade, 2014, p. 181

as other legal proceedings that are economically equivalent to the granting of loans, in part where these loans are not secured. Also, these persons may not be elected to the committee of creditors. The prohibition of selection of persons associated with the debtor into the creditors committee has been introduced in order to prevent outvoting of other bankruptcy creditors by the related persons. An important novelty is that the persons related to the debtor (except those who in the ordinary course of their activities deal with the provision of credits or loans) are a special class of creditors and do not vote on the reorganization plan which disables abuse by the related persons. Changing the position of affiliated entities is reflected in the exclusion of the appointment of a bankruptcy trustee or an independent expert to monitor the implementation of the reorganization plan. It also facilitates the refutation of legal transactions concluded with related parties, primarily by providing security for the obligations of persons related to the debtor and the credit or loan repayment. The change of treatment of related entities can lead to a significant reduction in lending within the group of related parties and loan owners. In preparing the proposal of novelties in 2014, the introduction of consolidated bankruptcy was discussed, after which the final version of the proposal was dropped.

Therefore, the unresolved problem of multiple applications receivables based on joint liability of related entities in all bankruptcy proceedings remained, which should be addressed through future changes in the law.

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## ***KONSOLIDOVANI STEČAJ POVEZANIH LICA***

REZIME: Novelama Zakona o stečaju iz avgusta 2014. godine značajno je pogoršan procesni položaj lica povezanih sa stečajnim dužnikom, kroz ograničavanje ili isključenje njihovih prava. Uvođenje restriktivnog režima za povezana lica obrazloženo je potrebom otklanjanja uzroka koji su omogućavali zloupotrebe i korupciju. Predviđeno da se lica koja su povezana sa stečajnim dužnikom namiruju u novoustanovljenom poslednjem



- četvrtom isplatnom redu i ne mogu da budu birana u odbor poverilaca, kako bi se sprečilo preglasavanje ostalih stečajnih poverilaca od strane povezanih lica. Bitna novina je da lica povezana sa stečajnim dužnikom (osim lica koja se u okviru svoje redovne delatnosti bave davanjem kredita ili zajmova) čine posebnu klasu poverilaca i ne glasaju o planu reorganizacije, čime su onemogućene zloupotrebe od strane povezanih lica. Promena položaja povezanih lica ogleda se i u isključenju prava imenovanja za stečajnog upravnika ili za nezavisno stručno lice koje prati sprovođenje plana reorganizacije. Takođe, olakšano je pobijanje pravnih poslova zaključenih sa povezanim licima.

**Ključne reči:** *povezana lica, stečaj, isplatni red, odbor poverilaca, reorganizacija.*

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