

THE LEGAL POSITION OF SECURED CREDITORS IN FINANCIAL RESTURING AND BANCRIPTY

ABSTRACT: The legal position of secured creditors in financial restructuring and bankruptcy is a necessary and essential topic in legal and economic reality for both legal theoreticians and practitioners, particularly nowadays when a wave of global recession has caused difficulties in business and payment. Banks as the largest secured creditors are mostly affected with these difficulties in business. The author of this paper pointed out the modalities of treatment and payment in a proceeding of financial restructuring for secured creditors as well as the most important segments and solutions of protection of secured creditors represented in both the local bankruptcy law and business and court practice.

Key words: secured creditors, financial restructuring, bankruptcy.

I Secured creditors' rights

1. Secured creditors, concept and legislation.

Lien is the most common mean of securing monetary demands and, as that, it appears as the most widespread model of protection for secured creditors. It is the role where, in business practice, banks usually appear. With the contract for collateral security, the debtor or some third party /pledger/ commits himself to the creditor /pledgee/ to hand over some movable property

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where the property right exists in order to collect, before the other creditors, from its value if the debt is not paid when it is due, and according to the Lien Law on registered movable property, the lien without handing over the property or security without possession actual has been regulated.¹ The contract represents the legal basis for acquiring lien, and the procedure of acquiring it is represented by hand-over of pledged chattels when movable property is in question, that is registration in the land or mortgage registries or public registries as far as immovable property is concerned.²

On the basis of the mortgage deed, that is lien statement, an out of court settlement procedure could be conducted, but also the executive court proceedings if the lien creditor decides to do that. In the Law on mortgages, especially in provisions of the Second chapter, the legislator regulated out of court settlement procedure, which, in relation to the procedure, was regulated by the Law on basic property relations and the Law on enforcement and security³ in much more economical and suitable manner.⁴

Common-law lien on movable property is based on the list /distrain/ of property in an executive procedure. Legal lien is created directly on the basis of the law and, therefore, it is neither necessary for a lien debtor to hand over

¹ Article 966. of the Law on obligations and contracts, *Official Gazette of the SFRY*, no. 29/78, 39/1985, 45/1989- decision of the Constitutional Court of Yugoslavia and 57/89, *Official Gazette of the FRY*, no.31/93 and *Official Gazette of the Serbia and Montenegro*, no. 1/03- Constitutional charter/ regulates the contract for collateral security, and our legislator has used the Lien Law on registered movable property to regulate the lien without handing over the property or security without possession actual for securing creditors' demands. By Article 8 of the Lien Law on registered movable property, *Official Gazette of the RS*, no. 57/03, 61/05 and 64/ 06./ the legislator has regulated the concept of the contract for collateral security, rights and obligations of contracting parties for the purpose of securing creditors' demands, the registration of lien in the registry, settlement with the lien creditor and the cessation of lien. What is particular is that in accordance with the provisions of this law lien is acquired upon the conclusion of contract for collateral security in a written form, which is concluded by both the pledger and creditor and by registering the lien in property registry.

² Mortgage is lien on immovable property. Mortgage is created by registering in the competent registry of immovable property on the basis of: 1/contract or court settlement /mortgage by contract/; 2/lien statement /ex parte mortgage/; 3/ law /legal mortgage/; court order /court mortgage/. The pledging of immovable property is conducted in a manner that the pledged property stays in possession actual of the debtor, and the lien is registered in public registries. With the day of the beginning of application of the Law on mortgage the provisions of articles 63. to 69. of the Law on basic property relations have become obsolete, *Official Gazette of the SFRY*, no. 6/1980 and 36/1990, *Official Gazette of the FRY*, no.29/1996 and *Official Gazette of the RS*, no. 115/2005-state law/, which does not apply on mortgages concluded prior to its coming into operation/ that is till January 4, 2006/, unless the contracting parties agree otherwise.

³ Law on enforcement and security, *Official Gazette of the RS*, no. 31/01

⁴ Article 39. of the Law on mortgage, *Official Gazette of the RS*, no. 115/05

the property to a lien creditor in possession actual, nor to register that in public registries. Legal lien is a special type of lien which occurred directly ex lege, for the purpose of securing creditors' demands from particular contracts in economy, and the creditor can sell the pledged property, if the secured demand, which is due to be collected, has not been satisfied and he can use the money received for the collection of debt.⁵

The law on obligations and contracts regulates only the lien on movable property and therefore the secured right based on retention refers only to movable property. Money can also be pledged. In that case lien gets the term security, which, by its nature and purpose is equal to lien, with the difference in the fact that the object of lien is property, and in security it is cash or securities. Apart from garnishment of a debtor's demand, legal lien on debtor's rights can be acquired by seizure of demands on the account of the administrative debtor. Public registry is being kept for the garnishment of securities through seizure and garnishment of other securities through the seizure of demands from securities.⁶

2. About secured creditors.

It is a secured creditor's right to get satisfaction from the value of the property⁷ or the right independently from the bankruptcy proceedings and collective and proportionate satisfaction⁸ for the demand which is secured by lien or with a right to property which is equaled to it or the right of the bankrupt. It is the right of priority of privileged satisfaction⁹, since it is secured by the right of mortgage or lien or some other appropriate right, that is being the right of retention and the right of priority collection. */separatisti ex iure creditii/*.¹⁰

⁵ Article 1064. paragraph 3. of the Law on obligations and contracts.

⁶ Dukić Mijatović M., (2010). Bankruptcy law, *the Faculty of Law for commerce and judiciary the University Business academy*, Novi Sad., p.237.

⁷ Mitrović, V., (1926). Bankruptcy law with special overview of Serbian legislation, Belgrade, p.126.

⁸ Eraković, A., (2003). Rights of recovery and secured rights in bankruptcy, *Collection of papers from the Faculty of Law of University of Rijeka*, (3), p.651.

⁹ Barč, R., (1939). Basics of settlement rights and bankruptcy law, Belgrade, p. 36.

¹⁰ See more Velimirović, M., (2010). Law on Bankruptcy, Symbol, Novi Sad, p.189; Spasić, S., (2008). Legal actions of bankruptcy of commercial associations on civil proceedings and enforcement procedure, Current issues in bankruptcy law, *the Lawyers Association of the Republic of Srpska*, Banja Luka, p. 81–107; Spasić, S. (2010). Novelties in the Law on bankruptcy, *Collection of papers from VII traditional scientific congress Zlatibor legal days University Business Academy Faculty of Law for commerce and judiciary Novi Sad and magazine Law-theory and practice*; Spasić, S., (2008). Relationship and delimitation between the enforcement

Secured creditors are privileged creditors of a bankrupt, therefore they satisfy their demands before the other creditors, with no regard to the course and results of a bankruptcy procedure. Secured rights are the rights for satisfaction from one property. Our Law on bankruptcy has preserved the solution from the previously valid Law on bankruptcy of Republic of Serbia¹¹ and that is being the disposition that commenced a distraint proceeding before the enforcing court, i.e. being the court of general jurisdiction in connection with the realization of the secured right should not be carried out before the very court. Hereafter, upon the decision on the continuation of an opened proceeding aimed towards the realization of the secured right it is carried out before the commercial court, which has the actual jurisdiction to act in bankruptcy proceedings. By opening the bankruptcy proceedings the right of secured creditor to be satisfied from the pledged property during the bankruptcy proceedings is not disturbed, so he remains in the same position as if the bankruptcy proceedings have not been opened.¹²

Secured creditors have the right to proportional satisfaction from the bankruptcy estate, as creditors in bankruptcy, even if they waive their status of a secured creditor or if they cannot collect their secured debt without their fault. Secured creditors submit a written statement about the waiving of secured creditor's status to a bankruptcy judge or a trustee in bankruptcy.¹³

and bankruptcy procedure in Serbia, Current issues in bankruptcy law, *the Lawyers Association of the Republic of Srpska*, Banja Luka, p. 107–133; Dukić Mijatović M., (2010). *A Guide through Bankruptcy Proceedings – An overview on bankruptcy legislation of former Yugoslav republics*, Novi Sad, p.195, Dukić Mijatović M., (2009). Amendments to the law on bankruptcy *Law, theory and practice*, 26 (1–2), pp.73–84; Čolović, V., (2007). The relation of the bankruptcy proceedings and reorganization proceedings, *Legal life*, 56, (12), pp. 285–301.

¹¹ If we draw parallels of similarities and differences between our current bankruptcy law and the Law on forced settlement, bankruptcy and dissolution, we can notice that the legislator, with the previous law, regulated the fact that the opening of bankruptcy procedure did not affect the right to separate satisfaction from designated properties, that is debtor's property /lien right, satisfaction right, retention right and other secured rights/. Previous law gave the authority to bankruptcy assembly to render the decree which was to allow the continuation of stopped proceedings before the enforcing court upon the recommendation of the secured creditor and also with the authorization of enforcing court to continue and conduct the enforcement procedures before the general jurisdiction court upon the recommendation of the secured creditors.- See Dukić Mijatović M., (2010). *Bankruptcy Law, the Faculty of Law for commerce and judiciary the University Business academy*, Novi Sad., p. 81.

¹² See more Spasić, S., (2010). Bankruptcy Reform- Answers to a financial crisis at the global level and in Serbia, *Legal life* (12)

¹³ See article 49. paragraph 4 of the Law on Bankruptcy.

Secured right acquired by distraint within the last 60 days prior to the opening of bankruptcy proceedings stops being valid, for the purpose of protecting the other creditors and their proportional satisfaction.¹⁴

As far as secured rights of creditors who acquired the right, but have not been able to complete its registrations in public registries with appropriate authorities are concerned, the bankruptcy judge, according to provisions of our previously valid bankruptcy law as the authority for the bankruptcy procedure, would render the registering decision in the form of decree.¹⁵

If creditors have possession actual and possessory lien on property, they are not obliged to hand the property over to the bankrupt until he pays them their secured debts.¹⁶

The right of satisfaction in a concordance with the provisions of our current administrative law has kept the continuity in relation to a previous legal solution, due to the fact that registering the encumbrance of the writ of execution into public registries allows the executive creditor, who has proposed satisfaction and has not previously acquired the lien, to, by registering the decree on enforcement, acquire the right to be satisfied from person's immovable property before the person who has later acquired the lien on that immovable property or the right to satisfaction.¹⁷

¹⁴ In a situation where all creditors know about the debtor's unfavorable economic-financial status, 60 days prior to the opening of proceedings, they would all, in a form of a short notice, demand the securing of their debts and in that case the creditor who would submit the motion for seizure earlier could satisfy himself in a complete sum. The other creditors could not collect their monetary demands, not even partially, if there would not, for this legal solution, exist the bankruptcy estate, and someone would have the secured right over every property. However, this does not mean that the creditors who acquired the secured right by enforcement within the period of 60 days are in more unfavorable position in the bankruptcy proceedings than the creditors who acquired secured rights by contract or on the basis of the law, since that kind of acquiring secured right could be disputed as legal act of the bankrupt. - See Dukić Mijatović M., (2010). *Bankruptcy Law, the Faculty of Law for commerce and judiciary the University Business academy*, Novi Sad, p. 224.

¹⁵ Jurisprudence of Commercial Courts, Report, no. 3/2006, p. 143.

¹⁶ The creditor of a due demand who has in possession one of debtor's properties has the right to keep it until the demand is paid to him. Therefore one can realize his right as a creditor only in bankruptcy proceedings, as a secured creditor. The law on obligations and contracts regulates only the lien over movable properties and therefore the secured right based on retention applies only to movable property. - See more Babić, I., (1997). *Law of Contract Lexicon*, Belgrade, p. 271.

¹⁷ See more Mijatović, M., (2011). *Legal position of preferential and secured creditors in bankruptcy*, Master thesis, Faculty of Law for commerce and judiciary of the University of Business Academy in Novi Sad

II Modalities for protection of creditors' of secured demands rights

1. Legal position of creditors' of secured demands in financial restructuring

The conditions and manner of financial restructuring of commercial associations by consent in Republic of Serbia, are regulated by the Law on the financial restructuring of commercial associations¹⁸ by consent enforced at the latest before the opening of a bankruptcy procedure in conformity with the Law on bankruptcy.¹⁹ Financial restructuring of commercial associations by consent represents an out of court procedure of restructuring of corporate debts by consent through redefining debtor-creditor relations between the commercial association in financial difficulties and its creditors, primarily banks, but the other creditors in an out-of-court procedure as well. The aim of the financial restructuring of commercial associations by consent is to recognize and solve financial difficulties in due time and to create new conditions for a normal continuation of business activities for a corporate debtor. In that manner, a commercial association in financial difficulties is allowed to survive and to carry on with business activities and, at the same time, bankruptcy is avoided regardless the existence of more permanent insolvency as a reason for bankruptcy from article 11 – 12. of the Law on bankruptcy.²⁰ Financial restructuring can be conducted if at least two domestic or foreign banks are participating in it in the role of creditors, but all other creditors too. For conducting institutional mediation in financial restructuring it is necessary to have the consent of both parties – creditors and a debtor.²¹ Commercial chamber of Serbia, upon the request of the debtor and one or more creditors, provides help in establishing cooperation between the debtor and creditors for negotiations about restructuring of debtor-creditor relations and support to

¹⁸ Law on the financial restructuring of commercial associations by consent, *Official Gazette of the RS*, no. 36/11

¹⁹ Kozar, V., (2012). Debt dormancy (moratorium) in the procedure of financial restructuring, Collection of papers Traditional 9th congress "Legal days Prof. Slavko Carić, PhD." University of Business Academy, Faculty of Law for commerce and judiciary, Novi Sad, 2012, p. 226.

²⁰ Dukić Mijatović, M., (2010). Overview of legal procedures in the course of establishing demands of bankruptcy laws in the region, Thematic Collection of papers The Right of countries in the region publisher Institute for comparative law, Belgrade, pg. 368 – 390

²¹ Article 3. of the Rulebook on conditions and manner of institutional mediation in financial restructuring of commercial associations by consent, *Official Gazette of the RS*, no. 65/11 and no. 67/11

debtors and creditors during the negotiations because of their successful completion. Financial restructuring is competed with the Agreement on financial restructuring. With provisions of article 15 of the Law on financial restructuring of commercial associations by consent it is provided that the demand which is being restructured and which is secured by the mortgage, that is lien on movable property and rights, is substituted by restructured secured debts, so the mortgage, that is lien on movable property and rights, as well as the by-law in connection with secured debt which is being restructured, continues to exist as a mean of security of the restructured demand, in a concordance with the agreement on financial restructuring. Cadastre of real-estates, that is the second registry of lien rights, performs the change of data in the registered mortgage, that is lien on movable property and rights, according to the amount of the restructured secured debt, as well as the other conditions of the restructured secured debt. Mortgage, that is lien on movable property and rights, presents a mean of security of the restructured secured debt up to the amount of the secured debt which is being restructured, and in case that the amount of the restructured secured debt is attenuated in relation to the amount of the secured debt which is being restructured, cadastre of real-estates, that is the second registry of lien rights, performs the change of data in the registered mortgage, that is lien on movable property and rights.

2. Legal position of secured creditors in bankruptcy

a) Legal position of secured creditors in bankruptcy proceedings.

A secured creditor in the proof of being indebted has to designate the property on which he has acquired the secured right if it is the case of the secured demand and the amount of its debt which is not secured, if his demand is not secured completely.²² In the procedure of debts establishing, the reasoning of bankruptcy judge about the list of debts is delivered to the trustee and creditors in bankruptcy and the reasoning about challenged debts is delivered to the

²² “All in all, the obligation of a secured creditor to register at the same time up to which amount his demand will not be covered by secured right is pretty much unspecified. A secured creditor does not know if, with the sale of pledged property, he will acquire higher or lesser price, if he is going to be satisfied in full or there will be a surplus, or whether he will get less than his debt is. He can only conditionally submit the proof of being indebted, about which the trustee in bankruptcy will not be able to make a plea for the very same reasons. The secured creditor should submit the proof of being indebted, in order not to lose his right by expiration of time, if he does not satisfy himself in full from the sold property.”—Slijepčević, D. – Spasić, S., (2006). Commentary on the Law on Bankruptcy proceedings, Cesmecon, Belgrade, p. 302.

trustee in bankruptcy and each and every creditor in bankruptcy whose debt has been challenged, but not the secured creditors.²³ Secured creditors' demands are pretty much based on ministerial acts. The trustee in bankruptcy²⁴ or the bankrupt provides the adequate protection of property, in a manner which would ensure that the value and state of property remain unchanged.²⁵ According to the provisions of the article 93 paragraph 5 of the Law on bankruptcy, the judge in bankruptcy renders the decision about the request of a secured creditor within 20 days from the day of the receipt of that request. If the judge in bankruptcy does not make the decision upon the request in the stipulated term, it is considered that the injunction on enforcement has been temporarily abrogated in relation to the submitter of the request in so far as the abrogation is necessary for implementation of secured creditor's rights over the property which is the object of securing his property in concordance with law.²⁶ In order to realize the plan for reorganization, the legislator has, among all other measures, stipulated the sale of property from bankruptcy estate, with or without the lien or the transfer of such a property in the name of satisfying demands and enforcement or changes in lien right.²⁷ Secured creditors can satisfy their demands as creditors in bankruptcy, if they have not succeeded, in total or partially, to satisfy themselves throughout separate satisfaction, i.e. if they waive separate satisfaction. Then they satisfy their rights

²³ See more Spasić, S., (2010). Bankruptcy Reform- Answers to a financial crisis at the global level and in Serbia, *Legal life*; Dukić Mijatović, M., (2010). An overview on modalities of protection for creditors in bankruptcy in the light of the Law on bankruptcy, Collection of papers from VII traditional scientific congress Zlatibor legal days, pg. 339 – 375, Čolović, V., (2003). The Plan of bankruptcy, Law and business, 40, (5–8), p. 986–994.

²⁴ See more Spasić, S., Šarkić, N., Sibinović, Đ., (2011). Judiciary professions, Belgrade

²⁵ The court will not demand from secured creditors to expose themselves to higher risk or to suffer losses, in order to provide the payment of creditors which are accorded a lower rank. The rule of priority in collection implies that the rights of creditors which are accorded a higher rank have to be treated always as more important the rights of creditors which are accorded a lower rank. Although these creditors' demands are created before the opening of bankruptcy proceedings, they are to be realized in bankruptcy. However, the right for property to be seized or to conduct the enforcement over the debtor in any other manner is temporarily delayed on the basis of moratorium. Other elements of the right, such as the status of the demand and temporary collection, stay intact, unless they are challenged in the demand establishing proceedings. Dukić Mijatović, M., Mijatović, M., (2011). Legal position of secured creditors in bankruptcy, *Legal life* (11), p. 205– 221.

²⁶ "Interest is calculated on secured demands in bankruptcy proceedings, if it has been contracted, but only up to the level of value of property which serves for securing the demand." Decree of Higher commercial court Pž. 11441/2005 as of October 27, 2005.

²⁷ Spasić, S., (2007). Disputable legal questions and practical problems in reorganization procedure, Zlatibor legal days, Business Academy, Novi Sad, p. 108. and Spasić, S., (2009). Bankruptcy estate – An Overview on harmonization of bankruptcy law, *Law and economy* (5–8), p 322–342

proportionately against the debtor in relation to the size of debts. “By the sale of property on which secured rights were acquired a special bankruptcy estate is formed, which is used for satisfaction of secured creditors. If special bankruptcy estate is not sufficient for settling the debt of a secured creditor completely, he has the right to collect unsettled part of his debt as a creditor in bankruptcy. And if, upon the satisfaction of secured creditor, there is a surplus left, it is used for satisfying other creditors.”²⁸ Also, in a sale of bankrupt as a legal entity the conclusion follows that secured debts in each case are collected before unsecured debts. The request of secured creditors sent to the trustee in bankruptcy for more favorable sales procedure is in its procedural nature recourse against the reasoning of trustee in bankruptcy on proposed sales. When the property which is being sold is the subject to secured debt of one or more secured creditors, the secured creditor can, within ten days from the receipt of notification of proposed sales, propose the more favorable procedure for cashing the property.²⁹

b) Legal position of secured creditors in reorganization procedure.

It is an open question whether it is necessary to provide a bigger participation for secured creditors in the creditors’ assembly. In fact, the possibility to vote about the debtor’s bankruptcy has not been given to secured creditors, since their interests and the procedures of their satisfaction are significantly different in relation to the interests and the procedures of satisfaction of creditors in bankruptcy. Secured creditors also have the authorization to submit the plan of reorganization, under condition that they have at least 30 % of secured debts in their possession.³⁰ Conversion of debt into capital stock has been stipulated in Article 128 paragraph 1 item 11 of the Law on bankruptcy proceedings as one of the measures for the realization of the reorganization plan. Law on bankruptcy, in Article 157 paragraph 1 item 9 as one of the measures for the realization of the reorganization plan stipulates the conversion of debts

²⁸ Jankovec, I., (1999). Commercial Law, Belgrade, p. 224

²⁹ If the property was the object of securing debt of one or more secured creditors from the achieved price primarily the costs of sale are regulated which include the reward for trustee in bankruptcy and from the remaining sum secured creditors whose debt was secured with the property sold are paid in concordance with their right of priority. Satisfaction of secured creditors has to be performed within three days since the day trustee in bankruptcy received the assets on the basis of the sales of property. – Article 133. paragraph 4. of the Law on bankruptcy.

³⁰ Đukić Mijatović, M., (2008). Corporate management in bankruptcy, *Collection of papers Faculty of law University of Istočno Sarajevo*, 4, pp. 207 – 232 and Spasić, S., (2007). Disputable legal questions and practical problems in reorganization procedure, Zlatibor legal days Business Academy, Novi Sad.

into capital. From the content of interrogatory stems from that the bank as an (unsecured) creditor in bankruptcy has reported the debt in bankruptcy proceedings over the debtor and that its debt has been collected in total (100%). If all creditors' debts, established in bankruptcy proceedings over the debtor, are settled in a manner that the adopted plan of reorganization which stipulated for all debts to be converted to founder's rights has been completely enforced, by which the conditions for the cessation of bankruptcy proceedings over the debtor have been fulfilled by the cessation of the very same, then it is considered that in this manner the bank has collected its debt from the debtor (which has been secured on property in possession of the third party) in total, and therefore the obligation has ceased according to article 295 of the Law on obligations and contracts and the conditions for discharge of mortgage on property of the third party according to provisions 43 and 44 of the Law on mortgage have been met.³¹

III Conclusion

Financial restructuring of commercial associations by consent, represents an out-of-court procedure of restructuring of corporate debts by consent through redefining debtor-creditor relations between the commercial association in financial difficulties and its creditors, namely banks primarily, but the other creditors in out-of-court procedure also. The aim of the financial restructuring of commercial associations by consent is to recognize and solve financial difficulties in due time and to create new conditions for a normal continuation of business activities for a corporate debtor. In that way, a commercial association in financial difficulties is allowed to survive and to carry on with its business activities and, at the same time, bankruptcy is avoided regardless the existence of more permanent insolvency as a reason for bankruptcy. A secured creditor has the right of priority in collection from certain property of the bankrupt, on which he possesses lien or the right to settlement. He does not have a general lien on complete debtor's property and all of his earnings, which would weaken debtor's position, and for some part of debts which remain unsettled, they collect their debts alongside the creditors in bankruptcy. Secured creditors also have the authorization to submit the plan of reorganization, under condition that they have at least 30 % of secured debts in their possession. In fact, the possibility to vote about the debtor's bankruptcy has

³¹ Answers to questions of commercial courts which have been established on sessions of the Section of Commercial appellate court held on November 9th and 10th, 2010 – Jurisprudence of Commercial Courts, Report, (3/1)

not been given to secured creditors, since their interests and the procedures of their satisfaction are significantly different in relation to the interests and the procedures of satisfaction of creditors in bankruptcy.

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***Pravni položaj poverilaca obezbeđenih potraživanja
u finansijskom restrukturiranju i stečaju***

R e z i m e

Pravni položaj poverilaca obezbeđenih potraživanja u finansijskom restrukturiranju i stečaju, nametnula se kao nužna i neophodna tema u privredno pravnoj stvarnosti, izuzetno aktuelna za pravne teoretičare i praktičare, posebno danas kada usled talasa nove globalne recesije dolazi do otežanog poslovanja i naplate potraživanja. Sa ovom problematikom se sve više suočavaju banke, kao najveći poverioci obezbeđenih potraživanja, te je autor ovim radom ukazao na modalitete postupanja i naplate, koje pruža finansijsko restrukturiranje poveriocima obezbeđenih potraživanja, ali i na najbitnije segmente i rešenja zaštite razlučnih poverilaca, koja su zastupljena kako u domaćem stečajnom zakonu, tako i poslovnoj i sudskoj praksi.

Ključne reči: *poverioci obezbeđenih potraživanja, finansijsko restrukturiranje, stečaj.*

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