International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

www.chasecambria.com

Annual Subscriptions:
Subscription prices 2017 (6 issues)
Print or electronic access:
EUR 730.00 / USD 890.00 / GBP 520.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

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ARTICLE

Serbia: Proposal to Improve Position of Secured Creditors in Insolvency Proceedings

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Introduction

Relatively weak position of secured creditors under Serbian insolvency law has been partly blamed for the perpetuation of a high ratio of NPLs on the books of Serbian banks.[1] In its 2015 Strategy for Resolution of Non-Performing Loans,[2] ('Strategy') the Government of Serbia pledged to propose amendments to the Insolvency Act to improve the landscape for enforcement of secured creditors' claims.

Against this background, the Ministry of Finance circulated in October 2016 a proposal for the amendments to the Insolvency Act.[3]

The proposed amendments to the Insolvency Act aim at improving the position of secured creditors through the reduction of time-to-money period, increase of options for the secured creditor to acquire the collateral in exchange for the debt, and grant of priority to DIP (debtor-in-possession) financing in the event of subsequent collapse of the debtor.

The article outlines the position of secured creditors in an insolvency situation under Serbian law, and then discusses the proposed amendments to the Insolvency Act.

Position of secured creditors in insolvency situation under Serbian law

In an insolvency situation, secured creditor is not in the driving seat when it comes to enforcement of its collateral. Automatic stay on enforcement of claims applies not only to ordinary creditors but also to secured ones.[4] As a result, the timing, manner and administration of the sale of collateral, as well as the distribution of the proceeds, are in the hands of the insolvency administrator. Upon the motion of secured creditor, the court may lift the stay only if the secured creditor proves that the insolvency administrator has failed to adequately protect the collateral and no other measure to safeguard the value of collateral is available.[5] Stay can also be lifted if the creditor proves that its claim is less than the value of the collateral while the collateral is not of essence to potential reorganisation of the debtor.[6] In either case, even if the secured creditor proves his case, the court may, at its discretion, dismiss the request and confirm the stay.[7] In practice, moratorium on enforcement of secured claims is rarely lifted.

In theory, entrusting insolvency administrator with the sale of collateral is justified by the belief that he will be able to generate higher proceeds for the benefit of ordinary creditors and lower-ranked secured creditors, compared to what would happen if the secured creditor, driven by self-interest, were given the right to enforce its collateral. However, in the reality of Serbian insolvencies, secured creditor on average receives 56.5% of

Notes

1 According to the latest data, published by the National Bank of Serbia in its Report on the Baking Sector in Serbia for Q2 of 2016, non-performing loans (NPLs) represent 20.2% of the total portfolio of Serbian banks. Available in Serbian at <https://nbs.rs/internet/latinica/55/55_4/kvartalni_izvestaj_II_16.pdf> (accessed on 15 November 2016).

2 Strategy for Resolution of Non-Performing Loans (*Strategija za rešavanje problematilnih kredita,* 'Official Gazette of Serbia' no. 72/15), available in Serbian at <www.mfin.gov.rs/UserFiles/File/strategija%20krediti/1%20NPL%20Strategija%20(srb)%20-%20Rezime.pdf> (accessed on 15 November 2016).

3 Draft Law on Amendments to the Insolvency Act (*Nacrt zakona o izmenama i dopunama Zakona o stečaju*), adopted by the Ministry of Finance on 6 October 2016, available in Serbian at <www.privreda.gov.rs/javna-rasprava-o-nacrtu-zakona-o-izmenama-i-dopunama-zakona-o-stecaju> ('Draft') (accessed on 15 November 2016).

4 Article 93, paragraph 1 of the Insolvency Act (*Zakon o stečaju,* 'Official gazette of Serbia', nos. 104/2009, 99/2011, 71/2012 and 83/2014) ('Insolvency Act').

5 Id., Article 93, paragraph 4.

6 Id., Article 93, paragraph 5.

7 Decision of the Commercial Court of Appeals, Pvž 15/2014 of 5 February 2014 – *Sudska praksa privrednih sudova – Bilten br. 1/2015* (Decisions of commercial courts – Bulletin no. 1/2015).

its secured claim,[8] while 20% of all insolvency proceedings have lasted for more than four years.[9]

The frustration with the effectiveness of insolvency proceedings has presumably made creditors, including secured ones, more amenable to agreeing to pre-packed reorganisation plans. Pre-packed reorganisation plan (so-called *UPPR*) is a restructuring plan prepared by insolvent debtor and filed to the court along with a petition to initiate insolvency proceedings and impose a moratorium on enforcement of claims pending creditors' deliberations on the plan.[10] UPPR is binding on all creditors if in each creditor class the creditors who hold a simple majority of all claims vote in favor of the plan.[11]

While there are no reliable statistics, it is safe to say that the number of successfully implemented UPPRs is neglectable. A major reason for massive failures of UPPRs is the absence of serious operational restructuring measures and lack of independent control over the debtor's management.[12]

There is a casual link between the efficiency of insolvency proceedings and successful implementation of UPPRs. If the debtor knows that insolvency proceedings will be swift and efficient to the benefit of the creditors, he is more likely to try to avoid such outcome in the particular case by proposing a viable UPPR and acting in line with it. Likewise, from the perspective of the creditors, the better protected they are in insolvency proceedings, the less pressed they feel to agree to UPPRs they do not believe in.[13] In that sense, the amendments proposed in the Draft are a welcome development even though they do not revolutionise the position of secured creditors.

Proposed changes to the position of secured creditors

Right of a secured creditor to sell its collateral: The Draft does not propose to change the general rule according to which the sale of collateral is a prerogative of the insolvency administrator. To a certain extent, the amendments even narrow down the existing options available to secured creditors. Presently, if the court lifts the stay, the stay cannot be reinstituted. According to the Draft, however, the secured creditor will have a period of six month, extendable once for another six months, to complete the sale of the collateral. If the creditor misses the deadline, the power over the collateral reverts to the insolvency administrator.[14]

The Draft crates a rebuttable presumption in favor of secured creditor that the collateral is not essential for reorganisation or for sale of debtor as legal entity. The insolvency administrator is entitled to rebut the presumption and keep the control over the collateral.[15] The proposed also seek to exclude debtor's affiliates (other than licensed financial institutions) from the list of creditors entitled to petition the court to lift the stay on enforcement.[16]

Reduction of the time-to-money period. The existing Insolvency Act imposes no deadline on the insolvency administrator to offer collateral for sale. If the proposed amendments were adopted, insolvency administrator would be obliged to offer all collaterals for sale within six months from the final and binding decision on bankruptcy of the debtor concerned. This period is extendable only once, for another six months.[17] On its face, the proposal benefits the secured creditors. However, given that no sanction applies in case the insolvency administrator fails to comply with the six-month deadline, there is a fear this new rule will remain a paper tiger.

Credit bidding. The most important improvement to the secured creditors' position is in the proposal to allow secured creditor to bid for the collateral with its claim and offset the claim against its obligation to pay the purchase price. If the secured creditor's claim exceeds the sales price, the secured creditor is required to advance the difference, as well as the costs of sale.[18]

Notes

8 According to the data compiled by the Serbian Agency for Licensing of Insolvency Administrators (ALSU) and made available to the author by the members of the working group that prepared the Draft.

9 Id.

10 Article 156 *et seq.* of the Insolvency Act.

11 Id., Article 165, paragraph 10.

12 The Strategy concedes that 'Meaningful debt restructuring in Serbia (in general and in the context of insolvency) is rare. Reorganisation via UPPR is often used, but in majority of cases only as a technique for restructuring and debt rescheduling, coupled with liquidation of certain assets in certain cases of high importance. Operational turnaround is rarely achieved…'.

13 This conclusion is supported by the data compiled by the Serbian Agency for Licensing of Insolvency Administrators (*ALSU*) and made available to the author by the members of the working group that prepared the Draft. After the previous round of improvements to the Insolvency Act, adopted in the form of amendments in 2014, the number of initiated insolvency proceedings jumped from 210, as recorded in 2014, to 583 in 2015. The trend seems to continue as the first half of 2016 saw 254 new insolvency proceeidngs. A the same time, the number of approved UPPRs halved, from 80 in 2014 to 41 in 2015.

14 Id., Article 93g.

15 Id., Article 93b.

16 Id., Article 93v paragraph 3.

17 Id., Article 133a.

18 Id., Article 136b paragraph 1 point 1).

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Credit bidding is an important means of protecting secured creditor against the risk of its collateral being sold at a depressed price. However, credit bidding is at the same time able to produce a chilling effect on other bidders, who may be hesitant to compete with a secured creditor if the latter is incentivised to bid as high as its secured claim goes. The amendments do not propose that the court be granted with the power to ban credit bidding for cause.

Direct sale of collateral by insolvency administrator. Insolvency administrator may sell collateral in direct negotiations, rather than in a competitive procedure, if it obtains approval of the board of creditors,[19] a body representative of ordinary creditors.[20] The secured creditor does not have the power to veto such decision. The proposed amendments seek to reverse this situation, by empowering the secured creditor with a veto over bilateral sale of the collateral, under the condition that the proposed price is lower than the secured claim and no competitive sale process was previously attempted.[21] Furthermore, the secured creditor or its related party is supposed to obtain the right of first refusal with respect to the collateral offered to a third party in direct sale.[22]

Lease of collateral. Under the present legislation, the insolvency administrator is entitled to lease the collateral and thus practically prevent its sale for indefinite period of time. The proposed amendments seek to reverse this, by requiring the secured creditor's consent to the lease. However, the right to veto the lease of the collateral belongs only to the secured creditor who can prove that it is likely to settle its claim from the proceeds of the sale of the collateral.[23] This excludes second and lower ranked secured creditors, if the value of the collateral is equal to or less than the value of the first-ranked creditor's claim.

Bulk sale and sale of debtor as legal entity. If the proposed amendments become the law, secured creditor will be entitled to challenge the insolvency administrator's decision to sell the debtor's assets in bulk or to sell the debtor as legal entity. In that case, the court is to decide on the feasibility of the administrator's proposal and ear-mark the portion of the overall purchase price to be used to settle the claim of the dissenting secured creditor.[24] The consent of the secured creditor to bulk sale or sale of debtor as legal entity is required only if the projected portion of the over-all purchase price slated for the satisfaction of that secured creditor is less than 50% of its secured claim.[25]

Fresh financing

Part of the reason for lack of success with UPPRs has been in the inability of debtors to obtain fresh financing.[26] The amendments address this vicious circle by stipulating that the loans granted and security obtained in the course of the UPPR implementation cannot be avoided as preference.[27] Furthermore, if the UPPR debtor collapses into bankruptcy, any liability under the fresh financing granted in the course of the UPPR implementation will be treated as liability of the bankruptcy estate and repaid in priority to the pre-existing claims regulated by the UPPR.[28]

Conclusion

The proposed changes to the Serbian Insolvency Act aimed at improving the position of secured creditors in insolvency proceedings may encourage the secondary market of secured non-performing loans. At the same time, the prospect of credit bidding and other promised improvements in enforcement of collateral could also entrench the banks in their decisions not to dispose of secured non-performing loans but instead pursue enforcement of their collaterals.

In any event, the amendments have the potential to improve the efficiency and credibility of insolvency proceedings. Once insolvency proceedings become a real threat to debtors rather than to their creditors, debtors may become motivated to approach restructuring options more seriously

Notes

19 Article 132 paragraph 9 of the Insolvency Act.
20 Id., Article 38.
21 Article 132 paragraph 10 of the Draft.
22 Id., Article 136g.
23 Id., Article 28 paragraph 3.
24 Id., Article 133 paragraph 5 and Article 135 paragraph 1.
25 Id., Article 136v paragraph 1 point 1).
26 According to the Strategy, 'given that financing in Serbia is mainly asset-based, the existing deficiencies in the protection of secured creditors' rights significantly contribute to the challenges in finding fresh financing for debtors in distressed situations, just like the fact that there are no rules for protection and additional security of those who provide fresh financing.'
27 Article 126, paragraph 1, point 1) of the Draft.
28 Id., Article 104.

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International Corporate Rescue

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