ON MODELS OF OVERCOMING BUSINESS CRISIS: BANKRUPTCY PROCEEDINGS OR CHANGE IN STATUS\(^1\)

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Abstract
Many studies have applied econometric methods in research of business entities’ development within business environment, and tried to predict the occurrence of bankruptcy reasons, that consequently lead to the opening of bankruptcy proceedings. But, the bankruptcy proceeding is just one of the possibilities that a business has if it faces insolvency. Alternative can be different changes in debtor’s status, which are, together with restructuring proceedings, i.e. pre-bankruptcy proceedings, methods to engage the remaining assets in a more productive way, in new entrepreneurial endeavors. There are many factors that cause the difference between the bankruptcy plan and change in debtor’s status, but it can be said that the goal of both is the same: continuation of business activities.

The analysis from Croatian perspective reveals that the bankruptcy plan model, i.e. pre-bankruptcy settlement has not been successful in European environment. When it comes to practical application, the choice between legal implications of either the opening of bankruptcy proceedings or execution of changes in debtor’s status is not a simple one. It is beyond dispute that the Companies Act and the Bankruptcy Act (both with their accompanying regulations) are

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characterized by modern solutions. Still, in a legal sense, system cannot nearly be considered as finished. The ongoing public debate on some aspects of legal regulation of market, and vagueness or inconsistencies that emerged in application of existing regulation of bankruptcy, clearly point to the areas and issues that should be regulated or reformed in a speedy manner.

The goal of this paper is to analyze the detected problems and to offer answers to the dilemmas that can emerge in present or future business crises of firms. It is important to stress that scope of this paper does not allow an exhaustive and detailed analysis, but will provide an insight to some, by authors’ opinion important aspects of the regulation of bankruptcy and changes in debtor’s status.

**Keywords:** change in status, bankruptcy plan, pre-bankruptcy settlement

JEL Classification: H1, H12

1. **INTRODUCTION**

The authors’ approach in this paper consists of the following research components. Taking into consideration the complexity of the problem analyzed in this paper, as well as the fact that it is a current issue in Croatia, authors devote to the in-depth explanation of the concepts of bankruptcy proceeding and change in status. Comprehensive review that covers change in status and bankruptcy proceeding problem area entails both the analysis of the legal framework that regulates them, and the analysis of qualitative and quantitative indicators of their efficiency, including the consequences they have in business and legal domain in Croatia. Next, the literature review is performed. Even though there are numerous contributions, both from economic and legal field, there are limitations in regard to inability of giving conclusive answers, or useful explanations and appropriate approaches that deal with the choice between reorganization of business and some of the models of change in debtor’s status. The problem formulation follows in context of Croatian economic and legal environment. The paper is based on the assumption that the comprehension of such environment specificities could be crucial in understanding the problem matter of the paper, as well as for the choice between bankruptcy proceeding and change in status. Finally, the recommendations for more efficient legal approach to the insolvent businesses are given.
2. DEFINITION OF CONCEPTS (AND ADDITIONAL EXPLANATIONS)

The implementation and the goal of the bankruptcy proceeding are regulated in detail by the Bankruptcy Act\(^2\) (Official Gazette of the Republic of Croatia [OG], 71/2015). Within the concept of bankruptcy proceeding two basic, even typical models of corporate bankruptcy should be distinguished. The first imposes that it is justified to end the crisis of the firm where the whole capital is lost (the value of total assets is lower than the value of total liabilities) by opening the liquidation bankruptcy proceeding. Theory states that in such proceeding all of the assets that a business possesses at the moment of opening of the bankruptcy are to be sold. The same applies to the assets the business might obtain in the course of the proceeding. The business may be also sold as a whole in order to accomplish the most favorable payment of claims to the creditors (above all the unsecured ones). The outcome is always, exclusively the removal of the bankruptcy debtor from the court register (Bankruptcy Act, Article 2, Paragraph 2, OG, 71/2015). Contrary to the liquidation bankruptcy, the other model, reorganization (pre-bankruptcy proceeding or bankruptcy plan) is also one of the possible ways how to conduct the bankruptcy proceeding, and the only alternative to the liquidation bankruptcy (cashing-in the debtor’s assets) (Malbašić; 2005). Namely, in order to improve the efficiency of the legal protection in the field of bankruptcy, the Bankruptcy Act has been changed several times since 1996, but the technique of conducting the bankruptcy resulted with no advancements (Tomas Žiković et al.; 2014, 320). The application of the Bankruptcy Act led, as a rule, to the extinction of the business. That was the reason for the implementation of the Act on Financial Operations and Pre-Bankruptcy Settlement in 2012. Its goal was to enable the restructuring and continuation of the debtor’s business through the pre-bankruptcy settlement (Vuković & Bodul; 2014, 8).

In the proposal of the Act on Financial Operations and Pre-Bankruptcy Settlement, as the main reason for the inception of the pre-bankruptcy proceeding it was stated that the implementation of the Bankruptcy Act so far brought only the extinction of businesses. Further argument stated that in the

legislation of the EU countries there is a tendency towards the model of restructuring and survival of businesses, as modeled by Chapter 11 of the Bankruptcy Code of the United States. When the restructuring of the debtor was enabled by the Act on Financial Operations and Pre-Bankruptcy Settlement, the financial restructuring of the bankruptcy debtor was abandoned within the bankruptcy proceeding. The creditors were left with the only option within the bankruptcy plan: to transfer the whole debtor’s assets over to the legal entity to be founded by the bankruptcy debtor (so called transferable bankruptcy plan) (OG, 133/2012). Despite the stated, the theory has evaluated the possibilities and the procedure of restructuring as regulated by the Act on Financial Operations and Pre-Bankruptcy Settlement as “a significant setback in the development of the Croatian bankruptcy legislation, especially when it comes to the legal institution of bankruptcy plan” (Garašić; 2013, 490). That points to the necessity of another, even bolder revision of the bankruptcy legislation.

According to the new Bankruptcy Act from 2015 the provisions concerning the pre-bankruptcy settlement are moved from the Act on Financial Operations and Pre-Bankruptcy Settlement to the new Bankruptcy Act as a pre-bankruptcy proceeding. The bankruptcy plan and the bankruptcy proceeding have a goal of survival of insolvent business, if certain corrective measures on both sides (owner’s and creditors) are taken. New/old solutions of the insolvency plan, with yet again numerous measures of economic, financial, legal and organizational nature give considerably more possibilities to the debtor to exit the crisis and settle creditor’s claims in an acceptable way. Namely, the Bankruptcy Act states the measures that can be applied individually and collectively, and the list of measures is not exhaustive, meaning that other measures are allowed if they are important for the implementation of the bankruptcy plan, and if they are not in collision with ius cogens regulations. On the other hand, the fact that the bankruptcy legislation is only one element of the legal system that affects the company management should not be overlooked. The legal regulation of bankruptcy proceedings itself is not sufficient to ensure the smooth functioning of economic developments in a country as it is also necessary to apply legal provisions in the field of primary status law that is, the Companies Act. As for the types of companies, the Companies Act has left a theoretical classification on the partnerships (general partnership, limited partnership, economic interest groupings, and, in a broader sense, civil law partnership and secret society) and corporations (joint stock company and limited liability company).
Frequent changes in Companies Act are the result of the attempts to harmonize the Companies Act with the European directives and regulations relating to the organization of companies. Moreover, it is in this context that the Act on the introduction of the European Company - Societas Europea (SE) and the European Economic Interest Grouping (EEIG) were adopted (Barbić; 2015, 3). Perhaps the most significant feature of the Companies Act is a large number of non-mandatory provisions by which the members of the company have the option to manage the company according to their needs.

The legislator devoted special importance to status changes carried out through a merger, division and transformation of the company, all of which are carried out without liquidation. Fusion occurs through merger or acquisitions of two or more companies and their termination and continuation in the new company. The main characteristic is that both forms of fusion, acquisition and merger, can legally be achieved only within corporations with the main difference between acquisition and merger being that the acquisition means that the acquirer already exists and does not interrupt its continuity, and acquired companies cease to exist, while in merger two or more companies establish a new one and founders cease to exist. Division implies the formation of new companies by division of an existing company in a manner which is contrary to the procedures of status changes—merger and acquisition of companies. The division is carried out by separation or split. The separation is carried out through simultaneous transfer of the respective assets of the dividing company, with its termination without performing liquidation, onto two or more new companies set up to perform the separation (separation with foundation) or in two or more companies that already exist (separation with takeover). The split is carried out by transferring one or more parts of the assets of the dividing company, which does not cease to exist, into one or more new companies set up to perform the separation (split with foundation) or to one or more companies that already exist (split with takeover). The transformation of a company changes its legal organizational form in a different one without interrupting the legal continuity of the company.

According to Companies Act provisions transformations (numerus clausus) that can be carried out are: transformation of a joint stock company into a limited liability company, the transformation of a limited liability company into a joint stock company, the transformation of a joint stock company into a general partnership and a limited partnership, the transformation of a limited liability company into a general partnership and limited partnership and transformation...
of a partnership into a corporation. A more detailed analysis of status changes is in many ways limited by the complexity of the subject research and the scope of this work. However, it should be noted that all legal solutions in the Companies Act regarding this domain are fully harmonized with EU directives.

3. BACKGROUND AND LITERATURE REVIEW

In Croatia, there is, perhaps, a hundred scientific articles dealing with the extensive and complex problems of the bankruptcy legislation. Moreover, there are a modest number of monographs regarding bankruptcy (Dika; 1998, Eraković; 1997, Sajter; 2008) as opposed to capital works, scientific articles that exist in the law, such as US and German law. Nevertheless, in recent years, an increasing number of studies are dealing with the economic and legal effects of the liquidation and reorganization bankruptcy proceedings. The largest number of economic, usually, empirical research in the field of bankruptcy deals with the key indicators of bankruptcy proceedings (i.e. the cost of bankruptcy proceedings, duration of bankruptcy proceedings and the level of recovery of creditor’s claims), and carries out a comparative-legal analysis and discusses the relationship between the intensity of bankruptcy use and a series of variables (Sajter; 2007, Sajter; 2008, Sajter; 2010, Schönfelder; 2002, Šverko Grdić et al.; 2009).

When comparing the effectiveness of the bankruptcy system it is common to accept the latest available data of the study “Doing business” by the World Bank, and that is what the authors applied in this paper. The latest issue of the mentioned report exposes the fact that among all the reforms to strengthen legal institutions in 2014/15 in the world, the smallest number of them are recorded in the area of resolving insolvency (WB; 2015, 34). The overall number of insolvency reforms in the period from 2005-2015 is 150 (56 or over one third in EU countries, 2 in Croatia)(WB 2005-2015; authors’ calculations).

The reforms typically work out. Recovery rates for bankruptcy claimants (creditors, workers and government) are significantly higher for the reformers, even controlling for country income levels. Rationale behind this relationship is that reformed bankruptcy regimes allow viable businesses to solve a short-term liquidity crisis, and insolvent businesses are rapidly liquidated (WB; 2006, 67).

In the table that follows starting and ending values of indicators in the time series from 2004 to 2016 for EU countries are presented.
### Table 1: Resolving insolvency indicators (time in years; cost and recovery in %)

<table>
<thead>
<tr>
<th>Country</th>
<th>Time first</th>
<th>Time last</th>
<th>Cost first</th>
<th>Cost last</th>
<th>Recovery first</th>
<th>Recovery last</th>
</tr>
</thead>
<tbody>
<tr>
<td>Austria</td>
<td>1.3</td>
<td>1.1</td>
<td>18</td>
<td>10</td>
<td>72.5</td>
<td>82.7</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.9</td>
<td>0.9</td>
<td>4</td>
<td>3.5</td>
<td>86.2</td>
<td>89.3</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>3.8</td>
<td>3.3</td>
<td>18</td>
<td>9</td>
<td>34.2</td>
<td>34</td>
</tr>
<tr>
<td>Croatia</td>
<td>3.1</td>
<td>3.1</td>
<td>18</td>
<td>14</td>
<td>26.1</td>
<td>30.5</td>
</tr>
<tr>
<td>Cyprus*</td>
<td>1.5</td>
<td>1.5</td>
<td>15</td>
<td>14.5</td>
<td>70.7</td>
<td>71.4</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>9.2</td>
<td>2.1</td>
<td>38</td>
<td>17</td>
<td>16.8</td>
<td>66</td>
</tr>
<tr>
<td>Denmark</td>
<td>4.2</td>
<td>1</td>
<td>8</td>
<td>4</td>
<td>59.8</td>
<td>87.8</td>
</tr>
<tr>
<td>Estonia**</td>
<td>3</td>
<td>3</td>
<td>8</td>
<td>9</td>
<td>40</td>
<td>40</td>
</tr>
<tr>
<td>Finland</td>
<td>0.9</td>
<td>0.9</td>
<td>1</td>
<td>3.5</td>
<td>90.2</td>
<td>90.1</td>
</tr>
<tr>
<td>France</td>
<td>2.4</td>
<td>1.9</td>
<td>18</td>
<td>9</td>
<td>46.6</td>
<td>77.5</td>
</tr>
<tr>
<td>Germany</td>
<td>1.2</td>
<td>1.2</td>
<td>8</td>
<td>8</td>
<td>50.3</td>
<td>83.7</td>
</tr>
<tr>
<td>Greece</td>
<td>2.2</td>
<td>3.5</td>
<td>8</td>
<td>9</td>
<td>45.6</td>
<td>34.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>2</td>
<td>2</td>
<td>38</td>
<td>14.5</td>
<td>30.8</td>
<td>41.7</td>
</tr>
<tr>
<td>Ireland</td>
<td>0.4</td>
<td>0.4</td>
<td>8</td>
<td>9</td>
<td>88.9</td>
<td>87.7</td>
</tr>
<tr>
<td>Italy</td>
<td>1.3</td>
<td>1.8</td>
<td>18</td>
<td>22</td>
<td>43.5</td>
<td>63.1</td>
</tr>
<tr>
<td>Latvia</td>
<td>1.2</td>
<td>1.5</td>
<td>4</td>
<td>10</td>
<td>85</td>
<td>48.1</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1.2</td>
<td>2.3</td>
<td>18</td>
<td>10</td>
<td>52.4</td>
<td>42.8</td>
</tr>
<tr>
<td>Luxembourg***</td>
<td>2</td>
<td>2</td>
<td>15</td>
<td>14.5</td>
<td>41.6</td>
<td>43.8</td>
</tr>
<tr>
<td>Malta****</td>
<td>3</td>
<td>3</td>
<td>10</td>
<td>10</td>
<td>39.2</td>
<td>39.6</td>
</tr>
<tr>
<td>Netherlands</td>
<td>2.6</td>
<td>1.1</td>
<td>1</td>
<td>3.5</td>
<td>86.2</td>
<td>88.9</td>
</tr>
<tr>
<td>Poland</td>
<td>1.5</td>
<td>3</td>
<td>18</td>
<td>15</td>
<td>68.2</td>
<td>58.3</td>
</tr>
<tr>
<td>Portugal</td>
<td>2.6</td>
<td>2</td>
<td>8</td>
<td>9</td>
<td>69.9</td>
<td>73.4</td>
</tr>
<tr>
<td>Romania</td>
<td>3.2</td>
<td>3.3</td>
<td>8</td>
<td>10.5</td>
<td>6.9</td>
<td>32.7</td>
</tr>
<tr>
<td>Slovak Republic</td>
<td>4.8</td>
<td>4</td>
<td>18</td>
<td>18</td>
<td>39.6</td>
<td>54.7</td>
</tr>
<tr>
<td>Slovenia</td>
<td>3.7</td>
<td>0.8</td>
<td>18</td>
<td>4</td>
<td>23.6</td>
<td>88.2</td>
</tr>
<tr>
<td>Spain</td>
<td>1.5</td>
<td>1.5</td>
<td>8</td>
<td>11</td>
<td>83.4</td>
<td>71.2</td>
</tr>
<tr>
<td>Sweden</td>
<td>2</td>
<td>2</td>
<td>8</td>
<td>9</td>
<td>73.2</td>
<td>76.6</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1</td>
<td>1</td>
<td>8</td>
<td>6</td>
<td>85.8</td>
<td>88.6</td>
</tr>
<tr>
<td>World leader (Singapore)</td>
<td>0.8</td>
<td>0.8</td>
<td>3</td>
<td>3</td>
<td>89.7</td>
<td>89.7</td>
</tr>
<tr>
<td>Average EU</td>
<td>2.42</td>
<td>1.97</td>
<td>13.1</td>
<td>10.2</td>
<td>55.6</td>
<td>63.8</td>
</tr>
<tr>
<td>Distance to leader (%)</td>
<td>67</td>
<td>32</td>
<td>77</td>
<td>71</td>
<td>37</td>
<td>29</td>
</tr>
<tr>
<td>Croatia</td>
<td>74</td>
<td>74</td>
<td>83</td>
<td>79</td>
<td>71</td>
<td>66</td>
</tr>
</tbody>
</table>

Last = 2015

First = 2004 (time, cost); 2005 (recovery) for all countries except *, **, ***,**

* first observation 2010
The data presented in previous table gives evidence that EU countries have improved framework of resolving insolvency (time shortened from 2.4 to less than 2 years, cost lowered from 13.1% to 10.2% of debtor’s estate, and recovery rate increased from 55.6% to 63.8% of creditor’s claims, in average). Still, looking at the EU data compared to the world leader (Singapore) significant lag is noticed, especially considering the relatively high cost of resolving insolvency where EU lags 71% behind the benchmark. Croatian data shows that changes are very small and that system is very far from efficiency that is achieved at the world frontier, it lags behind in all indicators by 73% in average. The presented data strongly points to the need of further changes and reforms in the field of insolvency, especially in Croatia. Analysis of the practices in the most reformative countries reveals the most important directions in improving insolvency proceedings (Škalamera-Alilović & Dimitrić; 2015, 777): simplification of the procedure, encouraging the active role of creditors, and introduction of provisions to prevent abuse of the bankruptcy proceedings and to facilitate the restructuring of the company. Some of such changes in provisions in Croatia are elaborated and proposed in the remainder of the paper.

The doctrine warns that due to the methodology that was used such studies have significant limitations because they are based on the perception, and not on hard data (Radulović; 2011), even though the use of soft data is commonly spread in fields where hard data is unavailable.

In order to eliminate the weaknesses of the existing bankruptcy legislation and to make the bankruptcy process more efficient, legal doctrine (Dika; 2012, Garašić; 2007, Garašić; 2013, Vuković & Bodul; 2012) and profession (Eraković; 2007, Hrastinski Jurčec; 2007) analyzed a series of procedural measures that ultimately contributed to the resulting series of changes in bankruptcy legislation. In their works they analyzed procedural actions, their advantages and disadvantages, consequences and preconditions for a (more) successful application. For this work the important texts are those that analyze the possibilities for the bankruptcy plan and pre-bankruptcy procedures. These texts deal with legal requirements of pre-bankruptcy procedures, the procedural actions,
the authorized proponents, conditions that must be meet in a settlement, the
principles of creditors classification in the different groups, the procedure of
notification and voting, the necessary majority to accept the settlement, the ab-
sence or the necessity of court confirmation of the plan, the legal consequences
of the adopted plan, the protection of creditors, following the implementation
of the settlement and its refutation (Bodul & Vuković; 2015, Čuveljak; 2015).

Analyzing the literature in the field of status changes one has an impression
that the creators of the Companies Act wanted the Act to be a basic, system act
and that other related regulations, such as the Bankruptcy Act, needed to be har-
monized according to solutions adopted by the Companies Act (Barbić; 2010,
Ivanjko & Kocbek; 1996, Barbić et al.; 1996, Eraković; 2008, Gorenc, 1996, Slak-
oper; 2009, Zlatović et al.; 2011). Doctrinally, this is quite true, but on a prac-
tical and empirical business level of status changes and in light of normal func-
tioning of the legal system, the situation essentially changes. All modes of status
changes aim to establish a more rational balance between ownership and control
functions, on the one hand, and strengthening of the company’s position on the
market, on the other hand. However, due to a rare application of these measures
it is left to a future practice to demonstrate the effectiveness of their application

4. PROBLEM FORMULATION: BANKRUPTCY
PROCEEDINGS VS. STATUS CHANGES

There is no doubt that freedom of choice, as one of the basic principles of
modern forms of organizing economic entities, prevails both as a principle and
practice unless the administration/management board is limited to just a few pos-
sibilities when establishing an economic entity. Nevertheless, administration or
management board should evaluate a purposeful option between restructuring
through bankruptcy plan or status changes, in order to achieve the effect of better
market positioning, more efficient growth and overcome business problems. On
one hand, we have a multiplicity of options of status changes (see above) which
basically have no direct effect on the status of the company, but they bring inno-
vations in basic characteristics and organizational structure of the new company.
On the other hand, in the framework of measures for the implementation of the
bankruptcy plan a change of the status of the debtor can also be carried out. Nev-
Nevertheless, when adopting the bankruptcy plan a key role is played by the creditors, the court and the accountant in bankruptcy, and so the process of status changes through the bankruptcy plan differs from the normal procedure of status changes, regulated by the Companies Act. So the question arises - whether implementation of status changes through the bankruptcy plan is in the greater interest of the creditor or debtor and what are the legal consequences of status changes for the debtor, administration, staff and members of the company?

5. WHY THE BANKRUPTCY PLAN?

Supporting the thesis that the status change, as a measure within the bankruptcy plan, enables better and faster recovery of the company, and in order to reply to the above stated question, the authors will present modus operandi of obtaining a bankruptcy plan explaining the benefits of the bankruptcy plan in conclusion.

In the introduction, we pointed out that our bankruptcy legislation allows developing a bankruptcy plan which may deviate from the statutory provisions of the liquidation and distribution of the bankruptcy mass. This points out the flexibility through which the legislator wants to motivate all participants in bankruptcy proceedings, as well as potential investors. The intention of the legislator was that the submitter of the bankruptcy plan has the possibility to find an economically rational and more operational solution for a specific debtor under circumstances of a specific case. Each bankruptcy plan consists of the preparatory and implementation base. Preparatory base contains information on what is planned to be done, and implementing base on the manner in which it is planned to be carried out. In practice it is most common to apply measures governed by the Companies Act which naturally required its use (for example, in the case of acquisition or merger). One of the most delicate issues in regard to the bankruptcy plan is sorting the creditors in the groups. The procedure of adopting the bankruptcy plan lasts from the moment of submitting the plan until the bankruptcy judge renders the decision on confirmation of the plan. The decision on confirmation of the plan has constitutive effect and acts toward all creditors (erga omnes) from the moment the decision becomes final, which is the moment when de jure and de facto the whole process of acceptance and confirmation of the plan ends. The company’s management is obliged to respect the confirmed plan and regularly fulfill their obligations towards all participants.
in terms of the plan. Each creditor is authorized, on the basis of enforceable documents, (final decision confirming the bankruptcy plan and a decision establishing his claim) to run independently enforcement proceedings in order to settle his undisputed claim in compulsory manner, provided that the debtor is significantly late in fulfilling his obligations. As a key element it is important to highlight the legal consequences of the initiation of bankruptcy proceedings according to Bankruptcy Act and that is procedural legal consequences relating to all litigations, enforcement proceedings, insurance procedures and non-contentious proceedings in progress. All proceedings are interrupted when the legal consequences of the bankruptcy proceedings enter into force, and that is the moment when the ad on the opening of bankruptcy proceedings is published on the court’s website (e-bulletin board of the court).

6. CONCLUSION

When it comes to the analysis of the bankruptcy plan and the status agreements relevant studies and doctrine indicate that the structure of the results of those procedures has not met the objectives set. Currently available statistics on bankruptcy and status changes usually show only half the truth - they reveal the number and type of procedures, but do not mention the failure of rescuing negotiations, the impact on third parties or individual community or long-term success or failure of bankruptcy plans and agreements. In all of these forms of reorganization it is essential that the preparatory and implementation base of the bankruptcy plan and the status agreement present the most important information on the management and the likelihood of success of the implementation of the agreement or bankruptcy plan, and all that to enable the creditors to make the most purposeful decision in the decision-making process. Considering that such information is affected by both legal decisions and numerous institutional factors (unfavorable social context, problems in the payment system) we believe that the best way could be implementing status changes in the framework of a reorganization plan.

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