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STRENGTHENING THE FRAMEWORK FOR BANKRUPTCY AND PRE-BANKRUPTCY PROCEEDINGS IN CROATIA

PROJECT REPORT

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and

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INTRODUCTION

In 2015, Croatia enacted a new Bankruptcy Act. The Legal Transition Team of the European Bank for Reconstruction and Development ("**EBRD**") was very active in commenting on such legislation and in policy discussions with the Croatian authorities on the reduction of the high level of non-performing loans ("**NPLs**") in the banking sector.

In February 2016, the EBRD and the World Bank presented a report to the Croatian authorities entitled "Impediments to NPL Resolution", which considered a number of elements relevant to NPL resolution including the need for sound bankruptcy and restructuring frameworks. Later that year (November 2016), the EBRD organised a workshop on out-of-court restructuring. One of the main conclusions of the workshop was that further amendments to the bankruptcy law, coupled with a change in culture were needed to promote *in-court* corporate reorganisation and thereby also encourage *out-of-court* corporate restructuring.

In October 2017, the Bankruptcy Act was significantly amended to address certain shortcomings that were detected therein. The trends and tendencies of recent legislative reforms are more thoroughly explained in Schedule 2.

Even though such legislative changes represent a noticeable progress, further improvements to the Croatian bankruptcy and restructuring regimes are necessary to prevent further NPLs and deliver financial stability and long-term economic performance.

To that end, the Ministry of Justice of the Republic of Croatia (the "**Ministry**") and the EBRD's Legal Transition Team have launched a cooperation project to address legal and practical issues of pre-bankruptcy and bankruptcy proceedings in Croatia (the "**Project**"), with the aim to bring together key stakeholders in Croatia in a review of the insolvency legislation and practices.

The EBRD is a leading investor and a policy adviser in the region. It has significant experience in addressing legal and practical implementation issues connected with bankruptcy and restructuring frameworks in the region. It plays a key role in legal reforms by, *inter alia*, developing and implementing technical cooperation projects aimed at assisting local authorities in establishing investor-friendly legal systems.

The Ministry is keen to improve its bankruptcy regime and align it with best practices from neighbouring European countries including Austria and Germany. To that end, the EBRD is

assisted by a team of national and international experts, namely the Croatian law firm Mamić Perić Reberski Rimac LLC ("**MPRR**") and the Austrian law firm Schönherr.

MPRR is one of the leading law firms in Croatia whose team regularly advises both domestic and international clients in a variety of legal transactions, including debt collection, bankruptcy and pre-bankruptcy proceedings, and NPLs portfolio sales.

Schönherr is a leading full service law firm in Central and Eastern Europe. Its bankruptcy and restructuring team has experience in advising both lenders and distressed borrowers on pre-bankruptcy reorganisation and re-financing. In addition, the team frequently acts as legal advisor in cross-border bankruptcy proceedings and in a number of NPLs portfolio sales throughout the region.

The Project encompassed a roundtable event for selected representatives of local stakeholders to discuss impediments of the existing bankruptcy framework in Croatia (see Section 2.2). Also, a set of separate interviews were held with key local market participants and international experts in the bankruptcy sphere (see Section 2.3). The outcome of such roundtable discussions and interviews is comprised in this Report.

This document contains key findings of the joint efforts of the EBRD, the Ministry, and MPRR and Schönherr. These findings are based both on their own professional experience, as well as the feedback of stakeholders who have participated in the Project.

The objective of this Report is to identify shortcomings in the existing bankruptcy legal framework and to provide specific recommendations in which these could be addressed. The final aim is to improve the Croatian bankruptcy regime and to align it with the best practices from neighbouring European countries, as stated above.

The proposed recommendations also aim to improve the practical implementation of legislative solutions while preserving the consistency of the Croatian bankruptcy regime. This should finally result in the change of the current general negative perception of bankruptcy proceedings (as primarily being the procedure for liquidation of assets of the company) by both local market participants as well as international investors, improving the general business environment and practices.

DISCLAIMER

This document has been produced releasing EBRD from any liability relative to the selection of MPRR and Schönherr and the quality of their work. In no respect shall EBRD incur any liability for any loss, cost, damage or liability related to the engaging or monitoring of MPRR and Schönherr or as a consequence of using or relying upon their services.

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DEFINITIONS

In this document, unless the context explicitly requires otherwise, the following terms shall have the following meanings:

administrator	means, unless the context requires otherwise, an administrator (Croatian: *povjerenik*) in pre-bankruptcy proceedings as defined by the Bankruptcy Act.
Amendment	means the Law on Amendments to the Bankruptcy Act (Croatian: *Zakon o izmjenama i dopunama Stečajnog zakona*), published in the Official Gazette of the Republic of Croatia, no. 104/2017.
Bankruptcy Act 1996	means the Bankruptcy Act (Croatian: *Stečajni zakon*), published in the Official Gazette of the Republic of Croatia, nos. 44/1996, 161/1998, 29/1999, 129/2000, 123/2003, 197/2003, 187/2004, 82/2006, 116/2010, 25/2012, 133/2012, 45/2013 and 71/2015.
Bankruptcy Act	means the Bankruptcy Act (Croatian: *Stečajni zakon*), published in the Official Gazette of the Republic of Croatia, nos. 71/2015 and 104/2017.
bankruptcy trustee or **trustee**	means, unless the context requires otherwise, bankruptcy trustee (Croatian: *stečajni upravitelj*) in bankruptcy proceedings as defined by the Bankruptcy Act.
Chapter	means a chapter of this Report.
Companies Act	means the Croatian Companies Act (Croatian: *Zakon o trgovačkim društvima*) published in the Official Gazette of the Republic of Croatia nos. 111/1993, 34/1999, 121/1999, 52/2000, 118/2003, 107/2007, 146/2008, 137/2009, 111/2012, 125/2011, 68/2013 and 110/2015.

Consultants	means jointly MPRR, as local, and Schönherr as international legal advisers specialised in insolvency proceedings in their respective jurisdictions.
Croatian National Bank	means the Croatian National Bank (Croatian: *Hrvatska Narodna Banka*), with the headquarters in Zagreb, Trg hrvatskih velikana 3.
EBRD or **Bank**	means the European Bank for Reconstruction and Development, an international financial institution established under the Agreement Establishing the European Bank for Reconstruction and Development, a multilateral treaty signed in Paris on 29 May 1990, with its headquarters at One Exchange Square, London EC2A 2JN, United Kingdom.
Financial Agency	means the Financial Agency (Croatian: *Financijska agencija*), with registered seat in Zagreb, Ulica grada Vukovara 70.
insolvency	means, depending on the context, pre-bankruptcy proceedings, bankruptcy proceedings or both together.
Ministry	means the Ministry of Justice of the Republic of Croatia.
MPRR	means Mamić Perić Reberski Rimac Odvjetničko društvo d.o.o., with a registered seat in Zagreb, Ivana Lučića 2a.
Pre-Bankruptcy Act	means the Pre-Bankruptcy Act (Croatian: *Zakon o financijskom poslovanju i predstečajnoj nagodbi*), published in the Official Gazette of the Republic of Croatia, nos. 108/2012, 144/2012, 81/2013, 112/2013, 78/2015 and 71/2015.
Project	means the technical cooperation project of EBRD to assist the Ministry with identifying issues within the existing bankruptcy framework with the aim to

	strengthen the legal framework for bankruptcy and pre-bankruptcy proceedings in Croatia.
regulated companies	means those companies which report to and whose operations are regulated by a competent authority and which, *inter alia*, need the approval of such authority to acquire shares in other companies.
Schedule	means a schedule to this Report.
Schönherr	means Schönherr Rechtsanwälte GmbH, Schottenring 19, A-1010 Vienna, Austria, a limited liability company established and existing under the laws of Austrian Republic, registered with the companies' register of the Commercial Court of Vienna under 266337 p.
Section	means a section of this Report, unless expressly stated otherwise.

1. EXECUTIVE SUMMARY

The following recommendations for improvement of pre-bankruptcy and bankruptcy frameworks in Croatia are presented in this Report:

	Recommendation	Section
Pre-bankruptcy Proceedings	Introduce an option for creditors to appoint a creditors' committee which would be analogous to the creditors' committee (Croatian: *odbor vjerovnika*) in the bankruptcy proceedings.	3.2.1(i)
	Introduce the right of minority creditors (i.e., those having at least 10% of all determined claims) to request the scheduling of extraordinary hearings for purposes of exercising their rights as creditors in pre-bankruptcy proceedings.	3.2.1(ii)
	Guarantors should be clearly recognised as contingent creditors (modelled on the basis of the German bankruptcy framework).	3.2.2
	Allow secured creditors to participate in pre-bankruptcy proceedings (as secured creditors) and agree to haircuts and extensions of their secured claims whilst keeping the security instrument (with the same priority ranking) for the remaining claim.	3.2.3
	Mandatory substantial review of the proposed restructuring plan by a certified auditor should be introduced or, alternatively, the right of minority creditors to request a review of the restructuring plan at the expense of the requesting parties.	3.2.4(i)
	Creditors should have more rights in the process of discussing the proposed restructuring plan (e.g., suggest amendments to restructuring plans before the hearing to discuss the plan).	3.2.4(ii)
	Judges should have more authority in the process of reviewing and approving the agreed restructuring plan (i.e., analysing the feasibility of the plan, seek a clarification of any unclear terms and address contradictions).	3.2.4(iii)
	The Croatian National Bank should have more time to review requests for debt-to-equity swaps from credit institutions and debtors should be able to request the approval of debt-to-equity swaps by the Croatian National Bank before pre-bankruptcy proceedings have begun.	3.2.5(i)
	Rules set out in Article 53 of the Bankruptcy Act (currently applicable to credit institutions only), should be extended to other regulated companies that need approval of a competent authority to make a	3.2.5(ii)

	debt-to-equity swap.	

	Recommendation	Section
Bankruptcy Proceedings	Additional measures (such as economic penalties to managers that breach their duties) should be introduced as deterrents to motivate debtors to comply with their obligation to timely file for bankruptcy when required by law.	3.3.1(i)
	Eliminate the obligation of secured creditors filing for bankruptcy to show evidence that they are unlikely to be able to settle their claim from the value of the security instrument(s), in order to ease the commencement of bankruptcy proceedings when the standard is met.	3.3.2(ii)
	Creditors that have, in expedited bankruptcy proceedings (Croatian: *skraćeni stečajni postupak*), requested the opening of regular bankruptcy proceedings and paid the costs of the proceedings, should not be required to demonstrate that they have claims against the debtor and, if they are secured creditors, that the value of their collateral does not cover the total amount of their claim.	3.3.1(iii)
	Secured creditors should be able to propose the method of sale of pledged assets.	3.3.2
	The Bankruptcy Act should clearly state that, at the fourth and each subsequent auction for the sale of real estate, the bidding will start at HRK 1.	3.3.2
	In electronic auctions, during the entire auction, bidders should be able to place new higher bids, even if their bid is the highest registered bid.	3.3.3(i)
	Bidding on electronic auctions should not close outside of business hours and the bidding should continue for as long as there are interested bidders.	3.3.3(ii)
	Costs of unsuccessful challenging of a claim of another creditor should be borne by the creditor who has challenged the claim.	3.3.4
	Application of the rules on the single agreement concept set out in Article 182(4) and the rules on netting set out in Article 182(6) should be extended to apply to energy qualified contracts so to enhance the environment for energy trading in Croatia.	3.3.5

	Recommendation	Section
	Licensing of bankruptcy trustees should be stricter in terms of the necessary qualifications, knowledge and skills. Candidates for bankruptcy trustees should undergo a formal training programme	3.4.1(i)

Bankruptcy Trustees	before they can take the exam for bankruptcy trustees.	
	More information about bankruptcy trustees (i.e., current number of appointments, information about debtor's business in previous proceedings, outcome of previous proceedings) should be available to the judges before appointing bankruptcy trustees.	3.4.1(ii)
	The mechanism for the selection of the initial bankruptcy trustee should give greater flexibility to judges, allowing them to select the best fit candidate in each particular proceeding.	3.4.1(iii)
	The grounds for bankruptcy trustees to request a temporary exclusion from future appointments should be enhanced.	3.4.1(iv)
	The appointment of the initial bankruptcy trustee for large debtors should be excluded from the selection by the computer-based system.	3.4.1(v)
	Introduce a framework to facilitate specialised firms to be appointed as bankruptcy trustees to increase the standards of the profession.	3.4.1(v)
	Training and education of bankruptcy trustees should be more focused on practical issues, include more case study workshops and cover the topics suggested by the bankruptcy trustees themselves.	3.4.2
	The Ministry should distribute to all bankruptcy trustees guidelines and instructions with relevant information, resources and practical advice on current topics relevant for pre-bankruptcy and bankruptcy proceedings.	3.4.2
	Higher fees should be paid to bankruptcy trustees if the bankruptcy plan is approved to incentivise restructuring.	3.4.3
	All correspondence addressed to the debtor after opening of bankruptcy proceedings, needs to be sent to the designated address of the bankruptcy trustee and not to the registered office of the debtor.	3.4.4

	Recommendation	Section
Modern Technologies	Judges should be given direct and full access to all available electronic databases relevant for pre-bankruptcy and bankruptcy proceedings, including all public registers where titles to assets are registered, with all the available search engines (amongst others, the land register, the companies register and the single register of bank accounts).	3.5.2
	All documents filed by a creditor when reporting their claims should be made available to other creditors via the e-notice board, in order to increase transparency and certainty of bankruptcy proceedings.	3.5.3
	Creditors should submit their claims, as well as all supporting documentation, electronically.	3.5.3

2. METHODOLOGY AND FINDINGS

2.1 General remarks

The aim of the Project was to bring together key stakeholders in Croatia in order to review the bankruptcy and pre-bankruptcy framework in order to detect shortcomings and areas for improvement, and provide precise suggestions and recommendations aligned with best practices from neighbouring European countries (in particular, Austria and Germany).

To that end, the Consultants have:

- examined extensive legal literature and practice;
- together with the Ministry, organised the roundtable for selected local stakeholders to discuss the existing legal framework for bankruptcy and pre-bankruptcy proceedings in Croatia (please see Section 2.2.);
- held meetings and interviews with both local and international experts in the field of insolvency law (please see Section 2.3.);
- collaborated closely with EBRD's Legal Transition Team and the Croatian authorities; and
- drafted the Report identifying shortcomings in the existing legal framework and setting out precise and concrete recommendations on how to address such shortcomings.

The Report offers a number of proposed solutions addressing the specific needs and impediments of the Croatian pre-bankruptcy and bankruptcy framework in the following four areas:

- impediments to pre-bankruptcy proceedings;
- shortcomings in bankruptcy proceedings;
- ways of improving the role and position of bankruptcy trustees; and
- use of modern technologies and implementation of technical solutions.

2.2 Roundtable discussion

A roundtable discussion with key stakeholders in Croatia was held on the 6th of October 2017, at the premises of the Ministry. The aim of the roundtable was to gather reputable representatives of all key stakeholders in Croatia to discuss the existing insolvency framework in Croatia and highlight potential areas for improvement.

The event was attended by a large number of leading insolvency practitioners and stakeholders from a diverse range of backgrounds, amongst others, the following:

- judges of Commercial Courts and of the High Commercial Court of the Republic of Croatia;
- prominent bankruptcy trustees and representatives of the Croatian Association of Bankruptcy Trustees;
- partners from leading law firms;
- representatives of different major creditors such as banks and other financial institutions; and
- representatives of various governmental authorities (in particular, the Ministry, the Croatian National Bank and the Financial Agency).

The roundtable discussion was divided into four panels, with each panel focusing on a particular group of topics:

- Pre-bankruptcy proceedings - lessons learned from other EU countries.
- Bankruptcy proceedings - practical issues and challenges.
- The role and regulation of bankruptcy trustees.
- The use of new technologies in bankruptcy proceedings.

A detailed agenda of the roundtable is shown in Schedule 1 to this Report.

2.3 Interviews with key stakeholders

For the purposes of gathering further and more detailed feedback, as well as personal insight through direct dialogue with key stakeholders, MPRR and Schönherr held numerous separate informal interviews with various insolvency practitioners in Croatia from, amongst others, the following backgrounds:

- representatives of the Ministry;
- judges of the High Commercial Court of the Republic of Croatia, as well as judges from the commercial courts of Zagreb and Split;
- bankruptcy trustees from Zagreb, Split, Rijeka and Osijek, as well as representatives of the Bankruptcy Trustee Association; and
- representatives of banks and financial institutions.

During the interviews, the stakeholders were asked to respond to several questions, amongst others, the following:

- address any specific shortcomings that were spotted during the roundtable, elaborate further on those and/or address any other impediments that were not discussed (see Sections 2.4.1 to 2.4.4);
- give their personal insight and opinion on some of the shortcomings identified at the roundtable and any other issues they have faced in their professional experience in the fields of bankruptcy and restructuring; and
- suggest any other areas where the laws could also be improved in order for Croatia to have an efficient and sound pre-bankruptcy and bankruptcy and system.

MPRR and Schönherr have also interviewed a number of international experts from different jurisdictions (i.e. Austria, Germany, Italy and Australia) and different professional backgrounds (judges, faculty professors and academics, financial advisors and managers, representatives of international financial institutions, etc.).

The international experts were questioned about, amongst others, (i) whether they have encountered the same or similar shortcomings in the corresponding jurisdiction; and (ii) in case the same or similar impediments exist (or have existed), how such shortcomings are (or have been) addressed and, if the case may be, resolved. They were further asked to suggest successful practices and solutions from their jurisdictions that they would find generally beneficial if introduced into the Croatian pre-bankruptcy and bankruptcy framework.

2.4 Findings

Following the discussions at the roundtable, as well as the contribution of both local and international experts in the course of the interviews, we have identified the following shortcomings in the Croatian pre-bankruptcy and bankruptcy frameworks. The detected shortcomings are briefly described in this Section 2.4. These shortcomings, as well as the proposed recommendations are described in more detail in Chapter 3.

2.4.1 Pre-bankruptcy proceedings

Both the interviewees and the participants at the roundtable have stressed the importance of an efficient pre-bankruptcy framework for the banking sector and the

general economy. Currently, Croatian bankruptcy proceedings are significantly slower, less efficient and costlier when compared with similar proceedings in neighbouring jurisdictions.

The table below summarises the main topics discussed and the shortcomings identified concerning pre-bankruptcy framework in Croatia.

Topics discussed:	Identified shortcomings:	Section
Lack of clear guidance on how to treat and rank guarantors' claims	Guarantors (often family members or other individuals connected with or related to the debtor) are recognised as creditors and could outvote the actual creditors; in other cases they are not recognised as creditors at all	3.2.2
Option for secured creditors to participate in the pre-bankruptcy proceedings as ordinary "unsecured" creditor in respect to the economically unsecured part of their claim	Secured creditors may opt for: (i) participating in the bankruptcy proceedings as secured creditors for the entire amount of their secured claim; or (ii) waiving the entire security. There is no option for secured creditors to participate in the bankruptcy proceedings in respect to the portion of their secured claim which will likely not be settled from the value of the security instrument	3.2.3
Importance to balance the role of the debtor and that of its creditors in drawing-up the restructuring plan	Creditors may only propose changes to the restructuring plan at a very late stage	3.2.1
Mandatory review of a restructuring plan by an auditor	There is no independent review of the restructuring plan, which is necessary to assess, amongst others, the reasonability and feasibility of such plan	3.2.4
Role of creditors in pre-bankruptcy proceedings	Creditors have too little influence in pre-bankruptcy proceedings	3.2.1

2.4.2 Bankruptcy proceedings

The table below summarises the main topics discussed and the shortcomings identified concerning bankruptcy framework in Croatia:

Topics discussed:	Identified shortcomings:	Section
Impediments regarding the opening of bankruptcy proceedings	Reluctance of insolvent and over-indebted companies, as well as their creditors, to file for bankruptcy	3.3.1
Sale of pledged assets	Electronic auctions are not always the most suitable mechanism for the sale of pledged assets and can result into undue delays and extra costs for the bankruptcy estate	3.3.2
Complaints about the frequency of reforms of the legislative framework	The need for bankruptcy reforms (which are often rather extensive and frequent) should be balanced with the need to have consistent legislative framework for bankruptcy procedures	
General perception and awareness of bankruptcy proceedings by market participants	There is a need to: • incentivise culture and use of effective tools for restructuring • lower the costs and improve the time efficiency of bankruptcy proceedings • enhance the overall perception of bankruptcy proceedings as proceedings to reorganise and restructure viable companies in short-term financial distress	

2.4.3 Bankruptcy trustees

In addition to the issues concerning the pre-bankruptcy and bankruptcy frameworks in Croatia, many stakeholders have also raised specific issues which concern the bankruptcy trustees, in particular the role and regulation of bankruptcy trustees in Croatia.

The objective here was to determine and identify the core problems that need to be addressed in order to strengthen the role, significance and contribution to the bankruptcy framework of such an important institution and raise the standard of the profession of bankruptcy trustees in Croatia.

The table below summarises the main topics discussed and the shortcomings identified concerning bankruptcy trustees in Croatia:

Topics discussed:	Identified shortcomings:	Section
Appointment of the appropriate bankruptcy trustee	The current mechanism to appoint bankruptcy trustees is inefficient and lacks flexibility to match the skills and experience of each professional with the needs and particularities of different bankruptcy proceedings Besides, the rights of judges and creditors to replace or challenge the automatically appointed bankruptcy trustees should be enhanced in order for those rights to be exercised in a clear, objective and impersonal manner	3.4.1
	The rule that allows bankruptcy trustees to seek for a voluntary temporary exclusion from new appointments lacks flexibility for them to use that right effectively	3.4.1
Education and training of bankruptcy trustees	The training and education of bankruptcy trustees are inadequate. Trainings are not uniform and tailor-made for the needs of bankruptcy trustees Most bankruptcy trustees lack practical knowledge and experience to face the challenges that administering large debtors or administering bankruptcy procedures where the debtor will continue its business operations in bankruptcy The education and trainings for bankruptcy trustees in the areas outside of Zagreb are inadequate or inexistent	3.4.2
Orientation and culture of restructuring	The preparation works for a restructuring are not valued in proportion to the increased workload that such cases imply for bankruptcy trustees There is no culture of restructuring among market participants and bankruptcy practitioners	3.4.3

2.4.4 The use of new technologies in bankruptcy proceedings

Most participants noted that a lot of progress has been made in the last years by introducing electronic auctions, the e-notice board (Croatian: *e-oglasna ploča*), e-case file (Croatian: *e-predmet*). However, the following impediments were also identified:

Topics discussed:	Identified shortcomings:	Section
Electronic communication between participants	Currently, electronic communications between the court and various other stakeholders is not feasible The Ministry and the Financial Agency are currently working on introducing an e-platform for paperless communication between all participants (*e-Razmjena*). The new platform should be operative in 2018	3.5.1
Access to databases by commercial courts and bankruptcy trustees	Neither commercial courts, nor bankruptcy trustees have direct access to the existing databases This has a negative effect on the duration and the costs of pre-bankruptcy and bankruptcy proceedings	3.5.2
Additional support that could be provided by the Financial Agency	The Financial Agency is constantly developing various technical solutions that can be beneficial in court proceedings. However, technical support that could be provided by the Financial Agency is not sufficiently exploited by the courts	

3. DETECTED SHORTCOMINGS AND RECOMMENDATIONS

3.1 General remarks

Although the pre-bankruptcy and bankruptcy framework in Croatia has significantly improved in recent years, the prevailing opinion among stakeholders is that the current system is still burdened with unnecessary formalities and that the duration of bankruptcy proceedings can be rather long, which can hinder viable debtors to be effectively restructured preserving the value already created (i.e., jobs, synergies, etc.).

When outlining certain shortcomings, the authors were guided by the aim of finding a balance between different and often opposing interests of the stakeholders that could intervene in pre-bankruptcy and bankruptcy proceedings.

Concrete solutions and recommendations with basis on international best practice (in particular, with Germany and Austria) are outlined in this Chapter 3 of the Report.

3.2 Pre-bankruptcy proceedings

Pre-bankruptcy proceedings have significantly changed since the enactment of the Bankruptcy Act.

While the general sentiment is that recent legislative reforms introduced by the Bankruptcy Act and the Amendment are likely to result into a more efficient and effective pre-bankruptcy proceedings, the following topics are highlighted as crucial areas for further improvement.

3.2.1 Role of creditors in pre-bankruptcy proceedings

(i) Creditors' committee

Creditors often feel that they do not have enough say in the process of restructuring of their debtors within pre-bankruptcy proceedings.

Considering the nature of pre-bankruptcy proceedings, their urgency, and often large number of creditors with conflicting interests, it is difficult to involve creditors more in pre-bankruptcy proceedings, except in formal hearings.

International experts have provided the example of the German "Schutzschirmverfahren". In these proceedings the court may, under certain circumstances, appoint the members of a (preliminary) creditors' committee even before the first creditors' meeting.

The creditors may vote in their creditors' meeting to discontinue the creditors' committee, as well as to appoint or replace members. The creditors' committee has to assist and supervise the bankruptcy trustee or the debtor in possession in conducting the business of the debtor. The members have full access to the books and accounts of the debtor. Certain extraordinary actions, such as the sale of the debtor's business, require prior consent of the creditors' committee.

Similar institute exists also in Croatian bankruptcy proceedings, where creditors' committee (Croatian: *odbor vjerovnika*) may be appointed to represent interests of creditors in the bankruptcy proceedings.

Modelled on these two examples, the Bankruptcy Act could be amended to introduce an option of creditors to appoint a creditors' committee in pre-bankruptcy proceedings. Such creditors' committee would be made up of representatives of different classes of creditors (similarly as envisaged in Article 96 of the Bankruptcy Act for the creditors' committee in bankruptcy proceedings) and could be appointed after the claims of creditors are determined by the bankruptcy trustee. Creditors' committee, as a representative body of creditors, consisting of only few persons (up to 9 persons), would be more flexible and would be able to exercise the rights of creditors in the pre-bankruptcy proceedings with more ease then all creditors acting together.

Such creditors' committee could also meet outside of scheduled formal hearings in the proceedings and could act on behalf of creditors in respect to certain procedural issues (e.g., replacing administrator, questioning whether debtor is operating in line with the legal obligations, etc.) or negotiate the terms of a restructuring plan with the debtor. However, each individual creditor should still keep the right to make its own separate proposals of amendments to the restructuring plan and the right to vote on the final restructuring plan.

Notwithstanding the above, in order not to introduce too many different systems regarding creditors' committee in pre-bankruptcy proceedings, we suggest to

model it to a large extent on the existing provisions for creditors' committees in bankruptcy proceedings, as regulated by the Bankruptcy Act.

Recommendation:
• Amend the Bankruptcy Act so to introduce an option for creditors to appoint a creditors' committee which would be analogous to the creditors' committee (Croatian: *odbor vjerovnika*) in the bankruptcy proceedings.

(ii) Right to request that hearings are summoned

Creditors can, in principle, exercise most of their procedural rights in pre-bankruptcy proceedings only at formal hearings before the court. To be able to exercise their rights effectively (e.g., replace the administrator), creditors should have a right to request that a hearing is scheduled with a short notice.

Therefore, the courts should be required, if so requested by a minority of creditors (e.g., by those having at least 10% of all determined claims), to schedule hearings within a short period of time (e.g., within 8 to 15 days from the day when the request is filed with the court) with the agenda proposed by the creditors, with items on the agenda that are within the competences of creditors to decide on (e.g., replacement of administrator). If the agenda as proposed by the creditors does not concern issues on which the creditors can decide on, the court should reject the request for a hearing.

This way, the creditors will be enabled to more effectively exercise their rights within pre-bankruptcy proceedings.

Recommendation:
• Amend the Bankruptcy Act so to introduce a right of a minority of creditors (i.e., those having at least 10% of all determined claims) to request that the court schedules extraordinary hearing with the agenda proposed by such creditors, which should be held within 8 to 15 days from the day when the request is filed with the court.

3.2.2 *Position of guarantors in pre-bankruptcy proceedings*

The treatment of guarantors is not regulated explicitly in the Bankruptcy Act and the only provisions that may apply are considerably vague. This leads to significant discrepancies between the practices in various courts in Croatia.

It is highly important to have certainty on who will be considered a creditor and will, subsequently, have voting rights that may affect, amongst others, the vote on a restructuring plan.

Creditors have reported that the uncertainty of how guarantors are treated, in particular whether or not they have voting rights in pre-bankruptcy, is the main factor on why creditors distrust pre-bankruptcy proceedings.

The Bankruptcy Act should be amended to clearly regulate the position and rights of guarantors in pre-bankruptcy proceedings.

Under the Austrian law, guarantors (as well as any other joint debtors of the insolvent entity) may file their claims in bankruptcy proceedings but have to declare them as contingent claims.

While some categories of contingent claims may entitle the creditor to vote in the bankruptcy proceedings (e.g. creditors of contingent claims for representations and warranties), guarantors have no right to vote in bankruptcy proceedings as long as the creditor, whose claim the guarantor guarantees, participates in such proceedings. The aim here is that a claim should not be taken into account twice (i.e., the main claim and the recourse claim under the guarantee). If the creditor has not filed its claim in the proceedings or the claim has been partially or fully paid by the guarantor, the latter will have a right to vote in bankruptcy proceedings.

By way of comparison, in German bankruptcy proceedings, guarantors may not participate in bankruptcy proceedings so long as the creditor whose claim the guarantor has guaranteed participates in such proceedings. The accepted restructuring plan does not affect the rights of creditors against co-obligors and guarantors and creditors may seek full amount from the guarantors regardless of the terms of the restructuring plan. Although guarantors will, in principle, not

participate in pre-bankruptcy proceedings for their contingent claims, any recourse claims that they may have against the debtor if they pay to the creditor will be affected by the restructuring plan to the same extent as the claim of the creditor against the debtor (i.e. it will proportionally be affected by any haircut which may be agreed).

In Spain, creditors who have not voted in favour of the restructuring plan will retain their right to claim the full amount of their claim to the guarantors (who cannot decline payment based on the voluntary arrangement reached by the debtor with its creditors). Hence, the creditor will have an option to choose whether it is happy to support the restructuring process or if it prefers to keep its existing rights intact.

Therefore, based on the examples from other countries, guarantors should be, in principle, treated as contingent creditors without the right to vote on the restructuring plan if they have not made any payments under their guaranties. On the other hand, if they have paid under their guarantees, they should have a claim for the amount effectively paid.

However, in situations where guarantors have not paid under the guarantees, it is important to properly regulate how pre-bankruptcy proceedings affect the obligations under guarantees.

Based on the German model, this should be regulated in a way that still allows the creditor to have an option to try to enforce the guarantee in full amount against the guarantors, but without jeopardising the pre-bankruptcy restructuring process.

The above principles should also apply to situations where there is a co-debtor who is jointly and severally liable for the entire claim.

Recommendations:
• Article 35 *et al.* of the Bankruptcy Act should be amended so that: ○ guarantors are clearly recognised as contingent creditors in pre-bankruptcy proceedings; ○ guarantors are allowed to participate in pre-bankruptcy proceedings as parties only if (i) they have paid under the guarantee (and

therefore have a non-contingent recourse claim against the debtor) or (ii) if the creditor, whose claim the guarantor has guaranteed, has failed to report its claim in pre-bankruptcy proceedings and is hence not participating in it;

- the restructuring plan approved does not affect the rights of creditors against guarantors and the creditors may seek the full amount from the guarantors regardless of the accepted restructuring plan.

3.2.3 Position of secured creditors in pre-bankruptcy proceedings

The enactment of the Amendment has somewhat improved the position of secured creditors in terms that they may now participate in pre-bankruptcy proceedings if they waive their security completely or if they are unable to settle their claim from the right of separate settlement.

However, the Bankruptcy Act still does not allow secured creditors to participate in a restructuring and still keep their security instruments. This means that if a secured creditor wishes to support the restructuring and agrees to haircuts and/or delayed repayment (as proposed in the restructuring plan), the secured creditor will lose its security instrument.

This is particularly important as the success of restructuring plans often depends on the debtor continuing its business operations and keeping the possession of its material assets, which are usually pledged as security to secured creditors.

In such situations secured creditors usually opt to keep their security instruments and the claim intact and thus lose the right to enforce their claim against the debtor rather than agree to participate in the restructuring process and lose their security instruments.

Where secured creditors have decided not to participate in the restructuring, they may no longer enforce their claim directly against the debtor and the success of the restructuring is no longer of any importance to them. They are, therefore, not motivated to wait with foreclosure on the assets given to them as security and usually proceed with foreclosure regardless of the ongoing restructuring.

Creditors and banks, in particular, have expressed their views that secured creditors should have an option to participate in pre-bankruptcy proceedings and agree to haircuts and extensions of their secured claims (and thus support the restructuring) and still keep the security instrument (with the same priority ranking).

Recommendation:
• Articles 35, 36 and 153 *et al.* of the Bankruptcy Act should be amended to allow secured creditors to have an option to participate in pre-bankruptcy proceedings (as secured creditors) and agree to haircuts and extensions of their secured claims whilst keeping the security instrument (with the same priority ranking) for the remaining claim.

3.2.4 Review of restructuring plans

Before a restructuring plan proposed by the debtor can be accepted by creditors and approved by the court, creditors and the court will need to have opportunity to properly assess the proposed restructuring plan. In the following subsections we have analysed the assessment of restructuring plans by (i) certified auditors; (ii) creditors; and (iii) judges and have made certain recommendations on how to enhance such a review.

(i) Review of restructuring plan by certified auditors

Until 2015, the restructuring plan had to be submitted together with a positive opinion by a certified auditor. Under the Bankruptcy Act, no such review is required.

Other than the creditors' vote, there is in fact usually no substantive review of the restructuring plan's feasibility by the courts and/or the administrator. This can lead to restructuring plans that are either unfairly disadvantageous for creditors or that are so ambitious that it is highly unlikely that the debtor will ever be able to fulfil the plan.

Pursuant to the current system, a restructuring plan may be rejected by the court in case it is unlikely that its implementation would render the debtor liquid in the period until the end of the current year and in the next two calendar years. However, it is questionable whether the court has enough specific skills and

capacity to review restructuring plans and make an educated and well-reasoned business-based decision.

Both situations could be avoided by providing for a mandatory review of the proposed restructuring plan by a certified auditor, who is independent from the debtor or the creditors. The auditor should act for the benefit of all parties in the proceedings, but should be engaged and paid for by the debtor.

If not made mandatory, such review should be at least optional, at the request of minority of creditors (e.g. those having at least 10% of all determined claims) or at the request of the creditors' committee (if one has been established).

The preferred option would be to make the review mandatory, as the latter option could lead to delays in the proceedings, since the review can be asked for by creditors only after the claims have been examined and determined and it will still take some time for the auditor to properly review the proposed restructuring plan.

In comparison, under the Austrian insolvency law, this issue is addressed by an obligation of the administrator and the court to evaluate restructuring plans. They have to confirm that plans are adequate and, in particular, that plans are better than the expected liquidation proceeds in bankruptcy proceedings.

This test is formal and substantive: the administrator will usually have all assets of the debtor appraised by an expert. On this basis, the administrator will state whether the proposed payment to the creditors under the plan is at least equal to their expected recovery in case of a liquidation of the debtor's assets. The administrator will also have to assess whether the plan can likely be fulfilled.

If the proposed restructuring plan does not need external financing (e.g., loan or equity contribution), but is supposed to be financed by future cash flows from the debtor’s business, the administrator shall assess whether it is likely that future cash flows will be sufficient to fulfil the debtor's payment obligations under the restructuring plan.

The test to be applied in Croatian pre-bankruptcy proceedings should be similar to that in Austria, but adapted to fit the Croatian legal and economic environment.

For example, considering that such substantive review of the restructuring plan requires certain specific skills (e.g. bookkeeping, cash flow analysis, etc.), it is recommended that the review is made by a certified auditor, rather than by the court or the administrator[1].

It should be noted that a mere requirement that there is an opinion of an auditor on certain key issues, as was the case with the former pre-bankruptcy regime until 2015, is not sufficient. Opinions issued by auditors in pre-bankruptcy proceedings that were initiated before the Bankruptcy Act were often very rudimentary and without explaining why the auditor believed that the restructuring plan was feasible. Therefore, we are not proposing here to return to the earlier regime

Creditors have reported that they were often not convinced by the auditor's opinion, as it was not clear why the auditor believed that the restructuring would succeed, when all other indicators suggested that the restructuring plan was not feasible (e.g. the remaining debt is envisaged to be repaid from the cash flows generated by regular business operations, while there is an ongoing foreclosure on all material assets of the debtor, which are supposed to generate such cash flows).

Therefore, the auditor should be required to:

- check all the documents and prepare all reports as was required under Article 47 of the Pre-Bankruptcy Act;
- if it has a positive opinion on the feasibility of the restructuring plan, also explain its opinion, in particular taking into account the current financial situation of the debtor, proposed restructuring measures, the business plan of the debtor and financial projections;
- when assessing feasibility of the restructuring plan, auditors should be required to check whether the rights of secured creditors could jeopardise the feasibility of the proposed restructuring plan[2];
- opine whether the implementation of the restructuring plan will likely enable the debtor to be capable of making payments until the end of the calendar year and two consecutive years[3].

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1 Considering that administrators are appointed from the same lists as bankruptcy trustees, the lack of certain specific skills of bankruptcy trustees, as explained in Section 3.4 below, also applies here.
2 Please also see Section 3.2.3.
3 Please also see Section 3.2.4(iii).

Given that auditors may not have access to all the relevant information to properly assess the financial situation of the debtor or the proposed restructuring plan, the debtor should explicitly be required to furnish the auditor with any information it seeks for the purpose of reviewing the restructuring plan.

If the auditor believes that the information provided or statements made by the debtor are likely incorrect or incomplete (i.e. where it may not reasonably assume that they are true and complete) he should be required to issue a negative opinion on feasibility of the proposed restructuring plan.

The opinion of the auditor should be available to creditors at least some time before creditors have to exercise their rights and make statements as to whether they support the restructuring plan or not. Also, it is important that the opinion of the auditor is available to the creditors before any discussion on the proposed restructuring plan takes place.

Therefore, the review of the restructuring plan by an auditor should be made in an early stage of the pre-bankruptcy proceedings. However, the opinion of the auditor should be made available to the creditors at the latest 15 to 30 days before the hearing for voting on proposed restructuring plan.

It should also be required that the auditor who has given a positive opinion on the proposed restructuring plan is present at the hearing when the restructuring plan is discussed. The creditors should also be able to ask questions to the auditor and ask that it explains its opinions regarding the proposed restructuring plan.

The auditor should also opine on any changes to the restructuring plan which may be made to the restructuring plan after the earlier opinion of the auditor was issued.

If the judge is not satisfied with plausibility of the opinion of the auditor, the court may appoint (at the expense of the debtor) another auditor to review the proposed restructuring plan and provide the opinion.

If creditors (e.g., those who have at least 50% of all determined claims) are not satisfied with the plausibility of the opinion of the auditor, they too should be able to request that the court appoints (at the expense of creditors who have made

such proposal) another auditor who is acceptable to creditors who have made the proposal.

As a result, the Bankruptcy Act should be amended as follows:

Recommendations:
• Introduce a mandatory substantial review of the proposed restructuring plan by a certified auditor that will be appointed by the court in the early stage of the proceedings (preferably, at the same time the decision on opening of pre-bankruptcy proceedings is rendered). • Alternatively, introduce the right of minority creditors to request a review of the restructuring plan by a certified auditor at the expense of the requesting parties. • The certified auditor should comment on the feasibility of the restructuring plan. • The certified auditor should be paid by the debtor (unless appointed at the request of creditors) but should act in the interest of both the debtor and the creditors. • The certified auditor should be present at the hearing where proposed restructuring plan will be discussed. • The debtor should expressly be obliged to furnish the auditor with any information it seeks.

(ii) Right of creditors to comment on the restructuring plan

Although the Bankruptcy Act allows creditors to discuss proposed restructuring plans and propose amendments, creditors feel that this stage of the process is not adequately regulated.

Currently, the Bankruptcy Act states that the hearing to vote on the proposed restructuring plan must take place at the latest 30 days from the decision determining the final list of creditors (exceptionally, the hearing could be rescheduled, but only once and only up to 15 days). At such hearing, creditors have the option to discuss. However, the framework for such discussions is rather limited and does not explicitly allow for extended discussions and negotiations neither between debtor and its creditors nor for discussions between different classes of creditors.

Consequently, creditors can *de facto* either accept or decline restructuring plans (risking a failure of the plan, the bankruptcy of the debtor and a possible greater loss in liquidation).

Where there is a good dialogue between a debtor and its creditors, a prudent debtor will, in most cases, have communicated the terms of the restructuring to the majority of its creditors before initiating pre-bankruptcy proceedings. Additional discussion between such debtor and its creditors during the formal pre-bankruptcy proceedings regarding the terms of the restructuring may be necessary, but likely reduced only to those terms that have not been agreed in advance.

However, in case of debtors who have many creditors with whom they have a poor communication or no communication whatsoever, pre-bankruptcy proceedings should ensure a forum to discuss the terms of the restructuring.

Creditors should be given the right to provide comments and ask questions to the debtor and/or the administrator, as well as ask for changes of the restructuring plan in writing prior to the hearing in which the plan will be discussed.

The above referenced creditors' comments, together with the debtor's feedback thereto, should be provided sufficiently in advance to all other creditors and the court before any decision is made. In order to avoid undue delay in pre-bankruptcy proceedings, creditors should be given a short deadline[4] for providing such comments and make specific suggestions.

In comparison, neither in Austria nor in Germany creditors have the formal right to request changes to the proposed restructuring plan. However, in Germany, unlike in Austria, the plan has to be provided to the creditors' committee for their comments, but the debtor is not required to accept such comments.

Thus, the above described system, based on the German insolvency code, is suggested.

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[4] If the recommendation to have a mandatory review of the proposed restructuring plan by an independent certified auditor will not be accepted, then creditors should have more time (at least 3 to 4 weeks) to review and comment on the proposed restructuring plan, as they may need to seek assistance of consultants or other experts to be able to analyse the restructuring plan and form an opinion on the restructuring plan.

The Bankruptcy Act should also allow that the debtor and a majority of creditors (e.g., those who have more than 50% of all determined claims) can agree to extend the deadline to try to reach an agreement on the restructuring plan (e.g., up to 30 or 60 days).

This is important; in particular, if the success of the restructuring and the support of the creditors are dependent on new financing from strategic investor or new financing that requires additional time to be agreed and aligned with the terms of the restructuring plan.

Recommendations:

• Introduce provisions to the Bankruptcy Act so to:
  ○ enable creditors to provide written comments on the restructuring plan and propose amendments to the plan in written before the hearing for discussion on the restructuring plan;
  ○ enable the debtor to respond in writing to comments made by creditors;
  ○ ensure that the courts are required to distribute proposals and comments to all parties before the hearing (via e-notice boards or otherwise).
• Articles 55 and 60 of the Bankruptcy Act should be amended to allow that the debtor and a majority of creditors (e.g., those who have more than 50% of all determined claims) can agree to extend the deadline to reach an agreement on the restructuring plan more than once and for a longer period then now (e.g., up to 30 or 60 days).

(iii) Review of the restructuring plan by a judge

The review of the restructuring plan by a judge under the current pre-bankruptcy framework is rather limited and is focused on examining whether the restructuring plan has all the elements required by law. Judges do not examine the contents of the proposed measures or their feasibility. It is left up to creditors to decide whether the proposed restructuring plan is acceptable to them or not.

In most cases, there will be no need for a judge to have the authority to enquire into the feasibility of the restructuring plan or into how the debtor proposed to implement the restructuring measures.

However, in situations where required majority of creditors have voted in favour of a restructuring plan which contains unclear or contradictory provisions, the judge has no authority to withhold its approval of the restructuring plan and the pre-bankruptcy agreement solely on the basis of its opinion that they are not clear or contain contradictions.

The judges have therefore noted that it would be beneficial if they had more authority in the process of approving the restructuring plan and pre-bankruptcy agreement (which implements the restructuring plan that was accepted by the creditors).

While Article 61 of the Bankruptcy Act provides the rules in which situations judges can withhold their approval, it would be beneficial to add another general provision which would enable judges to withhold their approval if they are of the opinion that the restructuring plan and the pre-bankruptcy agreement are not feasible, if they are unclear or if they contain contradictions.

Also, currently the Bankruptcy Act provides that the judge can withhold its approval if from the restructuring plan it is not evident that the implementation of the restructuring plan will likely enable the debtor to be capable of making payments until the end of the calendar year and two consecutive years.

For a judge to be able to examine this, it will need to have support of appropriate professionals (e.g. auditors), as judges will likely lack specific skills required to form an opinion on this issue.

If review of a restructuring plan by a certified auditor is made mandatory[5], the judges' opinions on the restructuring will be better grounded and elaborated.

Alternatively, if review of a restructuring plan by a certified auditor is not made mandatory, judges should have an option, if they doubt whether this condition is met, to appoint an independent auditor (at the expense of the debtor) to assist them in forming an opinion on this matter.

[5] Please see Section 3.2.4. (i) above.

Recommendations:
• Amend Article 61 of the Bankruptcy Act to enable judges to withhold their approval if they are of the opinion that the restructuring plan is not feasible, is unclear or contains contradictions. • Introduce a mandatory review of the proposed restructuring plan by a certified auditor or, alternatively, enable judges to engage an independent auditor (at the expense of the debtor) to analyse whether the conditions for approving pre-bankruptcy agreements (in particular, the plan's feasibility) are met.

3.2.5 Approval of the regulator of debt-to-equity swaps

(i) Extension of deadlines

Pursuant to Article 53 of the Bankruptcy Act, credit institutions need to seek the approval of the Croatian National Bank to make debt-to-equity swaps, where such conversions are proposed by the debtor in the restructuring plan. The Croatian National Bank will then have eight (8) days from the receipt of the request to make a decision on whether to grant its approval or not.

At the roundtable, it was noted by representatives of the Croatian National Bank that eight days is a very short deadline for the Croatian National Bank to properly asses the implications of a debt-to-equity swap and the impact on the credit institution - in terms of regulatory requirements applicable to credit institutions.

The Croatian National Bank suggested that a period of two (2) months would be more appropriate, because it would allow its staff enough time to properly asses the request and make investigation into the implications of such debt-to-equity swap.

However, the suggested extension of such deadline to approve debt-to-equity swaps might jeopardise the deadline in which pre-bankruptcy proceedings should be completed (i.e., 300 days). Therefore, it seems reasonable to limit the deadline for the Croatian National Bank to grant its approval to 30 days from the receipt of the request.

Another solution could be to allow debtors who propose debt-to-equity swaps to propose alternative ways of dealing with the relevant claims in case the Croatian

National Bank does not grant its approval for such swap. In those situations, the lack of approval by the Croatian National Bank would not automatically lead to the termination of pre-bankruptcy proceedings, as the restructuring could still be completed without the debt-to-equity swap.

Finally, a debtor who proposes a debt-to-equity swap to a credit institution should have the right to request the consent of the Croatian National Bank prior to filing the request to commence pre-bankruptcy proceedings, in order to reduce the uncertainty attached to the decision of the Croatian National Bank.

Also, to prevent the debtor's business being jeopardised, the Croatian National Bank would have to be under strict confidentiality obligations, explicitly regulated by law. This way, the debtor could prepare the restructuring plan in advance and give the Croatian National Bank more time to reach an informed decision.

Other countries have dealt with this issue in a different way. For example, in Germany no creditor can be forced to participate in a debt-to-equity swap. Thus, if a financial institution were prohibited from taking part in such a restructuring measure, it could simply refuse to participate. Such refusal would not block the entire debt-to-equity swap, so the other creditors could move ahead with converting their debt.

Adapting the Croatian law to the German system would be quite a drastic change, as it would abandon the strict principle of equal treatment of creditors. The stakeholders did not think such a big change necessary but believe that the measures indicated above should adequately address the shortcomings of the current framework in Croatia.

Recommendations:

- Amend Article 53 *et al.* of the Bankruptcy Act to:
  - Extend the deadline given to the Croatian National Bank to review requests from credit institutions up to 30 days.
  - Allow debtors to seek the approval of the Croatian National Bank for debt-to-equity swaps before applying for pre-bankruptcy.
  - Prescribe an obligation of Croatian National Bank to keep confidential any information received in the process of approving the debt-to-equity swap.

(ii) Extension of the application of Article 53 of the Bankruptcy Act

Currently, Article 53 of the Bankruptcy Act applies only to approvals that credit institutions need to seek from the Croatian National Bank. The Bankruptcy Act does not regulate the approvals that other regulated companies (e.g., leasing companies[6]) need to request for the same purpose (i.e., to make a debt-to-equity swap).

Given that the framework envisaged in Article 53 of the Bankruptcy Act could, in principle, be also applied to all regulated companies that need approval of their regulator (competent authority) to acquired shares in other companies, it would be good to extend the scope of Article 53 so that it applies to all regulated companies and not only to credit institutions.

Recommendation:
• Amend Article 53 *et al.* of the Bankruptcy Act to extend its application to other regulated companies that need approval of a competent authority to make a debt-to-equity swap.

3.3 Bankruptcy proceedings

Recent legislative reforms introduced significant improvements, particularly concerning the duration of bankruptcy proceedings in Croatia. Currently, bankruptcy proceedings last for, on average, three years from the commencement of the proceedings and most of proceedings run without significant procedural delays.

However, certain shortcomings and legal uncertainties within bankruptcy proceedings have been detected, amongst others, the following.

3.3.1 Opening of bankruptcy

The impediments identified regarding the opening of bankruptcy proceedings (Croatian: *otvaranje stečajnog postupka*) comprise, on the one hand, inconsistent

[6] Article 25 of the Leasing Act (Croatian: *Zakon o leasingu*; published in the Official Gazette of the Republic of Croatia nos. 141/2013) envisages situations in which leasing company is required to seek the prior consent of the regulator (Croatian Financial Services Supervisory Agency).

rules regarding the objective criteria for the automatic opening of bankruptcy proceedings and, on the other hand, the reluctance of both creditors and debtors to file for bankruptcy.

The general impression of market participants is that the opening of bankruptcy proceedings takes place far too late and too far in the complexity of financial difficulties, operational problems and extensive indebtedness, which considerably hinders, if not impedes any possibility of reaching a voluntary arrangement with creditors, within bankruptcy.

A late opening of bankruptcy also affects the expected recovery by creditors'. This is because the debtor that continues to operate while being in financial difficulties usually neglects the regular maintenance and upkeep of its assets (hence their value is reduced) and is usually unable to service its debts regularly (steadily increasing the total outstanding debt).

(i) Reluctance of debtors to file for bankruptcy

An important aspect for a bankruptcy framework to be efficient is the recognition and awareness of market participants about the benefits of filing for bankruptcy. Other than being required to file for bankruptcy by law, companies should see the benefits of filing for bankruptcy (in particular, the possibility of restructuring by adopting a bankruptcy plan).

However, debtors tend to actively delay the submission seeking to commence bankruptcy proceedings, even when they have been insolvent for years. This is because the opening of bankruptcy implies that a bankruptcy trustee will take over control over the debtor's assets and business.

Besides, management and shareholders perceive bankruptcy, in most cases, as losing the company for good and thus struggling to keep control over the company for long.

The general perception of market participants, in particular of distressed companies, about bankruptcy proceedings needs to improve.

However, this may not be accomplished with legislative changes only. More success stories in restructuring cases within bankruptcy are required.

In addition, it should also be considered whether the existing penalties imposed on debtors' directors are effective enough and whether a stronger threat of criminal and civil liability will serve as a deterrent to ensure that debtors management complies with their duties to timely file for bankruptcy as required by law.

Pursuant to Article 626 of the Companies Act[7], directors may be found guilty if they fail to timely file for bankruptcy. In particular, managing directors may be fined or sentenced to prison for up to 2 years.

Notwithstanding the above, from the publicly available information on, we did not find references to recent decision condemning directors for such a criminal offence[8]. This is particularly interesting, considering the number of cases[9] in which the Financial Agency has filed for bankruptcy as a consequence of the debtor's accounts being blocked for more than 120 days (which implies that the directors of those companies failed to file for bankruptcy in time[10]).

If bankruptcy proceedings are opened for reasons other than the debtor filing for bankruptcy, the court should examine whether the debtor's directors have failed to comply with the requirement to timely file for bankruptcy. In case the court doubts (Croatian: *osnova sumnje*) that the directors may have failed to comply with their duty to timely file for bankruptcy, the Bankruptcy Act should be amended to ensure that a notification is sent to the office of the competent state attorney, who may undertake a criminal investigation against the debtor's directors.

The interviews with Austrian experts revealed that similar concerns are much lower in Austria. The interviewees attributed this to the potential personal civil

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7 Companies Act (Croatian: *Zakon o trgovačkim društvima*) published in the Official Gazette of the Republic of Croatia nos. 111/1993, 34/1999, 121/1999, 52/2000, 118/2003, 107/2007, 146/2008, 137/2009, 111/2012, 125/2011, 68/2013, 110/2015.

8 We have seen references to criminal cases which concern this particular criminal offence (e.g. Kž-47/07 - County Court in Bjelovar; Kž-273/13 - County Court in Velika Gorica), but they are from before 2010. Also, from the available information, it seems that the offenders are prosecuted for this criminal offence usually only if they are also prosecuted for other white-collar crimes.

9 According to Article published in Večernji list on 27th of February 2016 (title: *Fina podnijela 19.725 zahtjeva za skraćeni stečajni postupak*), the Financial Agency has, up until then, filed over 20,000 motions for opening of bankruptcy of debtors whose accounts were blocked for longer than 120 days.

10 For more information on timing in which managing directors should have filed for bankruptcy, please see Section 3.3.1(iii) below.

liability of directors for the damages caused by a delayed opening of bankruptcy proceedings and the fact that such claims are actually pursued in practice.

According to a decision of the Austrian Supreme Court, even former managing directors may be held liable for the damages caused by their failure to timely apply for bankruptcy (OGH 22.10.2007, 1 Ob 134/07y). Further, where shareholders have instructed or otherwise influenced the management not to file for insolvency when due, shareholders may also be held liable for damages caused to creditors.

Austrian law further provides for an automatic personal liability of the debtor's directors up to EUR 4,000 to cover costs of bankruptcy proceedings. It shall be noted that this obligation of managing directors exists regardless of whether they filed for bankruptcy in a timely manner.

Austrian practitioners consider civil liability as a sufficient incentive to comply with the law.

In Germany, directors that fail to timely file for bankruptcy may face criminal charges carrying sentences of up to three years of jail.

While Article 110(3) of the Bankruptcy Act envisages civil liability of the debtor's directors for damages caused to creditors if the directors fail to timely file for bankruptcy, there are not many cases where creditors have tried to enforce such civil liability regime.

In general, stakeholders believe that the existing law providing for criminal and civil liability of directors in Croatia is sufficient; however, the enforcement of such provisions should be improved.

The creditors feel that, due to lengthy proceedings and complexity of the facts that need to be proven and evidenced[11], they will likely spend more money in trying to enforce such liability regime than they will actually recover from these directors. Therefore, creditors are often reluctant to enforce the liability regime of

[11] Creditors will need to demonstrate that they have incurred damage and that such damage is direct consequence of management failing to timely file for bankruptcy.

managing directors, which does not serve as a deterrent that motivates directors to comply with their duties and timely file for bankruptcy.

Legislative changes to the bankruptcy framework will likely not change the stance that creditors have towards enforcing such civil liability regime.

Nevertheless, as an additional deterrent, automatic personal liability of managing directors to cover the costs of bankruptcy proceedings could be implemented on the basis of the Austrian model to motivate managing directors to timely file for bankruptcy and make them cover (at least partially) the costs of bankruptcy proceedings. As opposed to the Austrian regime and to motivate managing directors to comply with the Bankruptcy Act, managing directors should always cover the costs of bankruptcy proceedings, except in those cases where bankruptcy commences at their request.

Therefore, application of Article 113 of the Bankruptcy Act should be extended to all situations where debtor's directors failed to timely file for bankruptcy.

Recommendations:

- The Bankruptcy Act should be amended to include provisions which regulate that:
  - if bankruptcy proceedings commence for reasons other than the debtor filing for bankruptcy, the court should examine whether the debtor's directors have failed to comply with their duty to timely file for bankruptcy;
  - if the court has any doubts (Croatian: *osnova sumnje*) that the debtor's directors may have failed to comply with their obligation to file for bankruptcy on time, the court should notify the office of competent state attorneys.
- Article 113 of the Bankruptcy Act should amended to extend its application to all situations where debtor's directors failed to timely file for bankruptcy, regardless of who has filed for bankruptcy.

(ii) *Impediments when creditors file for bankruptcy*

The process for creditors to file for bankruptcy can be very lengthy, even where debtors have been insolvent for years. Consequently, the question was raised as

to what creditors could do in situations of persistent and deliberate avoidance of bankruptcy by debtors.

The introduction of mandatory filings by the Financial Agency[12] has significantly reduced the need of creditors to file for bankruptcy, as the Financial Agency will automatically do that if the debtor's bank accounts are blocked for more than 120 days.

However, there are still situations in which a creditor may file for bankruptcy and the debtor's bank accounts are not blocked (e.g., the bank accounts of the debtor have been closed, creditors do not have appropriate documents - basis for payments - to block bank accounts of the debtor or have chosen not to block them, etc.).

Furthermore, the mandatory filing by the Financial Agency usually leads to expedited bankruptcy proceedings (Croatian: *skraćeni stečajni postupak*), in which creditors will likely need to seek the opening of regular bankruptcy proceedings[13].

In case a creditor proposes the opening of regular bankruptcy proceedings, it will be required to demonstrate that all the statutory requirements to open bankruptcy proceedings are met (including that it has a claim against the debtor and, if it is a secured creditor, that it will not be able to settle its claim from the security instrument). This means that it will need to follow the same steps as if it were the original applicant and not the Financial Agency.

While everyone agrees that a party seeking the commencement of bankruptcy proceedings should prove that it is likely that it has a claim against the debtor and thus, demonstrate its legal interest to file for bankruptcy; creditors believe that the requirement of secured creditors to prove that they will likely not be able to settle their claim from the security instrument is rather heavy and an unnecessary burden imposed on secured creditors.

When assessing whether secured creditors will not likely be able to settle their claims from the security instrument, bankruptcy courts usually compare the amount of the secured claim versus the value of the asset on which the security

[12] For more information please see Section 3.3.1(iii) below.
[13] For more information please see Section 3.3.1(iii) below.

instrument is created. If the amount of the claim is higher than the value of the asset in question, the test is satisfactorily met.

Croatian courts have taken the stance that relevant facts (such as the amount of the claim[14] and the value of the assets that serve as security) should be determined by certified court experts. This implies that the secured creditor will need to advance the costs of such court expert and that court experts will need some time to do their analysis and release their findings and opinion. All this is both financially- and time-consuming.

Besides, when assessing the likelihood that a secured creditor will be able to settle its claim from the security instrument, the courts do not take into account: (i) the costs of enforcement proceedings (e.g., court fees, legal fees, costs of appraisal and sale) required to sell the asset in enforcement proceedings; (ii) the average time needed to sell the asset (and the fact that default interests will accrue and the value of the asset will deteriorate during enforcement[15]); (iii) the fact that the assets are usually sold in auctions below the appraised value; and (iv) the fact that assets may not be sold at all, if there are no interested buyers.

On the other hand, bankruptcy proceedings are not voluntary. Instead, applicable laws explicitly regulate that filing for bankruptcy is mandatory where the debtor is unable to make payments or is over-indebted[16].

Considering the above, it seems that the current burden of proof imposed on secured creditors is both too heavy of a burden and an unnecessary requirement that makes the commencement of bankruptcy proceedings more complicated.

In Austria, by comparison, secured creditors have to prove their condition as creditors, but not that the collateral granted for such claim is insufficient to discharge the entire claim.

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[14] Value of the claim is only determined by court experts if the debtor has challenged the amount specified by the creditor. However, in most situations where debtor opposes opening of bankruptcy, it will challenge all statements made by the creditor regardless whether they are correct or not.

[15] This moreover since it often takes several years from initiation of enforcement proceedings before the creditors are settled in enforcement proceedings.

[16] This is evident from the fact that Article 110 of the Bankruptcy Act clearly envisages situations where filing for bankruptcy is mandatory.

Therefore, it was suggested by creditors in bankruptcy proceedings in Croatia that the burden of proof imposed on creditors (including secured creditors) should be revised and reduced in a way that applicants will only need to prove their condition as creditor.

Recommendations:
• Article 109(3) of the Bankruptcy Act should be deleted to remove the requirement that secured creditors, if they are filing for bankruptcy, need to prove that they will likely not be able to settle their claim from the security instrument.

(iii) Automatic filing for bankruptcy

Since insolvent and over-indebted debtors in Croatia mostly do not comply with their obligation to file for bankruptcy when required by law[17], objective criteria for automatic filing for bankruptcy by governmental authorities significantly helps in mitigating the negative effects of the late opening of bankruptcies caused by the above referenced reluctance of debtors to file for bankruptcy themselves.

The Bankruptcy Act introduced a mandatory filing for bankruptcy by the Financial Agency if the bank accounts of a debtor have been blocked for more than 120 days[18]. This has proven to be a significant improvement in terms of opening of bankruptcy proceedings against insolvent companies, as now there is a mechanism to automatically push insolvent companies into bankruptcy if their bank accounts have been blocked for more than 120 days. This is particularly useful in situations when there is no interest of either the debtor or creditors to file for bankruptcy (e.g., the debtor has no assets or their value is insignificant and the costs of filing for bankruptcy by the creditor will likely exceed the expected recovery in bankruptcy).

However, when the Financial Agency files for bankruptcy of a debtor whose accounts have been blocked for more than 120 days, the Financial Agency and the court often do not have information about the value of the estate or if debtor does

[17] For more information on reluctance of debtors to file for bankruptcy please see Section 3.3.1(i) above.

[18] The Bankruptcy Act actually reads that the Financial Agency is obliged to file for bankruptcy if a legal entity has "unfulfilled basis of payments in the Priority Records of Basis for Payments" (Croatian: *Očevidnik redoslijeda osnova za plaćanje*), but since this in practice means that the accounts of the debtor have been blocked, for simplicity of reading, we have used the term "account blocking" throughout Section 3.3.

not have any employees (the lack of which constitutes a reason to conduct expedited bankruptcy proceedings instead of regular bankruptcy proceedings).

In expedited bankruptcy proceedings, the court will only examine (on the basis of information provided by the debtor) whether the assets of the debtor are sufficient to cover the costs of the proceedings. If the debtor does not furnish the court with the list of its assets and obligations or if such list suggests that the debtor's assets are insufficient to cover the costs of bankruptcy proceedings and the creditors did not request the opening of regular bankruptcy proceedings, the court will render the decision on simultaneous opening and closing of bankruptcy.

If a creditor, nonetheless, prefers to request the opening of regular bankruptcy proceedings, it will need to file a motion to commence bankruptcy and advance the costs of the proceedings. Such creditor will also assume the position of the party who has filed for bankruptcy.

This means that such creditor will be required to demonstrate that all the preconditions and requirement to open bankruptcy proceedings are met. These requirements in practice lead to lengthy and costly proceedings[19].

Although the court would have opened (and, within the same decision, also closed) bankruptcy proceedings if the creditor did not interfere by stating that it wants regular bankruptcy proceedings to be conducted, the requesting creditor is still required to demonstrate that the preconditions for opening of the bankruptcy are met. Considering that all the legal effects derived from the opening of bankruptcy proceedings would have occurred if the creditor did not interfere, it seems unreasonable that the mere fact that the creditor has chosen to advance the costs for regular bankruptcy proceedings entails additional costs and procedural burdens for requesting creditors (as well as for the relevant court).

If a secured creditor is unable to demonstrate to the court that it is likely that its entire claim will not be settled with the proceeds obtained from the sale of the assets that serve as security, the court will deny the motion to open bankruptcy proceedings.

[19] For more information on filing for bankruptcy by creditors, please see Section 3.3.1(ii) above.

As a result of the above, we suggest amending Article 433 of the Bankruptcy Act to include a provision which stipulates that, if the debtor did not furnish the court with the list of its assets and obligations or if such list suggests that the assets of the debtor are insufficient to cover the costs of bankruptcy proceedings, the creditor who has filed for bankruptcy does not need to demonstrate, if it is secured creditor, that it will not be able to settle its claim from the security instrument. This means that if the creditor's petition to conduct regular bankruptcy proceedings was the only reason why the court did not simultaneously open and close the proceedings, the requesting creditor (and the court) should not be burdened with additional procedural requirements, as well as additional costs.

Recommendations:
• Article 433 of the Bankruptcy Act should be amended to include a provision which stipulates that if the debtor did not furnish the court with the list of its assets and obligations or if such list suggests that the assets of the debtor are insufficient to cover the costs of the bankruptcy proceedings, the creditor who has proposed opening of regular bankruptcy proceedings does not need to demonstrate that it has a claim against the debtor and, if it is secured creditor[20], that it will not be able to settle its claim from the security instrument.

3.3.2 Sale of pledged assets

Until recently, pledged assets were sold at auctions held in courtrooms. New legislation envisages that pledged assets will be sold through electronic auctions hosted by the Financial Agency. Even though it seems to be a relief from some of the workload imposed on the judges in bankruptcy proceedings, in some situations it is shown as counterproductive.

Both creditors and bankruptcy trustees have mixed feelings regarding electronic auctions. Even certain judges agree that sometimes, the electronic sale of assets rather complicates and extends the proceedings instead of making it faster and easier.

[20] If the recommendation to remove the requirement that secured creditors, when filing for bankruptcy of their debtors, need to demonstrate that it is likely that they will not be able to settle their claim from the security instrument is accepted, then the latter part of this recommendation may become superfluous. For more information, please see Section 3.3.1(ii) above.

Stakeholders in general believe that secured creditors should have an option to choose how a pledged asset will be sold (i.e., court auction, electronic auction, by sale on regulated market by an authorised agent, by means of direct agreement between bankruptcy trustee and the buyer, or other reasonable means of sale of such asset). If secured creditors do not decide on the method of sale, the bankruptcy trustee should have an option to propose to the judge the best method to do so.

Furthermore, another impediment regarding the sale of pledged assets concerns the lack of clarity of Article 247(6) of the Bankruptcy Act. This provision envisages that pledged immovable assets may be sold at the fourth electronic auction at a starting price of HRK 1. However, it does not regulate what will happen if it is not sold at the fourth auction.

The practice has shown that courts interpret this provision of law differently. Some argue that subsequent auctions should be repeated until the pledged asset is sold, each time starting the bidding at HRK 1. Others argue that auctions should restart from the first auction again (i.e., with the bidding starting at 3/4 of the appraised value of the asset). Some even argue that Article 247 of the Bankruptcy Act does not allow for any further auctions in bankruptcy after the fourth one.

To resolve this lack of clarity, Article 247(6) of the Bankruptcy Act should be amended to state that, at the fourth and each subsequent auction for the sale of immovable assets, the bidding price will start at HRK 1.

Recommendations:

- Article 247(4) of the Bankruptcy Act should be amended to:
  - allow secured creditors to propose the method of sale of pledged assets (e.g. court auction, electronic auction, sale on regulated market by an authorised agent, direct agreement between bankruptcy trustee and the buyer, or other reasonable means);
  - enable bankruptcy trustee, if secured creditors do not make any proposal, to propose how pledged assets should be sold.
- Article 247(6) of the Bankruptcy Act should be amended to state that, at the fourth and each subsequent auction for the sale of immoveable assets, the bidding price will start at HRK 1.

3.3.3 *Electronic auctions*

Stakeholders feel that there are a number of procedural and practical obstacles that make the current electronic auction system inefficient. The main objections from key stakeholders are the following:

(i) Bidding

Fixed bidding steps (Croatian: *dražbeni korak*), as well as the required participation of, at least, one more bidder to raise the bid, makes very difficult for bidders to increase their bids by more than the determined bidding step.

Besides, a bidder may not increase its bid unless another bidder has made a higher bid. Therefore, currently, it is impossible to raise the bids if there is not, at least, one other bidder participating in the auction.

We suggest amending Article 21(7) of the Rulebook on the Method and Proceedings for Sale of Real Property and Movable Property in Enforcement Proceedings[21] to allow a bidder to keep placing higher bids, regardless of the fact that their current bid is the highest bid made so far in the auction.

We understand that the Financial Agency intends to propose to the Ministry amendments to the Rulebook on the Method and Proceedings for Sale of Real Property and Movable Property in Enforcement Proceedings in respect to the of rules on bidding steps, but no information is publicly available yet as to the proposed amendments.

Recommendation:
• Article 21(7) of the Rulebook on the Method and Proceedings for Sale of Real Property and Movable Property in Enforcement Proceedings should be amended to allow a bidder to keep placing new higher bids, regardless of the fact that their bid is the highest bid made so far at the auction.

[21] Rulebook on the manner and proceedings of sale of real estate and movable property in enforcement proceedings (Croatian: *Pravilnik o načinu i postupku provedbe prodaje nekretnina i pokretnina u ovršnom postupku*), published in the Official Gazette of the Republic of Croatia No 156/2014.

(ii) Auction closing time

The terms of electronic auctions usually state that the auction will end at midnight, which requires bidders to remain in the office late at night to participate in auctions.

Lawyers that usually represent secured creditors and often participate in auctions on behalf of secured creditors have noted that this significantly complicates the participation in auctions, particularly because the technical requirements to participate require the participant to have the necessary electronic certificate, which are only available to them on the computers at their offices.

We suggest amending Article 17 of the Rulebook on the Method and Proceedings for Sale of Real Property and Movable Property in Enforcement Proceedings to require that the closing time for an auction can only be on a business day between 09:00 and 16:00.

Another problem are the bids placed just before the auction is closed, because other bidders will not have the opportunity to place a higher bid. Practice has shown that interested bidders often wait to place bids until just before the closing of the auction, hoping to place the highest bid. This, in combination with the requirement that the bid can be placed in the amount which exceeds the current highest bid only by a fixed amount (bidding step), leads to purchase prices at auctions often not reaching the amounts that could have been reached if the bidding would have continued for so long as there are bidders interested in making higher bids.

Since it is in the best interest of all parties (i.e., both creditors and debtors) that the highest purchase price is achieved at auctions, we suggest amending the rules on bidding at electronic auctions so that the auction closing is extended each time a bid is made during the period of the last ten minutes of the auction, so that auction closing can occur only ten minutes from the time when the last bid was placed. This way, the auction will be open for bidding so long as there are interested bidders to place bids.

Recommendation:
• Article 17 of the Rulebook on the Method and Proceedings for Sale of Real Property and Movable Property in Enforcement Proceedings should be amended to require that the closing time for an auction can only be on a business day between 09:00 and 16:00. • The Rulebook on the Method and Proceedings for Sale of Real Property and Movable Property in Enforcement Proceedings should be amended so that the auction is extended each time a bid is made less than ten minutes before the close of the auction, so that the auction closing occurs only ten minutes from the last bid was placed at the auction.

3.3.4 Costs of unsuccessful challenging of claims

The amount and the classification of creditors' claims can be challenged in bankruptcy proceedings either by the bankruptcy trustee or by other creditors. However, such challenges are not decided on within bankruptcy proceedings. Parties need to initiate separate litigation before a different court to resolve those. The parties to such separate litigation will be the debtor (represented by the challenger, who would be acting on behalf of the debtor) and the creditor whose claim has been challenged.

Bankruptcy trustees have complained about the costs of unsuccessful challenges, when claims of creditors are challenged by other creditors.

If the challenge is brought by another creditor, other creditors may not prevent such challenge (or the ensuing litigation), even if they think that the latter is unreasonable.

If the challenge is not successful, the creditor whose claim was challenged may seek reimbursement of incurred legal expenses.

Since the challenger was acting on behalf of the debtor, the costs of losing such litigation are borne by the debtor's estate and by not the challenger. Given that these costs are incurred after the commencement of bankruptcy proceedings, they are deemed to be post-bankruptcy costs and, as such, they have preference over any other bankruptcy claims.

Bankruptcy trustees have noted that this challenging model has been misused by some creditors, causing a significant damage to other creditors' recovery.

In Austrian insolvency proceedings, while creditors may challenge the claims of other creditors, they also bear the risk of any costs under such proceedings. The estate will only be liable for any costs of such proceedings if the challenge is successful and the costs for such proceedings are not refunded by the defendant. Even in this case the estate will only be liable if and to the extent the estate benefited from the challenge; thus, the estate will never pay more than the amount that the defendant would have received had his claim been acknowledged.

To remedy this, we suggest amending the Bankruptcy Act so that the costs of all unsuccessful challenges of other creditors' claims are borne by the creditor who has brought the challenge.

Recommendation:
• Article 266(2) of the Bankruptcy Act should be amended so that the costs of the unsuccessful challenge of other creditors' claims are borne by the creditor who has challenged the claim.

3.3.5 Wholesale energy trade agreements

The European Federation of Energy Traders (EFET)[22] has brought to our attention that the Bankruptcy Act should also be amended in order to introduce close-out-netting concepts for physically settled energy wholesale transactions.

A netting-friendly statutory environment is of great importance for the proper functioning of the energy commodity trading markets.

Currently, Article 182 (6) and (7) of the Bankruptcy Act explicitly regulates the application of the contractual netting clause in case of qualified financial contracts only.

[22] EFET represents the interest of wholesale energy traders in the CEE/SEE-region and aims with this proposal to improve energy trading conditions in Croatia.

The EFET feels that, due to the similarity between physically settled commodity trading and financial services markets in terms of the impact set upon by the contractual netting clause, the application of Article 182(6) should be extended to apply to energy trading transactions.

Current non-recognition of netting in energy trading transactions limits the trading potential for Croatia-based energy companies. This in turn results in key European market participants in the electricity and gas market limiting their trading with Croatian traders, or making their trading volume conditional upon submission of bank guarantees. Bank guarantees are expensive and put Croatian companies at a disadvantage compared to comparable trading companies seated in neighbouring countries. In comparison, Austria, Slovenia and Italy have netting-friendly insolvency laws.

In order to achieve a netting-friendly regulation in Croatia, the EFET proposes the inclusion of a new article in the Bankruptcy Act modelled on the basis of Article 24b of the Slovenian Bankruptcy Act[23], which explicitly extends the application of rules on contractual netting in case of qualified financial contracts onto "other qualified contracts" as well.

Recommendation:

• The Bankruptcy Act should be supplemented to include new article which will:
  ○ provide the definition of the energy qualified contracts;
  ○ extend the application of the single agreement concept set out in Article 182(4) to the energy qualified contracts; and
  ○ extend the application of the rules on netting set out in Article 182(6) to energy qualified contracts.
• Article 66 of the Bankruptcy Act should be amended to include reference to the new article introduced in line with the above recommendation.

[23] Article 24(b) of the Slovenian Bankruptcy Act says:
(1) Other qualified contract means individual or master agreement on payment of monetary obligation whose object is trading with electricity or other energy product, provided existence of an agreement on netting according to Article 24a Para. 2 is common for that type of trading.
(2) Provision of this Act shall apply to the agreement from the first paragraph in a similar way in which they are applied to qualified financial contracts and agreements on netting.

3.4 Bankruptcy trustees

Bankruptcy trustees are central figures in most insolvency regimes. Likewise, in Croatian bankruptcy proceedings, a partial or total divestment of debtor's management powers is required. Hence, the appointment of a bankruptcy trustee is necessary to administer or liquidate debtor's assets.

In order to ensure competencies needed to perform various tasks associated with managing a financially distressed or insolvent business, it is crucial to ensure a sound legislative basis. These tasks also require specialists with sufficient legal, financial and commercial expertise. This includes judges, lawyers, accountants and bankruptcy trustees, as well as turnaround experts (a profession which still needs to be developed in Croatia).

3.4.1 Appointing the appropriate bankruptcy trustee

Only licensed bankruptcy trustees can be appointed in bankruptcy proceedings. However, each bankruptcy proceeding is different and has specific challenges that the bankruptcy trustee will have to address. Therefore, it is essential that the system of appointment of bankruptcy trustees allows for the best skilled bankruptcy trustee to be selected by commercial courts for a particular bankruptcy case.

(i) Certification process

It is a general opinion of the stakeholders that the criteria to be authorised to act as a bankruptcy trustee and be listed on the list of bankruptcy trustees should be more robust. Candidates for bankruptcy trustees should demonstrate greater knowledge and experience before being certified as bankruptcy trustees.

The current certification process[24] focuses on examining whether the candidate meets minimum formal requirements[25] and whether he has basic knowledge of

[24] The certification process for becoming the bankruptcy trustee is currently regulated in the Rulebook on Professional Exam, Training and Education of Bankruptcy Trustees (Croatian: *Pravilnik o polaganju stručnog ispita, obuci i usavršavanju stečajnih upravitelja*) published in the Official Gazette of the Republic of Croatia no. 104/15.

[25] The formal requirements are: (i) it has legal capacity (Croatian: *poslovna sposobnost*); (ii) it possesses a university degree equivalent of 300 ECTS); (iii) it has passed the exam for bankruptcy trustee; and (iv) is worthy of acting as bankruptcy trustee.

the legislation regulating bankruptcy, civil law and bookkeeping. Candidates are not examined on their practical knowledge and skills.

Countries such as Germany and Austria do not have formalised qualification criteria for bankruptcy trustees, but have only general requirements such as that only "knowledgeable" individuals should be added to the list of bankruptcy trustees and appointed as bankruptcy trustees. Austrian law, however, prescribes that larger or more complicated cases should only be given to experienced trustees. In Austria individuals that are not listed may be appointed if, in the opinion of the relevant judge, they are best suited to handle a particular insolvency case.

While there is no strict requirement on this, most bankruptcy trustees in Austria and Germany tend to be lawyers, tax advisors or auditors. Further, most trustees have acquired their skills by working with a more experienced trustee in the course of their professional education and early years of their career before becoming trustees themselves. Courts usually test new trustees by giving them smaller cases. This system works only because in Germany and Austria judges may freely assign cases to individual trustees and is therefore currently not transferrable to the Croatian framework because the Croatian legislator has decided to abandon the system in which the judges are free to appoint bankruptcy trustees at their discretion in favour of a computer-based system for the selection of bankruptcy trustees (see Section 3.4.1(iii) below).

The process of certification of bankruptcy trustees in Croatia could be enhanced so that bankruptcy trustees receive formal training before becoming certified bankruptcy trustees. Such formal training should be organised by the Ministry and should cover all the basics of the pre-bankruptcy and bankruptcy framework. Particular focus should be on the practical skills required to act as bankruptcy trustee, rather than focusing only on theoretical knowledge of laws.

Also, the exam for becoming a bankruptcy trustee should be more demanding in that candidates should have to demonstrate more practical knowledge required to act as bankruptcy trustees. The examination should therefore also include case study questions.

Recommendations:
• The Bankruptcy Act and the Rulebook on Professional Exam, Training and Education of Bankruptcy Trustees should be amended in order to: ○ introduce formal training for candidates for bankruptcy trustees before they can take the exam for bankruptcy trustees; and ○ require that candidates for bankruptcy trustees need to demonstrate practical knowledge and skills at the exam for bankruptcy trustees.

(ii) Categories of bankruptcy trustees

In the current Croatian bankruptcy system, bankruptcy trustees are classified into two lists based only on their years of experience as bankruptcy trustees. Bankruptcy trustees who have one (1) year of professional experience after passing the professional exam are listed on List A. Bankruptcy trustees with less than one (1) year of professional experience are listed on List B.

Currently, bankruptcy trustees can come from a wide variety of professions (i.e. any person with a university degree in any field). In most cases, their formal education has not prepared them for the challenges that they will encounter in bankruptcy proceedings. After they have been certified as bankruptcy trustees, most bankruptcy trustees need additional training and experience before they can successfully tackle more complicated bankruptcy cases.

Stakeholders believe that there are significant discrepancies in skills between different bankruptcy trustees who are listed on the same list.

The lists of bankruptcy trustees should contain additional information on bankruptcy trustees listed thereon. For example, they could contain certain indicators of a particular experience of bankruptcy trustees or certain skills that they have which could be relevant in particular bankruptcy proceedings. This information should be available to the judges in the process of appointing bankruptcy trustees.

The type of information could include the following with respect to the cases that the bankruptcy trustee has led:

- the number of bankruptcy cases per each industry (e.g., tourism, transportation, metal industry, agriculture, etc.);

- the number of bankruptcies of companies with a turnover exceeding a set amount;
- the number of bankruptcies of companies with a total book value of assets exceeding a set amount;
- the number of bankruptcies of companies with a number of employees exceeding certain number; and
- the average duration of proceedings of his cases;
- additional skills of the bankruptcy trustee that could be demonstrated with a degree or a different documented proof (e.g., certified auditor, attorney at law, knowledge of foreign languages, court expert, etc.); and
- whether he is a full-time or a part-time bankruptcy trustee (i.e. is he pursuing another career in parallel with bankruptcy administration).

Ideally, these would be in a form which would allow the computer-based system[26] to use such indicators in selecting bankruptcy trustees in each case.

Another suggested improvement is to introduce an option to establish specialised firms for bankruptcy administration that would have to meet stricter criteria than individual bankruptcy trustees and which would be listed on a separate list. These specialised firms would then be appointed in large and complex bankruptcies[27].

Recommendations:
• Articles 77 to 81 of the Bankruptcy Act, as well as other implementing regulations should be amended to: ○ include in the lists of bankruptcy trustees additional information on the particular experience or skills of the bankruptcy trustees that can serve as additional criteria in the process of appointing bankruptcy trustees; and ○ ensure that such additional information is in the form compatible with the computer-based system used for the selection of bankruptcy trustees.

[26] Please see Section 3.4.1. item (iii) for more details.
[27] Such specialised firms for bankruptcy administration are further discussed in Section 3.4.1. (v) below.

(iii) Mechanism for appointing bankruptcy trustees in particular cases

Currently, a judge appoints as the initial bankruptcy trustee a bankruptcy trustee randomly selected by a computer–based system. Such computer- based system selects the bankruptcy trustee from the list of bankruptcy trustees certified with that commercial court considering only their workload (the number of active bankruptcy proceedings in which such trustee is appointed). The computer-based system does not take into account personal skills of the bankruptcy trustee, complexity of its active cases (i.e. the actual workload), or specific needs of the bankruptcy proceedings at hand.

Judges have the authority to reject the appointment of the bankruptcy trustee selected by the automatic selection system. However, this requires an explanation and justification of why they believe that this particular person is not fit to be appointed in that particular case. Therefore, judges are often reluctant to exercise such authority. This is particularly so, since such a decision would likely be perceived by the bankruptcy trustee whose appointment was rejected as offensive, given that it will likely be based on the reasoning that such bankruptcy trustee lacks the necessary skills or experience.

Creditors can also change the bankruptcy trustee at any time during the proceedings. However, such decisions are rare as they require the majority (in claim value) of votes of creditors.

Practice has shown that neither judges nor creditors exercise these rights very often. This reluctance is in most cases caused by the fear of being accused of having a personal motivation or negative relations with the replaced bankruptcy trustee.

The stakeholders therefore believe that the mechanism for selecting bankruptcy trustee should either allow greater flexibility to enable judges to have more options in selecting the bankruptcy trustee who they believe is best fit to be appointed in that particular proceedings or at least take into account more factors when automatically selecting the bankruptcy trustee.

One of the recommended solutions is that the computer-based selection system, in addition to the number of active bankruptcy cases, also takes into account

additional criteria for appointment (e.g. previous experience with bankruptcies in similar industries or similar size of companies or same geographic region, etc.)[28]

Another solution[29] is that the computer-based system shortlists three to five bankruptcy trustees from which the judge can select the one he believes is best fit for the job, without the need to explain its decision.

The need to explain the choice of the bankruptcy trustee from the shortlist generated by the computer-based system would not only cause additional workload for the judges, but would also place them in a difficult situation where they have to explain why they believe that one bankruptcy trustee is better than another. This could likely lead to bankruptcy trustees holding grudges against the judges. It is a general sentiment that the negative effects of possible poor personal relations between judges and bankruptcy trustees will likely outweigh any expected benefit of having available the reasoning behind the selection of a bankruptcy trustee from the shortlist created by a computer.

Also, it was noted that both judges and creditors often do not have an up-to-date comparable profile of the bankruptcy trustees available online to be able to assess their skills and competences when considering their appointment as bankruptcy trustees. It would be beneficial if a platform with uniform information on all bankruptcy trustees was created and kept up-to-date by the Ministry, which should contain detailed information on various skills and experience of the bankruptcy trustees.

In order to find the best approach, best practice from other countries should also be taken into consideration. As noted above in Section 3.4.1(i), in Austria and Germany the judge may decide freely who to appoint as trustee, usually by choosing from the list of registered bankruptcy trustees. Judges will take into account experience, expertise in any specific industry (if needed), organisational set-up and workload when choosing a trustee. Also the relevant trustee has to be independent in the particular case at hand. In Austria, it is common that the debtor unofficially discusses with the judge in advance what the expected

[28] However, this will be possible only if recommendation to have additional information on the bankruptcy trustees in courts' database is accepted. For more information on what such additional information should be, please see Section 3.4.1(ii) above.

[29] This solution can be implemented in parallel with the previous proposal that the computer based system takes into calculation also additional criteria when randomly selecting bankruptcy administrator.

challenges of the individual case will most likely be (e.g. large number of employees, specificities of the relevant industry, cross-border matters, etc.) and sometimes even suggests specific trustees for the case. The judges are not obliged to discuss such matters with the debtor or follow any suggestion.

While this system works in Germany and Austria, there are doubts that a system giving judges open hands would also be the best option in Croatia, particularly considering that before the enactment of the Bankruptcy Act judges did have more influence over whom to appoint as a bankruptcy trustee. This system was intentionally changed, as it was not perceived as fair and impartial trustee Thus, despite best practice from other jurisdictions, it is questionable to what extent can this be implemented in Croatia. Rather, more focus should be placed on modern technology to improve the automatic selection of bankruptcy trustees by taking into account more factors relating to the case and the relevant bankruptcy trustees when automatically choosing the bankruptcy trustee.

Another issue with the automatic selection of bankruptcy trustees is the geographic location where the bankrupt company is located.

The lists of bankruptcy trustees are currently formed for each commercial court. Since several commercial courts have been merged together, the jurisdiction of some courts covers a rather large area. This means that a bankruptcy trustee in one city may be appointed as the bankruptcy trustee of a company having the corporate domicile in a different city, possibly even several hundred kilometres apart. This has proven rather inefficient, in particular if a smaller company is involved.

Bankruptcy trustees believe that they should have an option to request that the system prevents them from being automatically appointed in certain geographical area under the jurisdiction of certain court if that area is not in the region of their residence. However, such exclusion should be available only for the whole area covered by a permanent office of a commercial court and not on a randomly selected area, so that bankruptcy trustees can only request not to be appointed on the whole territory under the jurisdiction of a permanent office of a commercial court.

We are not aware of similar problems in other jurisdictions. Where judges may freely choose a bankruptcy trustee, they will usually choose a local bankruptcy

trustee (if such person is also adequately qualified for the specific case). Also, bankruptcy trustee may refuse cases if he believes he would not be able to handle them. In general, this seems to be an issue that is largely due to the specific geography of Croatia, in particular the long coast and numerous islands.

Recommendations:
• Amend Articles 84 and 85 of the Bankruptcy Act, as well as other implementing regulations in order to: ○ enhance the computer-based selection system to be able to take into account previous experience and skills of bankruptcy trustees when making the selection; ○ introduce a mechanism where the computer system would make a random choice and provide the judge with a shortlist of three to five pre-selected candidates among which the judge can appoint the bankruptcy trustee based at its own discretion; ○ introduce an option for bankruptcy trustees to opt out of being appointed as bankruptcy trustees of companies with the seat in the territory under the jurisdiction of certain permanent offices (Croatian: *stalna služba*) of a commercial court. • Make publicly available or, at least to judges, updated profiles on bankruptcy trustees so that the judges can properly assess their previous experience and professional profile when making the appointment of the initial bankruptcy trustee.

(iv) Temporary exclusion from appointment at the request of bankruptcy trustee

The Amendment introduced the option for bankruptcy trustees to request a temporary exclusion from new appointments. However, the law allows bankruptcy trustees to exercise such option only if they request to be temporarily excluded from further appointments for a period which can expire only two years after the end of the calendar year in which the request was filed. Bankruptcy trustees feel that this is too long of a period.

Bankruptcy trustees have reported that the lack of flexibility is demotivating them from exercising this right. Due to the lack of flexibility of this provision, they will likely opt not to exercise this right even if their workload is excessive or if they have personal issues which obstruct them in duly fulfilling their obligations. This may, in turn, result in lower quality and efficiency of their work.

If bankruptcy trustees have an option to request a temporary exclusion from further appointments for a shorter period, they will more likely decide to use such right in situations where they feel that their current workload or personal condition is preventing them from properly taking on new cases. This is particularly relevant as the initial stage of bankruptcy is usually the most work-intensive for bankruptcy trustees. In the early stages of the proceedings, the bankruptcy trustee needs to familiarise himself with the company, take control of the company and examine all reported claims. All of this it needs to do in a short period of time.

Instead of a fixed period, the Bankruptcy Act could prescribe a certain minimum and maximum period for temporary exclusion. Bankruptcy trustees should be able to determine the duration of the exclusion from new appointments within the prescribed range. It was suggested by bankruptcy trustees that the appropriate range for the duration of such temporary exclusion should be between six months and two years. Therefore, bankruptcy trustees would have the opportunity to adjust their request with demands of their active cases, personal circumstances or other reasons for requesting temporary exclusion.

Recommendation:
• Article 84 of the Bankruptcy Act, as well as other implementing regulations, should be amended in order to set a minimum and maximum period of temporary exclusion (e.g. from six months to two years), which is to be determined at the discretion of the bankruptcy trustee.

(v) Appropriate management of bankruptcy of large debtors

The choice of a competent and experienced bankruptcy trustee is especially important if a debtor is a large company with a complex structure - for example, a debtor that has a substantial book value of assets, turnover, number of employees, is a part of a group of companies, etc.

Therefore, the appointment of a bankruptcy trustee in bankruptcy proceedings of large companies should be separately regulated.

For a company to be qualified as a large company in terms of bankruptcy legislation, it should suffice that it qualifies as a large entrepreneur (Croatian:

veliki poduzetnik) in terms of the relevant rules on bookkeeping and accountancy.[30]

In such cases, the mechanism for the appointment of bankruptcy trustees must:

- be made on sound and objective criteria, and also
- address specific circumstances of the relevant debtor in a professional and efficient manner. More particularly, it should take into account the turnover, the book value of assets, the number of employees and the industry of the debtor.[31]

Automatic computer-based appointment of bankruptcy trustees is considered by judges and other stakeholders, to be inadequate for such large companies.

Judges should be able to select an appropriate bankruptcy trustee, considering his/her experience and individual skills. For judges to be able to do so, they have to have appropriate information on skills and experience of bankruptcy trustees and freedom to select the bankruptcy trustee whom they believe is best fit for the job[32].

Another possible solution could be to establish companies specialised in bankruptcy administration, which may contribute to raise standards of the profession.

In order to be licensed as a firm for bankruptcy administration, such firm should comply with certain requirements, such as:

- employ at least two bankruptcy trustees listed on the A list, who have experience and expertise, including (if possible) experience in specific industry relevant for the debtor (e.g. construction, energy, naval sciences, management of factories, etc.);

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30 Accountancy Act (Croatian: *Zakon o računovodstvu*); published in the Official Gazette of the Republic of Croatia nos. 78/2015, 134/2015, 120/2016) prescribes that it shall be deemed that a company is a large entrepreneur if it exceeds at the end of financial year thresholds in at least two of following three categories: (i) its total assets have a book value of more than HRK 150,000,000, (ii) its income exceeds HRK 300,000,000, and (iii) average number of employees during the financial year exceeds 250 employees; or if the company is one of the explicitly listed regulated companies (e.g. banks, insurance companies, funds, etc.).

31 In parallel, experience of bankruptcy trustees should be available in a form that will enable the computer-based system to take it into account when selecting bankruptcy trustees. For more information please see Section 3.4.1(ii).

32 For more information on the mechanism for appointing bankruptcy trustees, please see Section 3.4.1(iii).

- have employed or contracted the supporting staff and consultants (e.g. accountants, economists, lawyers, real estate experts, etc.) with appropriate education, expertise and competences, demonstrated by the relevant university degree and years of professional experience; and
- be insured against professional liability.

Reserving the appointment of bankruptcy trustees strictly to such specialised firms in bankruptcy proceedings against large and complex companies should significantly enhance the efficiency of bankruptcy proceedings.

Recommendations:
• Articles 77 to 95 of the Bankruptcy Act, as well as other implementing regulations should be amended to: ○ set objective threshold to be classified as a large company by referring to the definition a large entrepreneur (Croatian: *veliki poduzetnik*) in terms of the relevant rules on bookkeeping and accountancy; ○ exclude such large companies from automatic computer-based appointment of bankruptcy trustees; ○ set a higher threshold of expertise and experience for the bankruptcy trustee to be appointed to manage bankruptcy proceedings of debtors that qualify as large companies or offer a legal framework for establishing specialised firms for bankruptcy administration which would be appointed to manage large bankruptcy cases.

3.4.2 Education of bankruptcy trustees

The lack of proper education and practical knowledge of bankruptcy trustees and inaccessibility of education to them in the areas outside of Zagreb have been identified as a significant disadvantage of the Croatian bankruptcy trustee regime.

While bankruptcy trustees often have a background in accountancy, business or law, it is not necessary that they are qualified in any such profession and can come from many different backgrounds. This means that their formal education is unlikely to have prepared them for all the challenges they may encounter in bankruptcy administration.

Also, the bankruptcy framework is constantly developing and bankruptcy trustees need to continuously update their knowledge. Therefore, continuing and meaningful education of bankruptcy trustees is paramount for efficient bankruptcy administration.

Up until two years ago, there was no structured educational framework intended for the education of bankruptcy trustees. Since 2015, the Ministry has taken over the responsibility for the education of bankruptcy trustees. The Ministry has made it mandatory for each licensed bankruptcy trustee to participate in at least three workshops organised by the Ministry every two years. The training is provided by the Ministry every month in the form of courses and workshops on certain topics selected by the Ministry. Trainers are usually judges and bankruptcy trustees.

All stakeholders have recognised the introduction of mandatory education for licensed bankruptcy trustees as a step forward and very beneficial. However, there is still room for improvement.

Bankruptcy trustees often attend only trainings that are mandatory to maintain their license. Bankruptcy trustees believe that such trainings do not adequately prepare them for all the tasks they are facing in bankruptcy proceedings and that their continuing education is something that still has room for improvement.

Bankruptcy trustees have also noted that educational needs of bankruptcy trustees listed on different lists (which are based on their experience) are not the same. The education should be tailor-made to target the needs, the experience and knowledge levels of each group of bankruptcy trustees. Specifically, the bankruptcy trustees listed on B list will require more general and theoretical training, as well as basic case study training to help them overcome the lack of practical experience in bankruptcies. On the other hand, more experienced bankruptcy trustees listed on the A list will need more case study training with a greater focus on more specialised and specific skills (e.g. forensic skills required to challenge illegal actions of the debtor prior to opening of the bankruptcy, organisation of restructuring, etc.).

This is crucial when it comes to administering complex bankruptcies, in particular when creditors have decided that a debtor should continue with its business operations. The system, as it stands, does not incentivise those bankruptcy

trustees that may seek reorganisation because the obligations assumed by the bankruptcy trustee are too burdensome.

When appointed, bankruptcy trustees immediately assume the role of all bodies of the company, including the management. In most cases, this is not an issue as the companies in bankruptcy usually terminate their business activities. There is, therefore, only limited need for bankruptcy trustees to get involved in the operational management of the company.

However, when creditors have decided for debtor to continue with business operations (e.g., if a restructuring will be attempted in bankruptcy), bankruptcy trustees need to ensure that the company adequately continues its operations. This means that the bankruptcy trustee will need to take over managing the business operations of the debtor as if it was its management board. This could pose a problem if the appointed bankruptcy trustee is not experienced in managing companies from that particular field of business or in managing of companies at all.

To assist bankruptcy trustees (in particular those who lack background and experience in managing of companies) in overcoming challenges related to managing of business operations of the debtor, the training should not only focus on the issues and skills typically required for bankruptcies, but should also include workshops aimed at enhancing other skills of bankruptcy trustees (e.g. management skills, negotiating, human resources skills, basics of labour law, basics of contract law, etc.).

Also, the courses and workshops organised as part of the training are often limited to going through the legislation to (re)acquaint the bankruptcy trustees with the applicable rules. Bankruptcy trustees feel that the training should, instead, focus more on new information and knowledge of various skills which were not covered by their formal education. This can be done through providing workshops which are more case study based and by making available written guidelines on various issues they may face (e.g. accounting, examination and challenging of claims, organisation of business operations of the debtor, etc.).

The training should be tailor-made to suit the needs of the bankruptcy trustees. Since their needs may change from time to time, organisation of the training should be responsive and adaptive to the changing needs of the bankruptcy

trustees. While the Ministry is constantly re-evaluating the courses and workshops it has previously organised and is asking bankruptcy trustees for their feedback, bankruptcy trustees feel that their associations could participate more in selecting the topics for the training to make the training more useful to them.

Currently, associations and organisations of bankruptcy trustees are informal and are organised by bankruptcy trustees themselves. Bankruptcy trustees believe that, if they were better organised into associations (with better funding and more members), such associations could be a useful platform to organise experience and knowledge exchange between bankruptcy trustees and aid bankruptcy trustees in everyday challenges that they face.

Furthermore, a lot has to be done in order to ensure that such training is also available to bankruptcy trustees outside the Zagreb area. Bankruptcy trustees feel that education should be provided on the level of each commercial court or at least at the four largest commercial courts (Zagreb, Split, Rijeka and Osijek) and not only in Zagreb.

It would also be beneficial to enhance the training of trainers to help trainers prepare better and more meaningful training for the bankruptcy trustees.

Drafting of a detailed handbook for the bankruptcy trustees with instructions and tips on what they can do in various stages of bankruptcy would also be helpful with resolving day-to-day questions which bankruptcy trustees face.

However, to be able to improve the continuous education of the bankruptcy trustees, it was also noted that more funds should be attracted[33] and made available to the Ministry.

[33] The EBRD has already raised funds from the European Commission to develop a Training Methodology in Croatia and provide the training to bankruptcy trustees and training for trainers. Within the scope of the upcoming project "Support to strengthen the framework for insolvency and restructuring practitioners in Croatia", training methodology and training materials will be developed to enhance the training of bankruptcy trustees and trainers of bankruptcy trustees.

Recommendations:

- The Rulebook on taking professional exams, training and development of bankruptcy trustees[34] should be amended to ensure that the training and education of bankruptcy trustees should:
  - be more focused on the practical issues and should include more case study workshops;
  - cover specific issues that are not strictly related to bankruptcy law and other topics suggested by the bankruptcy trustees themselves;
- The Ministry should undertake to draft and distribute guidelines and instructions with the relevant information, resources and practical advice to all bankruptcy trustees.
- The Ministry should also:
  - put additional efforts in decentralisation of trainings and education, so to at least organise the trainings at four largest commercial courts (Split, Zagreb, Rijeka, Osijek); and
  - attract more funds to support the Ministry in providing better quality of trainings in a more uniform and more accessible way;
- The Ministry should encourage and support cooperation between bankruptcy trustees and the work of associations of bankruptcy trustees.

3.4.3 Incentives for restructuring

Practice has shown that liquidation of companies is a preferred model of dealing with bankrupt companies. Although bankruptcy legislation allows restructuring to be conducted in bankruptcy proceedings, there have been only few examples of successful restructurings in bankruptcy in Croatia.

Many argue that there would be more cases of attempted restructurings in bankruptcy if there were more initiative (and financial support) from creditors and if the additional workload imposed on the bankruptcy trustee were adequately rewarded.

Without the support of the majority creditors, restructuring in bankruptcy is not possible.

[34] (Croatian: *Pravilnik o polaganju stručnog ispita, obuci i usavršavanju stečajnih upravitelja*) published in the Official Gazette of the Republic of Croatia No. 104/15.

Secured creditors (who usually have the majority of votes in the assembly of creditors) are often sceptical towards restructuring as a way of dealing with bankrupt companies. They find it easier to proceed directly with the sale of the whole bankruptcy estate in order to liquidate the debtor's assets and settle their claims (as they have priority in settlement) rather than risk with the restructuring process.

Legislative reforms, in and of themselves, will not necessarily change the creditors' attitude towards restructurings. However, many believe that creditors would have more faith in the restructuring processes if the prerequisites for successful restructurings were set in place (primarily if bankruptcy is opened as soon as company becomes financially distressed - as explained in Section 3.3.1, and if bankruptcy trustees had better skills required to successfully organise the restructuring process - as explained in Sections 3.4.1 and 3.4.2. Therefore, it is essential that other aspects of the Croatian bankruptcy framework are enhanced as proposed in this Report[35].

Bankruptcy trustees also feel that the preparation of restructuring is not appropriately compensated. Namely, the preparation and monitoring of the implementation of the bankruptcy plan means significantly increased workload for the bankruptcy trustee in comparison to the liquidation of the bankruptcy estate. If fees payable to bankruptcy trustees are proportionally higher in case of restructuring, thus honouring the additional work by bankruptcy trustees, bankruptcy trustees would be more incentivised to proceed with restructuring.

Right now, it is much easier for bankruptcy trustees to simply proceed with selling the bankruptcy estate. That way, they can at least ensure the funds (proceeds of the sale of the bankruptcy estate) for their fees will be paid.

If the maximum amount prescribed for the fee for monitoring the implementation of a bankruptcy plan was increased from HRK 30,000 *per annum* (e.g. up to HRK 100,000 *per annum*), this would allow bankruptcy trustees, in case of more complex bankruptcy plans, to receive a fee which is proportionate to the workload required by them.

[35] For more information on other proposals relevant for restructuring please see Sections 3.4.1 and 3.4.2.

In comparison, other countries provide for a separate remuneration in cases where a debtor's business continues. For example, in Austria and Germany trustees are remunerated based on the total value of claims recovered by the creditors in the bankruptcy procedure (i.e. the value of the claims settled). Therefore, they are incentivised to achieve maximum recovery for the creditors. Both countries also allow for an increase of the remuneration in case the business of the debtor has been continued by the trustee. The amount of the extra remuneration depends on the circumstances of each specific case.

Recommendations:
• Amend Article 12 of the Decision on Criteria and Method of Calculation and Payment of Fees to Bankruptcy Trustees[36] so that the maximum fee for monitoring the implementation of a bankruptcy plan was increased from HRK 30,000 *per annum* to HRK 100,000 *per annum*.

3.4.4 Receipt of correspondence on behalf of debtor

After opening of bankruptcy proceedings, the bankruptcy trustee assumes the role of all corporate bodies of the debtor and is the only one authorised to act on behalf of such debtor. If any action needs to be taken by the bankruptcy debtor, the bankruptcy trustee is the only one who can take such action.

For a bankruptcy trustee to be able to timely react to any court order or other formal decision of an authority addressed to the debtor, the bankruptcy trustee will need to receive all the mail addressed to the debtor. This has proven to be an issue in situations where a bankruptcy trustee cannot receive the mail at the registered address of the debtor (e.g. the debtor is registered at abandoned premises or at the private address of the shareholder).

In such situations, authorities continue to send the correspondence to the address of the debtor registered in the court register. However, such mail is often not received by the bankruptcy trustee. After several unsuccessful attempts to deliver the mail to the registered address, the authorities make a formal delivery by publishing the correspondence on the notice board of a local court.

[36] (Croatian: *Uredba o kriterijima i načinu obračuna i plaćanja nagrade stečajnim upraviteljima*) published in the Official Gazette of the Republic of Croatia No. 105/15.

This has proven to be a problem in situations where public notaries deliver their writs of execution. If the delivery of a writ of execution is made by publishing it on the notice board of a local court, it is possible that the bankruptcy trustee will not see it and will not be able to file an appeal against it (if required). In such situations, the writ of execution will become final and enforceable against the bankruptcy estate and can be used to block bank accounts of the bankruptcy estate without bankruptcy trustee even knowing that they exist.

To resolve this issue, the Bankruptcy Act should include an explicit provision that, after the opening of bankruptcy proceedings, any correspondence addressed to the bankruptcy debtor needs to be sent to the address of the bankruptcy trustee (which is also visible in the court register).

It has been noted that it would be beneficial to keep the registered seat of the debtor in the court register unchanged (i.e. not change it to the address of the bankruptcy trustee), as the change of the registered seat could affect the jurisdiction of the commercial court in charge of the bankruptcy proceedings and thus unnecessarily complicate the proceedings.

Recommendations:
• The Bankruptcy Act should be amended to include an explicit provision that, after opening of the bankruptcy, any correspondence addressed to the debtor needs to be sent to the address of the bankruptcy trustee and not to the registered seat of the debtor.

3.5 Modern technological solutions

The use of modern technology could make communication between courts and parties more efficient and could speed up the proceedings. Compared to its neighbouring countries, Croatia lags behind on the digitalisation of the judicial process.

At the roundtable the Ministry noted that it is currently implementing a new system that will allow secure electronic communication between courts and other stakeholders. All participants of the roundtable had expressed high hopes that such system would facilitate, and reduce the duration of, proceedings.

3.5.1 *Electronic communication between stakeholders*

The current Croatian legal framework does not provide for electronic communication between various stakeholders in pre-bankruptcy and bankruptcy proceedings. In particular, motions cannot be filed electronically and files cannot be accessed electronically.

During the roundtable, it was stressed that the necessity to file motions and communicate between courts and state agencies physically delays proceedings and creates significant extra work for the involved stakeholders. Providing for electronic communication and access to the files could significantly speed up the process and free up capacities at the courts, the Financial Agency, the trustees, bankruptcy trustees and lawyers.

According to the information shared at the roundtable, the Ministry is currently working on the implementation of a system for electronic communication between courts and various parties involved in court proceedings (project: *e-Komunikacija*)[37].

Provided that this system is properly introduced during 2018, detected shortcomings may be addressed.

Recommendation:
• Roll-out the system for electronic communication that is currently under development.

3.5.2 *Sharing of information*

While the Financial Agency and other agencies have well-maintained electronic databases, courts and bankruptcy trustees do not have direct access to such databases. Croatian courts currently have to file written requests to the Financial Agency (or other competent authorities) to receive information, such as information on debtors' accounts.

[37] The project e-Komunikacija is currently in the pilot stage and is expected to be fully implemented by the end of 2018. For more information, please see: https://pravosudje.gov.hr/vijesti/pilot-projekt-e-komunikacija-i-sporazum-o-sufinanciranu-radova-za-izgradnju-poslove-zgrade-za-potrebe-smjestaja-pravosudnih-tijela/18130

While in other areas, such as databases maintained by the Financial Agency, digitalisation has made significant progress, the land register is not yet fully electronically available, creating delays and uncertainties in respect to the legal status of the real property.

Whether or not bankruptcy proceedings can be run efficiently and in the best interest of creditors often depends on the information being readily available. Giving courts direct and full access to the existing agencies' databases and completing the digitalisation of the land register, could significantly speed up pre-bankruptcy and bankruptcy proceedings.

While most of existing databases are, at least partially, publicly available, search engines available to the public are often limited and the public can only search them if they have details of the records they are looking for. A general search based only on the information on the beneficiary of record is usually not available to the public, but only to the competent authority in charge of the database.[38]

It would be beneficial if courts (i.e. judges in charge of pre-bankruptcy and bankruptcy proceedings) had access to all existing databases with all the available search engines to search such databases, including the ones that are currently not publicly available.

Recommendation:
• Give judges direct and full access to all available electronic databases relevant to pre-bankruptcy and bankruptcy proceedings, including all public registers where titles to assets are registered, with all the available search engines.

3.5.3 Publication of documentation on claims reported by creditors

If a claim reported by a creditor is accepted by the bankruptcy trustee, it can nonetheless still be challenged by another creditor at the examination hearing. To enable creditors to use this right effectively, creditors should also be able to examine the reported claims of other creditors.

[38] This means (e.g. in case of land register) that the public can view all the registered information on a real property registered in a land registry sheet. However, it may only open the land registry sheet if it knows the land plot number or land registry sheet number. The public cannot search the land register by names or personal identification numbers of registered title holders and, thus, cannot trace assets of the debtor.

To that end, several stakeholders that usually represent creditors in bankruptcy proceedings have noted that documentation on reported claims (whole report with its appendices) should be published online at least ten days before the hearing for examination of claims. To facilitate such publication, as well as reporting of the claims, the electronic communication systems referred to in Section 3.5.1 above should also allow for reporting claims electronically.

Recommendations:
• Amend the Bankruptcy Act so that all documents filed by a creditor when reporting a claim are made available to other creditors via the e-notice board. • Article 36 of the Bankruptcy Act should be amended in order to require that claims are reported electronically.

4. CONCLUDING REMARKS

The aim of this Report is to outline the principal shortcomings and areas for improvement of the current Croatian insolvency framework. Furthermore, the Report also intends to provide the international perspective to impediments identified as well as international best practices, to deal with similar issues that serve as the basis for the set of recommendations and proposed solutions included in the Report.

To that end, it is hoped that this Report will serve the Ministry as the basis and a guideline for the upcoming regulatory reforms of the Croatian pre-bankruptcy and bankruptcy framework as it offers a variety of proposed solutions and recommendations.

Regulatory reform based on this Report will hopefully result in more effective and efficient pre-bankruptcy and bankruptcy framework and, consequently, in better general perception of the pre-bankruptcy and bankruptcy proceedings in Croatia.

European Bank
for Reconstruction and Development

Schedule 1

ROUND TABLE AGENDA

REPUBLIKA HRVATSKA
Ministarstvo
pravosuđa

European Bank
for Reconstruction and Development

STRENGTHENING THE LEGAL FRAMEWORK FOR BANKRUPTCY AND PRE-BANKRUPTCY PROCEEDINGS IN CROATIA

Ministry of Justice

Ulica grada Vukovara 49, Zagreb

6 October 2017

PROGRAMME

6 October 2017

9:00 – 09:30

Participants' arrival and coffee reception

09:30 – 10:00

Welcoming remarks

Vedrana Jelušić Kašić, Director, Regional Head for Croatia, Slovenia, Hungary and Slovak Republic, EBRD

Marie-Anne Birken, General Counsel, EBRD

Josip Salapić, State Secretary, Ministry of Justice of the Republic of Croatia

10:00 – 11:00

Pre-bankruptcy proceedings in Croatia: Lessons learned from other EU countries - Panel discussion chaired by Miriam Simsa, Partner, Schönherr Austria

- *Aleksej Mišković*, Partner, Law Firm Glinska & Mišković
- *Željko Šimić*, Judge, High Commercial Court
- *Bojan Fras*, Vice Governor, Croatian National Bank
- *Zoran Vučićević*, General Counsel, Raiffeisenbank Austria d.d.

11:00 – 12:00

Bankruptcy proceedings in Croatia: practical issues and challenges - Panel discussion chaired by Jelena Madir, Director, Chief Counsel, Financial Law Unit, EBRD

- *Igor Periša*, Judge, High Commercial Court
- *Suzana Skorija*, Director, H-Abduco d.o.o.
- *Pavo Mišković*, Managing Director, Corporate, Investment and Private banking, Zagrebačka banka d.d.
- *Luka Rimac*, Partner, Mamić Perić Reberski Rimac Law Firm LLC
- *Jelenko Lehki*, Bankruptcy Trustee, Croatian Association of Bankruptcy Trustees

12:00 – 12:30

Coffee break and refreshments

12:30 – 13:30

Strengthening the bankruptcy trustee framework in Croatia - Panel discussion chaired by Jaime Ruiz Rocamora, Principal Counsel, EBRD

- *Mira Hajdić*, Bankruptcy Trustee, Croatian Association of Bankruptcy Trustees
- *Ante Galić*, Judge, Commercial Court of Zagreb
- *Igor Vidra,* Sector Head, Directorate for Civil, Commercial and Administrative Law, Ministry of Justice of the Republic of Croatia
- *Ivana Žitnik*, Head of Legal Corporate Collection Department, EOS Matrix d.o.o.
- *Luca Grgić Petrović*, Sector Head, Directorate for Public Notaries and Administrative and Other Affairs, Ministry of Justice of the Republic of Croatia

13:30 – 14:30

The use of new technologies in bankruptcy proceedings - Panel discussion chaired by Judge Nevenka Baran, Adviser to the Minister, Ministry of Justice of the Republic of Croatia,

- *Duško Koruga*, Bankruptcy Trustee, Croatian Association of Bankruptcy Trustees
- *Vinka Ilak*, Senior Legal Specialist, Financial Agency
- *Jelena Nushol*, Partner, Bardek, Lisac, Mušec, Skoko in cooperation with CMS Reich-Rohrwig Hainz
- *Nino Radić*, President, Commercial Court of Zagreb

14:30 – 15:00

Concluding remarks

Igor Vidra, Sector Head, Directorate for Civil, Commercial and Administrative Law, Ministry of Justice of the Republic of Croatia

Jaime Ruiz Rocamora, Principal Counsel, EBRD

Vedrana Jelušić Kašić, Director, Regional Head for Croatia, Slovenia, Hungary and Slovak Republic, EBRD

Schedule 2

RECENT LEGISLATIVE REFORMS AND DEVELOPMENTS IN THE LEGAL FRAMEWORK FOR BANKRUPTCY AND PRE-BANKRUPTCY PROCEEDINGS

Croatian Bankruptcy legislation has been amended numerous times in recent years. This has led to different provisions being applicable to the ongoing bankruptcy proceedings, depending on the date the proceedings are initiated.

Moreover, the Act on Financial Operations and Pre-bankruptcy Settlement of 2013 was revoked entirely after numerous constitutional challenges had been filed. It was replaced by the Bankruptcy Act, which introduced the current legal framework for pre-bankruptcy and bankruptcy proceedings.

During the last two years, it has become clear that the proceedings are too rigid and difficult to enforce. This has a discouraging effect for both debtors and creditors to (timely) initiate (pre)bankruptcy proceedings.

In order to address these issues, the Law on Amendments to the Bankruptcy Act was enacted in October 2017 (the "**Amendment**"). It aims to facilitate pre-bankruptcy proceedings and addresses certain identified shortcomings of pre-bankruptcy and bankruptcy proceedings. While the Amendment contains provisions aimed at a general clean-up of the Bankruptcy Act, it also introduced a number of material changes (see Schedule 2).

New Rules on Financing in Pre-bankruptcy Proceedings

The most important innovation introduced by the Amendment is the possibility for debtors to obtain "new money" in the pre-bankruptcy phase.[39] Before the Amendment, there were no rules on the status of such temporary financing. Significant legal uncertainty on the rights of creditors under such financing *de facto* prevented debtors in pre-bankruptcy from obtaining new funds.

The new provision introduced by the Amendment applies to proceedings initiated after the entry into force of the Bankruptcy Act of 2015 (i.e. 1 September 2015) if the

[39] Article 13 of the Amendment, new Article 62(a) of the Bankruptcy Act.

hearing on the restructuring plan was not held before the entry into force of the Amendment (i.e. 2 November 2017).

With the consent of creditors who collectively hold more than two thirds in value of the legally recognised claims, a debtor may now take on new money to ensure continuity of business during the pre-bankruptcy proceedings. The court has to decide on the amount and conditions of such new money, as well as on the deadlines for the settlement of claims thereunder.

Should the debtor subsequently file for bankruptcy, the creditors who gave the new money financing pursuant to this provision, will have a priority settlement. The priority ranking is limited up to the amount of the new financing, and will not affect the ranking of creditors with the first higher settlement ranking (i.e. creditors with employment related claims).

Moreover, the taking of such new money will not be considered as a legal action disrupting the right of equal settlement of creditors or as putting certain creditors in a more favourable position. Therefore, it will not be voidable under insolvency related voidance rules.

Creditors are thus incentivised to provide new finance as they can be quite certain that their loan will be repaid. These changes have been welcomed by market participants as remedying a significant shortcoming in pre-bankruptcy proceedings.

Other amendments to pre-bankruptcy Proceedings

- *Easier burden of proof to demonstrate the existence of pre-bankruptcy*

  It will now be easier to prove that the pre-bankruptcy threshold is met. Previously, the applicant had to convince the court, by providing sufficient evidence, that the prerequisites for pre-bankruptcy were met. Now the applicant only has to demonstrate that the existence of pre-bankruptcy is more likely than not.

- *Formal requirements to apply for pre-bankruptcy have been lowered*

  The Amendment introduced the provision facilitating formal requirements to apply for pre-bankruptcy. Namely, the applicant does not have to submit evidence of

negotiations with the creditors, balance sheets or evidence of the total revenue for the last financial year. These changes should make it easier for debtors to apply for the commencement of pre-bankruptcy proceedings.

- *Pre-bankruptcy proceedings may be initiated only if a debtor is not permanently insolvent*

  The Amendment has clarified that pre-bankruptcy proceedings may only be initiated if debtor is not permanently insolvent (as opposed to temporary liquidity problems) at the time of the submission before the court. Previously, the law was unclear as to the point of time in which this requisite should be met.

- *Creditors may transfer their claims (including associated voting rights) during pre-bankruptcy*

  While this was a common practice before, the law did not explicitly state whether such transfers were actually allowed within pre-bankruptcy. The Amendment contains explicit provision allowing such transfers.

- *Secured creditors with a direct claim against the debtor may participate in pre-bankruptcy proceedings as ordinary creditors*

  The Amendment clarifies that secured creditors with a direct claim against the debtor may participate in pre-bankruptcy proceedings as ordinary creditors if they waive their claim over any security interest. Where a secured creditor has a direct claim against the debtor but waives its right to separate settlement, such claims will be treated as ordinary unsecured claims.

- *Other changes to pre-bankruptcy proceedings include the following*:

  - The application for pre-bankruptcy may now be withdrawn until the court has decided on the commencement of the proceedings.
  - The deadline for completion of pre-bankruptcy proceedings has been extended from 120 days to 300 days from the date of the commencement of pre-bankruptcy proceedings.
  - Certain procedural deadlines have been extended, giving creditors more time to file their claims (21 days, as opposed to previously 15 days) and the

bankruptcy trustee and the debtor to challenge these claims (30 days compared to previously 8 days).

- The additional deadline for the completion of pre-bankruptcy proceedings (that may be granted by the court) has been reduced from 90 to 60 days.
- Pre-bankruptcy proceedings may no longer be terminated for any of the following reasons:
  - if the amount of claims recognised in pre-bankruptcy proceedings is by 10% higher than the amount of liabilities indicated by the debtor in its motion to commence pre-bankruptcy proceedings;
  - if the amount of claims disputed in pre-bankruptcy proceedings (which claims had been asserted by creditors before courts or other competent authorities before the motion to open pre-bankruptcy was filed) exceeds 25% of all reported claims; or
  - if the amount of claims of employees and former employees as reported by the debtor is by 10% lower than the amount of these claims as determined by the court on the basis of an employee's complaint.
- The opening of pre-bankruptcy proceedings does not affect qualified financial contracts that allow close-out netting (this was formerly envisaged for bankruptcy proceedings only).

It remains to be seen if these changes will in fact encourage more pre-bankruptcy proceedings and lead to a more satisfactory result of these proceedings.

Changes to bankruptcy proceedings

- *Imminent insolvency as a new basis to commence bankruptcy proceedings*

  A significant material change introduced by the Amendment is the introduction of a new standard to commence bankruptcy proceedings: the imminent threat of insolvency (Croatian: *prijeteća nesposobnost za plaćanje*). A debtor may now file for bankruptcy if it is likely that he will not be able to fulfil its existing obligations by their maturity. While this has already been a reason to open pre-bankruptcy proceedings, until now it was not sufficient grounds to initiate bankruptcy proceedings.

- *Other material changes to bankruptcy proceedings*

  - The applicant may now withdraw its application for bankruptcy proceedings until the court has rendered a decision on opening bankruptcy proceedings.
  - Amendments have been made in determining the first higher priority ranking of employees' claims, state budget claims etc. and applicable law on the mode of settlement of such claims.
  - Provisions on costs of redemption and allocation of purchased price from the sale of security have been amended. Namely, costs of determining and costs of sale of the object of the right of separate settlement have been prescribes in a lump sum amount as 5% of total proceeds acquired.
  - A legal presumption that a creditor who presents an execution deed or a non-final judgement has therefore sufficiently proven the existence of its claim for purposes of initiating bankruptcy proceedings - has been abolished.
  - Only secured creditors that have a direct claim against the debtor personally may file for bankruptcy, this means that creditors who have received only a security from the debtor securing a third-party obligation may not file for insolvency of the security provider anymore.
  - Bankruptcy trustees may now request to be temporarily exempt from any appointments during a period of two years. The law does not specify for which reasons the bankruptcy trustee may request such exemptions. However, even when the bankruptcy trustee uses its right for temporary exemption, the trustee may continue working on the pending cases it is already appointed to.
  - Requests seeking a group of affiliated companies to commence joint bankruptcy proceedings (Article 391, Croatian: *stečajni postupci povezanih osoba*) are no longer admissible.

These amendments may lead to a faster and more efficient commencement of bankruptcy proceedings. By the same token, the opening of bankruptcy proceedings at an earlier stage may allow more space for bankruptcy trustees to try to restructure the debtor while the company still has unpledged assets, vital turnover and possibilities to recover. Besides, should restructuring not be possible, the liquidation of the bankruptcy estate will commence before, reducing loss of value created and bigger losses for creditors.