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ECONOMIC AND LEGAL ANALYSIS OF THE SUPREME COURT'S PRESIDENT REPORT REGARDING BANKRUPTCY CASES: STARTING THESES

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ABSTRACT

Since we live in times of rapid social changes in all spheres of human activity, the alleged purpose of which is to create better living conditions, it is extremely important for economic and legal science and practice to provide adequate explanations on the interpretation of the legal norm, the development of certain branches of law, and the interpretation of the existing economic environment. Statistical data for the purposes of this analysis are numerical indicators of the volume of work of the courts in the field of bankruptcy proceedings in a period of one year, based on official data from the Supreme Court of the Republic of Croatia. It must be acknowledged, however, that the statistics now available generally show only half the truth- they tell us about the number and types of submissions, but they tell us nothing about the failure of reorganization negotiations, the impact of insolvency on third parties or communities, or the long-term success or failure of bankruptcy, pre-bankruptcy or consumer bankruptcy plans. Moreover, the statistics do not reveal what is most important: how completed pre-bankruptcy settlements, bankruptcy plans, and consumer bankruptcy plans work in practice, specifically, whether the debtor has properly fulfilled assumed obligations to creditors and, if assumed obligations have not been fulfilled, whether liquidation bankruptcy or foreclosure proceedings have been initiated as a last resort, with no chance of a fresh start. Although the statistics of the entire Report of the President of the Supreme Court on the state of the judiciary for 2020 suggest an improvement in the quality of court work, this research assumes that the analysis of only quantitative indicators of judicial institutions cannot provide a complete picture of the quality of judiciary and that there is room for the functionalization of bankruptcy legal protection. Accordingly, the aim is to propose certain activities that will result in appropriate changes in practice and regulations where it is necessary.

Keywords: *Bankruptcy cases, Directions of reform, Report, Statistics, Supreme Court, 2020*

1. DISCUSSION FRAMEWORK

The new bankruptcy act (hereinafter: BA) entered into force on September 1, 2015 (Bodul and Vuković, 2015; Bodul and Nakić, 2018.). Since the Bankruptcy Act has been amended seven times since 1996, the legislator decided to pass a new law. However, with regard to the bankruptcy proceedings it is only an amendment to the existing law, while the pre-bankruptcy

procedure has changed significantly. The BA (OG, No. 71/15, 104/17) returned the institute of bankruptcy plan and introduced the rules of pre-bankruptcy settlement. The institute of pre-bankruptcy settlement is now regulated in such a way that it is fully conducted before the court, but the debtor can use this possibility only until the presumption on the basis of which the bankruptcy proceedings must be opened has been fulfilled. However, in practice,perhaps the most important change is the obligation of the Financial Agency (hereinafter FINA) to file a bankruptcy petition if the legal entity has recorded unexecuted payment bases in the register of payment bases for a continuous period of 120 days. However, in almost two years of application of the new BA, it has been noted that the number of pre-bankruptcy proceedings initiated is relatively low (273 proceedings initiated), with the restructuring plan accepted and the pre-bankruptcy agreement confirmed in only 58 cases. Therefore, the Act Amending the Bankruptcy Law, which entered into force on November 2nd 2017, primarily aims to facilitate pre-bankruptcy proceedings by prescribing realistic deadlines for the implementation of certain measures in the proceedings. The Consumer Bankruptcy Act (OG, No. 100/15, 67/18) has been implemented based on the postulates of financial rehabilitation (hereinafter: CBA). In the bankruptcy plan and pre-bankruptcy proceedings as an alternative to liquidation bankruptcy, certain similarities with the consumer property bankruptcy proceedings can be observed, since the "economic recovery" of the consumer as the subject of the proceedings is the primary objective (Art. 2). However, consumer bankruptcy proceedings have a specific substantive objective that relates only to the rehabilitation of debtors, which is a differntia specifica compared in relation to corporate bankruptcy (Bodul, 2011).

2. METHODOLOGY OF THE WORK

The dynamics of bankruptcy statistics in the Republic of Croatia is not sufficiently researched, both because of structural instabilities and because of the frequent reforms of the bankruptcy system, the primary goal of which is to terminate bankruptcy proceedings as quickly as possible. As a result, the phenomenon of insolvency has not been systematically addressed and no serious research has been conducted on the reasons that prevent the expeditious completion of bankruptcy proceedings, but only frequent reforms of the regulations have been carried out because it was currently thought that they would quickly lead to some acceptable results. Thus, the paper does not claim to provide a comprehensive analysis, but the problem identified by the authors refers to the insufficient analysis of the impact of (pre)bankruptcy proceedings and consumer bankruptcy proceedings. This is certainly supported by the fact that the Ministry of Justice and Pulic Administration and public authorities (FINA, Commercial Court, Supreme Commercial Court, Municipal Court, District Court, Supreme Court, Tax Administration) have partial competences related to (pre)bankruptcy proceedings and consumer bankruptcy proceedings, and it is not clear who is responsible for the proceedings as a whole. As a result, there is no unified system for monitoring the status of cases or relevant statistics that would serve as a starting point for evaluating the measures applied and appropriately formulating new ones. The existence of clear indicators would certainly facilitate the current evaluation of the implementation of all insolvency procedures, as it would be free from any bias. As a result, in the Republic of Croatia it is still not possible to relate the number of bankruptcies to any economic variables and the analysis of bankruptcy statistics is limited to a simpler form of observation of the frequency of bankruptcies. Therefore, the analysed statistics, although scarce, provide only a basic insight into the dynamics of consumer and business bankruptcies in the Republic of Croatia for the period of 2020, with the aim of determining whether the numerical indicators have achieved the goals defined by legal and strategic acts. For the purpose of the work, telephone interviews were conducted with representatives of bankruptcy proceedings. The perspective of each interviewee is based on the knowledge and decades of experience gained in the practise of applying the bankruptcy law, which is certainly an

important factor in assessing the improvement, but also the degree of optimization of the existing legal framework. Due to the discretion of the interlocutors, their names are not mentioned in the text.

2.1. Numerical / quantitative data on consumer bankruptcy proceedings and comments

With the adoption of the new Consumer Bankruptcy Act in 2015, the possibility of bankruptcy over the assets of all natural persons was introduced into the Croatian legal system. Municipal courts have jurisdiction to conduct consumer bankruptcy proceedings, while certain county courts decide on appeals against first-instance decisions. With the entry into force of the provisions of the Act Amending the Consumer Bankruptcy Act on January 1, 2019, the courts have received an extremely high number of cases of simple consumer bankruptcy proceedings. In February 2019 alone, 10,718 cases were received, while the largest number of cases were received in March 2019 (31,830) and April 2019 (34,198). Thereafter, the courts continued to receive fewer cases, a trend that continued through 2020, when the inflow of this type of case decreased by 81%, from 96,041 to 18,463 cases. Compared to 2019, the inflow decreased from 1,289,716 cases to 1,178,265 cases, or 9% of the total number of cases received in 2020. The smallest share of the total number of cases received by the district courts relates to cases of regular consumer bankruptcy proceedings. In analysing consumer bankruptcy proceedings, one of the major shortcomings of the CBA is the fact that the proceedings fall under the proper jurisdiction of district courts, not commercial courts, which traditionally conduct these types of proceedings, raising the question of whether courts that do not specialise in these types of cases will be able to adequately conduct and ultimately enforce them. Indeed, the objective need for courts to specialise is not a whim, but a necessary result of the requirement for effective bankruptcy protection, and the fact that district courts are unfamiliar with complex bankruptcy issues calls into question the possibility of adequate consumer bankruptcy proceedings. Although there are hundreds of thousands of blocked citizens, case law indicates a modest number of regular consumer bankruptcy proceedings in Croatia, somewhat reminiscent of the anti-commons problem, i.e., a problem that is not reflected in the race of creditors or debtors to cancel their debts, but in their passive behaviour. Thus, although the CBA provided a procedure with clear deadlines and legal consequences, clear enough to allow the debtor and the creditor to find their own solution to the problem, and allowed for a more efficient plan-making mechanism and ensured compliance with international standards, it lacked an outcome. However, the impact of the CBA on accelerating the process will be limited unless existing institutional capacity is improved. The extent to which the CBA's goals can be achieved depends on a number of factors, such as reforming the incentives for willingness to become a trustee in consumer bankruptcy cases.

2.2. Numerical / quantitative data on corporate bankruptcy proceedings and comments

In accordance with the provisions of Art. 21. of the Courts Act (OG, No. 28/13, 33/15, 82/15, 82/16, 67/18, 126/19, 130/20), commercial courts, as courts of first instance, conduct both pre-bankruptcy and bankruptcy proceedings. Analysis of commercial court proceedings by type shows that bankruptcy proceedings also account for the largest share of the total number of proceedings received. However, the settlement rate for bankruptcy cases is over 100%, which means that more cases are settled than new ones are received. For both unresolved cases and resolved cases, one of the most important indicators is the duration of resolved cases. At the same time, the indicator DT (indicator of the duration of the settlement of cases) shows that the commercial courts take the most days to settle bankruptcy cases, which take 360 days on average. Compared to the previous year, the time needed to dispose of bankruptcy cases has increased from 308 to 360 days, which is still within the acceptable range of one year. This is certainly due to the COVID-19 pandemic as well as the earthquake that hit Zagreb.

It should be noted that the Act on Intervention Measures in Enforcement and Bankruptcy Proceedings (OG, No. 53/20) was in force for the period of special circumstances from May 1st, 2020 to October 18th, 2020, and according to the provisions of Article 6 of the said Act, the reasons for bankruptcy that occurred during the period of special circumstances within the meaning of this Act were not a prerequisite for filing a petition for the opening of bankruptcy proceedings. Therefore, the President of the Supreme Courts indicates that the problems in the economy as a result of the pandemic are still present to some extent, so it was expected that in 2021 there will be some increase in the number of bankruptcy cases. The Report also shows the inflow of bankruptcy cases. The inflow of cases implies the cases received in the observed period. However, analysing the Report, it is not clear whether the inflow of cases has increased from year to year, and for that purpose the available statistics of High Commercial Court (HCC, 2021) should be analysed. Moreover, one of the important parameters in the analysis is the number of judges dealing with bankruptcy cases. In general, the same number of bankruptcy cases was resolved in 2020 as in 2019, but it is not clear whether the number of judges working on bankruptcy cases increased or decreased, because if we look at the average number of resolved cases per judge, the statistics would look different. The resolution of disputes through arbitration is a direct function of the basic goals of bankruptcy proceedings: 1) the greatest possible satisfaction of bankruptcy creditors, 2) minimal costs, and 3) short duration (Article 262 of the Civil Code). However, the symbolic and almost no indicators of the results of resolving disputes through arbitration in bankruptcy show that the arbitration procedure has not gained the popularity that was expected with its introduction. It should be emphasised that the methodology on which this research is based deals directly with the legal framework and its compliance with international standards and best practises. The authors believe that the solutions offered by BA are modern and show the tendency to introduce the market logic in resolving debt-creditor relations in bankruptcy proceedings. For example, Directive (EU) 2019/1023 (OJ L 172, 26.6.2019, pp. 18-55), the provisions of which must be implemented in the upcoming amendments to BA, does not provide for "revolutionary" solutions, especially with regard to preventive restructuring, as the Croatian regulations for pre-bankruptcy proceedings are essentially in line with the solutions contained in the Directive. Moreover, the Report of the President of the Supreme Court on the state of the judiciary in 2020 and the status of bankruptcy proceedings, while not showing the results of completed bankruptcy proceedings, identifies some problems affecting the results and proposes recommendations that are likely to be important in achieving the objectives of bankruptcy proceedings. And so:

a) it is necessary to require the Bankruptcy Manager (BM) to submit turnover data on all accounts of the debtor in electronic form to the court file. This will add to the already transparent process (random allocation of cases from the BM, publication of all documents on the e-bulletin board website of the courts). However, it is also partly the result of bankruptcies attracting media attention, where theory and practice show that proposals to open bankruptcy proceedings, especially if they involve large companies with many employees, have a great chance of attracting media attention. Unfortunately, most of the media, as well as the general public, do not understand the complexity of bankruptcy proceedings and their impact on socioeconomic relations. The BM often becomes a target of public criticism. Some will attack its credibility or impartiality based on special interests. Debtors and creditors may complain that the BM is "too demanding", that it is difficult or sympathetic to one side in the procedings. Politicians may join in this public criticism. The public is likely to see the opening of bankruptcy and the entry of the BM into businesses as the immediate cause of business closures, layoffs, often perceiving all of this as fraudulent behavior, etc., and not realizing that the problem is really insolvency and that bankruptcy and pre-bankruptcy procedures are the solutions.

The problem arises from the variety of objectives that arise from the initiation of bankruptcy proceedings, but also from the fact that an efficient bankruptcy procedure must achieve many, often incompatible, objectives.

b) the compensation of the BM needs to be further regulated by the Compensation Ordinance, and the total compensation of the BM should not be higher than the salary of the bankruptcy judge for a period of one (or two) years. This type of legal evaluation or thesis is superficial and reduces to only two sentences in the Report. Indeed, one of the fundamental questions in bankruptcy is: how to design a system of fees and rewards that provides an appropriate incentive for the BM? The system of rewards must be predictable, fair, and encouraging, but also flexible so as to be applicable in very different circumstances - bankruptcy or reorganization, legal entities of different sizes, but also in special circumstances, exempli gratia, when changing the BM. Otherwise, the risk of inadequate BM advocacy and thus "expensive and slow" proceedings increases. The issue of adequate remuneration and fees depends on the context in which the bankruptcy proceedings are conducted. Therefore, when analyzing the fee and incentive system, it would be wrong to make the aforementioned thesis without taking into account the specific circumstances, such as the number and quality of the BM, the type of appointment, the relationship between the bankruptcy judges and BM, the legacy cases of the previous bankruptcy system, the corporate structure, the expected average bankruptcy estate, the representation of reorganization proceedings in relation to bankruptcy resolution, etc. Comparative experience shows that the compensation and reward system is closely related to the position of creditors in the selection of BM. Basically, compensation and reward systems can be as follows: they can be set by creditors in agreement with BM (bargain based); they can be prescribed by a scale that takes into account additional criteria such as time or complexity of the case (regulation based) and they can be based on the calculation of time spent on the case - according to a specific schedule/ daily allowance (cost or time-sheet based). Basically, doctrine shows that most systems allow creditors to self-recognize interest and motivate BM because ultimately it is their assets that are at stake. An approach that allows supply and demand to be matched, i.e., BM on the one hand and creditors on the other, would lead to a market formation of the price of BM labor. The success of the application of this system depends on several factors, primarily who selects the BM and the ability to conduct adequate monitoring supervision. Potential problems arise in small and medium-sized bankruptcies or when bankruptcy creditors have conflicting interests. Therefore, even in developed bankruptcy systems, the rules on the basis of which the amount of the award and the way of calculating the fee are determined need to be more precisely defined. The expected reward and compensation in the case of the applied tariff can also be considered as a reserve criterion for BM prices, which puts the BM in a relatively better negotiating position. Most countries, both those with case law tradition and those with civil law tradition, use a combination of these systems. In those countries with case law tradition reward and compensation are formed by negotiations of creditors and BM, with the possibility of using scales. The civil law oriented countries mainly use the prescribed scale model. The problem in practice is that creditors often behave disinterested or passively during bankruptcy proceedings and do not want to take an active role to ensure the maximum protection of their interests. They leave it to BM to "run the business, which is important because bankruptcy judges do not have the ability to run the entire proceedings, while at the same time they are much more likely to write petitions and objections to the work of both the court and BM.

c) the duration of the electronic public auction or bidding before FINA must be shortened and further transparently regulated. The advocated public access to auctions is something that

will certainly contribute to the transparency of sales, but while the introduction of new technologies is positive in any case, the question is whether the same could be achieved in and through the courts? This is all the more true as the sale of bankruptcy properties is nowadays portrayed in a negative light in the media. Therefore, the parties should be given the opportunity to exercise their rights in court proceedings.

d) without going into detail, the Report also modestly addresses how the justice sector as a whole is managed, i.e., who decides on its structure, how activities are regulated, and what resources (such as financial and human) are required. In this context, it is proposed that bankruptcy and other insolvency proceedings / pre-bankruptcy proceedings be conducted in commercial courts / in larger courtrooms equipped with audiovisual equipment. With few exceptions, the financing of the courts is inadequate and represents a significant obstacle to the efficiency of the judiciary, so the financial impact of this recommendation is not yet fully foreseeable from today's perspective. Indeed, anecdotal evidence suggests that some courts are still relatively well funded, while there are other parts of the country where courts are in dire financial straits. This is interesting because funding is centralized, which means that something like this could not happen, because a centralized approach to funding means that the risks of providing inadequate services should be spread evenly among all recipients of funding.

e) prevent companies with bankruptcy or pre-bankruptcy grounds from merging because this avoids the initiation of bankruptcy or pre-bankruptcy proceedings. In modern democracies, entrepreneurial and market freedom, i.e., the market economy and competition, are regarded as the basis of the economic structure, but also as a human right and fundamental freedom that enjoys constitutional protection. However, the state cannot rely exclusively on the principle of laissez-faire, but such a determination of the state requires, in addition to the guarantees of corporate freedom, the need for state intervention. In this sense, the question can be asked - is it possible and permissible to apply the measure of restricting entrepreneurial and market freedom by preventing mergers in companies where there are bankruptcy or pre-bankruptcy grounds? Indeed, a legally similar but not identical solution exists in the area of tax law. With the amendments to the General Tax Act (OG, No. 78/12), the Croatian legislator adopted a measure that it called "abuse of rights" in order to stop the very widespread practise of establishing new companies with the aim of transferring business or profits to the new company after the previous company was over-indebted. Under the protection of a separate legal personality of the company, the members of the corporation could continue their business after having previously over-indebted the company, without any risk of their personal responsibility being called into question. Therefore, the measure in question, which restricts entrepreneurial and market freedom, must be considered and analysed in detail in light of the principle of proportionality, which states that freedoms and rights may be restricted only to the extent necessary to achieve the objective pursued by that restriction. The above should also be analysed from the perspective of inviolability of property, i.e., the right to peaceful enjoyment of property, which is a fundamental constitutional guarantee that ensures the exercise of economic (entrepreneurial) activity.

Since numerical indicators do not provide a complete picture of the bankruptcy problem, the authors also included qualitative indicators obtained by analysing the content of final judgments. The analysis of the verdicts indicated the consistency and unambiguity of the argumentation, so the analysed sample of cases suggests a high quality of the substantive aspects of the verdicts.

However, it is feared that this will change due to the announcements of the Ministry of Justice to raise the judicial standard (Framework Criteria for the Work of Judges). The doctrine states that second instance judges often look for any (not necessarily valid) reason to revoke/ annul a first instance decision in order to save the time needed to analyse the merits of the case. Due to the pressure on first instance judges just described, objective reasons for overturning their decisions will also be more frequent in the second instance. As a result, first instance judges who are more conscientious about procedural discipline, such as suppressing procedural abuses by the parties and rejecting their unnecessary motions, will suffer. The doctrine goes on to say that "a large proportion of cases will be resolved essentially over a longer period of time in the overall decision-making process, even though statistics will show a shorter average duration of disputes."

3. INSTEAD OF A CONCLUSION

We believe that insolvency regulations are normatively sound in terms of legal systematics, legal techniques and consistency of standardization, to which the commercial courts have certainly contributed through their jurisprudence and action, as well as through the intensive and constant elaboration of legal solutions. However, given the fact that the issue of bankruptcy proceedings in countries with a long market tradition is a dynamic area where new solutions are sought to follow the trend of changes in the international economy, the question of the appropriateness and necessity of changes in insolvency law is extremely topical. Moreover, after several decades of intensive reforms of the judicial system, the Republic of Croatia continues to face major challenges in establishing a functioning judicial bankruptcy system. We believe that this is due to the fact that there is a conflict between two principles in bankruptcy proceedings. One is to conduct the proceedings in the shortest possible time and the other is to satisfy the creditors with the highest possible percentage. However, these two goals are mutually exclusive, as bankruptcy petitions are usually filed after the culmination of poor business decisions, complex debt-creditor relationships, and often various business abuses and criminal acts, etc. These problems create a vicious cycle in which it is very difficult to prioritize needed reforms. Ultimately, this Report does not show a comprehensive picture of the situation, as it is not clear how many bankruptcy proceedings were completed due to insufficient bankruptcy assets or without dividing assets among creditors, the structure of creditors is not visible, or who the largest and most frequent creditors are, the private sector, the public sector, or employees. Moreover, it is not clear whether bankruptcy proceedings are initiated within the statutory time limits et seq. While there are a number of reforms that would be both important and urgent, there are also those that must be given priority, as they can help create an environment for more ambitious structural reforms. Indeed, this implies a revision of both the "bankruptcy policy" and the policy's relationship to bankruptcy with a view to solving key judicial problems. This is confirmed by the analyzes of the judicial system of the Republic of Croatia carried out by the EU in recent years, in particular by the Report on the Rule of Law in the Republic of Croatia for the purposes of drafting the Commission's Annual Report on the Rule of Law in the EU Member States (European Commission, 2021).

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