Analysis of Corporate Restructuring and Insolvency in Hungary

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Elena Petrovska
Head of Hungary Office
European Bank for Reconstruction and Development
T +36 1 486 3020
E PetrovsE@ebrd.com

Catherine Bridge
Principal Counsel
European Bank for Reconstruction and Development
T +44 20 7338 6670
E BridgeC@ebrd.com

In collaboration with:

Balázs Tüske
Partner
Transaction Advisory Services
T +36 1 451 8153
M +36 30 919 3783
E Balazs.Tuske@hu.ey.com

Tibor Pálszabó
Partner
Tax Advisory Services
T +36 1 451 8601
M +36 30 280 5243
E Tibor.Palszabo@hu.ey.com

Gergely Horváth
Local Partner / Head of the Hungarian Banking and Finance Practice
Réczicza White & Case LLP
T +36 1 488 5200
F +36 1 488 5299
E ghorvath@whitecase.com

Gabriella Pataki
Associate
Réczicza White & Case LLP
T +36 1 488 5200
F +36 1 488 5299
E gpataki@whitecase.com

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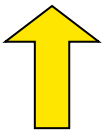 Medium impact with a medium implementation time

"Short implementation time" is defined with a time horizon not exceeding 1 year

"Medium implementation time" is defined with a time horizon between 1 to 3 years

RELEVANT ISSUE	PRACTICAL CONSEQUENCE IDENTIFIED	MAIN RECOMMENDATION	PRIORITY
1. Transfer/ acquisition of NPLs			
1.1 There is a licensing requirement for entities purchasing claims in a "business-like manner" (*üzletszerűen*). This requirement is currently interpreted in a restrictive manner.	▶ The licensing requirement for any entity purchasing claims from a bank in a "business-like manner" to be duly licensed in Hungary as a financial services provider, together with the existing licensing application process is burdensome and may limit access to the NPL market by secondary investors.	▶ The existing licensing system should be reviewed to ascertain whether the existing licensing lifted or requirements could be easedand/ or the licensing application process streamlined for corporate NPL purchasers to enable more secondary investors to enter the market.	
1.2 Under the New Civil Code, pledges/mortgages are considered to be novated or "newly-established" where there is a transfer of the whole contractual position (szerződés átruházás).	▶ This new provision adversely affects the transfer of rights and obligations (including any related security interest) under a loan agreement, triggering the commencement of a new "hardening period" for any security rights transferred to NPL purchasers.	▶ The New Civil Code should be amended to ensure that the hardening period following the transfer of a formerly granted security is not re-triggered (or the parties can agree so in advance) upon any transfer of a loan and underlying security to a new lender. ▶ Alternatively, an exemption should be granted to applicable hardening periods in the Bankruptcy Act for security transferred to a new lender under a loan agreement (provided that any underlying hardening period has expired).	

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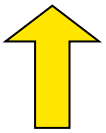
2. Eliminating Tax Disincentives to NPL Resolution and Creating Tax Incentives			
Introducing tax incentives			
2.1 Hungarian legislation does not contain any tax incentives facilitating the resolution of NPLs.	▶ NPL resolution is a very costly exercise that reduces the ability of banks to devote funds (and time) for new lending.	▶ In addition to potentially stricter regulatory controls, tax incentives could be introduced to encourage NPL resolution e.g. reducing the Bank Tax if a bank sells or writes off a certain amount of NPLs in a given period.1	
Cancellation of bad debts from banks' balance sheets			
2.2 Under Hungarian accounting standards non-performing receivables may only be cancelled from banks' financial accounts if certain conditions are fulfilled.	▶ Banks recognise receivables in their accounts that are fully impaired and have a very remote chance of recovery. These receivables can only be cancelled after a long period has elapsed (typically following a liquidation procedure, which may take 2-3 years).	▶ Under IFRS banks may write off or cancel bad receivables if there is no reasonable expectation of recovery. Hungary is considering the adoption of IFRS (particularly for banks) within the next 2-3 years, which would improve the position on banks' balance sheets.	

[1] Tax incentives can easily be drafted in a way that only confers benefits to corporate NPL holders

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Waiver of debts			
2.3 A full or partial waiver of receivables in a pre-insolvency scenario and as part of a reorganisation plan in bankruptcy proceedings is recognised as revenue of the debtor. The debtor must pay corporate income tax on the revenue recorded. Tax losses from previous years may only partially offset the tax liability pre-insolvency. However full tax losses can be offset if the receivable is waived in a bankruptcy reorganisation plan approved by the court or in a liquidation procedure.	The tax liability of the debtor may result in cash flow problems for the debtor and undermine the success of any restructuring.	A tax exemption may be granted to debtors whose debts are fully or partly waived due to potential or actual insolvency in line with the approach taken in certain EU jurisdictions. Alternatively in a pre-insolvency scenario, all tax losses carried forward from previous years could be permitted for offsetting the resulting gains without limitations.	
2.4 There is an interpretation in tax audit practice that requires evidencing the "business-like nature" of any waiver of debts by banks in order for banks to classify the costs of such waiver as tax-deductible.	Evidence of "business-like nature" creates the potential for a challenge by the tax authority. There have been a number of such cases in practice. Classifying the waiver costs as non-tax-deductible may increase the credit losses of the bank.	It would be helpful for the business community if the Ministry of National Economy could publish its existing (internal) interpretation that evidence of the business like nature of the waiver is not necessary.	
Debt to equity conversions			
2.5 Debt to equity conversions in a pre-insolvency restructuring scenario or as part of a reorganisation plan in bankruptcy proceedings may trigger corporate tax liability at the debtor. Tax losses from previous years may only partially offset the tax liability pre-insolvency. However full tax losses can be offset if the receivable is waived in a bankruptcy reorganisation plan approved by the court or in a liquidation procedure.	The tax liability of the debtor may result in cash flow problems for debtors and undermine a successful restructuring.	A tax exemption should be granted to debtors where a debt to equity conversion takes place in a pre-insolvency scenario due to actual or threatened insolvency, or in bankruptcy in line with the approach taken in certain EU jurisdictions. Alternatively in a pre-insolvency scenario, all tax losses carried forward from previous years could be permitted for offsetting the resulting gains without limitations.	

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Real property acquired via security enforcement			
2.6 The acquisition of real property by a bank is subject to real estate transfer tax. Banks benefit from a reduction in real estate transfer tax if the acquisition is in the context of a security enforcement or sale of security in liquidation. However if the property is not re-sold by the bank within 3 years, a penalty tax becomes due. Upon future sale of the property, the transfer tax is levied again.	▸ Real estate transfer tax can be a significant cost and can almost never be recovered from the debtor in an enforcement or liquidation scenario, thus increasing the likelihood of credit losses.	▸ Given the current market conditions, real estate transfer tax could either be (temporarily) abolished in full for the acquisition of real property by banks through security enforcement. ▸ Alternatively, the period available for banks to utilise the reduced tax rate in security enforcement could be extended from the current 3 years to 6 years (the maximum allowed holding period under banking legislation).	
2.7 The above mentioned beneficial tax treatment in cases where real estate is taken over by the bank as a result of security enforcement or liquidation does not apply to financial enterprises e.g. leasing companies, or certain institutions carrying out lending activities, which are not fully licensed banks. Financial enterprises can have substantial NPL portfolios and the acquisition of real property by financial enterprises either as a result of security enforcement or liquidation would trigger the full real estate transfer tax.	▸ Real estate transfer tax can be a significant cost for financial enterprises and can almost never be recovered from the debtor in an enforcement or liquidation scenario, thus increasing the likelihood of credit losses.	▸ Extending the beneficial tax treatment to financial enterprises would ensure that they are not subject to unfair discrimination vis-à-vis banks.	
2.8 Real property acquired by a bank pursuant to a security enforcement or liquidation process continues to be subject to property taxes while held by the bank, even if not utilised.	▸ Banks may hold property that does not generate any cash flow; therefore, property taxes may increase credit losses.	▸ Given the current market conditions, property taxes could be abolished or reduced for a limited period during which real property is held by a bank pursuant to security enforcement or liquidation. .	

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3. Better Cooperation among Banks to Reduce NPL Exposures			
3.1The Budapest Approach sets out principles governing the multi-creditor restructuring of debtors in financial difficulties and cooperation among stakeholders.	▶ The Budapest Approach is not used on multi-creditor restructurings in practice.	▶ Consideration should be given by the Banking Association and the National Bank of Hungary to reviving the Budapest Approach e.g. by suggesting a collective revision of the Budapest Approach and implementation by banks in their standard working practices and/or targeting specific corporate NPLs for application of the Budapest Approach	

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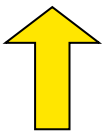
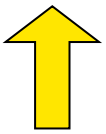
4. Enforcement against NPL Borrowers			
4.1 Management of the court enforcement procedure and choice of bailiff is statutorily determined on the basis of the debtor's registered seat, or upon the creditor's request, on the location of the debtor's assets.	▸ Creditors have no influence on the identity of the court bailiff. ▸ Important factors, such as professionalism, workload, previous feedback from stakeholders, cannot be taken into account in the existing bailiff appointment system.	▸ Creditors should be entitled to play a greater role in appointment and selection of the court enforcement officer, potentially by introducing a private sector element into the existing State-operated system. ▸ If no appointment right is granted, a creditor should at least be able to object to the appointment of a particular bailiff.	
4.2 The court bailiff's costs must be advanced by the creditor initiating the enforcement proceeding.	▸ A creditor may not have sufficient information at the outset to predict whether enforcement will be successful and the bailiff's costs may be significant.	▸ Creditors with an enforceable deed should be able to obtain any necessary advance information from the bailiff, subject to sufficient data protection for the debtor.	
4.3 Unless a direct sale is agreed, assets must be sold by the bailiff at auction via the electronic system operated by the Hungarian Chamber of Court Bailiffs.	▸ Stakeholders report that this website is difficult to use in practice and not attractive for potential bidders.	▸ Creditors should be given the opportunity to provide regular feedback on the electronic system to the Chamber.	
4.4 The court bailiff's base fee is calculated according to the value of the case i.e. amount of claim for any monetary claims or the amount of work performed, regardless of the outcome of the enforcement process.	▸ Under the existing fee structure there are no real incentives for the court bailiff to ensure the efficient sale of assets. ▸ Creditors report that bailiff fees are high and enforcement procedures frequently last more than one year.	▸ The system of remuneration for bailiffs should be reviewed. ▸ Specific statutory duties and deadlines should be set for bailiffs to respond to creditors and generally conclude the enforcement in a timely manner.	
4.5 The court bailiff is not subject to any regular reporting requirement to creditors.	▸ Creditors may not necessarily receive all relevant information in a timely manner, despite the existing duty of bailiffs to provide information to creditors upon their request.	▸ The bailiff should have regular reporting obligations towards creditors.	

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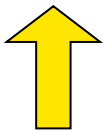
4.6 In the court enforcement procedure, objections against enforcement (*végrehajtási kifogás*) by creditors are decided by assistant judges at first instance level.	▶ The high turnover of assistant judges impedes consolidation of a unified judicial practice, undermining legal certainty and predictability. ▶ Assistant judges do not receive any specific training on enforcement and commercial issues	▶ The rotation system for assistant judges should be reformed and specialised training provided to assistant judges on enforcement objections, together with clear guidelines on enforcement objections and related commercial issues.	

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5. Effective Bankruptcy Proceedings to Improve NPL Restructuring			
5.1 Tax authorities are unable to accept less than 100% recovery on tax claims in bankruptcy proceedings pursuant to Hungarian tax law restrictions.	▸ Debt restructuring proposals are sometimes blocked because the tax authorities do not reduce their claims.	▸ Tax authorities should have the ability or, to avoid any State Aid issues, be required in certain circumstances to reduce their tax claims as part of a bankruptcy reorganisation plan. The Ministry for National Economy could issue guidance on how the tax authorities should exercise their right and discretion (if any) to waive tax claims. ▸ It would also be desirable to allow the Hungarian tax authority to waive tax liability in a pre-insolvency situation, to save the taxpayer from having to go into liquidation.	
5.2 The debtor does not need to prepare a business plan or reorganisation plan in order to file for bankruptcy.	▸ Bankruptcy proceedings can be initiated by the debtor without a professional and reliable reorganisation plan. ▸ Debtors are not properly prepared for financial and operational restructuring and for related costs.	▸ The Bankruptcy Act should be amended to require that a preliminary business/ reorganisation plan (and possibly also independent accountant's report) is part of the bankruptcy filing. ▸ Legislation should elaborate more on the required content of both the preliminary and the final plans. ▸ Legislation should strengthen the trustee's role in assistance of the debtor with preparation of a professional and reliable reorganisation plan.	

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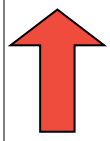
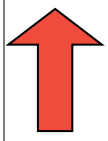
5.3 There is no existing "fast track" bankruptcy procedure involving the filing of a reorganisation plan by the debtor pre-agreed with its majority creditors.	▶ Debtors have no quick alternative to the ordinary court-led bankruptcy procedure to achieve a reorganisation agreement with their majority creditors (and cram down of any dissenting creditor minority). ▶ Ordinary bankruptcy proceedings take a long time and have material reputational and operational risks for debtors.	▶ Consideration should be given to creating a "fast-track" option in bankruptcy to enable debtors to prepare a reorganisation plan with the support of their majority creditors in advance of filing and minimise any time spent in bankruptcy (together with associated risks).	
5.4 The debtor may propose a number of restructuring measures in the bankruptcy reorganisation agreement including write-off, extension of debt maturity, assumption of debt by third parties, debt to equity conversion and/or the granting of new security interests.	▶ The form of reorganisation agreement is proposed by the debtor and creditors cannot propose a competing plan, although they can suggest amendments. ▶ In practice, the agreement is overly focused on debt write-off and neglects other restructuring measures, particularly debt for equity conversions, which enable creditors to benefit from a potential future "upside" in the business. ▶ The enforceability of certain restructuring measures is ambiguous due to the lack of supporting statutory provisions.	▶ Creditors should be given wider rights to make proposals to the overall restructuring (e.g. financial and/or operational restructuring steps and changes in management of the debtor). ▶ Legislation should facilitate implementation of different restructuring measures. ▶ Consideration should be given to preventing existing shareholders from blocking debt for equity conversions.	

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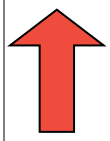
5.5 A claim can be classified as disputed if there is ongoing litigation in relation to the claim or if so decided by the trustee. Ongoing litigation is heard before an ordinary court and not a bankruptcy court. Creditors with disputed claims are excluded from voting at creditors' meetings but can still be bound by the vote of other creditors.	▶ Bad faith debtors frequently initiate litigation against creditors before filing for bankruptcy to exclude creditors from voting. ▶ Litigation can be protracted and usually does not end before the conclusion of the bankruptcy proceedings. ▶ Due to the erroneous practice of trustees and bankruptcy judges, the entire claim is classified as disputed even if litigation only affects a portion of the claim. ▶ As a result bona fide creditors can be excluded from voting on a reorganisation plan and yet still be bound by its terms.	▶ The trustee and bankruptcy courts should be required to pay particular attention to the circumstances of litigation initiated by the debtor. ▶ Both legislation and accompanying jurisprudence should ensure that only the portion of the claim affected by litigation is to be classified as disputed. ▶ To the extent practicable the same court handling the insolvency case should also examine the litigation. Otherwise there should be an expedited procedure for the court hearing the litigation matter to ensure that a bona fide creditor is not excluded from voting.	
5.6 Any decision at the creditors' meetings in bankruptcy can be passed by a simple majority of registered creditors in both secured and unsecured creditors' classes.	▶ Bad faith debtors frequently influence the voting by creating fictitious claims, the beneficiaries of which are related to the debtor. ▶ Trustees and judges only conduct a formal review of claims lodged by creditors. Judges do not have the authority or capacity to investigate and filter out fictitious claims. Trustees, whose role it is to register and classify creditor claims, tend to accept the debtor's position rather than investigate any "suspicious" claims.	▶ Judges and trustees should receive special commercial and accounting training to enable them to better filter "suspicious" claims. ▶ Trustees and judges should have access to information from banks and authorities regarding the financial affairs of the debtor and trustees should be under a duty to investigate suspicious claims. ▶ A debtor's attempts to enrol fictitious creditors should be penalized by law.	
5.7 Courts may only examine whether the settlement plan and reorganisation agreement in bankruptcy proceedings are in compliance with applicable law.	▶ Generally, only a formalistic review of the technical details of the settlement and related procedure is conducted by the court, although we understand that judicial practice is evolving to examine issues of "fairness".	▶ Courts should be entitled to rely on expert input where necessary when reviewing proposed settlement agreements. ▶ Judges should receive special financial and commercial training to enable them to assess reorganisation plans.	

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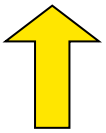
5.8 The trustee's base fee is calculated on the basis of the book value of the debtor's assets. Trustees receive their base fee irrespective of their performance. In the event of a successful settlement, the trustee is entitled to an additional success fee.	▶ If the debtor has a single asset with a significant book value (for instance, an SPV with valuable real property), the trustee's fee can be unreasonably high. ▶ Courts usually do not exercise their right to adjust the trustee's fee according to the circumstances of the case. ▶ The rigid remuneration structure does not incentivise trustees to play a more active role in the proceedings.	▶ The remuneration structure (base fee and success fee) for trustees should be reviewed to take into account best practice and ensure that it provides the right incentives for performance. ▶ Training should be provided to bankruptcy judges to ensure that they examine the fairness of the trustee's fee and make adjustments, if needed.	
5.9 There are no existing incentives for rescue financing in bankruptcy.	▶ Without rescue financing or additional financing in place, many debtors cannot continue to operate as a going concern during and following bankruptcy proceedings.	▶ Further support should be granted for rescue financing to encourage new lending to borrowers in financial difficulty e.g. priority ahead of unsecured creditors (or possibly, in certain limited circumstances, also other secured) in any subsequent liquidation.	

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6. Effective Liquidation Proceedings to Liquidate NPL Exposures			
6.1 The most common reason for filing for liquidation is the debtor's failure to dispute or pay its previously undisputed or acknowledged debt within 20 days from the relevant due date and following a written demand. The debtor can avoid liquidation if it proves that it disputed the relevant claim on its merits in due course.	▸ No "real" insolvency test is applied by courts during the examination of liquidation filings, only a formal review is conducted. ▸ It appears to be too easy for debtors to avoid liquidation by disputing creditors' claims. ▸ Liquidation courts do not examine whether the dispute is justified. This is subject to examination by ordinary courts in litigation.	▸ Insolvency judges should be entitled to resolve on liquidation if they reasonably believe that the outcome of the dispute initiated by the debtor regarding a creditor's claim will not fundamentally affect the fact that that debtor is insolvent and/or if it appears that the dispute is not well-founded or made in bad faith. ▸ Specialised training should be provided to judges to assess whether the debtor is technically insolvent. ▸ To the extent practicable the same court handling the insolvency case should also examine the litigation. Otherwise there should be an expedited procedure for the court hearing the litigation matter to ensure that there is no unreasonable delay to liquidation.	

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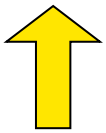
6.2 On commencement of liquidation proceedings, only the liquidator is entitled to dispose of the debtor's assets (including any secured assets) and is the ultimate manager of the proceedings. The liquidator may deduct the costs of the preservation, maintenance and sale of any secured asset, as well as the fees of the liquidator from the proceeds of the sale.	▸ There is a general lack of information provided to creditors during the liquidation process and a lack of transparency by some liquidators. ▸ Creditors (secured and unsecured) have very weak control over the course of insolvency proceedings and particularly any sales by the liquidator. ▸ Secured creditors do not have sufficiently strong rights in relation to the sale of assets secured in their favour and are reportedly not always consulted in practice. ▸ There is a conflict between secured creditors who expect the liquidator to sell the secured asset as soon as possible and the liquidator and unsecured creditors who are more interested in the maintenance of the debtor's operations.	▸ Legislation should introduce more detailed statutory obligations for liquidators regarding sale of the debtor's assets and deadlines for the performance of such obligations. The liquidator's information obligations towards all creditors should be strengthened. ▸ Consideration should be given as in most other European jurisdictions (i) to providing unsecured creditors with rights to approve a plan of sale by majority vote in respect of unsecured assets and (ii) to creating a separate approval procedure for secured creditors for sale of any secured assets and/or to allowing secured creditors to elect to segregate their secured asset from the liquidation estate at the outset of liquidation proceedings. ▸ Secured creditors should be granted more influence with respect to the sale of the secured asset (timing and auction price) and rights to assist in its sale.	
6.3 Other than private sales, the liquidation sale can take the form of a public tender or auction. The asset is sold at the highest price that can be achieved under the given market conditions. No bidding of debt by secured creditors is possible in the first two sales attempts by the liquidator: secured creditors may only acquire a secured asset in the early tender/ auction stages by advancing fresh money.	▸ The effectiveness of liquidation sales is decreased by the lack of transparency and potential buyers. ▸ Professional investors prefer buying assets from banks and not directly in liquidation; however, they often lose interest in the asset due to the lengthy proceeding. ▸ Secured creditors need to invest fresh money if they would like to purchase the asset for sale in the early stages of the proceeding.	▸ Potential buyers could be incentivized by certain tax and stamp duty discounts for sales in liquidation proceedings. ▸ A sufficiently and widely known, properly advertised and user-friendly tendering site should be established to facilitate sales in liquidation. ▸ Secured creditors should be given wider rights to "bid their debt at an early stage.	

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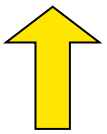
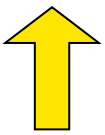
6.4 Provisions of the New Civil Code and the newly-inserted Article 4/A of the Bankruptcy Act relating to lenders' rights regarding the methods of enforcement (e.g. via a private sale by the lender) of the security deposit (*óvadék*) conflict with older provisions of the Bankruptcy Act.	▸ Conflict between the provisions causes uncertainty for creditors. ▸ Uncertainties deter creditors from concluding new financing agreements (under the New Civil Code) and from refinancing existing agreements (under the Old Civil Code).	▸ The New Civil Code and/or the Bankruptcy Act should be amended in line with recommendations in the Report to eliminate ambiguities.	
6.5 Liquidation proceedings must be concluded within two years of their commencement date. However, if there is ongoing litigation between the debtor and a creditor, this two year deadline is not applicable.	▸ Judges are overloaded and thus not in the position to properly oversee the proceedings and ensure that cases are handled efficiently by liquidators. ▸ The banks report that they have been involved in many lengthy liquidation proceedings of approximately four years.	▸ While the new on-line auction system (introduced in January 2015) is expected to improve the efficiency of liquidation sales, creditors should be given greater rights to scrutinise and object to the liquidator's actions or inactions and the timetable for the liquidation. ▸ Greater regulation and supervision of liquidators should be considered to ensure that liquidations are handled in a timely manner.	
6.6 In liquidation proceedings, a creditors' committee may be established by one third of the registered creditors if the claims of these creditors cover at least one third of the aggregate claims of the creditors entitled to vote. Alternatively creditors may appoint a creditors' representative under the same terms.	▸ Creditors' rights are not properly represented as only a few creditors' committees or creditors' representatives are established in practice. ▸ The administrative burden of establishment and operation of the creditors' committee is high compared with the low recovery rate in liquidation proceedings.	▸ If the efficiency of liquidation proceedings increases and potential returns to creditors increase, they may be more willing to establish a committee or appoint a representative	

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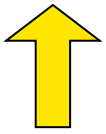
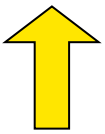
RELEVANT ISSUE	PRACTICAL CONSEQUENCE IDENTIFIED	MAIN RECOMMENDATION	PRIORITY
6.7 There is a general duty on the liquidator to take all steps necessary to unwind any actions by the debtor which increased the exposure of creditors before the liquidation proceeding. In liquidation proceedings, the liquidator must inquire at public registries and account holder banks to obtain information about the debtor's assets and rely on the debtor's executive officer for financial documentation and appropriate cooperation.	▸ Despite recent changes in law, the current tools of investigation and recovery of liquidators are still not powerful enough to properly assess the debtor's assets and ensure the return of any dissipated assets to the debtor's estate. ▸ Lack of information about the assets and pre-insolvency acts of debtors, and the lack of powerful measures for dealing with bad faith debtors significantly decrease the ability of liquidators to maximise the debtor's estate for liquidation.	▸ Legislation should be strengthened to ensure that that the liquidator can be found liable if it failed to investigate and seek the recovery of any material dissipated assets belonging to the debtor's estate or unwind acts detrimental to the creditors. ▸ Liquidators should be provided with tools similar to those of court bailiffs in terms of public registry search and direct enforcement measures against bad faith debtors or other third parties. ▸ More effective sanctions should be imposed on the debtor's executive officers in the event of non-compliance with their duty to cooperate with the liquidator and to provide it with documents and information related to pre-insolvency activity of the debtor.	
6.8 In liquidation proceedings, former and existing executive officers may be held liable if they did not take creditors' interests into account following the "threat of insolvency" and if the value of the debtor's assets decreased or the full satisfaction of creditors' claims was impeded as a result.	▸ The provisions related to directors' and shareholders' liability do not seem to work properly due to lack of information and evidential difficulties for the liquidator or creditor initiating the procedure. ▸ The court only establishes liability in the most obvious cases.	▸ More effective and dissuading sanctions should be imposed on the debtor's executive officers to ensure that they take creditors' interests into account when the company has entered the "zone of insolvency".	
6.9 Former and existing shareholders may be held liable for fraudulent transfer of their shares, misuse of their limited liability or for their "continuous adverse business policy" (*tartósan hátrányos üzletpolitika*) towards the debtor.	▸ The provisions for the fraudulent transfer of shares are rather vague and are not well-defined. ▸ Judges do not have the capacity to conclude a thorough review of matters where "continuous adverse business policy" is alleged.	▸ Legislation should clarify the provisions regarding shareholders' liability for fraudulent transfer of shares and "continuous adverse business policy".	

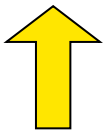
Executive summary

RELEVANT ISSUE	PRACTICAL CONSEQUENCE IDENTIFIED	MAIN RECOMMENDATION	PRIORITY
6.10 Legal powers and duties of liquidators are not clearly defined by the Bankruptcy Act.	▸ It is not always clear whether the liquidator should be acting in its name or in the name of the debtor (and any associated liability for its actions). ▸ The liquidator's mandate does not refer to the requirement to help to ensure the best possible return for creditors.	▸ Legislation should further clarify the liability of the liquidator and the scope of its duties (including the duty to protect the financial return to creditors).	
6.11 In liquidation proceedings, the liquidator's fee is 5% of the amount of the proceeds from the assets sold in liquidation and the proceeds from recovered claims, but a minimum of HUF 300,000 (approx. EUR 1,000). The liquidator is also entitled to receive 2% of the proceeds from any continuation of the debtor's activity. Liquidation costs are satisfied upon their due date.	▸ The framework for liquidators' fees was criticised by each stakeholder group consulted, including the Association of Insolvency Office Holders. The Association reported ambiguities in the existing fee structure. ▸ Creditors are concerned that liquidator fees are too high in comparison with the work performed and that liquidators account inappropriate items as liquidation costs to benefit from statutory priority of payment, which cannot be easily challenged by creditors.	▸ Further review of the remuneration structure for liquidators should be conducted to take into account best practice and the need to protect creditors. ▸ Further provisions should be introduced to enable liquidation costs to be reviewed by the court and creditors (outside of the existing objections process).	

Executive summary

RELEVANT ISSUE	PRACTICAL CONSEQUENCE IDENTIFIED	MAIN RECOMMENDATION	PRIORITY
7. Stronger Professional Capacity in Bankruptcy and Liquidation Proceedings for NPL Resolution			
7.1 The trustee and the liquidator are appointed by the court by a random electronic appointment system in both the bankruptcy and the liquidation proceedings.	▸ Stakeholders and creditors in particular have no influence on the appointment process and limited rights to replace a trustee/ liquidator. ▸ Some trustees/liquidators are not motivated to work to the highest professional standards because there is no link between performance and appointment.	▸ Consideration should be given to replacing the randomised system with a system of appointment by the court with significant input from creditors (and in bankruptcy also the debtor) to select the best performing trustees and liquidators or at least facilitate their replacement for under-performance.	
7.2 In both bankruptcy and the liquidation proceedings, creditors and any affected party may file an objection (*kifogás*) with the court against a trustee/liquidator's act or failure to act within 8 days of becoming aware of such act. If the court finds the objection well-founded, the act can be unwound and the trustee/liquidator may be held liable for damages for breach of any of its obligations.	▸ The deadline for filing an objection is relatively short (especially for banks and in complicated matters) and courts rarely reach a decision within the required time. ▸ Objections are typically rejected because of the lack of detailed provisions governing the office holder's duties and the difficulties faced by creditors in establishing breach of duty. ▸ Initiating litigation to establish the trustee's/liquidator's liability is not a real alternative since this proceeds before ordinary courts and lasts even longer than the objections process.	▸ Legislation should be more detailed in terms of the duties and responsibilities of the liquidator, the various steps in the proceedings and related statutory deadlines. ▸ Greater training and/or specialisation within the judiciary would enable insolvency judges to deal more effectively and efficiently with creditor objections.	

Executive summary

7.3 There is insufficient professional monitoring of the day-to-day operation of trustees/ liquidators, beyond the guidelines issued by the Hungarian Association of Insolvency Office Holders and the rights regarding their enrolment by the Ministry of National Development.	▸ Membership of the Association is voluntary. Guidelines and principles prepared by the Association are not legally binding on members. ▸ There is a lack of consistency of approach within the trustee/ liquidator profession, which decreases legal certainty and predictability for stakeholders.	▸ Trustees should be subject to a binding code of conduct and professional rules. ▸ Regulation, supervision and monitoring of trustees and liquidators should be strengthened and supported by appropriate disciplinary measures. ▸ Consideration should be given to an increase in the regulatory powers of the Ministry of National Development and/or the Association or the establishment of a chamber of IOHs.	
7.4 Banks report an increasing number of insolvency cases involving fraud and corruption.	▸ Effective investigation and criminal sanctioning is hindered by the lack of sufficient knowledge of police staff and public prosecutors	▸ Police staff and public prosecutors, in addition to insolvency judges, should receive more thorough training related to commercial, accounting and other business-related matters.	

Project background

1. Project background

Introduction of the Project

Introduction

- The National Bank of Hungary (the "**NBH**") is seeking to address the high volume of NPLs and the effect of NPLs on the financial stability and long-term economic performance of Hungary and the banks operating in Hungary. The NBH established a working group to address the NPL situation and as part of this initiative in 2014 requested the EBRD to conduct a review and analysis of the existing framework in Hungary for restructuring and insolvency and to propose measures to deal more efficiently with NPLs (the "**Project**").
- The Project goal was to identify any obstacles to deal more efficiently and proactively with NPLs in the corporate sector and suggest potential remedies, as well as incentives to promote NPL resolution for consideration by the NBH and government stakeholders[2]. The EBRD was assisted by EY as its financial advisor and by White & Case as its legal advisor on the Project and in preparation of this Project report.
- The Project report was approved by the Financial Stability Council of the NBH and formed the basis of discussions in January 2015 with the NBH and relevant government stakeholders, including the Ministry of Justice, the Ministry of National Economy and the Ministry of National Development. The report will be presented at a workshop on NPL resolution involving both public and private stakeholders to be hosted by the NBH in early March 2015 and will be the subject of further discussions with government stakeholders.

Methodology of gathering information

- A number of stakeholders with appropriate experience and exposure to the subject of this report were interviewed by EY and White & Case. These persons included the Chief Risk Officer and legal head of work out for six banks, representing 53% of Hungary's banking sector based on total assets.
- Meetings were also conducted with the following stakeholders:
  - Felszámolók és Vagyonfelügyelők Országos Egyesülete

    (Hungarian Association of Insolvency Office Holders)
  - Magyar Kereskedelmi és Iparkamara

    (Hungarian Chamber of Commerce and Industry)
  - Magyar Bírósági Végrehajtói Kamara

    (Hungarian Chamber of Court Bailiffs)
  - A number of high-profile insolvency judges.
- Information was obtained from these stakeholders on a number of matters including:
  - the background of the current NPL situation in Hungary and as it relates to the banks;
  - the experience of banks in handling NPL and restructuring measures used;
  - the most common financial, legal and taxation issues that banks had encountered which hindered resolution of NPLs; and
  - proposals to strengthen Hungarian enforcement and insolvency proceedings.
- Before the meetings, the EBRD sent an introductory letter to the banks informing them of the initiative and including a questionnaire (see Appendix D). In addition to the list of questions, banks were asked to mention specific examples on an anonymous basis to the extent possible under applicable bank secrecy provisions. The responses obtained during the interview formed a solid basis for this Report and were supplemented by the experiences of EY and White & Case.
- EY prepared the background and recommendations for the financial and tax topics addressed in the Report, while White & Case prepared the sections relating to the legal and regulatory framework. Any questions or observations in respect of these areas should be addressed to the appropriate party.

[2] Considerations in respect of the retail or household sector fall outside the scope of the LTT initiative. This is due to the different legislative frameworks and policy concerns in respect of retail NPLs.

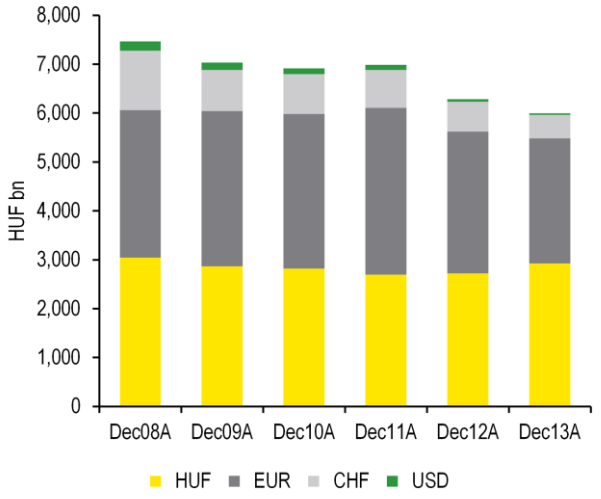
Analysis of NPL situation

1. Key reasons for current NPL situation
2. Key factors by managing NPL portfolios
3. Key barriers preventing change
4. Key issues in relation to the transfer of NPLs

Hungarian banking sector overview

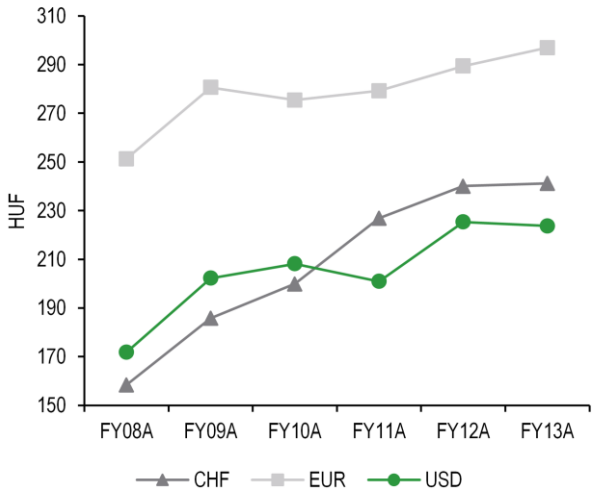
Total corporate loan portfolio by currency Dec08A-Dec13A

Source: Stability report of NBH



Annual average FX rates FY08A-FY13A

Source: Historical rates of NBH



ROE and ROA development FY08A-FY13A

Source: Stability report of NBH

Banking sector overview

Corporate loan portfolio overview

- As presented in the chart on the left total corporate loan portfolio decreased by 19.6% from HUF 7,463 bn (approx. EUR 25 bn) to HUF 5,999 bn (approx. EUR 20.1bn) between Dec09A and Dec13A.
- During the period FY08A - FY13A the share of FX denominated loans decreased from c. 60% to 50% but in a different extent. While USD denominated loans dropped by 82.8% and CHF denominated loans decreased sharply by 60%, the EUR loans decreased only by 15.5%.
- HUF denominated loans decreased by 3.7% from Dec08A to Dec13A, meaning the domestic currency gained, in relative terms, significance in the funding structure of the Hungarian corporations. This realignment is due to the intensive weakening of HUF causing higher monthly instalments for FX denominated loans.
- The weakening of HUF compared to EUR, CHF and USD is presented on the chart left below. Annual average of EUR, CHF and USD rates in HUF increased by 18%, 52% and 30% respectively from FY08A to FY13A. The relative small increase in HUF/EUR rates pushed corporations to replace CHF and USD loans with EUR denominated funding, which we could observe by the realignment of corporate loans.

Changes in regulatory environment

- The Hungarian Government introduced several measures in the previous years (1) to help consumers/ households suffering from increased monthly mortgage payments, (2) to help Small and Middle Enterprises (SME) to fund new investments and (3) to increase tax revenues.

1 Measures such as the Early Repayment Scheme and FX cap aim to protect households from increased monthly mortgage payments. The National Asset Management Agency (NAMAC) and the Quota system have the goal to protect households from forced eviction. The introduction of strict criteria for lending in FX is aimed at prohibiting the reproduction of retail FX loans.

2 The Growth scheme launched by the National Bank of Hungary (NBH) aims to facilitate new investments of SMEs and refinancing of FX loans by providing free of charge funding to commercial banks.

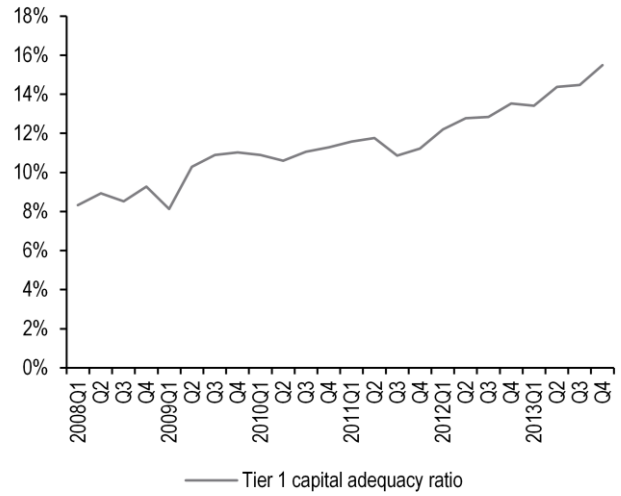
3 Due to unfavourable global funding environment since FY08A the budget deficit turned to be harder to finance, thus fiscal restraints had to be introduced and sector specific taxes had to be levied. For the Banking sector Bank tax, financial transaction tax and extra financial transaction tax (one-off payment in FY13A) were levied.

- Besides Governmental actions, litigations against Banks are also ongoing mainly related to FX retail loans.

Hungarian banking sector overview

Capital adequacy ratio of the Hungarian Banking sector

Source: Stability report of NBH



Profitability of the Sector

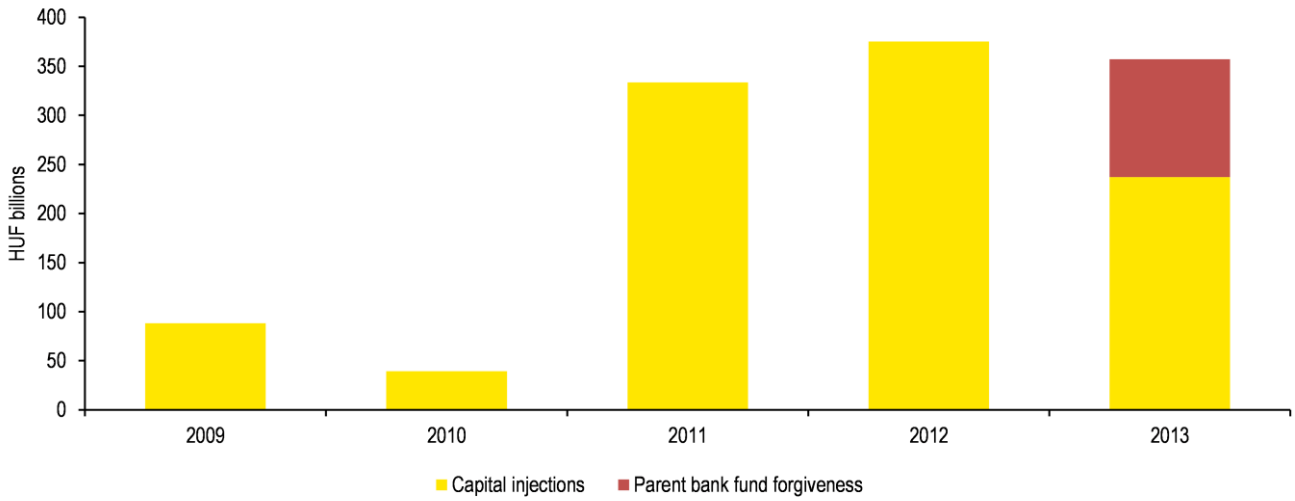
- The Banking sector was loss making between Q411A and Q313A. The positive return on equity (ROE) in Q413A was due to a one-off debt forgiveness at MKB. The adjusted ROE was still negative in Q413A, however improved significantly compared to FY12A.
- Profit before tax (PBT) of the Banking sector was HUF 114 bn in FY13A first time positive since FY10A. The one-off forgiveness is responsible for the profit; the adjusted result excluding this effect is a loss.

Capital injections

- Due to loss making operation of banks in Hungary, the parent banks injected new capital into Hungarian subsidiaries to meet capital adequacy ratio (minimum 8% or adjusted upwards for NBH requirements).
- Due to capital injections the Capital adequacy ratio (CAR) showed a significant increase in the last 5 years reaching 15.5% at Dec13A, meaning a 6.2 p.p. increase compared to Dec08A.
- Depending on the result of the AQR, it may or may not be required a further injection of capital. The result of Asset Quality Review (AQR) will be available in October FY14.

Capital injections FY09A-FY13A

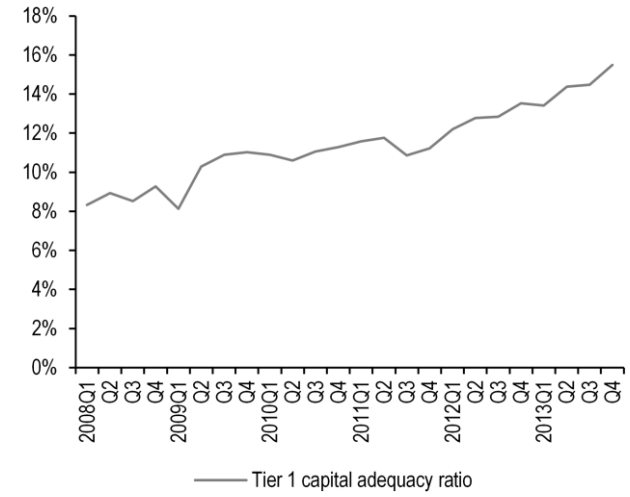
Source: Stability report of NBH



Key drivers of NPL stock increase based on historical data

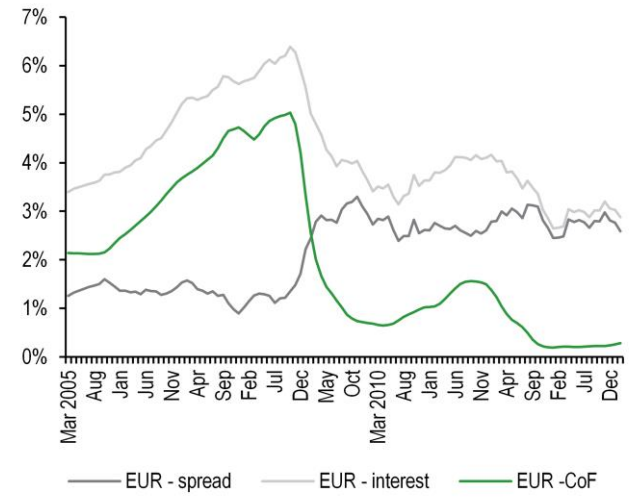
Annual average FX rates FY08A-FY13A

Source: Historical rates of NBH



Average interest rate and spread of newly issued corporate EUR loans

Source: Stability report of NBH and EY calculation



Drivers of NPL increase

- Increase in non-performing loans is due to a coincidence of multiple factors.

FX changes

- As presented in the section “Hungarian banking sector overview” the HUF devalued compared to EUR, CHF and USD by 18%, 52% and 30% from FY08A to FY13A. As a consequence monthly instalments of FX denominated loans increased sharply causing a high burden for corporations with HUF revenue only and not using hedges.

Interest rate changes of FX loans

- Due to doubled spreads compared to FY05A average interest rates (1.3% in May05A, 2.6% in Feb14A) of newly issued corporate loans decreased only marginally from 3.4% in May05A to 2.9% in Feb14A. The historical development of interest rates and spreads of EUR denominated non-overdraft loans is presented on the chart on the left below.

Decreasing corporate profits

- The economic downturn decreased corporate profits and made many companies loss making. In many cases the lower profit impaired the companies’ ability to pay the monthly instalments. As a result of downturn, many loans were cancelled or restructured during the last years.

Decreasing real estate values

- The main form of collateral used by corporate and project financing is real estate; the loan contracts were usually concluded with little available headroom. Due to the weakening HUF and decreasing real estate values, LTVs showed a significant increase affecting negatively both banks and corporations.

Decrease in consumption

- Consumption of households decreased due to increasing unemployment rates and decreasing salaries. Decreased level of demand forced corporations to reduce production/product prices and lower rental fees, which served as the primary sources of instalment payment. In case of real estate related project financing many projects were not finished or after finishing could not be sold, pushing debtors into non-performing status.

Changes in tax environment

- Due to the increased unemployment rate and the sharp decrease in consumption costs of social transfers (e.g. unemployment aid), causing an increased level of budget deficit. To prevent a significant increase in public debt the government levied sector specific taxes for financial institutions, telecommunication companies and retail companies.

Actual key indicators of NPL loans based on Management interviews

Drivers of corporate NPLs

Source: Management information

Main NPL drivers reported by corporate clients

- Numerous NPL increasing indicators were identified by the banks during the interviews with the consulting team. Some factors came up regularly at every meeting but some were specific and were mentioned by one bank only. Specific issues affecting one bank only are not presented, as EY was collecting only sector specific and not entity specific obstacles.
- The key drivers of corporate NPL increase mentioned by most banks are the following:

– The overall economic situation in Hungary is poor as a consequence of the global financial crisis (stagnating internal consumption, low level of investments). However signs of recovery have already been observed by the banks in Q114A. Corporate loans are expected to recover at a faster pace, but loans backed by real estate are expected to heal at a slower pace. Banks apply various restructuring measures to minimise the effect of the crisis.

– Over-lending and financing of speculative assets were mentioned by almost every bank as a trigger of current NPL situation. Two banks mentioned that most of the corporate/project loans were originated between FY06A-FY08A, when asset prices (especially real estate) were high and banks assumed that the economic growth was sustainable.

– FX changes are strongly responsible for increased monthly instalments, which are key drivers of non-payment. HUF devalued compared to EUR, CHF and USD by 18%, 52% and 30% respectively from FY08A to FY13A.

– An increased number of fraud cases (“moral hazard”) was mentioned as a serious issue by almost all banks and a driver against NPL resolution. Increased level of fraud generates a significant number of long lasting court cases, which hinders the efficient closing of NPL deals.

– As set out in the legal analysis at “Practical legal issues and suggestions” below the constantly changing and unfavourable legal environment is a main obstacle to NPL resolution. All the banks reported judicial processes to be slow and ineffective. The common view among banks is that the creditors’ position in restructuring and insolvency should be strengthened to improve the prospects of NPL resolution. In terms of actual problems the opinion of banks interviewed can be classified into two groups. The two views are:

1 The current legal environment is roughly appropriate, but the actual court enforcement/liquidation/bankruptcy proceedings are not performed in the interests of creditors. Creditors do not have sufficient control or influence over trustees and liquidators (**IOHs**). A solution would be an increased control of the appointment and/ or the removal of the IOHs.

2 The Bankruptcy Act has been amended on numerous occasions and is rather obsolete, thus, new legislation is required. The position of creditors has been strengthened by recent changes to the law, but creditors should be granted more effective control over the activity of the IOHs. Currently creditors are entitled to replace the liquidator by law, but this does not work effectively in practice. Another important point mentioned was to reduce the duration of liquidation proceedings.

– The behaviour of clients, judges and liquidators is also an obstacle to NPL resolution. Clients are mostly not cooperative, while judges and liquidators are usually not acting in the best interest of creditors as key stakeholders in insolvency.

– The communication of the Government about retail loans suggests banks are responsible for FX loans and actions will be taken to protect clients. This may have a negative effect on the payment of corporate clients as well.

– The illiquid and non-transparent secondary market for NPLs was mentioned by two banks as a main obstacle to selling NPLs. One of the banks indicated that the licensing procedure for NPL acquisition platforms discourages international investors. Another bank mentioned that the uncertain legal environment does not make Hungary attractive for potential international buyers.

- A detailed description of these issues is presented in the “Main barriers identified by stakeholders” Section of this Report together with certain proposed solutions.

Actual restructuring measures used by Banks

Common restructuring measures

Source: Management information

Restructuring measures applied by banks

- A wide range of restructuring measures is used by the banks. The actual options used depend on the debtor's financial situation, asset structure of the company and the market expectations in the specific industry.

Covenant amendments

- Banks are usually ready to waive or ease financial covenants for distressed companies. Financial covenants generally applied are: Loan to Value (LTV), Debt service coverage ratio (DSCR), Debt service reserve account (DSRA).

Financial restructuring

- Financial restructuring refers to a wide range of restructuring measures such as tenor extension, rescheduling of instalments, margin lowering, interim payment moratorium (total or partial) and release of interests or capital.

Voluntary asset sales

- In case of payment difficulties, banks allow customers to sell assets voluntarily at market price and use the proceeds for the prepayment of the loan.

Restructuring with haircut

- In case of restructuring with haircut the only difference is that besides financial restructuring elements already presented, part of the outstanding exposure will be cancelled. This solution is normally preferred after having unsuccessfully tried a rescheduling of payments under the loan.

Refinancing or refinancing with haircut

- Refinancing opportunities are only available for a limited number of good clients. In order to facilitate refinancing, banks have to offer a haircut for other commercial banks to refinance risky loans.

Debt to equity conversion

- In very limited cases, the conversion of debt to equity is also an option for the banks. This solution is rarely applied in practice due to the difficulties of subsequently exiting the position.

Debt to asset swap

- This solution is used mostly for real estate and in a few cases only, since banks do not like to keep real estate or inventory on their books.

Change of debtor's management

- In rare cases change of the debtor's management is also a potential solution. Sometimes the emotional attitude of the shareholders in relation of the management is an obstacle to a successful restructuring.

Grace period, moratorium

- Usually one of the first steps that banks take is to provide a grace period or moratorium for the debtor, during which period the debtor is not obliged to pay any instalments. This can help the debtor in case of temporary financial difficulty only.

Requesting additional collateral or security

- If the bank is not convinced about the healthy financial condition of a debtor, it may request supplemental collateral or security for the loan. However, usually distressed debtors are not able to provide any additional collateral.

Approach used for restructuring/exit of bad loans

Restructuring of distressed/ non-performing debtors

- The main approach preferred by banks is to restructure (and save) the loan and keep the debtor performing. Sale of NPLs is a last resort.
- Due to high level of NPLs, the illiquid secondary market, ineffective bankruptcy and liquidation procedures, banks make massive efforts to keep debtors and loans performing. A combination of various restructuring options is used to support debtors and help them to avoid default.
- Besides restructuring, refinancing of loans is also a favourable solution for banks to get rid of bad loans and to free-up resources and capital. In the current market environment bad and risky debtors can be only refinanced with a significant haircut.

Exit of bad loans

- There are two different approaches used by banks for managing non-performing loans:

1. Some banks prefer to manage NPLs in-house. These financial institutions emphasize the importance of changes to the Bankruptcy Act, in order to facilitate the resolution of NPLs.
2. Another group of banks would prefer to sell NPLs on the secondary market. These banks would push for the establishment of a transparent and liquid secondary market, which can be partly done by simplifying licensing requirements of NPL acquirers and/or the process for obtaining a licence. Changes to the Bankruptcy Act are supported by this group too.

Main NPL barriers identified by stakeholders

- Based on our interviews conducted with the banks and other stakeholders a wide range of obstacles have been identified to NPL resolution.
- The barriers can be classified as legal, tax and other barriers. The main elements are:

Legal

- In this section we will only identify the legal issues mentioned by the stakeholders in the interviews. The detailed description of the legal issues and framework is presented in section “Practical legal issues and suggestions” below. We note that in some cases the stakeholders did not make precise statements from a legal point of view. For example they mentioned that it is not possible to replace the liquidator, although this is, in fact, legally possible but does not work effectively in practice. In the section “Legal background” we provide a precise description of the relevant legislation.
- Most barriers identified by banks were related to the current legal environment. General issues regarding both bankruptcy and liquidation proceedings are the following:
  - duration of these proceedings,
  - lack of transparency and creditors’ control over the process, and
  - malicious acts of debtors abusing the bankruptcy/liquidation proceedings.

Bankruptcy procedure

- The “first come, first served” approach is followed by creditors and there are no generally accepted rules for creditor cooperation, notwithstanding the existence of the “Budapest Approach”.
- Bankruptcy proceedings are not applied properly in Hungary and are used mostly for postponing liquidation. The debtor and its shareholders are not aware that additional financing is required during bankruptcy proceedings (no preliminary business plan is prepared), with the result that the banks are less interested in contributing to the success of any bankruptcy settlement.
- As there is insufficient time and investigating capacity for the court and for the trustee to examine in detail the connection of creditors to the debtor or the proper legal basis for creditors’ claims, fictitious creditors, which are somehow connected or affiliated to the debtor, appear in the bankruptcy proceedings for the purposes of influencing the voting.

Liquidation procedure

- The number of acting liquidation judges is insufficient to cover the number of cases, leading to an increase in the duration of the proceedings and a lack of the “day-to-day” supervision of the liquidators’ activity.
- There is insufficiently widely-known (properly advertised) tendering site for bidding in practice, which stakeholders suggested is not user-friendly.
- The opportunity to change liquidators for under- or non-performance does not work effectively in Hungary in practice, due, among other matters, to the formalistic approach of many judges and the lack of detailed regulation of the liquidators’ obligations.
- Liquidation proceedings are executed slowly, but close to the statutory two year deadline for liquidation some judges push to close the cases immediately, disregarding any ongoing settlement disputes between the creditor and the liquidator.
- Liquidators have the right to cancel agreements of the debtors but creditors do not have the right to request the liquidators to cancel such agreements.
- For a most detailed summary of the legal barriers, please see the Practical legal issues and suggestions Chapter.

Transfer of claims

- Licensing issue
  - One of the key reasons cited by stakeholders for the large number of unsuccessful restructurings is the lack of a liquid secondary market for NPLs. Given the size of the Hungarian market and the average deal size of a Hungarian corporate NPL portfolio, the interest of both internal and external (non-Hungarian) potential bidders need to be facilitated. One of the measures that may increase the appetite of the secondary markets for the purchase of NPLs is the easing of the regulatory burden in connection with any NPL purchase.

Main NPL barriers identified by stakeholders

- Legal Framework
  - As a related consideration, the legal framework needs to be more attractive to potential investors. On the sale of an NPL exposure, a new creditor should be able to step into the shoes of the existing creditor, especially regarding the related security interests. However this is subject to uncertainty following the introduction of the New Civil Code and the concept of novation which suggests the re-triggering of hardening periods.

Tax and Accounting

- The State authorities (particularly the Hungarian tax authority) cannot accept any settlement proposal, whether in pre-insolvency or insolvency proceedings, other than a proposal that envisages a 100% recovery of their claims pursuant to applicable Hungarian tax legislation.[3]
- Revenue recorded relating to the partial waiver of the loan liability is subject to corporate income tax by the debtor, which is causing liquidity issues for restructured debtors since it cannot be fully offset by carried forward losses outside of insolvency and such carried forward losses may be ineffective in substantially reducing the tax liability in insolvency.
- Debt to equity conversion results in corporate tax liability at the debtor and it cannot be fully offset by carried forward losses, on the other hand in case of takeover of the company consolidation requirement would arise.
- Under Hungarian accounting rules, bad debts can be written-off by banks only if they qualify as uncollectible receivables at the end of the liquidation. Some banks proposed to create an exception for banks regarding this regulation, as liquidation procedures lasting for years hinder the write-off of already 100% impaired loans.
- The acquisition of real property as collateral is subject to real estate transfer tax. This was only mentioned as a minor issue, however it can mean significant amount of payments for the banks and particularly financial enterprises which do not benefit from the discount available to banks acquiring assets as part of a security enforcement or liquidation.
- Real estate assets acquired by banks following security enforcement and/or sales in liquidation remain subject to property taxes even if the property is unutilised or is actually only a non-cash generating plot.

Other

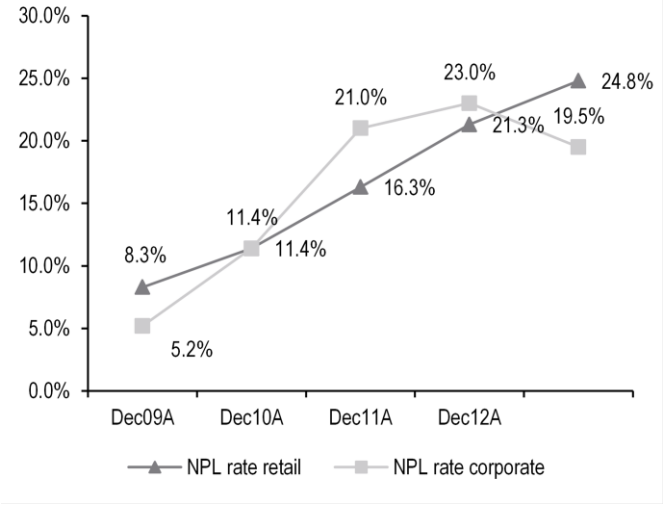
- One of the major problems is the attitude of debtors, namely, that there is a highly increased willingness not to repay the debts.
- A bank proposed to develop specific education of the police officers, state prosecutors and judges involved in financial fraud cases, which at the moment is missing. In addition, some other stakeholders proposed to set up specialized courts treating liquidation and bankruptcy proceedings.
- The Banking Association and other professional bodies should get more involved in the legislative proceedings.

[3] In Hungary, the Tax Procedure Act (Act. No. 92 of 2003) section 134 (2) explicitly prohibits the waiver of any tax claim towards a non-individual taxpayer. It remains nonetheless possible for the tax authority to waive interest and any tax penalty.

Lack of liquid secondary market

NPL rates

Source: Stability report of NBH



Features of the secondary market

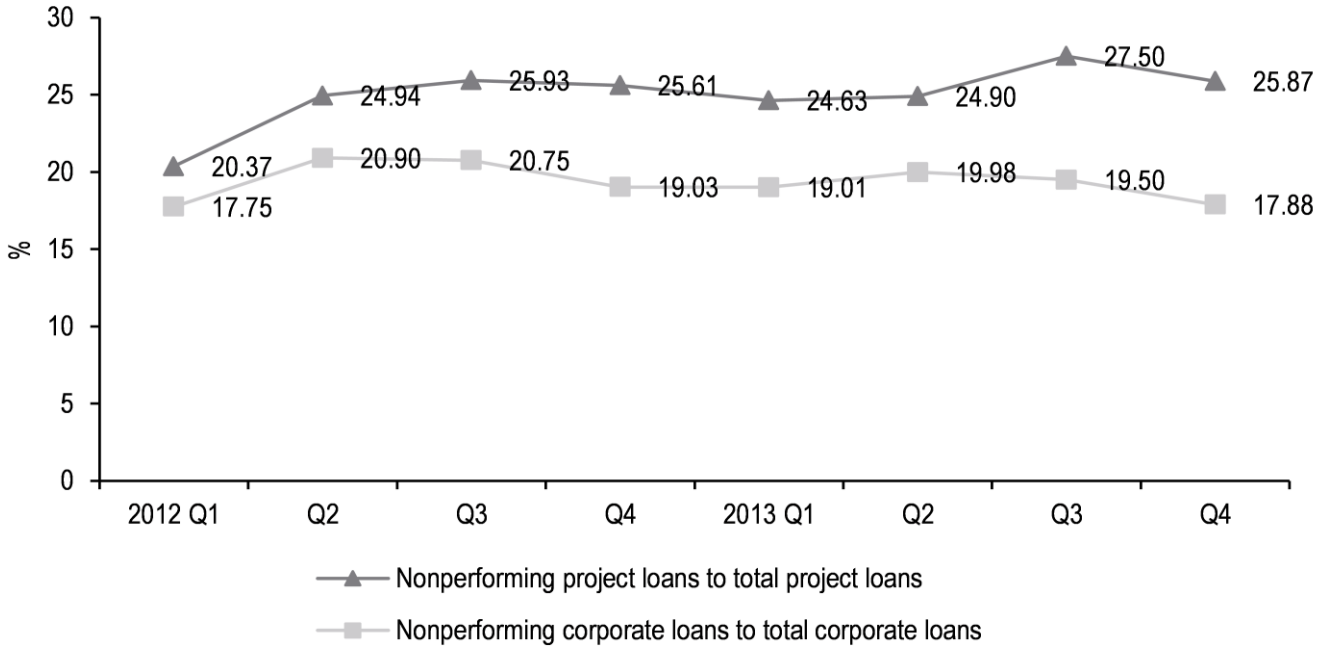
- One group of banks would prefer selling NPLs on the secondary market instead of managing them in-house, which can tie-up significant capital, liquidity and human resources.
- Due to the illiquid and non-transparent secondary market for NPLs this option is not commonly used in practice. These banks would support the setting up of a transparent and liquid secondary market, which can be facilitated by simplifying licensing requirements of NPL acquirer companies.
- One of the Banks indicated that the licensing procedure discourages international investors. Another bank mentioned that the uncertain legal environment make Hungary unattractive for potential international buyers.
- To confirm those statements a potential investor was interviewed regarding the obstacles of Hungarian NPL transactions. The list of points mentioned by the investor is presented below.

Obstacles mentioned by a potential foreign investor

- The Hungarian market is small, so the question an investor would ask if it is scalable (e.g. doing more than 1 transaction and stay for the longer term, that would make sense to understand before investing time and money). A deal of EUR 10 m equity would be too small for big international players. Purchase price for an NPL portfolio should be at least EUR 45-50 m to make international investors interested in Hungary (confirmed by interviewing 2 big hedge funds recently).
- Regulatory issues (bureaucracy) mean that an investor needs a licence to buy and manage NPLs. It takes time to get the licence and it is not guaranteed that the licence will be approved.
- There was uncertainty around whether the VAT is applicable or not to NPL transactions. Investors will not welcome that additional cost. Apparently in theory the applicability of VAT has been clarified, but in practice the EU interpretation is not necessarily used in Hungary.
- The sellers need to be committed to sell and prepare for the transaction beforehand; knowing what has to be

Portfolio quality in the corporate sector

Source: Stability report of NBH



Lack of liquid secondary market

done. Banks have to provide sufficient information for potential investors to investigate the portfolio.

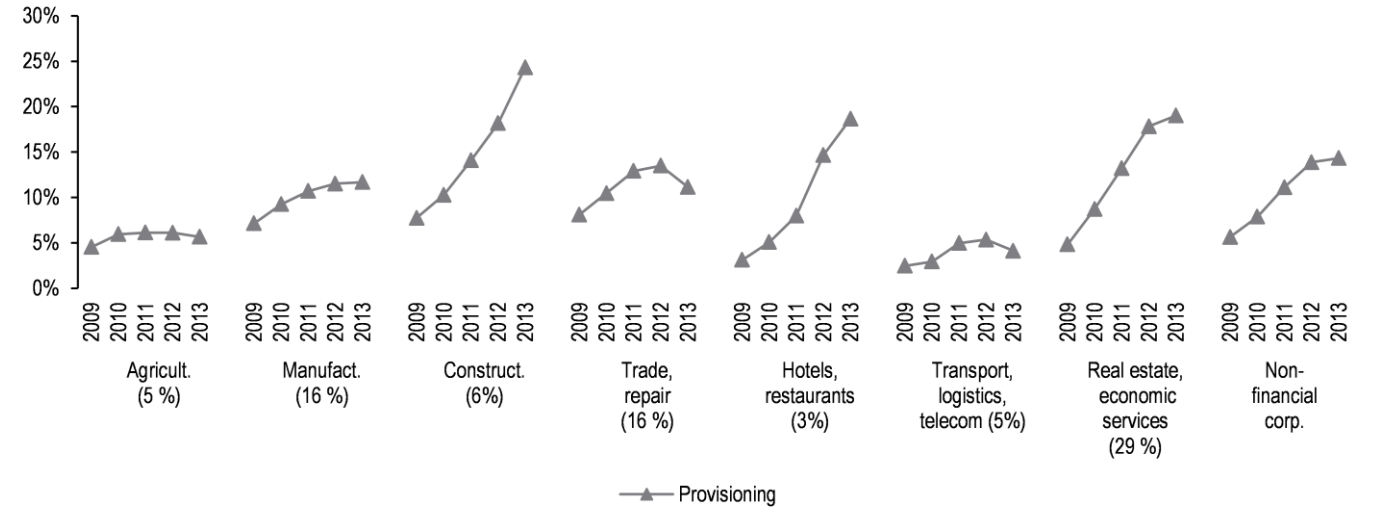
- There is a price gap between the seller's and the buyer's expectations, which does not facilitate NPL acquisitions. It is usually not communicated in advance but it is left at the end of the transactions, after having spent a significant amount of non-recoverable money in the transaction, which does not enhance NPL resolution. Both seller and buyer may use the net book value of the loans as starting point to set up expectations on the price. As a consequence, a realistic and adequate provisioning by the banks are important to facilitate discussions between the parties.
- Investors may not have enough time to access the data room, and sometimes the data room is poorly managed. In addition either because the bank secrecy or as bank is unwilling to share too much information it is sometimes hard for investors to understand what is in the portfolio.
- Transactions/loans having land or plot as collateral may not be welcome by investors due to the intrinsic difficulty of selling or realising real estate.
- Investors are worried about FX changes, as the volatility of HUF is relatively high; investors see a significant potential FX risk.
- The expected internal rate of return (IRR) is around 30% as the market is not very competitive (confirmed by a hedge fund).
- It would be essential to help banks to prepare better for transactions (data room, documentation) and increase confidence in investors.

Setting up an Asset Management Company

- Another way of helping the banks to dispose of NPLs is the establishment of an Asset Management Company (AMC). An AMC was established in 2014 in Hungary. The AMC is named MARK Group and is fully owned by NBH.
- According to the latest Financial Stability Report, MARK Group will take over real estate-related project financing NPLs from banks to free up capital in the banking sector and facilitate the increase in lending. The acquisition of such NPLs would take place at market value (below the net book value) meaning a one-off loss for banks. However, it has not yet been decided how the market value will be determined.

Provisioning on loans of non-financial corporations by industry

Source: Stability report of NBH



Tax and regulatory analysis

1. Tax, accounting and regulatory considerations

Report on corporate restructuring and insolvency in Hungary

1. CURRENT TAX ENVIRONMENT AND KEY ACCOUNTING ASPECTS

1.1. General tax and accounting rules

- Below we briefly summarize the main accounting and tax aspects to consider in understanding the issues that cause difficulties for banks in connection with their NPL portfolio from a tax and accounting perspective.
- The most important relevant legislation in Hungary is as follows:
  - Act on Accounting (Act C of 2000)
  - Government Decree on Financial Statements and Bookkeeping of Banks and Financial Enterprises (Government Decree 250 of 2000)
  - IFRS
  - Act Corporate Income Tax (Act LXXXI of 1996)
  - Act on Stamp Duties (Act XCIII of 1990) (this act covers real estate transfer tax)
  - Act on Value Added Tax (Act CXXVII of 2007)
  - Act on Local Taxes (Act C of 1990)
  - Act on Innovation Tax (Act XC of 2003)

Key Accounting aspects – Hungarian Accounting rules

- Banks are required to determine the expected recovery of their receivables regularly (at least quarterly) based on a review of the financial circumstances of their debtors.
- If the review shows that the expected amount recoverable is significantly and permanently below the book value of the receivable, the bank is required to record impairment on the receivable to decrease its book value to the expected amount recoverable.
- If the review shows that the expected amount recoverable is significantly and permanently above the current book value of the receivable, the bank is required to decrease the impairment recorded earlier on the receivable.
- Non-performing receivables (also including receivables with 100% impairment) are required to be recognized in the accounting records until they qualify as “uncollectible” receivables based on the Act on Accounting (assuming that the bank does not decide on the sale / partial waiver / in-kind contribution of the receivable).
- Strict rules apply to classify a bad debt as an uncollectible receivable. Generally, bad debts may become uncollectible in the following cases:
  - A certificate (or a written declaration) issued by the liquidator certifies that the debtor does not have any assets that could be used to settle the receivable.
  - If the receivable cannot be recovered from the assets taken over from the debtor based on the proposal for dividing the assets amongst creditors at the end of the liquidation procedure.
  - The creditor waives the receivable in a settlement agreement concluded by the creditors in the framework of a bankruptcy or liquidation procedure.
  - At the end of the execution procedure if the execution document proves that the assets of the debtor do not fully cover the receivable.
  - If the expected recovery costs are not proportionate to the amount that is expected to be recovered.
  - If the debtor cannot be located.
  - If the receivable cannot be enforced in a court of law.
  - If the receivable has expired under the statute of limitation in accordance with the legal regulations.
- Unpaid interest outstanding on bad receivables cannot be shown as a receivable in the balance sheet, or as income in the profit and loss account, until it is received.

Key Accounting aspects – IFRS rules

- Under IFRS, loans and receivables are required to be measured at fair value on the date they are initially recognized (IAS 39.43) adjusted in respect of any directly attributable transaction costs. Subsequent to initial

recognition loans and receivables are measured at amortized cost using the effective interest method and subject to review for impairment with gains and losses recognized in profit and loss when the instrument is impaired.

- An assessment for impairment is to be made at the end of each reporting period whether there is any objective evidence that a specific loan or group of loans is impaired (IAS39. 58). If such evidence exists, impairment testing is to be performed.
- A loan or group of loans is impaired if there is objective evidence of impairment as a result of one or more events that occurred after initial recognition (a loss event) and that loss event has an impact on the estimated future cash flows of the financial asset or group of assets that can be reliably estimated (IAS 39.59). Losses expected as a result of future events, no matter how likely they are to happen, are not recognized.
- Individual impairment assessments should be performed for loans that are individually significant and collective impairment assessments performed for any other groups of assets.
- Where there is objective evidence that an impairment loss has been incurred, the loss should be measured as the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the original effective interest rate.
- The carrying amount of the impaired receivable may be reduced either directly (i.e. reducing the asset partially or fully from the books) or through use of an allowance account and the loss should always be recognized in profit or loss (IAS 39.63).
- The current IFRS rules do not include specific guidance on when to use an allowance account or direct write off. These policies are determined on an entity by entity basis in conjunction with a bank's risk management policies. There is a generally accepted practice in countries applying IFRS of writing off receivables for which there is no reasonable expectation of recovery, irrespective of the status of the recovery process.
- Where amounts charged to an allowance account are subsequently written off, IFRS requires presentation in the notes to the financial statements of the criteria for write off.
- Accrued interest forms part of the amortized cost (of the receivable) to the extent the company expects recovery from it. Once a loan or receivable has been impaired, interest income is recognized using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.
- IFRS 9 'Financial Instruments' the new standard for accounting for financial instruments, was finalized in July 2014 and will be effective for reporting periods beginning on or after 1 January 2018. Under IFRS 9, the rules for calculating impairment will be under an 'expected loss' rather than an 'incurred loss' model, however, the guidance in relation to recording a loss either through an allowance account or directly is the same as under the current IAS 39 standard.

Corporate income tax

- Corporate income tax ("CIT") is calculated on the adjusted pre-tax profit at 10% / 19% The lower rate applies to the positive tax base up to HUF 500 million (approx. EUR 1,600), the higher rate applies to the excess part.
- Tax losses can be carried forward for five years ("TLCF"). TLCF can be utilized only up to 50% of the positive tax base of a given year.
- Impairment recorded by financial institutions on receivables arising from their financial activities is deductible for CIT purposes.

Local business tax

- Local business tax is generally calculated on the adjusted net sales revenue. However, in the case of banks, LBT is calculated on all kind of revenues with certain limited exceptions (income from securities, income from certain non-banking activities, extraordinary revenue is excluded).
- Interest income and foreign-exchange gains are taxable. Since the unpaid interest income on bad receivables cannot be shown as an income in the books, it does not trigger an LBT liability (certainly, interest becomes taxable if collected).
- Impairment on receivables is not deductible for LBT purposes.
- The tax rate is capped at 2%. The actual rate depends on the decision of the municipality where the company performs its business activities. The tax must be paid to the municipality that levied it and compliance with LBT legislation is subject to the control of the municipal tax authority.

R&D tax

- The R&D tax base is the same as the LBT base. The tax rate is 0.3%. Despite the identical tax base, this tax is a national tax, and needs to be paid to the state budget.
- Banks operating as a branch in Hungary are not subject to R&D tax.

Bank Tax

- Banks are subject to a special tax type, called surtax for financial organizations ("Bank Tax").
- Banks are obliged to pay Bank Tax as of 2010 and the tax liability is calculated in each year based on the adjusted balance sheet total of the 2009 year, i.e. the amount of the tax liability is the same in each year. The tax rate is 0.15% for the tax base up to HUF 50 billion (approx. EUR 163,000) and 0.53% for the excess part.
- There have been examples when the government provided tax benefits from the banking tax on earlier occasions in relation to the solution of the foreign exchange lending crisis in Hungary (30% of the losses suffered was granted as benefit).
- It is expected that the bank tax rules will be changed, because determining the 2015 tax base based on the 2009 financial numbers is not practical and raises questions of reasonableness.

Credit Institution Tax

- Banks that are profitable pay 30% Credit Institution Tax ("*hitelintézetek különadója*" in Hungarian) on their profits and fully credit it against Bank Tax. Credit Institution Tax is capped at the amount of Bank Tax calculated as if no Credit Institution Tax was applicable. The purpose of legislation with the introduction of the Credit Institution Tax was to partially replace the Bank Tax with an income tax, but this tax does not have an effect on the overall tax burden of banks.

Financial transaction tax

- Banks are also subject to financial transaction tax ("FTT").
- FTT is payable upon bank account debit transactions. The tax rate is 0.3% and capped at HUF 6,000 (approx. EUR 20), with the exception of cash withdrawals where the tax rate is 0.6% without any cap.

VAT

- Financial services are generally exempt from VAT. Banks are generally entitled to deduct the input VAT of their purchases only to the extent that the purchases relate to VAT-able activities.
- The standard VAT rate is 27%.

Transfer tax

- The takeover of real estate is subject to transfer tax. Transfer tax is payable by the buyer as follows:
  - Generally, the transfer tax is 4% up to HUF 1 billion (approx. EUR 3,300) of the market value of the real estate and 2% on the exceeding part, but capped at HUF 200 million (approx. EUR 650) per real estate.
  - However, in the case of banks, specific rules apply to the acquisition of real estate as a result of liquidation or execution procedures. In this case, the acquisition is subject to a reduced transfer tax rate of 2% provided that the bank will sell the real estate within three years. If the resale of the real estate does not take place within the three-year period, the bank is subject to an additional transfer tax liability at 4% (i.e. altogether, the transfer tax liability can be as much as 6%).

1.2. Hungarian tax and accounting implications of the potential alternatives to the NPL resolution

- We summarize below the Hungarian tax and the Hungarian accounting implications of the NPL resolution alternatives that were discussed with the banks during the interviews, such as
  - sale of receivables
  - partial waiver of receivables
  - takeover of real estate collateral/ secured assets
  - debt for equity swap
  - foreign exchange conversion

– rescheduling of debt.

1.2.1. Sale of receivables

Hungarian Accounting

- The bank may record a gain or loss amounting to the difference between the sale price and the book value of the receivable.
- The transaction does not affect the P&L of the debtor.

Corporate income tax

- The gain realized by the bank upon the sale is taxable for CIT purposes. Alternatively, the loss is tax deductible.
- Tax losses of the given tax year can be utilized to offset the gain recorded in the books of the bank. The gain can be offset by TLCF only up to 50% of the current year's CIT base.

Local business tax / R&D tax

- The transaction is neutral from an LBT / R&D tax perspective.

Bank Tax

- The transaction does not affect the Bank Tax liability of the bank.

Financial transaction tax

- The transaction does not affect the FTT liability of the bank.

VAT

- The sale price of the receivable is viewed as a consideration for a VAT-exempt service provided by the bank to the purchaser, thus, it may impair the VAT deduction ratio of the bank (if any).
- In cases when the purchaser of the NPLs entrusts a Hungarian company to manage and collect the NPLs, there are some uncertainties around the VAT treatment of the fee to be paid. Generally, consideration related to the collection efforts is VAT-able, while the consideration related to the management of the receivable may be VAT-exempt in certain cases.

1.2.2. Partial waiver of receivables

Hungarian Accounting

- If the amount waived exceeds the impairment recorded already in the books of the bank, the bank recognises the difference as expenditures in its financial accounts. The debtor records revenue amounting to the liability cancelled from its books.
- Based on the Act on Accounting, if the receivables relate to assets acquired, the revenue accounted for by the debtor/borrower has to be deferred. The deferral has to be released in proportion to the accounting depreciation of the assets in question, or at the time of disposing the assets.
- The waiver of the interest does not trigger any P&L effect, since – as discussed earlier – the unpaid interest on bad receivables are not shown in the balance sheet.

Corporate income tax

- Expenditures recorded relating to the partial waiver of receivables are generally deductible for CIT purposes at the bank.
- The revenue recorded by the debtor is subject to CIT at 10%/19%[4]. If the revenue has to be deferred because the receivables relate to assets acquired, only the revenue recorded in a given period as a result of the release of the previous deferrals is taxable.
- Tax losses of the given tax year can be utilised by the debtor to offset the revenue recorded relating to the partial waiver of receivables in a restructuring scenario. TLCF can be utilized only up to 50% of the tax base. As a special tax benefit, the debtor may use TLCF to fully offset its revenues deriving from the waiver of receivables in a settlement agreement approved by the court in a bankruptcy or liquidation procedure.

[4] The lower rate applies to the positive tax base up to HUF 500 million (approx. EUR 1,600), while the higher rate applies to anything above this threshold.

Local business tax / R&D tax

- Expenditures recorded relating to waiver of receivables are not deductible for LBT / R&D tax purposes at the bank.
- The revenue recorded by the debtor is not taxable.

Bank Tax

- The transaction does not affect the Bank Tax liability of the bank.

Financial transaction tax

- The transaction does not affect the FTT liability of the bank.

VAT

- The transaction is neutral from a VAT perspective and does not affect the VAT recovery position of the bank either.

1.2.3. Takeover of real estate collateral

Hungarian Accounting

- For the purposes of the takeover, the value by which the amount of the receivable is legally decreased has to be determined ("Transfer Value").
- The bank may record a gain if the Transfer Value exceeds the net book value of the receivables in the books of the bank.
- The debtor records the Transfer Value of the real estate as revenue. The accounting book value of the real estate is recorded by the debtor as expenditures.

Corporate income tax

- The gain (if any) realized by the bank upon the takeover of the real estate is taxable for CIT purposes at the bank.
- The positive / negative difference between the Transfer Value and the tax book value is taxable / tax deductible at the debtor (irrespective of the accounting gain or loss resulting from the transaction).
- Tax losses of the given tax year can be utilized to offset the taxable gain recorded relating to the transfer / takeover of the real estate. The gain can be offset by TLCF only up to 50% of the tax base.

Local business tax/ R&D tax

- The gain (if any) realized by the bank upon the takeover of the real estate is not taxable for LBT / R&D tax purposes at the bank.
- In general, the revenue recorded relating to the takeover of the real estate (i.e. the Transfer Value) is not subject to LBT / R&D tax at the debtor. However, if the real estate is recorded in the books as inventory, the revenue less the book value of the real estate cancelled is subject to LBT / R&D tax.

Bank Tax

- The transaction does not affect the Bank Tax liability of the bank.

Financial transaction tax

- The transaction does not affect the FTT liability of the bank.

VAT

- The VAT treatment is different depending on whether the real estate is
  - land, OR
  - building (also including the land on which the building stands)
- The VAT treatment of a building generally depends on whether the building is sold within two years from its first use or not:
  - If the building is sold within the two-year period, the sale should be subject to 27% VAT. The VAT is payable

by the debtor. The bank, if opted for taxation with respect to the sale / rental of real estate, should be able to recover the VAT from the tax authority.

- If the building is sold after the two-year period, the sale is exempt from VAT unless the debtor opted for the VAT-able treatment of the sale. In the latter case, the sale should be subject to the reverse charge mechanism, i.e. the bank has to charge and pay the VAT. (Certainly, the bank may recover the VAT if the conditions of the VAT deduction are met).

- The sale of a land is exempt from VAT. If the debtor opted for the VAT-able treatment of the sale, the sale should be subject to the reverse charge mechanism.
- Notwithstanding the above, the sale of building plot is subject to 27% VAT. The VAT is payable by the debtor. The bank, if opted for taxation with respect to the sale / rental of real estate, should be able to recover the VAT from the tax authority.

Transfer tax

- The takeover of real estate is subject to transfer tax. Transfer tax is payable by the buyer, i.e. the bank as follows:
  - Generally, the transfer tax is 4% up to HUF 1 billion (approx. EUR 3,300) of the market value of the real estate and 2% on the exceeding part, but capped at HUF 200 million (approx. EUR 650) per real estate.
  - However, in the case of banks, specific rules apply to the acquisition of real estate as a result of liquidation or execution procedures. In this case, the acquisition is subject to a reduced transfer tax rate of 2% provided that the bank will sell the real estate within three years. If the resale of the real estate does not take place within the three-year period, the bank is subject to an additional transfer tax liability at 4%.

Property tax

- Real estate taken over from the debtors is subject to property tax imposed by the local municipalities. Property tax is payable irrespective of whether the real estate is used or not.
- The tax rate for buildings is capped at HUF 1,821 / m2 or 3.6% of the half of the market price. The actual tax rate depends on the decision of the municipality where the real estate is located.
- The tax rate for land is capped at HUF 331 / m2 or 3% of the half of the market value. The actual tax rate depends on the decision of the municipality where the real estate is located.

1.2.4. Debt for equity swap

- During a debt for equity swap, the bank becomes a shareholder in the debtor by transferring the receivable by means of an in-kind equity contribution to the debtor.

Hungarian Accounting

- Depending on the difference between the contribution value and the book value of the receivable, the bank may record a gain or loss.
- The debtor accounts for a gain amounting to the difference between the face value and the contribution value of the loan receivable.

IFRS consolidation rules

- Based on the consolidation rules set out in IFRS 10 (Consolidated Financial Statements), even if only a minor interest in a debtor is acquired by the bank, the bank may be deemed to control the debtor should it have power or exposure to variable returns in the debtor and be required to consolidate.

Corporate income tax

- The gain or loss (if any) realized by the bank is taxable / tax deductible for CIT purposes.
- Future impairment (if any) on the shareholding acquired by the bank in the debtor is generally deductible for CIT purposes. However, there is an exception that if the debtor does not fulfil the capital requirements prescribed by the Act on Civil Code at the time of the debt for equity swap, any future impairment on the shareholding will not be deductible for CIT purposes.
- From the debtor's perspective, the gain recorded in the books is subject to CIT.
- Tax losses of the given tax year can be utilized by the debtor to offset the gain recorded in the books. The gain

can be offset by TLCF only up to 50% of the tax base.

Local business tax/ R&D tax

- The transaction is neutral from an LBT / R&D tax perspective.

Bank Tax

- The transaction does not affect the Bank Tax liability of the bank.

Financial transaction tax

- The transaction does not affect the FTT liability of the bank.

VAT

- The transaction is neutral from a VAT perspective.

Transfer tax

- The transaction is neutral from a transfer tax perspective.

1.2.5. Foreign exchange conversion

- During a foreign exchange conversion, the bank and the debtor agrees to change the currency in which the loan is denominated.

Hungarian Accounting

- In the case of restructurings carried out by FX conversion, the bank and the debtor may realize an FX gain or FX loss on conversion.
- The FX differences on the various transactions are recorded in the books on a gross basis, i.e. FX losses and FX gains from different transactions cannot be netted.

Corporate income tax

- The gain / loss realized by the bank and the debtor upon the FX conversion is taxable / tax deductible for CIT purposes.
- Tax losses of the given tax year can be utilized to offset the gain recorded in the books. The gain can be offset by TLCF only up to 50% of the tax base.

Local business tax / R&D tax

- The gain realized by the bank upon the FX conversion is taxable for LBT / R&D tax purposes. However, the loss is not deductible.
- The gain / loss realized by the debtor upon the FX conversion is not taxable / tax deductible for LBT / R&D tax purposes.

Bank Tax

- The transaction does not affect the Bank Tax liability of the bank.

Financial transaction tax

- The transaction does not affect the FTT liability of the bank.

VAT

- The transaction is neutral from a VAT perspective.

1.2.6. Prolongation, Rescheduling repayment

- Prolongation and the rescheduling of repayment do not have direct Hungarian accounting and tax implications.

2. IDENTIFICATION AND ANALYSIS OF SOLUTIONS AVAILABLE IN THE EU FOR SIMILAR SITUATIONS AND COMPARISON TO THE HUNGARIAN ENVIRONMENT

- With the active involvement of our European network experts, we have examined the tax practice of the UK, Italy, Greece, Spain and Germany to understand whether they have implemented solutions that could be applied also in Hungary for the difficulties hindering the NPL clean-up in Hungary. This section covers those difficulties for which we have found solutions in other EU countries, the EU solutions identified and their applicability in Hungary.

2.1. Waiver of debt

Difficulty hindering NPL clean up:

- Revenue recorded by the debtor as a result of a full or partial waiver of a debt in a pre-insolvency or a bankruptcy scenario is subject to corporate income tax and it can only be fully offset by carried forward losses if the receivable is waived in a settlement agreement approved by the court in an insolvency or liquidation procedure. This typically creates liquidity issues for the debtor.

EU solution and its workability in Hungary:

- In the UK, a tax exemption has been introduced for the revenue recorded by the debtor as a result of a full or partial waiver of debt:
  - in an insolvency process, or
  - if the waiver is made in a pre-insolvency scenario under a specified formal arrangement (called a Statutory Insolvent Arrangement) between the debtor and the creditors, or
  - if immediately before the waiver, it is reasonable to assume that without the waiver and any arrangement of which the waiver forms part there would be a material risk that at some time within the next 12 months the borrower would not be able to pay its debt.
- In Greece, a tax exemption has been introduced for the revenue recorded by the debtor as a result of a full or partial waiver of debt in cases where the waiver is made in a pre-insolvency scenario under a specified formal arrangement between the debtor and the creditors.
- In Poland if the waiver of debt is related to bankruptcy proceedings involving the possibility of entering into composition, the waived debt does not qualify as income of the debtor for corporate income tax purposes.
- Hungary could also introduce a tax exemption for the revenue recorded by the debtor as a result of a full or partial waiver of a debt, either as a general tax exemption or a limited tax exemption applicable only for cases when the borrower is in an insolvency process or if the waiver is made in a pre-insolvency scenario under a formal arrangement between the debtor and the creditors and without the waiver it is expected that the borrower would not be able to pay its debt.
- Alternatively, Hungary could allow the debtor to fully offset the revenue recorded as a result of the waiver by carried forward losses in all cases (not just in the case when the receivable is waived in a settlement agreement approved by the court in a bankruptcy or liquidation procedure).
- These solutions would not have a significant effect on the state budget, but would make the debt waiver a much more effective way for reducing NPLs (this is because without these solutions the debtor would most likely not be able to pay the tax triggered by the waiver, thus, the tax authority would start the liquidation process even if the debt is waived). Corporate tax exemption already applies during the liquidation procedure; the suggested changes would extend the tax exemption to pre-insolvency and bankruptcy scenarios as well.
- For a discussion on State Aid issues connected with the waiver of debt please see paragraph 4 “Regulatory Issues” below.

Other

- There is an interpretation in tax audit practice that requires banks to evidence the business-like nature of a waiver of debt in order to classify the related costs as tax-deductible. In our view, this is not required by law, however it has been the basis for challenges by the tax authority. The Ministry for National Economy shares this view and has issued private guidelines supporting such interpretation. It would help the banks to agree to debt waivers and therefore reduction of the NPL portfolio if the Ministry for National Economy were to publish its interpretation.

2.2. Debt for equity conversion

Difficulty hindering NPL clean up:

- In a pre-insolvency or a bankruptcy scenario, as discussed in section 1.2.4, in cases where the principal value of the loan is higher than the value of the shares issued, the debt to equity conversion results in a corporate tax liability for the debtor, which cannot be fully offset by carried forward losses. This can create liquidity issues for the debtor.

Potential solutions:

- In the UK, a tax exemption has been introduced for the income that the debtor records as a result of a debt to equity conversion. The tax exemption only applies if the release of the debt happens in satisfaction of the issue of share capital (the shares issued cannot have a right to a dividend at a fixed rate). The legislation and the guidance notes do not stipulate the quantum of shares that need to be issued and there is no specified correlation between the principal of the debt to be released and the value of the shares to be issued.
- Hungary could introduce a tax exemption for the revenue recorded at the debtor as a result of the debt to equity conversion, either as a general tax exemption or a limited tax exemption applicable only for cases when the borrower is in an insolvency process or if the conversion is made in a pre-insolvency scenario and without the conversion it is expected that the borrower would not be able to pay its debt.
- Alternatively, Hungary could change the corporate income tax rules to allow the debtor to fully offset the revenue recorded as a result of the debt to equity conversion by carried forward losses. Unlike waiver of debt, there is no existing Hungarian exemption for debt for equity swaps where the swap occurs in the context of a settlement agreement approved by the court in a bankruptcy or liquidation procedure.
- These solutions would have a positive effect on debtor liquidity and would impact significantly the state budget. They would also reflect practice applied in the UK.
- In practice, companies often establish the contribution value in an amount equalling the principal value of the loan. In this case, the debt for equity swap does not trigger any revenue for the debtor. We experienced a consistent practice of the tax authority to reclassify – for tax purposes – the transaction in these cases to a debt to equity conversion at a contribution value below the principal value of the loan (arguing that the fair market value of the loan is below its principal value considering that the debtor is insolvent), and to establish a taxable revenue at the debtor in the amount of the difference between the principal value of the loan and the contribution value established by the tax authority. In our view, there are good arguments supporting that the tax authority does not have the right to reclassify the transaction in these cases. We are in discussions with the Ministry for National Economy to clarify the issue.
- For a discussion on State Aid issues connected with debt for equity swaps please see paragraph 4 “Regulatory Issues” below.

Difficulty hindering NPL clean up:

- Upon the debt to equity conversion, the acquisition of shareholdings in the debtor during restructurings may result in consolidation issues for the bank based on IFRS 10[5].

Potential solutions:

- We do not believe that the above IFRS standard could be easily modified to arrive at a more favourable treatment of debt for equity transactions. Thus, it would be hard to eliminate this difficulty, i.e. we expect that the debt for equity solution will be less frequently used in the future.
- Nevertheless, examination of how the relevant standard could be altered to facilitate debt to equity conversions in the context of NPLs should be considered. In this regard how any potential change in the reporting standard could impact the public interest attached to accounting transparency should also be considered.
- If a solution exists that satisfies both the public interest and facilitates NPL resolution, such solution could then be proposed to the relevant international body managing international reporting standards.

[5] Based on the consolidation rules set out in IFRS 10 (Consolidated Financial Statements), even if only a minor interest in a debtor is acquired by the bank, the bank may be deemed to control the debtor should it have power or exposure to variable returns in the debtor and be required to consolidate.

2.3. Cancellation of NPLs from the books

Difficulty hindering NPL clean up:

- Bad debts can only be cancelled from the books of banks if they qualify as “uncollectible” receivables on the basis of the Act on Accounting. Based on the accounting rules, bad debts generally become uncollectible at the end of the liquidation, i.e., banks have to keep the NPLs in their books until the end of a lengthy liquidation procedure.

EU solution and its workability in Hungary:

- The current IFRS rules do not include specific guidance on when a receivable can be written off (i.e. cancelled) from the books as a bad receivable. IAS 39 requires an impairment loss to be recognised in profit and loss, either reducing the value of the impaired asset directly or through use of an allowance account. It is an accounting policy choice for companies in conjunction with their internal risk management policies for when to formally ‘write off’. There is a generally accepted practice in countries applying IFRS of writing off receivables for which there are no reasonable expectations of recovery, irrespective of the status of the recovery process.
- IFRS 9 (the new accounting standard for financial instruments finalised in July 2014 and effective for reporting periods beginning on or after 1 January 2018) contains similar requirements as IAS 39 in relation to recognition of impairment losses either directly or through use of an allowance account.
- In line with Hungary’s goal to harmonize Hungarian accounting rules with IFRS, Hungary should consider amending the Hungarian accounting rules applicable for impairment and write off of receivables to reflect IFRS. The new rules could be introduced for all companies or only for banks.

3. IDENTIFY HUNGARY SPECIFIC SOLUTIONS THAT HAVE NO PRIOR HISTORY IN THE EU, BUT ADDRESS AND RELY ON THE SPECIFIC HUNGARIAN TAX AND ACCOUNTING FRAMEWORK

- This section covers those difficulties for which we have not found solutions in other EU countries and the potential solutions that we identified.

3.1. Acquisition of real property as collateral

Difficulty hindering NPL clean up:

- The acquisition of real property as collateral is subject to real estate transfer tax. There is already a beneficial rule in the law for banks for cases when the real estate is taken over as a result of liquidation or execution procedure, providing a reduced tax rate (2%) for these cases, but the tax is still material and the reduced rate only applies if the bank undertakes to dispose of the real estate within three years.

Potential solutions:

- Increasing the tax benefit by introducing a full tax exemption for these cases and/or increasing the allowed holding period from three to six years (the relevant financial regulatory rules allow banks to keep the real estate for a maximum of six years).

  The suggested tax benefits would be applicable only in very limited circumstances with a designated purpose, so their effect on the state budget would not be significant and they would not mean any inconsistency or discrimination against any other market players, as they are not in the same or similar situation.

Difficulty hindering NPL clean up:

- Stamp duty legislation discriminates against „financial enterprises”, i.e. not fully licensed banks (e.g. leasing companies, or certain institutions carrying out lending activities), since the above mentioned beneficial rule in the law for banks for cases when the real estate is taken over as a result of liquidation or execution procedure does not apply to financial enterprises. Financial enterprises can have substantial NPL portfolios and the acquisition of property as collateral would trigger implications that would not apply if banks carried out the same transactions.

Potential solutions:

- Extending the above-mentioned beneficial rule to financial enterprises as well.

Difficulty hindering NPL clean up:

- Real estate acquired by banks as collateral remains subject to property taxes even if the property is unutilised.

This hinders NPL clean up in pre-insolvency, bankruptcy and liquidation scenarios as well.

Potential solutions:

- A tax exemption or a reduced tax rate could be introduced in the Act on Local Taxes for a temporary period (e.g. for the allowable holding period for transfer tax purposes) for cases when a bank or financial enterprise takes over real estate as a result of an enforcement or liquidation procedure.

  This solution would not have a significant effect on the state budget, but would prevent the costs of the banks (and, as a consequence, the costs of the debtor) from accumulating in those cases where there is no or minimal chance for recovery.

3.2. Lack of tax incentives facilitating NPL clean up

Difficulty hindering NPL clean up:

- There are no specific tax incentives aiming at the reduction of the NPL portfolio of the Hungarian banks.

Potential solutions:

- The following tax incentive could be introduced to facilitate NPL clean up:
  - A certain percentage of the value of the loss suffered on the NPL portfolio that the bank sells / writes off could reduce the Bank Tax liability of the financial institution. There have been examples when the government provided tax benefits from the Bank Tax on earlier occasions in relation to the solution of the foreign exchange lending crisis in Hungary. A similar approach with similar wording would not be unusual for either the banks or the tax authorities, and thus it should be relatively easy and straightforward to introduce it and control compliance. On previous occasions, 30% of the losses suffered were granted as benefit. The relevant calculations are easy to carry out and budgetary impacts could be accurately planned. As the wording and scope of the benefit is entirely in the hands of the Hungarian legislator, it is possible to limit the applicability of the benefits to corporate NPLs and exclude retail NPLs, if this is the Government's intention in this regard.

    The benefit could also be provided from other kinds of taxes, e.g. from CIT.

3.3. Tax authority can only accept 100% recovery on their claims

Difficulty hindering NPL clean up:

- The Tax Procedure Act[6] explicitly prohibits the waiver of any tax claim towards a non-individual taxpayer. It remains nonetheless possible to waive interest and any tax penalties. Debt restructuring proposals are sometimes blocked by the inability of the tax authorities to reduce their claims.

Potential solutions:

- The tax authority should be granted the possibility or (to avoid State Aid issues) required in certain circumstances to reduce its tax claims as part of a court restructuring under the Bankruptcy Act if this can help the debtor. The Ministry for National Economy could issue guidance on how the tax authority should exercise its right to waive tax claims.

  It would also be desirable to allow (or require) the Hungarian tax authority to waive tax liability in a pre-insolvency situation, to save the taxpayer from having to go into liquidation.

4. REGULATORY ISSUES

4.1. Licensing

- In the past, the practice of the Hungarian Financial Supervisory Authority was to require an entity purchasing even a single claim from a bank to be duly licensed in, or otherwise passported to, Hungary on the basis that entities purchasing claims in a "business-like manner" (*üzletszerűen*) needed to have a licence either as a bank or as another type of financial services provider, being a "financial enterprise" (*pénzügyi vállalkozás*). This requirement was applicable notwithstanding the number of claims were purchased, how many debtors were involved, whether the entire contractual position or merely claims were purchased and whether any related service was provided to the debtor by the new owner of the claim.

[6] Act No. 92 of 2003, section 134 (2).

► The NBH, as legal successor to the Hungarian Financial Supervisory Authority has confirmed a similar approach and the requirement for a licence for entities purchasing even a single claim in a "business-like manner" (üzletszerűen). Currently no "fast-track" licensing system exists for new investors to the Hungarian market interested in acquiring corporate NPLs. The NBH has 90 days from submission of all required documentation by the potential licensee to issue a licence as financial services provider to an investor.[7] Nevertheless the NBH has the discretion to extend the 90 day deadline by a further 90 days.

Potential solutions

► The NBH, as the legal successor of the Hungarian Financial Supervisory Authority, could review the existing licensing system for the purchase of NPLs (including the Act on the National Bank of Hungary and the NBH Procedural Rules of Licensing Proceedings) to ascertain how the licensing system could be reformed to encourage greater participation from corporate NPL secondary investors.

► One approach the Hungarian government and NBH could take is to relax or even abolish licensing restrictions for NPL purchasers. In a number of EU jurisdictions – e.g. in the UK, Spain, Italy, Poland and Romania – the acquisition of corporate NPL portfolios is not subject to possession of a regulatory licence.

► While control over entities that acquire NPLs en masse and actively and bilaterally manage relations with the debtor could remain under the supervision of the NBH as the national financial supervisory authority, an exemption could be introduced for one-off transaction or structures, with special regard to the banks' corporate portfolio, where the higher level of consumer protection is not necessary.

► To the extent the licensing requirement for any corporate NPL purchase (one-off or otherwise) is retained, NBH could seek to implement: (i) a streamlined application process, by reducing both the existing timeframe for licensing applications, as well as the documentation requirements, including those regarding corporate status and the requirement for NBH approval for the appointment of management personnel of any NPL purchaser[8]; and (ii) an expedited pre-clearance approval by NBH for a NPL licence for potential corporate NPL purchasers to enable such purchasers to have greater certainty and comfort regarding the likely success of a subsequent application to the NBH for licensing permission.

4.2. State Aid Considerations

► Illegal State Aid is provided whenever state resources are used in a form that distorts or has the potential to distort competition by favouring certain undertakings over others and trade between EU Member States is affected.[9] State Aid is broadly defined and can include tax exemptions, as well as other matters in respect of which the State exercises significant control.

► While the EU Commission is charged with keeping under constant review all systems of aid existing in Member States, it has not, to our knowledge, decided that any tax exemptions granted by the tax authorities in Greece and the UK for the waiver of debt or in the UK for debt for equity swaps in the context of a pre-insolvency or insolvency scenario to be incompatible with the rules of the EU internal market and the rules on State Aid. A key issue surrounding State Aid is whether the tax authority applies discretion in selecting certain undertakings over others.

[7] Act CXXXIX of 2013 on the National Bank of Hungary, Article 61.
[8] SPVs purchasing NPLs are also prevented from being Kft.-s (limited liability companies), but Zrt-s (companies limited by shares, with higher capital requirements) only.
[9] Treaty on the Functioning of the European Union - PART THREE: UNION POLICIES AND INTERNAL ACTIONS - TITLE VII: COMMON RULES ON COMPETITION, TAXATION AND APPROXIMATION OF LAWS - Chapter 1: Rules on competition - Section 2: Aids granted by States - Article 107 (ex Article 87 TEC).

Legal background

1. Legal background

Description of the legal environment

1. INTRODUCTION

This Section provides a general overview of the legal environment in Hungary regarding NPL resolution, with particular emphasis on enforcement and insolvency proceedings. The next Section then details issues of a legal nature within the current framework.

2. ENFORCEMENT OF CREDITORS' CLAIMS

- Since 2009, a creditor may initiate a payment warrant (*fizetési meghagyás*) procedure with a notary public. If the debtor does not object within fifteen days, the order for payment becomes final and binding and can subsequently be enforced. The order for payment procedure has become the most common method of debt collection and is a relatively simple, quick and inexpensive procedure. This procedure is available for claims of up to HUF 400 million (approx. EUR 1.3 million). However, if the debtor objects to the order for payment, the procedure becomes litigious and this may result in a protracted lawsuit.
- A creditor may also file a lawsuit with the relevant court requesting that the court order the debtor to pay the debt. Such litigation procedure will be completed by the issuance of a final and binding court order which can subsequently be enforced.
- If the creditor's claim has been incorporated in a notarial deed specifically setting forth, amongst others, (1) the amount owed, (2) the legal title of the claim and (3) the maturity date of the payment obligation, following the expiration of the maturity date set forth therein, the creditor is entitled to initiate an 'expedited' enforcement proceeding (*közvetlen végrehajtás*) based on such notarial document (i.e., without being obliged to commence and conclude a preliminary lawsuit against the debtor and obtain a final and binding court order).
- Creditors may also file for the liquidation of the debtor. Liquidation proceedings are of an exclusive nature, which means that during such proceedings no other parallel process to collect debts is possible against the same debtor. Creditors are not empowered to file for bankruptcy to seek a reorganisation of the debtor. This precludes a 'creditor led' reorganisation in bankruptcy.
- In the case of secured debt, the creditor may also seek satisfaction for its claims from the enforcement of any security interest by way of a court enforcement procedure or an out-of-court enforcement. Given that out-of-court enforcements are private sales conducted by creditors with minimal restrictions and practice in this area is more diverse, this Report focuses on court enforcement procedures only.

3. COURT ENFORCEMENT PROCEDURE

3.1. Basic steps of the court enforcement procedure

- The pre-condition of the court enforcement procedure is that the creditor obtains a final, binding and enforceable deed (*végrehajtható okirat*) as a result of:
  - an undisputed order for payment procedure against the debtor, as per section 1.1 (*Options for creditors in relation to the enforcement of their claim*) above;
  - a successful lawsuit against the debtor to pay its debt and, in the case of secured debt, to tolerate the enforcement of the security interest against its assets, as per section 1.1 (*Options for creditors in relation to the enforcement of their claim*) above; or
  - obtaining an enforcement clause (*végrehajtási záradék*) to the underlying notarial deed from a public notary, as per section 1.1 (*Options for creditors in relation to the enforcement of their claim*) above.
- The management of the court enforcement procedure falls within the competence of the court bailiff located at the registered seat of the debtor, or, if so requested by the creditor commencing the enforcement, the court bailiff located at the place of the debtor's assets. Otherwise, creditors do not have any influence on the identity of the bailiff.
- The bailiff will deliver the enforceable document to the debtor and demand that the debtor satisfies the claim of the creditor(s) within 15 days. In case of non-compliance, the bailiff will commence the enforcement by way of seizing the debtor's assets and registering the seizure with the public registries, if applicable. Generally, the seized assets remain in the debtor's possession and will not necessarily be subject to a sale since the bailiff must first attempt to satisfy the creditor's claim from the amounts available on the debtor's bank accounts.

Description of the legal environment

- In the meantime, the bailiff must also collect any information from the debtor and from the public registries regarding mortgages, charges or pledges registered over any asset of the debtor. Based on the notification from the bailiff, the beneficiary of the security interest may request that the competent court approves its joining the enforcement. The court approves the request if the secured claim is not disputed by either the debtor or the creditor commencing the enforcement. If this is not the case, the beneficiary must file a separate lawsuit against the debtor to enforce its security interest.
- The duration of the court enforcement procedure is subject to a number of circumstances but it frequently extends beyond one year.

3.2. Sale of the assets

- The appraised value (*becsérték*) of the assets to be sold is determined, as follows:
  - in the case of movable assets, either by the bailiff upon the seizure of the assets on the basis of the estimated market value, under the agreement of the parties or by an expert upon the request of any party; and
  - in the case of real properties, either by the bailiff on the basis of a value certificate not older than six months or by an expert upon the request of any party.
- The assets must be sold by the bailiff at an auction. A direct sale is also permitted, with the following conditions:
  - the direct sale must be requested by the parties, provided that they determine the purchaser to whom the asset should be sold, as well as the appraised value (*becsérték*) of the asset;
  - the debtor may unilaterally determine the purchaser and the appraised value (*becsérték*) of the asset (i.e., the consent of the creditor initiating the enforcement is not needed), if it can be reasonably expected that the proceeds from the sale will provide sufficient recovery for the costs of the enforcement and the claims of the creditor(s) initiating enforcement and the secured creditors having a collateral over the given asset; and
  - in the case of real properties, the beneficiary of any right registered with the land registry must also consent to the direct sale.
- The auction can be arranged via the electronic system of the Hungarian Chamber of Court Bailiffs and for certain types of assets such as real estate assets must be so arranged. The general rule is that the bidder offering the highest price must pay in cash immediately after the auction in the case of movables. The creditor commencing the enforcement is entitled to set-off its claim against the purchase price (credit-bidding) under certain circumstances, for instance, the consent of certain other creditors is to be obtained and certain costs are to be paid.
- The purchase price of real properties is to be paid in cash within 15 days following the auction and credit-bidding is not possible at the auction.

3.3. The costs of the court enforcement

- If the court enforcement is preceded by litigation, the creditor initiating the lawsuit is to pay a stamp duty of 6% of the claim which is to be enforced in such litigation. The amount of the stamp duty is capped at HUF 1,500,000 (approx. EUR 5,000).
- Furthermore, the costs and expenses of the court enforcement consist of:
  - a stamp duty payable to the court by the creditor commencing enforcement, which is 1% of the claim to be enforced, up to a capped amount of HUF 750,000 (approx. EUR 2,500);
  - the compensation of the court bailiff, which is linked either to the total value of the case (the amount of the outstanding claims) in the case of enforcement of monetary claims or to the amount of work performed in the case of the enforcement of specific activities, in both cases regardless of the outcome of the enforcement process;
  - the costs and expenses of the court bailiff, which consist of: (i) a lump sum amounting to 50% of the amount of the compensation of the bailiff, and (ii) the actual cash expenses incurred by the bailiff; and
  - the sales (collection) premium of the court bailiff, which is set out in accordance with a sliding scale according to the amount of the claim that could be recovered.
- The creditor initiating the enforcement must advance:
  - the compensation of the court bailiff;

Description of the legal environment

- 50% of the lump sum relating to the costs and expenses; and
- the amount of the future cash expenses as estimated by the court bailiff.

- We note that legislation regarding the bailiffs was significantly changed in late-2014, primarily in respect of the appointment of a Ministerial state commissioner and the establishment of an Office of Justice, but also regarding for example, the handling of complaints. The full effects of such recent changes have yet to filter into practice and cannot be assessed at this stage. In addition, changes to the Court Enforcement Act are expected in March 2015 . These will, for instance, extend the role of the Office of Justice to include the professional supervision and monitoring of the court bailiff, the handling of any complaints against bailiffs and initiation of legal proceedings against bailiffs who abuse the system. These changes are also likely to affect the conclusions of this report in due course.

4. INSOLVENCY PROCEEDINGS

- There are two types of insolvency proceedings currently available in Hungary:
  - Bankruptcy proceedings (*csődeljárás*), in which the debtor having financial difficulties attempts to reach a settlement with its creditors on the restructuring of its debts and the debtor and its shareholders remain in possession with the debtor's operations supervised by a court-appointed trustee (*vagyonfelügyelő*) and ultimately, by the court; and
  - Liquidation proceedings (*felszámolási eljárás*), in which the debtor is declared insolvent, typically resulting in the involuntary winding-up and liquidation of its assets. The debtor and its shareholders lose control over the assets and the entire proceeding which is managed by a court-appointed liquidator (*felszámoló*), with the court exercising statutory supervision.
- Please refer to the flowcharts in Appendix B and Appendix C for the basic steps of the above-mentioned proceedings.
- There are other proceedings resulting in the termination of the company that do not fall within the scope of the Project, such as:
  - Voluntary winding-up (*végelszámolás*), when a solvent company opts for its winding-up and its assets are distributed to creditors and owners by an administrator (*végelszámoló*), with the court of registration (*cégbíróság*) exercising statutory supervision; and
  - Involuntary de-registration proceedings (*kényszertörlési eljárás*), which are initiated and carried out by the court of registration without the involvement of an insolvency expert, if the company is to be terminated but the voluntary winding-up is not applicable or it is not in compliance with the laws.
- The largest commercial banks use a number of restructuring tools on a consensual basis (please see section Key factors by managing NPL portfolios above). However, Hungarian law currently does not provide for any formal, out-of-court proceedings for the financial restructuring of the debtor which would allow the debtor and/or its shareholder to remain in control during the negotiations between the debtor and its creditors, however, it would grant certain statutory guarantees for the creditors.

4.1. Scope of insolvency proceedings

- Only legal entities can be subject to either bankruptcy or liquidation proceedings in Hungary. Natural persons therefore fall outside the scope of the Bankruptcy Act.[10] Special regimes apply to certain legal entities, such as financial institutions and companies which have strategic importance (please see section 6 (*Special regime with respect to entities having strategic importance*) of this Chapter).

5. BANKRUPTCY PROCEEDINGS

5.1. Commencement of bankruptcy proceedings

- Bankruptcy proceedings can be commenced by the debtor on a voluntary basis. However, the debtor must obtain and file prior written approval from its shareholder(s). Legal representation is mandatory for the debtor.

[10] For this reason any consideration of the provisions of the Bankruptcy Act is not applicable to the issue of retail sector NPLs.

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- No insolvency test is applied upon or subsequent to the bankruptcy filing and the debtor is not obliged to prepare any business or reorganisation plan at this stage. Debtors are not prohibited from the voluntary submission of a plan with the filing application; however, this rarely happens in practice.
- Bankruptcy proceedings take precedence over liquidation proceedings. Consequently, the debtor can still file for bankruptcy even if an earlier liquidation filing was submitted to the court against the debtor and the court has not yet passed a first, non-binding resolution on the commencement of the liquidation.

5.2. Moratorium

- The debtor automatically receives a temporary moratorium upon filing the bankruptcy petition. If the court decides to commence the bankruptcy proceeding, the following will occur:
  - the court will grant the 'actual' moratorium to the debtor;
  - the court will appoint a trustee from the registry of the insolvency office holders with a random electronic appointment system (the statutory authorization of the judge to deviate from the result of the random appointment for cause was recently repealed); and
  - the annotation "under bankruptcy" (*cs.a.*) will appear in the name of the company.
- During both the temporary and the 'actual' moratorium:
  - no set-off may be made against the debtor;
  - no security interests may be enforced against the debtor's assets, however, the moratorium does not affect the enforceability of the security deposit (*óvadék*) and the close-out netting under certain circumstances;
  - no monetary claims may be enforced against the debtor;
  - the debtor may only undertake new obligations with the consent of the trustee;
  - the consequences of the non-payment or the late payment by the debtor does not apply;
  - the commencement of the bankruptcy proceedings and the debtor's non-payment of the obligations which become due prior to commencement of the proceeding cannot be reasons for any counterparty to terminate their agreement with the debtor; and
  - certain claims remain payable notwithstanding the moratorium, for instance, wages and related tax and duty payment obligations, public utility fees, and the trustee's fee and costs.
- Generally, the term of the moratorium is 120 days. However, it may be extended up to 240 days, or even up to 365 days, subject to the approval of a certain proportion of the creditors.

5.3. Registration of creditors

- Creditors must lodge their claims with the debtor and the trustee within 30 days following the publication of the court's order commencing the bankruptcy proceeding. They also need to pay a registration fee.
- If a creditor fails to report its claim within 30 days following the commencement of the bankruptcy proceedings, it loses the right to:
  - participate in the bankruptcy proceedings as a creditor, including the voting rights; and
  - enforce its claim against the debtor, including the initiation of a liquidation proceeding against the debtor.

  However, such creditor remains entitled to lodge its claim in a subsequent liquidation proceeding initiated by someone else, provided that the statutory deadline for the relevant claim has not lapsed.
- The only purpose for registering and classifying the claims is to determine the voting rights of the creditors. Unlike in liquidation proceedings, the assets of the debtor are not liquidated in bankruptcy proceedings, nor is there any "ranking" of the creditors' claims. Instead, the satisfaction of the creditors' claims is governed by the settlement agreement to be concluded with registered creditors in both the secured and unsecured creditor classes (please see below).

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- The trustee registers the creditors' claims, as follows:

	Creditor classes	
	Secured creditors	*Unsecured creditors*
Creditor groups	▶ acknowledged / undisputed	▶ acknowledged / undisputed
	▶ disputed	▶ disputed
	▶ claims of affiliated parties	▶ claims of affiliated parties
	▶ certain specific claims arising from assumption of debt or assignment	▶ certain specific claims arising from assumption of debt or assignment

- A claim can be classified as disputed either if there is an ongoing litigation in relation to the claim, or, in the absence of an ongoing litigation, the trustee may still decide to classify the claim as disputed for other reasons. Creditors with disputed claims are not entitled to vote at the creditors' meetings but they are entitled to a reserve or collateral to secure their claim until their claim is affirmed by a final and binding court decision.

5.4. Creditors' meetings

- In order to reach an agreement with the creditors, the debtor must invite all of its creditors to a creditors' meeting within 60 days following the commencement of the bankruptcy proceedings. The debtor is to prepare a reorganisation plan and a settlement proposal for the creditors' meeting, which documents are to be enclosed to the invitation to be sent to the trustee and the creditors. The shareholders of the debtor may provide assistance with the preparation of such documents and the debtor may also consult the trustee. Practically, the debtor can involve the creditors in the preparation of the settlement proposal and the reorganisation plan. However, it must avoid any unlawful preference of any creditor.
- The creditors' meeting may result in one of the following outcomes:
  - The creditors vote in favour of the settlement proposal and the reorganisation plan by a simple majority of the votes in the secured and non-secured creditor classes. There are no further classes for voting and no total two thirds by value threshold. The trustee countersigns the settlement and the court reviews the settlement. If the court approves the settlement with a final and binding decision, the bankruptcy proceedings will be successful and the debtor may return to its operations;
  - The creditors vote against the settlement proposal and the reorganisation plan but they support the debtor in preparing a revised proposal;
  - The debtor may initiate the extension of the moratorium (please see section 4.2 (*Moratorium*) of this Chapter), which may either by supported or rejected by a simple majority of the votes in the secured and non-secured creditor classes. There are no further classes for voting and no total two thirds by value threshold; or
  - The creditors vote against the settlement proposal and the reorganisation plan and they do not support the preparation of a revised proposal or any extension of the moratorium. In this case, the debtor reports the unsuccessful bankruptcy proceedings to the court and the court closes the proceeding and orders the liquidation of the debtor.
- If a settlement is reached, the court examines whether it fulfils the requirements of exercising rights in good faith and whether it contains provisions that are clearly and significantly unfair or disadvantageous for all the creditors or certain groups of creditors. The settlement agreement may not discriminate against non-approving or non-voting creditors. Courts usually do not examine the economic background or the financial feasibility of the settlement agreement.
- The settlement will also be binding on the creditors who did not consent thereto, or failed to take part in the conclusion of the settlement agreement despite of having been properly notified (cram down nature).

5.5. Directors' duties and liabilities

- During the bankruptcy proceedings, the executive officers of the debtor may continue their management activities to the extent permitted by the provisions of the moratorium. However, they must closely cooperate with the trustee as far as the debtor's assets are concerned. In order to ensure such cooperation, the applicable law sets

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forth certain fines which may be imposed on the executive officers during the bankruptcy proceedings in the case of infringement of the relevant rules.

5.6. Role and liability of the trustee

- The trustee's activities mainly include the registration of creditors' claims, the countersigning of the settlement agreement, contact with the court, the monitoring of certain provisions of the moratorium and generally, oversight of the debtor's operations during the bankruptcy. Otherwise, since the court-appointed trustee company will assign the matter to a private individual trustee employee, this specific trustee's professional approach will determine how active role the trustee intends to take in the proceeding.
- Creditors or any affected parties may file an objection (*kifogás*) with the court in respect of any act or omission of the trustee, such as against the trustee's decision on the registration of claims. In addition, the trustee may be held liable for damages in the case of the breach of any of its obligations.
- The trustee may be replaced by the court ex officio or upon the request of any creditor if it is proven that the trustee has repeatedly or materially violated a statutory obligation. Otherwise, the creditors are not entitled to request the replacement of the trustee without cause or evidence.
- The trustee's fee is to be calculated pursuant to a gradual system based on the aggregate book value of the assets as set out in the balance sheet that was part of the debtor's bankruptcy filing. This calculation does not take into account the debtor's liabilities. Consequently, if the debtor has one single asset with a significant value, such as a project company with a real property, the trustee's fee can reach a relatively high amount. In the case of a court-approved settlement, the trustee is entitled to an additional 15% of the base fee. The costs incurred by the trustee must be approved by the court and are to be borne by the debtor to the extent they are not satisfied from the registration fees paid by the creditors.

6. LIQUIDATION PROCEEDINGS

6.1. Commencement and term of liquidation proceedings

- The liquidation proceedings may be commenced by:
  - the debtor, the creditor or the administrator appointed in a preceding voluntary winding-up procedure, in which case legal representation is mandatory in relation to the filing and an insolvency test will be applied by the court; or
  - the court, for instance in the case of a preceding unsuccessful bankruptcy proceeding, in which case no insolvency test will be applied by the court.
- The court must decide on whether to open liquidation proceedings within 60 days following filing. The court's final and binding resolution on the liquidation commencement can take a considerable amount of time (generally 6-18 months) due to the supplementary requests issued by the court and appeals against the first instance decision by both the debtor (against the commencement of liquidation) and the filing creditor (against the refusal of the filing).
- The most common reason for creditors to file for liquidation is that the debtor has not disputed or paid its previously undisputed or acknowledged debt within 20 days from the relevant due date and, thereafter, did not pay such debt following receipt of written payment demand from the creditor. The debtor can avoid liquidation if it proves that it disputed the relevant claim in merit in due course. Insolvency judges usually do not examine whether the dispute was well founded since this is within the jurisdiction of the ordinary courts during litigation.
- The liquidation only becomes public once the final and binding court order on the liquidation commencement is published in the Companies' Gazette. This is the official commencement date of the liquidation (the "**Commencement Date**") and the mark "under liquidation" (*f.a.*) appears in the debtor's company name.
- If the court orders the debtor's liquidation, it also appoints a liquidator from the registry of insolvency office holders with a random electronic appointment system. The statutory authorization of the judge to deviate from the result of the random appointment for cause with a proper reasoning was recently repealed.
- As to the length of the liquidation proceedings:
  - The Bankruptcy Act sets out that the liquidation proceedings are to be completed within two years following the Commencement Date. However, if there is ongoing litigation between a creditor and the debtor, the final deadline is not applicable and thus, it cannot be closed until the final and binding closure of the litigation.

Description of the legal environment

- Generally, liquidation proceedings would, in all likelihood, last from nine months to over two years. This is subject to a number of different factors, such as the difficulty and complexity of the matter, the quantity of the assets of the debtor, the cooperation between the parties (i.e., the liquidator, the executive officers of the debtor, the creditors and the court), the success of the sale of the debtor's assets by the liquidator, the number of registered creditors, etc.

6.2. Moratorium and legal consequences of the liquidation

- There is no automatic moratorium under the liquidation proceedings. However, the court, upon the request of the debtor, may grant the debtor a grace period of up to 45 days to settle its debt, provided that there was no preceding bankruptcy proceeding, in which settlement could not be reached with the creditors or the settlement reached is not in compliance with the applicable law.
- Otherwise, the Commencement Date has, amongst others, the following consequences:
  - any monetary claim against the debtor in connection with any asset being part of the liquidation pool of assets can only be enforced within the liquidation proceedings and the assets can only be sold by the liquidator;
  - each payment obligation of the debtor becomes due and payable;
  - any ongoing enforcement procedures relating to assets owned by the debtor are terminated by the court and any claims pursuant to such procedures are added to all other claims against the liquidation pool of assets;
  - the executive officers and the shareholder of the debtor lose their control over the debtor's operations and only the liquidator is entitled to control the debtor's assets; and
  - the litigation proceedings which are ongoing on the Commencement Date will continue.

6.3. Registration of the creditors

- Creditors must lodge their claims with the liquidator within 40 days of the Commencement Date. Claims that are lodged after this period lapses will only be considered if all claims registered within 40 calendar days from the Commencement Date are already satisfied and there are still funds available. All claims (secured and unsecured) are subject to a 180-day cut-off date. Such period begins on the Commencement Date.
- Thus the failure of a creditor to lodge its claim within the 180-day deadline results in the creditor losing the right to enforce such claim by any lawful means.
- The liquidator registers the creditors' claims, as follows:
  - Secured creditors, provided that their security interest was established before the Commencement Date;
  - Claims of unsecured creditors, in the following sequence:
    1. liquidation costs;
    2. claims secured by a pledge over assets identified by detailed descriptions (*körülírással meghatározott zálogtárgy*) that were established prior to the commencement of the liquidation proceedings up to the value of the collateral minus the amount already paid to the relevant creditor in accordance with section 5.10 (*Security interests, priority of claims*) of this Chapter;
    3. alimony claims, life-annuity payments and similar claims;
    4. claims of private individuals which do not originate from business activities, claims of small and medium enterprises, and small-scale agricultural entrepreneurs;
    5. social insurance claims, overdue private pension fund membership fees, taxes and repayable government subsidies, water and sewage utility charges and costs related to the management of the debtor's assets;
    6. other claims;
    7. default interests as well as penalties and similar claims; and
    8. claims of persons or entities affiliated with the debtor and claims by the beneficiaries of gratuitous contracts with the debtor.
- A claim can be classified as disputed either if there is ongoing litigation in relation to the claim or, in the absence of ongoing litigation, the liquidator may still decide to classify the claim as disputed for other reasons. Creditors

Description of the legal environment

with disputed claims are not entitled to vote at the creditors' meetings. However, they are entitled to a reserve or collateral to secure their claim until their claim is affirmed by a final and binding court decision.

6.4. Creditors' meetings

- Creditors' meetings do not determine the course of liquidation proceedings as much as they do with bankruptcy proceedings.
- However, settlement may also be made in liquidation proceedings. Creditors and the debtor may conclude a settlement agreement at any time from the date which falls after 40 days following the Commencement Date but before the filing of the final liquidation balance sheet with the court.
- Settlement in liquidation proceedings can only be made if the consent of at least half of creditors entitled to conclude the settlement agreement is given by all creditor groups, provided that the claims of supporting creditors account for two-thirds of the total claims of the creditors entitled to conclude the settlement agreement.[11] In practice, a successful settlement is fairly rare in liquidation proceedings.

6.5. Directors' duties and liabilities

- Although the liquidator acts on behalf of the debtor during the liquidation proceedings, the executive officers of the debtor have several obligations that mostly relate to the commencement of the liquidation proceedings. Such obligations mainly include cooperating with the liquidator by providing the liquidator with documentation and all the relevant information related to the debtor's operations, including the closing balance sheet and closing inventory.
- A special liability regime provides that during the liquidation proceedings any creditor or the liquidator (on behalf of the debtor) may request the competent court to order that the persons who have been the executive officers of the debtor in the three-year period preceding the Commencement Date did not take the interest of the creditors into account when fulfilling their management obligations following the time when the "threat of insolvency" of the debtor incurred. Such court order may be made if the result of the above omission of the executive officers is that it:
  - decreases the value of company's assets; or
  - impedes the full satisfaction of the creditors' claims; or
  - impedes the settlement of the environmental damages.
- "Shadow-directors" (i.e., persons actually having considerable influence on the decisions of the debtor) are also deemed to be executive officers of the debtor for the purpose of the above liability regime.
- As to the timing, the creditors and the liquidator are not obliged to wait until closure of the liquidation proceeding to pursue director liability. They may initiate the above proceeding against an executive officer even after the interim balance sheet and the interim proposal for the satisfaction of the creditors' claims were approved by the court, provided that it appears from these documents that the debtor's assets will not provide sufficient cover for the satisfaction of the creditors' claims.
- Apart from the specific liability described above, the general rules of the New Civil Code also apply. Pursuant to such rules, an executive officer must perform his duties in accordance with the prioritized interest of the company. However, after becoming aware that a threat of insolvency exists, the executive officer must also take into account the creditors' interests. Should the executive officer fail to fulfil such obligation, the creditors may bring damage actions for amounts up to the value of their outstanding claims against the executive officer on the grounds of non-contractual liability.

6.6. Shareholders' duties and liabilities

- Upon the Commencement Date, the shareholders cease to exercise any control over the debtor's operations. However, they remain entitled to control their membership interest in the debtor.
- The shareholders and the former shareholders may be held liable for the unsatisfied claims of the creditors pursuant to the following liability regimes:

[11] In the liquidation proceedings, secured creditors and creditors listed in items 2, 4, 5, 6, 7 and 8 of section 5.3 (*Registration of creditors*) of this Chapter are entitled to vote.

Description of the legal environment

- Fraudulent transfer of shares, which may be established for transfers made within three years following the Commencement Date if, according to the interim liquidation balance sheet of the debtor, the accumulated debts of the debtor exceed 50% of the registered capital of the debtor;
- Misuse of unlimited liability of the shareholder (piercing the corporate veil), if the debtor is dissolved, and the debtor has unsatisfied obligations towards its creditors; and
- Continuous adverse business policy (*tartósan hátrányos üzletpolitika*), which may be established for a shareholder that controls directly or indirectly at least 75% of the shares or votes in the debtor if this shareholder controlled the debtor's operations in a way which is beyond the reasonable business risk.

6.7. Role and liability of the liquidator

- Due to the different role of the trustee (and the fact that bankruptcy proceedings are debtor-in-possession proceedings), the liquidator's rights are more powerful than the rights of the trustee. Upon the Commencement Date, the liquidator becomes the ultimate manager of the liquidation. Since the court-appointed liquidator company will assign the matter to a private individual liquidator, the professional approach of this specific person will determine the general flow and the timing of the liquidation, including the sale of the assets of the debtor. The liquidator also has a right to terminate the debtor's agreements or challenge any previous arrangements (please see section 5.9 (*Transactions vulnerable to being set aside*) of this Chapter).
- The creditors or any affected parties may file an objection (*kifogás*) with the court against the act or omission of the liquidator, for instance, against the liquidator's decision on the registration of claims.
- The liquidator company, and not the private individual liquidator, may be replaced by the court *ex officio*, or upon the request of any creditor if it is proven that the liquidator has repeatedly or materially violated a statutory obligation. Otherwise, the creditors are entitled to request the replacement of the liquidator without cause during the term of the proceedings only once, within a limited timeframe. This request can be made by at least half of creditors entitled to conclude the settlement agreement (please see section 5.4 (*Creditors' meetings*) of this Chapter).
- The liquidator is required to act at all times during the liquidation proceedings with the due care and diligence expected of a person in such position. The liquidator may be liable pursuant to the general rules of the New Civil Code for damages resulting from any breach of its obligations in a litigation before the ordinary court (i.e., not before the liquidation court).
- The liquidator's fee is 5% (or 3% if the commencement of the liquidation proceedings was ordered upon the termination of the bankruptcy proceedings) of the amount of the proceeds from assets sold in the liquidation proceedings and the proceeds from any amounts recovered belonging to the debtor's estate. However, the liquidator's fee will be a minimum of HUF 300,000 (approx. EUR 1,000). If the liquidator decides to continue the debtor's economic activity during the liquidation, it is also entitled to receive 2% of the proceeds from such activity.

6.8. Sale of the assets

- Creditors' claims are to be satisfied from the proceeds of the sale of the liquidated assets. The liquidator must commence, but not necessarily complete, such sale within 100 days following the Commencement Date, unless the creditors' committee (*hitelezői választmány*) or the creditors' representative (*hitelezői képviselő*) decides otherwise.
- The sale can only be completed in the form of a public tender or a public auction. The liquidator may also utilize other public forms of sale if approved by the creditors' committee, or if the public tender/auction is too costly (i.e., the costs of such process exceed the estimated revenue from such sale). A direct sale is therefore not possible in liquidation. By the end of 2014, an electronic platform for liquidation sales must be established and put into operation.
- The liquidator must sell the assets at the highest price that can be achieved under the given market conditions. Otherwise, the Bankruptcy Act does not facilitate a going concern sale. This is only a statutory preference in the case of the special regime for entities having a strategic importance (please see section 6 (*Special regime with respect to entities having strategic importance*) of this Chapter).
- The rights of the creditors' committee, but not the individual creditors, were recently strengthened with respect to supervision of the sale procedure. For instance, the creditors' committee may now:
  - request that the liquidator inform the committee about the appraisal and the sale procedures in advance;

Description of the legal environment

- comment on the appraised value (*becsérték*) of the assets; and
- request that the court appoint a different appraiser to verify the completed appraisal.

Nevertheless these powers remain relatively weak compared to many other jurisdictions, which require the prior approval of the creditors' committee or meeting for any sale of assets by the liquidator.

- There are certain restrictions as to the scope of the potential bidders. Namely, the liquidator, the shareholders, certain officers and the employees of the liquidator, as well as the sole or majority shareholder of the debtor are not entitled to acquire any assets in the liquidation sale.
- Secured creditors may only acquire the secured asset after two unsuccessful attempts by the liquidator to sell such asset, provided that they pay the costs and fees incurred by the liquidator. Otherwise, they can set-off their claim against the purchase price; however, they need to pay the surplus amount in cash if the purchase price exceeds the amount of their claim.

6.9. Transactions vulnerable to being set aside

- The liquidator has the right to terminate the agreements concluded by the debtor with immediate effect. The Bankruptcy Act does not specify further criteria to such termination, thus the scope of the exercise of this right mostly depends on the liquidator.
- The Bankruptcy Act sets forth certain hardening periods for transactions previously entered into by the debtor, such as:
  - five years for the intentional defrauding of creditors;
  - two years for transactions without any consideration or that are undervalued; and
  - 90 days for the unlawful preference of a creditor.
- If the above hardening periods have not yet lapsed, any creditor or the liquidator (on behalf of the debtor) may, within 90 days of becoming aware of, but not later than one year following the Commencement Date, request that the competent court set aside the given transaction.
- In addition, there is an additional hardening period of 60 days relating to services provided by the debtor beyond its ordinary course of business and resulting in the unlawful preference of a creditor. If the hardening period has not yet passed, the liquidator may, within 90 days of becoming aware, but not later than one year following the Commencement Date, reclaim the relevant payment or service provided by the debtor.

6.10. Security interests, priority of claims

- On the basis of the prioritized position of secured creditors, if the secured asset is sold, the liquidator may only deduct the costs of the preservation, the maintenance and the sale, as well as the fees of the liquidator (the latter of which is the 5% of the net purchase price) from the proceeds of the sale. The secured creditor is entitled to receive the remaining amount of the purchase price shortly after the sale, provided that the security interest was created before the commencement of the liquidation proceedings.
- The only exception is stipulated in respect of: (1) pledged property identified by detailed description (*körülírással meghatározott zálogtárgy*) if the pledge is registered with the registry of liens (*hitelbiztosítéki nyilvántartás*) over all the assets of the debtor; and (2) floating charges (*vagyont terhelő zálogjog*) under the Old Civil Code. In both these cases, only 50% of the sale price is to be distributed to the pledgee(s) shortly after the sale and the remaining 50% will not be treated as a privileged claim (please see section 5.3 (*Registration of the creditors*) of this Chapter). This means that all costs of the liquidation will rank ahead such claim.
- There are special rules applicable with respect to the security deposit (*óvadék*). Notwithstanding the commencement of the liquidation, the beneficiary of the security deposit can seek satisfaction from the secured asset directly within three months following the Commencement Date.
- The following cease upon the liquidator's sale of the asset: call option rights; repurchase rights; mortgages; charges; and pledges. If the creditor or the beneficiary exercises its option right or repurchase right after the Commencement Date and purchases the relevant asset of the debtor, the creditor is not entitled to settle its payment obligation by set-off against the debtor.[12]

[12] Please note that the New Civil Code has terminated the possibility to establish call option rights for the purposes of securing a payment obligation of the debtor (*biztosítéki célú vételi jog*).

Description of the legal environment

7. SPECIAL REGIME FOR ENTITIES OF STRATEGIC IMPORTANCE

7.1. Decision about the qualification

- The Hungarian Government is entitled to qualify a wide range of business associations as being of strategically significant importance (the "**Qualified Entities**") if it considers that the conclusion of the bankruptcy proceedings or the liquidation proceedings of the affected entities is consistent with the national or public interest. The Bankruptcy Act includes certain criteria for such qualification but it essentially falls within the Government's sole discretion.
- The government is entitled to decide on the qualification of any distressed organization within 30 days from the commencement of the bankruptcy proceedings or within 365 days from the commencement of the liquidation proceedings.

7.2. Implications of the special regime

- The main notable implications of the Qualified Entities treatment are that:
  - a state-owned insolvency office holder is granted an exclusive right to handle the bankruptcy or liquidation proceedings as trustee or liquidator, respectively;
  - several procedural deadlines are shortened in comparison with the default rules of the proceedings;
  - creditors have fewer rights in relation to, for instance, the sale in the liquidation proceeding; and
  - the liquidator must attempt to sell the assets as a going concern, and may also conclude the sale in a private form.

7.3. Examples

- In practice, a number of companies have been declared Qualified Entities since the enactment of this government right in 2011. The most significant ones became subject to liquidation proceedings a short while after being declared a Qualified Entity or, the liquidation proceedings were already in progress when the company was declared a Qualified Entity.
- The list of Qualified Entities includes, amongst others, the previous Hungarian national aviation company, certain larger companies in the meat industry, the largest Hungarian aluminium producing company, an insolvency office holder company, certain project companies related to strategically important projects and a large paper producing company.

Practical legal issues and suggestions

1. Main issues and potential solutions

Main issues preventing change and related possible solutions

1. INTRODUCTION

- This Section sets out a number of issues within the Hungarian legal framework, some of which were highlighted during interviews with the various stakeholders, and consequential changes of legal nature proposed for consideration.
- In particular, this Section focuses on:
  - transfer of security interests as part of any NPL purchase;
  - court enforcement;
  - bankruptcy; and
  - liquidation.
- Given the lack of a unified commercial practice and diverse and confidential nature of many of these proceedings, in-house restructuring methods (as widely used by creditors and referred to in other parts of this Report), including consensual restructuring solutions with debtors, shareholders and other affected third parties, as well as out-of-court enforcement without bailiff assistance are not included in this Report.

2. TRANSFER OF NPLs

2.1.1. Survival of security interests upon NPL transfer

Practical legal issues

- It should be ensured that upon the sale of one or more NPLs, the new creditor is able to step into the shoes of the existing creditor and benefit from all of the rights of such creditor, especially regarding the related security interests.
- The New Civil Code creates certain ambiguities regarding the status of a new (secured) lender. Notably, under Article 6:208.§ (3) it is stipulated that, notwithstanding the accessory nature of the pledges/mortgages (*zálogjog*), pledges/mortgages are to be considered as newly-established in respect of the transfer of the entire contractual position (*szerződés átruházás*), even if the obligors remain the same and the transfer only affects the creditor's side. This results in an unfortunate situation that such transferred security interests will become subject to re-commencement of hardening periods for the purposes of the Bankruptcy Act (Articles 40 (1) and (2) thereof).
- Although we note that:
  - it is uncertain whether NPLs can be transferred to another creditor in any way other than by this new Hungarian legal concept of transfer of the entire contractual position (*szerződés átruházás*), e.g., by way of the parallel application of (A) assignment (*engedményezés*, Articles 6:193-202 of the new Civil Code) and (B) transfer of obligations (*tartozásátvállalás*, Articles 6:203-207), and
  - such Article 6:208.§ (3) of the New Civil Code regulates the ranking of such newly-established security interests,

  it remains unclear that whether the hardened and unchallengeable nature of the security interests (for hardening periods, see section 5.9 (*Transactions vulnerable to being set aside*) of the Legal background Chapter) can be safely preserved in an undisputable way if the NPLs are transferred.

Potential solutions

- The continuation of the very same 'secured creditor' status and its survival following any sale of the NPLs should be preserved in order to prevent the re-triggering of hardening period for security. To facilitate this, Article 6:208.§ (3) of the New Civil Code should be amended either to permit the parties to agree in advance to divert from the principle of the security interests being re-established or it should be clarified that the survival of priority ranking extends to any other aspect of the security interests, such as the exemptions from the hardening period rules.
- Accordingly, we would propose one of the following options to expressly regulate for any change of the creditor position only that if any underlying hardening period has expired:

  (i) if all parties so agree, to allow such parties to divert from the rules of the contract transfer and to use the rules of assignment (6:193-202§) and transfer of obligations (6:203-207§, each being already currently referred to as secondary rules behind contract transfer) instead (i.e. using assignment and

Main issues preventing change and related possible solutions

debt transfer to achieve the same result as a full contract transfer is not a misuse of law), thereby avoiding the re-creating on security interests;

(ii) the parties are entitled, even if using the concept of contract transfer, to agree to "contract out" of the scope of this provision of re-establishing the security, despite the mandatory applicable rules of pledges; or

(iii) the second sentence of Article 6:208.§ (3) of the New Civil Code shall be supplemented so that not only the ranking of the previous pledge is preserved, but that the applicability of the 'hardening period' rules of the Bankruptcy Act is excluded for such security interests and/or those are to remain unchallengeable for the purposes of the hardening periods of the Bankruptcy Act (Articles 4 (1) and (2) thereof).

3. COURT ENFORCEMENT

3.1.1 General remarks

- Legal provisions relating to the enforcement of claims were subject to significant changes in 2009 and the general climate for creditors has been noticeably improved. In addition, further legislative changes were made in late-2014 and new changes are expected in March 2015. The number of court enforcement cases has significantly increased since 2009, as the modification of the statutory provisions of payment warrants (*fizetési meghagyás*) and the re-allocation of issuing such payment warrants from the courts to the competence of public notaries made it less cumbersome for creditors to initiate the enforcement of their claims.
- In practice, retail enforcement cases greatly outnumber the corporate ones, the latter forming only 20-30% of the total cases. Within this percentage, the proportion of matters with a deal value exceeding HUF 50 million (approx. EUR 170,000) is below 1%.
- The low number of enforcement matters with a significant deal value is caused by a fairly high number of other preventive measures and alternative procedures that are available for the creditors in such cases. Furthermore, liquidation proceedings seem to prevail: creditors prefer filing for liquidation as it is clearly threatens with more fatal consequences for the debtors and also it is usually more straightforward if the debtor owns a sufficient number of assets but more creditors are involved in the proceeding. However, if the debtor has (already) no assets, liquidation will start eventually, which results in the termination of the enforcement proceedings by virtue of law.
- The issues which also concern the subject matter of the Project can be summarized as follows – with certain possible suggestions also indicated immediately thereafter, as applicable.

3.1.2. Court bailiffs and courts

Practical legal issues

- Hungarian court bailiffs represent the power of the state, perform public functions and are entitled to apply force on behalf of the State in relation to their activity. However, court bailiffs are at the same time operating as profit oriented entrepreneurs who are impacted by current market conditions. This duality causes ambiguity as to the status of the bailiffs and their liability.

Proposed solutions

- While we believe the current statutory environment is largely appropriate and the court bailiff should be considered as a representative, and holder of all the statutory power, of the Hungarian State, consideration should be given to the better inter-connection of the initiator of the process (the creditor) and the means of enforcement (the court bailiff). While the bailiff acts independently, his/ her fundamental aim should be to facilitate the enforcement of the creditor's rights and supervise the enforcement process.

Practical legal issues

- The territorial scope of court bailiffs is statutorily determined (please see section 3.1 (*Basic steps of the court enforcement procedure*) of the Legal background Chapter). Thus, creditors cannot freely choose the court bailiff and they are not entitled to object to the identity of the competent court bailiff. As a result, important factors, such as professionalism, workload, specific knowledge and feedback from creditors, cannot prevail.

Main issues preventing change and related possible solutions

Proposed solutions

- While the public (state) functions and the requirements for neutrality and independence of court bailiffs should be respected, the currently rather rigid statutory appointment method of the competent court bailiff should enable the creditor initiating the enforcement proceeding to have more influence regarding the selection of the court bailiff. This appointment method could also include a more tailor-made fee arrangement, as permitted within the legal framework set out by the Court Enforcement Act.
- If the creditor initiating the enforcement is not granted the right to appoint the court bailiff, such creditor could at least be granted the right to object to the identity of the court bailiff assigned pursuant to the current legislative framework and suggest a replacement.

3.1.3. Sale of the assets

Practical issues

- Stakeholders agree that the electronic auction system for enforcement sales is useful in facilitating an increase in the transparency of auctions. However, there seem to be differences of opinions among stakeholders in relation to the operations of the relevant website. The Hungarian Chamber of Court Bailiffs believes that the system works sufficiently, the technical conditions have been developed and they also noted that English/German language access is in the process of being implemented.
- Banks do not seem to share the above opinion, claiming that the system is not sufficiently informative, the search options are rather difficult to use and the technical conditions leave a lot to be desired.
- In practice, the lack of potential bidders, which is market driven and falls outside of the legal and commercial framework, also causes issues, mostly for corporate enforcement cases and the sale of certain movables, such as production lines and specific machinery, which would only be relevant for a professional investor.
- Many banks report that in their experience certain court bailiffs are not very cooperative in relation to the request by potential bidders to inspect real estate property for sale (beyond the time formerly advertised by the bailiff for public inspection, as a preparatory step for an auction).

Potential solutions

- An analysis should be conducted by the Hungarian Chamber of Court Bailiffs of the existing electronic auction system (and its potential interconnection with other similar auction sites, such as the one already set up by liquidators or the tax authority) and creditors' feedback solicited. Thereafter feedback from creditors should be obtained regularly and improvements made to the system as applicable on the basis of such feedback.

Practical legal issues

- The purchaser must pay the entire purchase price of the real property shortly after any successful bidding. However, due to the remedies available for the debtor, the date of actual hand-over of the real estate purchased is usually quite uncertain and it may take a year until the purchaser is able to occupy the property it has paid for well before.
- Public utility providers usually force the new owner of the real property to pay the debt of the former consumer/owner of the real estate. This unfortunate practice imposes extra and unpredictable costs for banks upon the takeover of the collateral.

Potential solutions

- Payment of the full purchase price is essential to establish ownership, however a quicker and more effective judicial review of, and decision on, cases involving disputed real estate and any related costs. The Ministry of Justice expects that the new Civil Procedure Code will improve the efficiency of litigation in this and other areas.

3.1.4. Disproportionate fees and costs

Practical legal issues

- The creditor initiating the enforcement must pay to the court bailiff an advance of the costs of the enforcement and the compensation of the court bailiff (please see section 3.3 (*The costs of the court enforcement*) of the Legal background Chapter). However, upon initiation of the proceeding, the creditor cannot estimate whether the enforcement will be successful and whether it is worth advancing the related costs.

Main issues preventing change and related possible solutions

- The Court Enforcement Act formerly included the concept of a "preliminary proceeding" (*előzetes eljárás*), as used until 2007. According to the relevant provisions, upon the request of the creditor that had an enforceable deed, the court bailiff was to provide such creditor with information regarding the debtor's assets, the availability of such assets and any other enforcement procedures against the debtor. On the basis of such information, the creditor was in a better position to assess whether it was advantageous to initiate the enforcement and advance the costs thereof.

Potential solutions

- Despite the historically low number of such proceeding, a new proceeding similar in aim to the "preliminary proceeding" ought to be considered (subject to rectification of the deficiencies of the "preliminary proceeding"). Certainly, the necessary protection for the debtor should be ensured, such as data protection and the narrow scope of potential usage of the information obtained.

Practical legal issues

- The amount of the bailiff's fee is to be calculated on the basis of the value of the matter or the amount of work performed. In the experience of creditors, the fee of the court bailiff is too high in comparison with the work performed.
- Also, the bailiff is entitled to a sales premium in the case of a successful enforcement but the base fee and the costs are to be paid even in the case of an unsuccessful procedure. Therefore, creditors feel that there are no actual incentives for the court bailiff to ensure the fast and effective sale of assets and the quick and successful closure of the procedure.

Potential solutions

- In order to ensure that the court bailiff proceeds with the enforcement within a reasonable time frame, the fee of the court bailiff may be made more dependent on the length of the procedure or the completion of various steps in the sales process. So, as the enforcement procedure is progressing, the fee of the court bailiff would decrease within a reasonable framework and may also be partially linked to the actual proceeds realized by the bailiff.
- Specific statutory deadlines could be set forth for the court bailiffs to answer or perform the queries and requests of creditors and, more generally, encourage the rapid conclusion of the enforcement procedure for the best price reasonably attainable.
- In order to ensure the sufficient cooperation and communication among the stakeholders, the relevant legislation could also set forth a regular reporting obligation to the court bailiffs toward the creditors involved in the procedure. The relevant provision could also elaborate on:
  - The content of such reporting obligation, such as the summary of the actual amount of costs and expenses incurred by the court bailiff, the status of the sale of the assets, and any other information as to the financial status of the debtor which may be relevant; and
  - Time periods regarding when the reporting obligation is to be fulfilled, e.g., monthly, quarterly or semi-annually.

3.1.5. Judgment of objections

Practical legal issues

- There is no solid court practice in relation to the judgment of the objections filed in relation to the enforcement (*végrehajtási kifogás*). Such matters are dealt with by assistant judges at the first instance level, who are constantly changing, which impedes the establishment of a unified practice.
- Assistant judges do not receive any specific professional education as to court enforcement proceedings and related economic theory.

Potential solutions

- Education of assistant judges should be developed in order to address in detail the matter of enforcement objections. Clear guidelines should be prepared and shared among assistant judges regarding the key aspect of enforcement objections and the related economic issues.

Main issues preventing change and related possible solutions

4. PRE-INSOLVENCY PROCEEDINGS

4.1.1. General remarks

- The commencement of bankruptcy proceedings (and the consequential appearance of the "*cs.a.*" annotation in the debtor's legal name) is very stigmatizing in Hungary as in other countries, as very few commercial/trade counterparty are prepared to maintain a long-term relationship with a company in bankruptcy proceedings. The most knowledgeable insolvency judges consulted are in favour of introducing a formal pre-insolvency proceeding in Hungary. The legislative bodies could consider the concept in the Civil Procedure Act named "hearing to attempt settlement" (*egyezségi kísérletre idézés*) as a starting point.

Consequently, the introduction of an earlier and less court-regulated procedure should be considered as none currently exists in Hungary. The recent EU Commission "Recommendation on a new approach to business failure and insolvency"[13] recommends that a debtor in EU Member States should be entitled to recourse to restructuring at an early stage of financial difficulties, without the need to be technically insolvent. The Commission has also highlighted the importance of minimising court involvement. We understand that the Ministry of Justice is in the initial phases of considering the introduction of a pre-insolvency procedure in Hungary.

4.1.2. Potential approaches

- Carefully consideration should be given as to whether any formal pre-insolvency proceeding should be made public. If it is public, the "stigmatizing" effect would most likely be the same as it is with bankruptcy proceedings and losing the suppliers and principals is critical, even in the pre-insolvency phase. In some jurisdictions, such as France, certain types of pre-insolvency proceedings remain confidential.[14]
- Certain EU jurisdictions could also be provide useful examples when considering the scope of any pre-insolvency procedure for Hungary, such as:
  - **Germany** in 2012 introduced a pre-insolvency restructuring proceeding, available for the period between the petition for and the actual opening of the insolvency proceedings to enable the debtor to prepare a reorganisation plan. If a debtor files a petition to initiate insolvency proceedings on the grounds of illiquidity or over-indebtedness and also applies for self-administration, the insolvency court can grant the debtor a maximum of three months period of time, during which the debtor must work out the details of a reorganisation plan. Within that period, the court can order the prohibition or cessation of enforcement proceedings on the application of the debtor. During the pre-insolvency proceedings the insolvency court and the court-appointed trustee only supervise the debtor. Nevertheless, the proceedings can be interrupted before expiry of the period if the plan turns to be unachievable or the preliminary creditors' committee so decides (if there is no such committee, each individual creditor has a right to file petition against the plan).
  - The schemes of arrangement (Scheme) mechanism in the **United Kingdom** allows the company to make an arrangement / compromise with its creditors (or any class of them) which, if approved by the requisite majority of such creditors and sanctioned by the court, will be binding on all of them, whether or not they vote in favour of it. Creditors will only be bound by a Scheme if it is approved by those creditors or if the Scheme involves more than one class of creditors, by each class of creditors, at meeting convened by the court. For approval, support of at least 75% in value of the creditors (in each class) present and voting is requiredThis is a company law instrument which can be used in conjunction with an insolvent or struggling borrower.
  - The last comprehensive reform of the **Spanish** insolvency act, which entered into force in January 2012, introduced a similar mechanism to the English scheme of arrangement. It offers the debtor company the possibility of requesting the court to impose on all dissenting or non-signing unsecured financial institutions some provisions (basically, the agreed payment extension) of the refinancing agreement entered into by other financial institutions that hold at least 75% of debtor's liabilities with financial creditors at the time the agreement is entered into, provided that it does not impose a "disproportionate sacrifice" on the dissenting financial institutions.
  - French safeguard proceedings (*procédure de sauvegarde*) aim at enabling the company to continue its activity, maintain jobs, and discharge its liabilities by reorganizing the company under the court's supervision. However, this model can be considered rather creditor-unfriendly compared to the above examples.

[13] 12 March 2014, C(2014) 1500.
[14] For example, the French procedures of *mandat ad hoc* and *conciliation*.

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- In Croatia a new pre-bankruptcy settlement regime was implemented, effective from October 2012, for the purpose of achieving business turnaround of insolvent debtors and more favourable settlement of creditors than in bankruptcy proceedings. This model has, however, been heavily criticised and is in the process of being reformed.
- Although not yet significantly tested in practice because of its novelty, the new Slovenian insolvency legislation (adopted in the end of 2013) may also provide a useful example. This legislation regulates a new preventive restructuring proceedings which to be conducted in order to enable the debtor to take certain measures to restructure their financial obligations with financial lenders only (not trade creditors) based a financial restructuring agreement concluded mostly out of court.

4.1.2. Concerns in connection with a new pre-insolvency procedure

- The successful outcome of the restructuring does not always depend on whether it is conducted within a formalised procedure or not. It rather depends on the approach of the debtor and its shareholders. More specifically, if the parties are cooperative and acting in good faith, the restructuring may work even without a formal legal framework. If the debtor and its shareholders fail to cooperate any formal proceeding would most likely also be unsuccessful.
- The key factor is whether the debtor has any preliminary business and/or reorganisation plan that also includes how the restructuring and the debtor's operations would be financed during the proceeding. If the debtor does not have any professional plan which could also be relied on by the creditors, both a pre-insolvency procedure and the current bankruptcy proceedings would most likely fail.
- There is a lack of confidence and cooperation even among the lenders that should be addressed as part of any consideration to introduce a pre-insolvency procedure. In order to minimize the "first come, first served" approach, banks should prepare and accept non-binding, generally accepted rules for cooperating in the restructuring of their debtor in addition to the 'Budapest Approach'[15].
- The high number of creditors may diminish the effectiveness of any pre-insolvency procedure. In addition, it is to be noted that the composition of creditors is highly diverse and may include governmental authorities, small suppliers, as well as secured commercial banks. Nevertheless in a number of jurisdictions, only those creditors are allowed to vote whose claims are affected by the restructuring plan or decision. Moreover in certain jurisdictions, not all creditor classes must consent to the reorganisation for it to be binding on all creditor constituencies. In US Chapter 11 proceedings, where at least one class of "impaired" creditors approves the reorganisation plan, the plan may be imposed by the court on all other classes, including secured creditors and those classes which voted against the scheme provided that certain tests are met, including that dissenting creditors will receive at least as much as they would have otherwise received in a liquidation.
- Generally, many stakeholders consulted were wary of the introduction of a new formal procedure into the existing legislative framework and favoured the better practical application of the existing legal framework (including the reduction in existing abuses).

5. COMMON POINTS FOR BANKRUPTCY AND LIQUIDATION PROCEEDINGS

5.1.1. Appointment of trustees and liquidators (together the insolvency office holders, "IOHs")[16]

Practical legal issues

- Generally, the random electronic system of appointment is problematic since it does not encourage competition of services (and higher level of performance) and is premised on the assumption that all insolvency office holders are of equal standing and suitability for each insolvency case.
- The introduction of the random electronic appointment system resulted in the following unfortunate consequences:

[15] The 'Budapest Approach' attempts to create principles for the restructuring of debtors facing financial difficulties, the cooperation among stakeholders during such a restructuring and the creation of a code of conduct for creditors. It is based on the 'London Approach' and includes, amongst others, the preference for out-of-court restructuring, the provision of new money, the granting of a standstill period, and the conclusion of an independent business review.

[16] The assessment of EBRD relating to IOHs also includes relevant information in this respect. You may acccess the assessment via the following link: http://assessment.ebrd.com/insolvency-office-holders/2014/report.html. A country profile and overview of the Hungarian legal and regulatory framework for IOHs is available at http://assessment.ebrd.com/insolvency-office-holders/2014/country-profiles/hungary.html

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- There are no longer any regular discussions between judges in different courts regarding the IOHs, where once judges had the opportunity to exchange their relevant experience.
- The motivation of certain IOHs appears to have decreased so that they only aim to comply with the Bankruptcy Act at a minimum level to avoid fairly serious mistakes which may give rise to their exclusion. Instead, they should be motivated to complete their work at the highest professional standards in every aspect.

- Each stakeholder, including the Hungarian Association of Insolvency Office Holders, confirmed that the feedback of courts and creditors would be of importance. Creditors believe that they should be granted the right to participate in the appointment of IOHs. The Hungarian Association of Insolvency Office Holders would also support this idea since they are of the view that this could be a way to provide regular feedback about their work.

Potential solutions

- The current appointment system should be reviewed in order to allow stakeholders to provide more input. The primary purpose should be to ensure efficacy of insolvency proceedings, the fair and 'equal treatment' of insolvency office holders being of secondary importance.
- A number of possible models can be observed from other foreign insolvency regimes regarding the appointment of the IOHs:
  - In a number of countries (e.g., France, Spain, Belarus, Bosnia and Herzegovina, Poland) the court is, in practice, the sole body empowered to select and appoint the IOH. In these jurisdictions creditors have limited rights to request a replacement IOH. Grounds for replacement may be limited to IOH misconduct or breach of duty.
  - In some countries (e.g., Croatia and Latvia) it is not the court but a state body or agency, which has the primary role in determining the appointment of the IOH.
  - Other insolvency law frameworks (e.g., FYR Macedonia, Serbia, Slovak Republic, Slovenia and Ukraine) have introduced an automatic randomised IOH appointment system.
  - There is a growing trend in a number of countries (e.g. Bulgaria, Croatia, Germany, Romania and the UK) to allow the majority creditors to determine the appointment of the IOH by the court in most circumstances and at the outset of the proceedings.
- As described above an automatic randomised appointment system does not encourage IOHs to perform to the best of their abilities since their performance is not taken into account in the appointment system.This reduces ,competition within the IOH profession to the potential detriment of insolvency stakeholders. A court-driven appointment system or system where the appointment of the IOH is decided by a State agency or body does not necessarily introduce the right level of competition since the court and the State agency have no financial stake in the outcome of the insolvency proceedings and may not be expected to monitor the performance of the IOH to the same extent as insolvency stakeholders, in particular creditors. Allowing creditors to play a role in IOH appointment may encourage greater competition within the IOH profession and raise the standard of professional performance.
- The key recommendation is therefore that consideration should be given to replacing the randomized system in Hungary with a direct system of appointment by the court at the direction of majority creditors in liquidation and a system involving debtor input in bankruptcy given that this is a debtor-in-possession proceeding. According to this solution, stakeholders would be able to nominate or directly select the IOH. Such right may, however, be limited to the nomination or selection of the permanent IOH by majority creditors (enabling the court to appoint an initial or temporary IOH at the outset of the proceedings).
- Some insolvency systems that permit creditors to participate in the selection of the permanent IOH only allow such participation at a post-filing stage, either at the first creditors' meeting or assembly following the opening of insolvency proceedings. This is the case in Bulgaria, Croatia (in respect of bankruptcy proceedings only) and Estonia. In these countries the court, acting at its own discretion, will appoint an initial or temporary IOH and creditors will subsequently be requested to elect a permanent IOH.
- In Germany, Romania and the UK majority creditors can elect the IOH at the outset of the insolvency proceedings[17]. This is a recent development in Germany. Under pre-2012 German insolvency legislation the

[17] In Romania creditors can petition at the outset of the proceedings for the appointment of a particular IOH. Following changes to the Romanian Insolvency Code in 2014, any appointment request by a creditor will take priority over a parallel appointment request by the debtor.

Main issues preventing change and related possible solutions

court appointed a temporary administrator and creditors were only able to appoint a new administrator by majority vote at the first creditors' meeting. The administrator was rarely replaced by creditors in practice because of the resulting time and financial cost. However in 2012 German insolvency legislation was amended to enable a preliminary creditors' committee to be established by law for debtors of a certain size. This committee may select the insolvency administrator at the beginning of the insolvency proceedings and the court may only choose not to appoint such candidate if the person proposed is not suited to taking office. The German reform is perceived by many within the business community as being fairer to creditors, as well as more efficient and predictable in terms of outcome.

5.1.2. Distinction between private individual and corporate IOHs

Practical legal issues

- While the fact that the IOH is a company enables the IOH to employ persons with a range of skills and expertise required by the Bankruptcy Act, the current concept of the IOH is subject to criticism by the different stakeholders. More specifically, the court appoints an IOH company which subsequently assigns the matter to one of its qualified employees who will act as trustee/liquidator throughout the bankruptcy/liquidation proceedings. Creditors believe that the proceedings could be more efficient and predictable if they had some influence as to the identity of both the corporate and private individual IOHs. Furthermore, the Hungarian Association of Insolvency Office Holders raised concerns that the acts or omissions of the private individual IOH may result in the exclusion of the IOH company.
- In light of the above, the legal status and the liability of the private individual IOHs should be clarified. The stakeholders would also welcome the opportunity to provide regular feedback on the private individual IOHs representing the court-appointed IOH company.

Potential solutions

- Given that the IOH companies are privately owned companies, more transparency is needed in relation to the ownership and the operation of such companies.
- The liability, the rights and the obligations of the private individuals acting on behalf of the IOH company should also be elaborated. The relevant laws should also clarify the provisions relating to the handover of matters by the private individual IOH and the transition period in the case of the termination of the private individual IOH's mandate for any reason.
- Creditors and debtors should be given the opportunity to provide regular feedback about their practical experiences with both the private individual trustees and the trustee companies.

5.1.3. Miscellaneous issues

Practical legal issues

- There is no active, dedicated and sufficiently powerful regulatory body for the IOH profession. Trustee and liquidator companies are not supervised and monitored on a frequent and regular basis and are not subject to a universally binding code of ethical and professional conduct.
- Creditors report that in practice, it is almost impossible to replace the acting IOH, if the IOH violates the law, does not perform its obligations properly or only performs them with significant delay. This is particularly applicable to the bankruptcy proceedings, where creditors are not entitled to request the replacement of the trustee without cause (please see sections 5.6 (*Role and liability of the trustee*) of the previous legal background Section).
- If the IOH is replaced, the previous IOH receives the proportionate amount of its fee in any case. This does not seem to provide sufficient motivation for the IOH to avoid the exclusion and to attempt to complete its activities at the highest possible standards.

Potential solutions

- Greater regulation of IOHs should be considered to ensure the highest level of performance among IOHs. This would be facilitated by the establishment of a dedicated regulatory body for the profession, which could include a State agency or otherwise a self-regulating association for the profession. In respect of the latter the Hungarian Association of Insolvency Office Holders could be transformed into a chamber (*kamara*).

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- The Association believes that it could work more effectively in the form of a chamber, similar to the Hungarian Chamber of Court Bailiffs. Currently, IOHs only join the Association on a voluntary basis and therefore, some IOH companies are not members and not subject to its rules.
- If the Association worked as a chamber:
  1. all IOHs would, as members of the Chamber, be subject to its rules and regulations; and
  2. the Association could be required at law as part of its incorporation as a chamber to monitor and inspect the work of the IOH companies and their employees on a regular basis and in any event within a statutory minimum prescribed period e.g. on-site inspections once every two years. If accompanied by proper sanctioning and disciplinary powers, such regular monitoring could encourage a higher level of performance by IOH companies and a more efficient response to instances of IOH misconduct.
- The criteria relating to the replacement of the IOH without cause within a limited timeframe in liquidation could be eased so that instead of the simple majority of creditors, the creditors having at least 1/3 of the voting rights could be entitled to request such replacement.
- Consideration should be given to enabling a trustee in bankruptcy proceedings to be replaced more easily on application of the debtor and (in certain circumstances) also creditors.

6. BANKRUPTCY PROCEEDINGS

6.1.1. General remarks

- The current Bankruptcy Act was enacted in 1991 and was subsequently amended numerous times. Generally, each stakeholder agrees that the Act is obsolete in its current form and a new, modern bankruptcy act is needed in the long-term, instead of further piecemeal amendments which may not be effective.
- Currently, the bankruptcy section of the Hungarian Bankruptcy Act is relatively short in comparison with certain foreign insolvency legislation. Therefore, too much burden falls on the judicial practice to fill the gaps in the Bankruptcy Act or to clarify contradictory provisions. This solution rather seems to be unsustainable in the long-term in light of the limited judicial resources and the lack of the stare decisis system in Hungarian law.
- One of the most significant recent amendments of the legal framework of bankruptcy proceedings introduced in 2012-2013 was aimed at strengthening the restructuring nature of such proceedings to allow viable businesses facing financial difficulties to avoid liquidation and be saved. The long-term purpose of these changes was to decrease the high number of liquidation proceedings in favour of the bankruptcy proceedings.
- However, the bankruptcy proceedings still do not seem to fully facilitate restructurings and quite a number of issues can be identified which diminish or impede the efficiency of the bankruptcy proceedings in practice. These issues can be categorized and summarized, as follows.

6.1.2. Restructuring nature of bankruptcy proceedings is weak

Practical legal issues

- Insufficient timely emphasis on the need for a viable reorganisation plan:
  - The debtor must only prepare a reorganisation plan after a certain amount of time has already passed in the proceeding. More specifically, the bankruptcy filing does not even need to include a preliminary business or reorganisation plan. Such plans would serve to show the other parties that the debtor has well founded and actual intent to survive and continue its operations.
  - The Bankruptcy Act remains silent as to the content of the reorganisation plan to be prepared by the debtor. Although creditors need to vote on the reorganisation plan, both the reorganisation plan and the related voting are rather only formalities in actual practice.
  - The trustee's role in the preparation of the reorganisation plan is also not properly clarified. In practice, trustees are usually reluctant to get involved in this exercise despite the fact that their experience and expertise could help the debtor with the preparation of a professional and reliable business plan.
  - According to the practical experience, in the most severe cases, the financial restructuring itself is not sufficient but must also be accompanied by the operational restructuring of the debtor. The timeframe for bankruptcy proceedings is fairly short if the debtor is not properly prepared for any restructuring. In addition,

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the operational restructuring would require the involvement of professional advisors, further creating issues related to financing and timing.

- As most of the stakeholders noted, the constantly changing legal environment does not facilitate the business planning though. The reliable and professional business planning only works in a stable and predictable legal framework.

- Lack of liquidity to cover restructuring costs:
  - The debtor and/or its shareholders usually do not calculate the costs of the refinancing and the debtor's operations during the bankruptcy in advance. Neither do they take appropriate measures to ensure that other financing could be obtained for this purpose. This is definitely a difficult market and would require strong shareholder commitment which is missing in a number of cases.
  - The Bankruptcy Act includes certain provisions regarding the priority of rescue financing. These provisions are rather ambiguous though and only relate to affiliated companies granting any such financing. Other potential financing parties are not incentivised to grant rescue financing. The availability of rescue financing for debtors is one of the core principles articulated by the EU Commission in its Recommendation to Member States.[18]

- No incentives for creditors to cooperate:
  - Creditors are not sufficiently involved in the restructuring and no powerful rights are granted to the creditors' committee in the bankruptcy proceedings, which would motivate the creditors to cooperate and establish a committee.

  For instance, creditors are not entitled to propose certain restructuring measures, such as the change of the debtor's management in limited circumstances. In practice, the approach of existing management or the shareholders can block the restructuring in some instances.
  - It is to be noted that a number of different entities participate as creditors in bankruptcy proceedings. This highly diverse group includes not only commercial banks but also other creditors, such as governmental authorities which are not necessarily interested in the restructuring of the debtor.
  - There is a lack of proper cooperation between creditors during the bankruptcy of the debtor. As far as banks are concerned, mostly a "first come, first served" approach is followed in practice: there are no generally accepted rules for cooperation between the banks on restructurings, despite the existence of a set of restructuring principles known as the 'Budapest Approach' designed for application in private restructurings.[19]

- The tax authority as special type of creditor:

  – By reference to the prohibition on granting illegal direct State aid under the EU Treaty, the State authorities (including the National Tax Authority) argue that the applicable provisions of Hungarian law prohibiting any waiver of tax claims are justified and they are not in a position to accept any settlement proposal other than one which involves a 100% recovery of their claims (excluding interest and penalties, which can be waived). This can cause problems if tax is a major creditor, which it frequently is in the unsecured creditor class.

- Rigid court practice as to the content of the settlement agreement:
  - In addition to the waiver of debt, there are a number of practical restructuring measures which are not completely clarified either in the legal framework or in judicial practice.
  - The Bankruptcy Act only includes a short, not exhaustive list of examples which could be included and agreed upon in the settlement agreement, for instance, debt-to-equity swap, and extension of maturity and waiving of claims. In the absence of any further detailed provisions regarding these debt restructuring methods, it is challenging to reflect those arrangements in the settlement plan and reorganisation agreement.
  - Debt-to-equity swaps, which enable a creditor to benefit from any future upside in the business, are difficult to implement in practice. These include the undertaking of the current and the future shareholder, with the debtor being only the target of their agreement and it is unclear how and to what extent the involvement of third parties, other than the debtor and its creditors themselves (such as the debtor's shareholder(s) or third

[18] EU Commission "Recommendation on a new approach to business failure and insolvency", 12 March 2014, C(2014) 1500.

[19] The 'Budapest Approach' attempts to create principles for the restructuring of debtors facing financial difficulties, the cooperation among stakeholders during such a restructuring and the creation of a code of conduct for creditors. It is based on the 'London Approach' and includes, amongst others, the preference for out-of-court restructuring, the provision of new money, the granting of a standstill period, and the conclusion of an independent business review.

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party acquirer(s)), in the settlement agreement can occur and how these third partied become parties to, and rely on, the settlement agreement. Furthermore there are no provisions which would require the shareholders of the debtor to consent in circumstances to a debt for equity swap. Even if the legal framework for shareholder involvement in the settlement agreement were clear, there is a high risk that shareholders might fail to cooperate.

Potential solutions

- The Banking Association and NBH should consider ways to revive the "Budapest Approach" including by involving the banking community in the revision of the underlying restructuring principles governing the Budapest Approach and by selecting certain NPL cases for sponsorship of the Budapest Approach.
- Consideration should be given to the introduction of a "fast track" or accelerated route into bankruptcy. Namely, the debtor could be entitled to prepare a plan and get the approval of the majority of its creditors prior to the filing for bankruptcy in order to be able to benefit from a more efficient reorganisation procedure and thus decrease the time spent within formal bankruptcy proceedings. In 2011, Serbia introduced a "pre-packaged reorganisation plan" into its bankruptcy legislation which enables the debtor to petition for accelerated bankruptcy proceedings and confirmation by the court of the reorganisation proceedings, without necessarily requiring the appointment of a trustee. This restructuring method has proved to be successful because of its efficiency. Reduction of the court's role in formal insolvency proceedings is supported by the EU Commission's Recommendation.[20]
- The restructuring nature of ordinary bankruptcy proceedings could be strengthened by the following measures:
  - The timing of the preparation of the reorganisation plan and its content should be re-considered. As to the timing aspect, the debtor is to be motivated to make efforts to sufficiently prepare for the bankruptcy in advance. In this respect, there could be a requirement that at least a preliminary business plan, reorganisation plan or independent accountant's report is part of the bankruptcy filing, to be followed by a final and sufficiently developed plan within a reasonable timeframe.
  - Applicable law should elaborate more on the required content of both the preliminary and the final business/reorganisation plan. For instance, the following could be included in such plans: summary of the payment obligations of the debtor; other non-payment obligations of the debtor which may have material impact on the debtor's operations; the debtor's planned revenues and costs during the proceedings; the financial resources relating to the debtor's operations and the restructuring; and the debtor's detailed plans of how it intends to restore its operations, including the information regarding the involvement of an investor (if applicable).
  - Greater clarity and support could be provided for restructuring measures, including debt for equity swaps. For instance, it could be set out that despite not being involved in the bankruptcy proceeding as a party, the current shareholder of the debtor and others (e.g. newly-entering shareholders) can also be a contracting party to the settlement agreement and undertake to transfer its shares to the creditor affected by the debt-to-equity swap.
  - In this regard the German model may also be considered which goes even further in terms of creditors' rights, enabling a debt-to-equity swap, allowing the insolvency plan to provide for an amendment of any kind of shareholder rights including capital decreases and capital increases, or a compulsory transfer of shares to the creditors. By means of a cram down the insolvency court can approve the plan even if shareholders have refused to give their consent to it. In addition, Slovenia introduced compulsory debt-to-equity swap to be initiated by creditors, which means that the concept is becoming much more widely accepted within civil law jurisdictions.
  - In addition to their ability to propose amendments to the reorganisation plan submitted by the debtor, creditors could be allowed in certain circumstances to propose additional restructuring measures (such as replacing debtor's management) and/or propose a competing reorganisation plan to the debtor.
  - Rescue financing could be facilitated by granting additional rights to the relevant creditors, to enable such creditors to have a better recovery relating to their claims arising from the rescue financing should the debtor subsequently fail and go through liquidation; and decrease the legal risk that may be related to the provision of rescue financing. The following benefits could be given to creditors providing rescue financing:

[20] EU Commission "Recommendation on a new approach to business failure and insolvency", 12 March 2014, C(2014) 1500.

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- special priority, e.g., priority ahead of unsecured (or potentially, in specific circumstances e.g. for under-collateralised assets, other secured) creditors in any subsequent liquidation;
- the challenge rights of the liquidator would not apply for such transactions in any subsequent liquidation (please see section 5.9 (*Transactions vulnerable to being set aside*) of the Legal background Chapter); and
- clarification that rescue financing creditors would not be classified as "shadow directors" in terms of the debtor's operations (please see section 5.5 (*Directors' duties and liabilities*) of the Legal background Chapter) in any subsequent liquidation.

- Consideration could be given to the re-enactment of the right of the creditor to file for the bankruptcy of its debtor to ensure that the debtor is incentivised to file for bankruptcy in an early and timely manner. Filing early for bankruptcy at a stage when the debtor's financial position is not irredeemably compromised can significantly increase the prospects of a successful rescue. If the legislative framework strengthened the creditors' rights in the bankruptcy proceedings (e.g., to select the trustee, propose restructuring measures, etc.), enabling creditors to initiate bankruptcy would be beneficial and may result in a more pro-active approach by creditors.
- Tax authorities should be granted the ability to reduce their tax claims as part of a bankruptcy reorganisation plan in a manner that is compatible with the EU state aid rules.

  – While there are often related local law prohibitions on debt forgiveness in some EU jurisdictions (no debt forgiveness by the tax authorities is possible, for example, in Greece or Romania), it is permitted in other EU jurisdictions (such as the UK or Spain). There is no general (State Aid-related or other) prohibition in the EU on forgiveness of tax debts, provided certain criteria are met and thus the general prohibition under the Hungarian tax (explicitly prohibiting waiving any tax claim towards a non-individual taxpayer, other than interest and tax penalty) laws could also be lifted.

  – Such permission and the related conditions should be structured in such a way as to avoid any (sector-related or other) selectivity and theoretically available to all or most of the debtors in a bankruptcy process or otherwise in serious financial difficulty. The related conditions (such as (i) other creditors also voting in favour, (ii) tax debt constituting less than a certain threshold and (iii) the cancelled tax debt meeting the state aid *de minimis* conditions) would need to be set out clearly, but objectively and any misuse by debtors avoided.
- Generally, a predictable and stable legal environment would better facilitate the reasonable business planning and thus, the successful restructuring on the long-term.

6.1.3. Misuse of the legal framework by debtors

Practical legal issues

- Disputing creditors' claims to exclude creditors from voting:
  - Stakeholders report that if bad faith debtors wish to exclude a creditor from voting, they start litigation against such a creditor before filing for bankruptcy. The litigation initiated by the debtor proceeds before the ordinary court without expedited deadlines (rather than before the bankruptcy court and without due regard the deadlines applicable in the given proceeding). Therefore, a creditor that is classified as disputed may be unable to vote during the entire bankruptcy proceedings.
  - Due to the erroneous practice of trustees and/or bankruptcy judges, even if only a portion of the claim is disputed by the debtor before the court (e.g., the default interest), the trustee/bankruptcy court may classify the entire amount of the claim as disputed. This practice seems to be changing; however, clear provisions need to be included in the legal framework to avoid misuse.

Potential solutions

- To avoid or at least decrease the misuse by debtors, the Bankruptcy Act should include clear criteria in terms of disputed claims:
  - The current reference to "ongoing litigation", in which case the claim will be classified as disputed, is too vague. Judges should coherently apply legislation (with special regard to Article 12 (4) of the Bankruptcy Act regarding the dividable nature of a claim) to the effect that only the part of a claim which is exactly affected by the ongoing litigation can be classified as disputed and all the rest of the claim remains undisputed.
  - The trustee and the bankruptcy court should pay particular attention to claims in connection with which the debtor initiated litigation shortly before filing for bankruptcy.

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- Either the same court handling the insolvency case should also examine any litigation initiated by the debtor against any of its creditors (at least if it is initiated after the 'threat of insolvency' has arisen, in some time before the insolvency process has been started) or the ordinary court hearing the litigation matter should be required to deal with the matter on an expedited basis to ensure that the creditor is not excluded from voting if the litigation court established that it has a valid claim. To the extent that a major creditor is unfairly excluded consideration could be given to enabling the court to unwind the settlement agreement, as a deterrent to abusive behaviour by debtors.

Practical legal issues

- Fictitious creditors:
  - Debtors can influence the voting by creating fictitious, either secured or unsecured, claims. Due to the lack of any detailed examination of documentation by the trustee and the court, these fictitious creditors will most likely be registered as creditors in the proceeding.
  - In most cases, even if the trustee and/or the court suspect that creditors are fictitious, they do not have the proper statutory authorization and the investigating capacity to examine the merit of the claims or the underlying documentation (e.g., the debtor's books and the security agreements). Some corporate creditors are reportedly located offshore, which may cause difficulties in tracing the relevant corporate ownership.
- Generally, both judges and creditors report that the bankruptcy proceedings can easily be abused by the debtors. As a result, in most of the cases, the bankruptcy proceedings only serve the purpose of the postponing the liquidation for the further decreasing of funds by the debtor and/or its shareholders. This increases the potential losses of creditors.

Potential solutions

- Adequate filtering of fictitious creditors:
  - The rights and obligations of the trustee and the judges should be extended to the verification in merit of the entitlement and due enrolment of creditors (if necessary, using the "reverse evidencing" method, where the debtor shall actively prove that it has no connection with a given creditor), with special regard to the ones where links to the debtor or its shareholders can be suspected and in cases where other creditors question the grounds of the claims of such related-party creditors. Currently, a creditor only has the right to challenge the decision of the trustee (whereby it accepts or refuses the claim of another creditor), but given the time requirement of such challenges and the limited scope of manoeuvre for the trustee to refuse any such "friendly" creditor, such right is very limited value and hence should be strengthened.
  - In this respect the trustee and the judges should be entitled and also obliged to verify the grounds of the claims and their likely extent: offering disproportionately over-collateralized security to certain creditors (whether or not their related party status can be evidenced), such as offering unreasonably high value cash collateral by a debtor (as tenant) as penalty for prematurely terminating real estate leases with a related-party landlord (being one of the examples we came across), is to monitored and rejected or at least adjusted by the trustee and the judges and the voting rights should be set accordingly.
  - Any attempts by the debtor to register fictitious creditors should be penalized, for instance, by way of the automatic termination of the bankruptcy proceedings, increased criminal and civil law liability for directors and any cooperating IOHs.
  - Differentiation could be made amongst creditors due to the nature of the legal status of creditors: as the IOHs also confirmed, the strengthening of the rights of "real" creditors (usually being banks, other regulated financial service providers but also unsecured trade counterparties) would be also welcome by them. Prudent and properly supervised entities are usually more transparent, cooperative and reasonable and their claims are clearly well-funded in almost all of the cases. Accordingly, greater reliance on the data provided by, and strengthening/extending the rights of certain creditors (which are duly licensed financial service providers, in contrast with other secured, but usually artificially created and related-party creditors) could be considered.
  - Due to their regular review of the financial conditions of the debtors, commercial banks and the tax authority have important information regarding the debtors' claims and liabilities. Such information could be relied upon by the trustee and the court in relation to the classification of claims. Therefore, the legal framework could authorize the trustee to request information from the above entities, if it suspects that a fictitious creditor intends to lodge its claim with the trustee.

Main issues preventing change and related possible solutions

- Given the increasing quantity and importance of insolvency matters and their impact on the national economy, specialized insolvency courts similar to the specialized labour law courts would facilitate greater efficiency and specialism of judges appointed to insolvency cases. Such specialized insolvency courts and the related statutory authorization could ensure that:
  - the relevant judges receive the necessary commercial and financial training in so that they could acquire a more business-minded attitude;
  - the workload of judges could be decreased leading to greater efficiency in the handling of insolvency cases;
  - matters closely related to the given insolvency proceedings, for instance, the merit of disputed claims and the damages claim against the trustee, could be judged and decided within the framework of the same proceeding;
  - judges are required to:
    i) provide "day-to-day" supervision of the trustee's activities and quickly react to the petitions of creditors or the debtor;
    ii) complete a thorough review regarding the background of "suspicious" claims of most likely fictitious creditors, to protect the interests of the "real" creditors;
    iii) assess the feasibility of restructuring plans and how viable the company is as a going concern (for this purpose, judges may also obtain expert reports); and
    iv) chair the settlement meetings (*egyezségi tárgyalás*).

6.1.4. Trustee's exact role and capacity

Practical legal issues

- Lack of proper oversight and/or control of debtor's management:
  - The debtor remains in possession during the bankruptcy proceedings with certain restrictions. However, creditors report that such debtor management is inappropriate and there should be an independent person "in the middle" who oversees the proceedings, coordinates with the parties and is also responsible for the legal compliance.
  - In the absence of clear provisions as to the legal status and exact role of the trustee, trustees prefer to stay in the background, providing minimal assistance to the debtor in the preparation of the reorganisation plan and in the chairing of the creditors' meetings. However, the trustees' experience could be useful for reorganisation, since the debtor's management may not have the necessary expertise and experience.
  - The reticence of trustees to get involved may originate from the intention of the trustees to minimize their liability and the fact that trustees receive their fees irrespective of their performance.
  - The trustee is not vested with the same rights as the liquidator to challenge certain agreements of the debtor (please see section 5.9 (*Transactions vulnerable to being set aside*) of the Legal background Chapter). The right of the trustee to challenge transactions is limited to agreements concluded by the debtor during the moratorium without the approval of the trustee. However, the trustee may also notice some bad faith transactions of the debtor which were concluded before the commencement of the bankruptcy proceedings. While the trustee's duties were recently extended to report such transactions (as per Article 15 of the Bankruptcy Act) its rights and obligations in this respect can be further expanded.

Potential solutions

- The trustee's role in bankruptcy, while maintaining bankruptcy as a debtor-in-possession procedure, could be strengthened as follows:
  - The trustee's role could be expanded to include supervision of the formalities to be followed and the procedural steps to be taken by the debtor during the bankruptcy proceedings, such as the convening and chairing of creditors' meetings and notifications to creditors. In this respect additional duties, such as the more careful monitoring of the bankruptcy proceeding and of the debtor's communication with its creditors or the reporting to the court of any suspected abuse by the debtor could be prescribed for trustees.

Main issues preventing change and related possible solutions

- The trustee could be charged with the taking of action against any procedural irregularities and deficiencies of the debtor's management and shareholders and responsibility for assisting the debtor with the preparation of the settlement proposal and reorganisation plan.
- Consideration should be given to making the National Employment Fund (*Bérgarancia Alap*) available for the trustee also in bankruptcy proceedings to enable the debtor to continue its operations during the proceeding and ensure that its employees are duly paid in that period, hence reducing any irreversible damage to its personnel and expertise.

- The relevant provisions should also clarify that it is not the discretion but the obligation of the trustee to play a more active role in supervising the proceedings and to assist the debtor with the successful reorganisation. This does not necessarily need to be accompanied by an increase in the trustee's fees, which appear to be sufficiently motivating.

6.1.5. Formalistic approach of judges

Practical legal issues

- No detailed examination of "suspicious" claims:
  - Though creditors experience a number of abuses by bad faith debtors in relation to the influence of the voting (such as the involvement of fictitious creditors and the disputing of claims, mentioned in section *Misuse of the legal framework by debtors* of this Chapter, they report that judges tend to be reluctant to look into the background of these acts and to examine the merit of "suspicious" claims, merely formalities are checked by them.
  - Judges confirmed that it would indeed be extremely important to ensure that only "real" creditors take part in the bankruptcy proceedings. Judges also noted that they have neither the necessary financial, accounting and commercial knowledge, nor the sufficient investigating capacity to complete a thorough review. Most of all, they do not have proper legal authorization to delve into the details. In this respect, judges noted that while trustees can be sanctioned for missing deadlines (as those are clearly set in the Bankruptcy Act), but not for failing to refuse to countersign, duly investigate, report to the court or initiate a litigation in respect of frauds, fictitious creditors or the debtor entering into transactions against the will and interest of major creditors (which are clearly of more relevance), usually due to the lack of clear statutory obligations on the trustee's shoulders.

Potential solutions

- Greater training for the judiciary and/or specialism within the judiciary handling insolvency cases could enable judges complete a thorough review regarding the background of "suspicious" claims of most likely fictitious creditors, to protect the interests of the "real" creditors.

Practical legal issues

- Only legal aspects are considered upon the judgment of the settlement:
  - The legal framework only formally entitles courts to examine the formalities, i.e. whether the settlement agreement is in compliance with the Bankruptcy Act. Up until very recently (as we understand judicial practice is developing positively in recent months), this has resulted in the formalistic review of details, such as notifications to creditors, the signatures and the schedules of the settlement. Less emphasis was placed on the substantive content of the settlement agreement and the given bankruptcy proceeding as a whole and thus settlements, which are formally acceptable, but clearly included fraud, were adverse to certain creditors and not made by the debtor in good faith were approved.
  - While the court's final compliance check is definitely important, it should be done in conjunction with an in-depth assessment of the settlement agreement, the merit of the case and other aspects of the proceeding. This is particularly the case if we consider that there are already certain "filters" in the proceeding before the court (e.g., legal advisors of the debtor and creditors, voting, countersignature of trustee of the approved settlement and its confirmation that the settlement complies with the Bankruptcy Act) so narrowing and limiting the court's role to the formal legal examination does not seem reasonable.

Potential solutions

- It is to be noted that the above formalistic approach may change. In some of its very recent decisions, the Supreme Court (*Kúria*) highlighted the importance of the restructuring nature of the bankruptcy proceeding and

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ruled that the settlement agreement should not only include the arrangements on the satisfaction of claims but should also reflect a valid intent of the debtor to restructure its debts and to continue its operations.

- Consideration could be given to enabling judges to rely on an expert opinion as to the feasibility of the settlement agreement.

6.1.6. Fees of the trustee

Practical legal issues

- Disproportionate fee amount:
  - In some cases, the trustee is entitled to such a high fee that is unreasonable given the amount of work performed and the financial circumstances of the debtor. This arises from the provisions relating to the calculation of the trustee's fee, namely, that it is to be calculated on the basis of the book value of the debtor's assets (please see section 4.6 (*Role and liability of the trustee*) of the Legal background Chapter).
  - Theoretically, courts are entitled to decrease the fee in the given case. However, according to practical experience, courts rarely exercise this discretion.
- No real incentive for high performance by trustee:
  - The debtor is to bear that part of the trustee's fee which cannot be satisfied from the registration fees collected from the creditors on registration of the creditors' claims. The fact that the debtor must pay the largest portion of the trustee's base fee irrespective of the trustee's performance and there are no other pre-conditions for the payment of such fee decreases the motivation of the trustees to play a more active role in the bankruptcy proceedings.
  - The successful settlement is not a pre-condition for a trustee to receive fees. Instead, it automatically entitles the trustee to an additional success fee.

Potential solutions

- The remuneration structure (base fee and success fee) for trustees should be reviewed to take into account best practice and ensure that it provides the right incentives for performance. In this regard, either the base fee should be reduced or the split between the base fee and success fee re-determined.
- Bankruptcy judges should be encouraged to:
  - examine the proportionality of the trustee's fee and the amount of work completed by the trustee in the given proceeding;
  - exercise their right to adjust the amount of the fee to the circumstances of the case more frequently; and
  - take the feedback of debtor and creditors into account in relation to the trustee's activity, for instance, the trustee's contribution to, and assistance with, the preparation of the reorganisation plan and the successful settlement agreement.
  - As mentioned in section 5.1.1 (Appointment of trustees and liquidators) above, consideration should be given generally to reviewing the existing system of randomised IOH appointment and instead, giving greater rights to stakeholders in determining the identity of the IOH.

7. LIQUIDATION PROCEEDINGS

7.1.1 General remarks

- According to the statistics of the Hungarian Association of Insolvency Office Holders, 80-90% of the liquidation proceedings are conducted against "empty" companies, i.e., debtors without any valuable assets. The lack of financial resources for sufficient recovery results in highly tense conflicts of interest where it is fairly difficult to establish any cooperation among the stakeholders of the liquidation.[21]
- Creditors generally agree that the currently ineffective and detrimental nature of liquidation proceedings is caused by the lack of three important factors: 1) transparency, 2) proper balance of powers and 3) effective sanctions for infringements by liquidators, the debtor and/or its shareholders. At the same time, liquidators and judges highlight

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some further aspects which illustrate that there are multiple types of issues in relation to the current theory and practice of liquidation proceedings. These issues could be categorized and summarized, as follows.

7.1.2. Rights of the creditors[22]

Practical legal issues

- Lack of transparency and weak control over the proceedings:
  - The current legislative framework entitles the liquidator to be the ultimate manager of the entire proceeding. The Bankruptcy Act does not include detailed provisions as to how this must be carried out. The Hungarian Association of Insolvency Office Holders has prepared a number of guidelines and principles to its members, these documents are not binding on the members though. Consequently, the flow of the liquidation proceedings is highly dependent upon the approach of the individual liquidator in the given case.
  - Creditors report that they have no actual influence as to what happens in the liquidation proceeding and when. The liquidator must prepare a liquidation schedule (*felszámolási ütemterv*) and share it with the creditors upon request but practice indicates that this is not always observed.
  - The liquidator is entitled to terminate any agreement concluded by the debtor (please see section 5.9 (*Transactions vulnerable to being set aside*) of the Legal background Chapter). Creditors believe that they should be granted more influence in relation to the termination of material agreements, including the right to approve the termination or instruct the liquidator to terminate certain contracts.
  - Due to the issues in relation to the limited use of objection right (*kifogás*) of creditors, there are no effective challenge opportunities for creditors as to the scope of the liquidation costs, for instance, against overpriced agreements to store the assets and documents of the debtor or selling assets at an undervalue (with very limited possibilities to unwind the sale and having the assets returned to the liquidation estate).

Potential solutions

- Greater regulation of IOHs should be considered to ensure the highest level of performance among IOHs. This would be facilitated by the establishment of a stronger dedicated regulatory body for the profession, which could include a State agency or otherwise a self-regulating association for the profession. In respect of the latter the Hungarian Association of Insolvency Office Holders could be transformed into a chamber (*kamara*).
- The Association believes that it could work more effectively in the form of a chamber, similar to the Hungarian Chamber of Court Bailiffs. Currently, IOHs only join the Association on a voluntary basis and therefore, some IOH companies are not members and not subject to its rules.

Practical legal issues

- Lack of proper representation of creditors' interests:
  - The creditors' committee (*hitelezői választmány*) or the creditors' representative (*hitelezői képviselő*) is supposed to represent the creditors, particularly in larger proceedings where there are a number of creditors. However, these concepts only work in a limited number of cases due to the reasons set out below.
  - There appears to be too great of an administrative burden on creditors regarding the overall coordination of the establishment and the operation of the committee, the organization of the meetings, the preparation of minutes, the provision of information on a regular basis and the contact with the court and the liquidator, the drafting of an agreement (e.g., on the rights of the committee/representative, the financial sources of its operation, the provisions relating to the costs and expenses), as well as a by-law (e.g., on the voting procedure and the information flow between the creditors) and the finalization/negotiation of such documents with the other creditors.
  - Since most of the liquidation proceedings are conducted against "empty" companies, creditors feel that in light of the expected recovery, it is not worth the effort and the financing to establish a committee or to appoint a representative.

[22] The assessment of EBRD relating to IOHs includes relevant information in this respect. You may access the assessment via the following link: http://assessment.ebrd.com/insolvency-office-holders/2014/report.html. A country profile for Hungary detailing the legal and regulatory framework for IOHs is available at http://assessment.ebrd.com/insolvency-office-holders/2014/country-profiles/hungary.html

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Potential solutions

- If the efficiency of liquidation proceedings can be increased in the long-term and creditors can expect a better recovery of their claims, they may be more willing to establish a committee or appoint a representative.
- In addition, the rights of the creditors' committee and the creditors' representative should also be strengthened and the burden regarding their establishment and operation eased, in particular, in terms of the liquidation sales (please see below).

7.1.3. Liquidation sale

Practical legal issues

- While creditor's rights were recently strengthened (by the introduction of on-line sales and the right of creditors' committee/representative to inspect underlying valuations), there is still some lack of transparency and weak control over the sales process:
  - The most crucial part of the liquidation proceedings is the sale of the debtor's assets. Thus, it would be extremely important for creditors to properly oversee the sales and to have actual influence on the purchase price before and during the sales, rather than being effectively able to object such sales post-completion.
  - Secured creditors are not fully involved in the sale relating to the assets secured in their favour and have limited influence on the costs of the safekeeping and maintenance of secured assets.
- Limited scope of potential buyers:
  - According to the experience of banks, professional investors do not prefer buying assets directly in the liquidation but they would be more willing to buy directly from the bank. However, the bank can only take over the secured asset without injecting fresh funds after two unsuccessful sale attempts by the liquidator. Thus, banks usually face difficulties with the taking over of the secured asset due to the lengthy sale process, during which the potential investor may lose interest in the asset.
  - While market expects that the new on-line auction system (introduced in January 2015) will improve efficiency, increase recovery and decrease the length, no tendering site for bidding existed beforehand that is sufficiently and widely known, properly advertised and user-friendly. Thus, the access to a wider pool of "real" buyers is not ensured since the market is concentrated and negatively impacted by distressed asset buyers.

Potential solutions

- The following ideas could improve the efficiency of the liquidation sales and/or increase the recovery of creditors:
  - A reasonable and sliding scale system could be introduced regarding the liquidator's performance related fee amount. More specifically, the liquidator could be required to deduct a smaller percentage from the proceeds of the sale if it exceeds certain statutory deadlines, absent valid reasons.
  - Secured creditors already have a special status in the liquidation proceedings but could be granted greater rights in relation to the sale of the secured asset solely for the purpose of increasing the efficiency and effectiveness (financial return) of the sale. For instance, secured creditors could:
    - approve or disapprove the proposed sale by the liquidator or,
    - propose an alternative form for the sale,
    - from the outset exercise their right to separate settlement and sell the secured asset themselves outside of the liquidation proceeding.
  - There are examples in a number of EU countries (e.g., in Germany, in respect of real estates, in Sweden, with certain restrictions and in Luxembourg) where secured creditors retain the right to enforce their security interest outside the liquidation proceeding. This is also permitted under the UK insolvency system for liquidation cases.
- To incentivize potential buyers, certain tax and stamp duty discounts could be granted to persons/entities purchasing assets in liquidation (please see section 1.2.1 Sale of the receivable/ *VAT)*

Practical legal issues.

- The liquidator is entitled to decide whether it maintains the operations of the debtor during liquidation. The question of whether or not to maintain the operations of the debtor cause conflicts between the creditors. For

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instance, secured creditors expect the liquidator to sell the secured asset as soon as possible to get an immediate recovery for their claim. At the same time, unsecured creditors are more interested in the maintenance of the commercial operations of the debtor since they can expect some recovery of their claim only from the proceeds of such operations.

- The liquidator is to sell the assets at the highest price that could be achieved under the given market conditions. On the basis of their own valuation reports (which are, in certain cases, exaggerated in the liquidators' opinion), secured creditors usually object to the sale proceeding with the justification that the liquidator is selling the asset at undervalue. These objections result in significant delays in the proceeding. Closer cooperation between liquidators and secured creditors would be necessary in this regard to reduce delays.[23]

Potential solutions

- The rights of creditors should be strengthened in terms of approving the decisions and acts of the liquidator. For instance, a majority of creditors could be required to give their formal approval for any maintenance of the business operations of the debtor.
- Consideration should be given to creating a separate approval procedure for secured creditors and unsecured creditors to require the liquidator to receive prior authorisation and input from such creditors before sale of any assets and/or to allow secured creditors to elect to segregate their secured asset from the liquidation estate at the outset of liquidation proceedings.

7.1.4. Role of the liquidators[24]

Practical legal issues

- While recent legislative amendments have provided some clarity, the legal status and conflicts of interests rules for liquidators are still not clear and unambiguous:
  - The most severe issue experienced by judges and the Hungarian Association of Insolvency Office Holders is that the legal status and capacity of the liquidator are not clearly set out in legislation. In some cases, for instance, there is contradictory guidance as to the actions to be taken before the court in that the Bankruptcy Act states that the liquidator is acting on its own behalf while in other cases it is stated that the liquidator acts as the debtor's representative.
  - In practice, this causes conflicts in respect of the interests which the liquidator needs to represent. Creditors are of the view that the liquidator should protect creditors' interests. While creditors are important stakeholders and often lose out financially from an insolvency process, it is to be noted that under Hungarian law the main duty of liquidators is to ensure the fairness of the given liquidation proceedings in every aspect.
  - The legal content of the liquidator's mandate is also ambiguous. Namely, whether the liquidator's activity must be result-oriented or the liquidator is only responsible for the fair and diligent management of the proceedings. This ambiguity also influences the liability of the liquidator.

Potential solutions

- It is apparent that regulation of liquidators (and trustees) by a non-court body outside of specific proceedings is important. There are different models that could be followed as examples. Best practice in terms of active regulation involves the establishment of a regulator which is either:
  - A separate (State) agency;
  - A statutorily established self-regulatory entity.

  More passive regulatory models place reliance instead on the courts, which often have limited capacity to oversee the day-to-day activities of the IOH and a government Ministry, which again does not have the time and capacity to monitor the profession closely.
- As far as Hungary is concerned, consideration may be given therefore to the establishment of a dedicated regulatory body for the IOH profession, such as a State agency responsible for IOHs or a self-regulating

[23] We note that Hungary seems to be unusual in not requiring prior approval from secured creditors for the sale – this is seen in Egypt, Morocco and Tunisia, but not many other European jurisdictions. An overview of the consents typically required for sales by IOHs is contained at: http://assessment.ebrd.com/insolvency-office-holders/2014/report.html

[24] The assessment of EBRD relating to IOHs also includes relevant information in this respect. You may access the assessment via the following link: http://assessment.ebrd.com/insolvency-office-holders/2014/report.html. A country profile for Hungary is found at http://assessment.ebrd.com/insolvency-office-holders/2014/country-profiles/hungary.html

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association by transforming the Hungarian Association of Insolvency Office Holders into a chamber (*kamara*). This entity could be responsible for greater regulation, supervision and discipline of liquidators and ensure that liquidators fulfil their statutory obligations.

- The information obligation of the liquidator towards creditors (and its related liabilities for non-complying with these) should specifically be strengthened in the following areas:
  - the general right to request information as to the debtor's financial situation should be granted to any creditor and not only for a qualified group of creditors; and
  - the liquidator should be specifically obliged to provide information to creditors prior to, and during, the liquidation sale of assets and also on a regular basis.
- It would serve the interests of both the creditors and the liquidators, if the concept of severe or repeated violation of law by the liquidator, which may be the reason for its exclusion, were clarified in the legislative framework and in what circumstances such violation could be triggered for instance, whether this would encompass all actions having a materially adverse effect on creditors, such as the erroneous interpretation of the law by the liquidator; or the commencement of a criminal proceeding against the liquidator.

Practical legal issues

- Weak tools of investigation and recovery of assets by liquidators:
  - In order to successfully manage the proceedings, it is of importance that the liquidator first receives sufficient information about the debtor's assets. Once in possession of this information the liquidator can then take efficient actions against bad faith debtors. For these purposes, the tools available for liquidators do not seem to be sufficiently powerful.
  - Liquidators are not vested with the same rights as court bailiffs in relation to the access to, and research in, the different public registries. However, it would be very important to receive comprehensive information about the debtor's assets and the encumbrances over such assets, particularly if the liquidator does not receive proper documentation from the debtor. Greater powers of liquidators to ensure cooperation by third parties are therefore needed.
  - Liquidators must contact the account holder banks of the debtor to collect information as to the debtor's assets. Practical experience indicates that the account holders do not answer queries in a number of cases. Unfortunately, the liquidator does not have any tools to persuade or ensure that the account holders are responsive.
  - Liquidators are not State authorities, thus, they lack enforcement measures against the actions of bad faith debtors or third parties. According to a common practical example, the debtor concludes a fictitious lease agreement relating to its real property with a tenant related to the debtor. The liquidator has the right to terminate such a lease agreement; however, if the tenant does not vacate the property, the liquidator needs to initiate litigation to force the tenant to vacate. As a result, the liquidator is not in the position to sell the real property until the closure of the litigation which may take years.
  - There is a general duty on the liquidator to make all steps necessary to unwind actions whereby the debtor deprived creditors from their cover before the liquidation proceeding, but this hardly ever happens in practice.

Potential solutions

- The proper assessment of the debtor's assets and pre-insolvency activities would be facilitated by the following amendments to the legislative framework:
  - The obligation of the executive officer of the debtor to provide the documentation to, and closely cooperate with, the liquidator is to be strengthened by way of imposing more dissuasive, even criminal law related sanctions for the failure to comply with such obligation. In addition, it is to be clarified that the commencement of the liquidation does not exempt the executive officer from the above obligations, since failure to cooperate may have a detrimental impact on the ability of the liquidator to properly assess the debtor's assets and pre-insolvency activities and the outcome of the liquidation.
  - Rights should also be granted to the liquidator in terms of access to public registries similar to those of a court bailiff. Furthermore, land registry offices should enable searching on the basis of the debtor's name and not only on the basis of the plot number or the location of the property.

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- The current provision that the liquidator must contact the account holder banks of the debtor to collect information as to the debtor's assets should be supplemented by the obligation of the account holders to reply to such query, as well as the sanction regarding the failure to do so. In this regard, the relevant money circulation laws should be amended so that the only precondition of the information request by the liquidator should be the presentation by the liquidator of the court order relating to its appointment. The preparation of a specimen signature for the liquidator at the account bank should not be a precondition to the information request but only to any disposal by the liquidator over the bank accounts, for instance, money transfers.
- Legislation should be further strengthened so that the liquidator can be found liable if it failed to duly investigate and seek the recovery of any material dissipated assets belonging to the debtor's estate or seek to set aside other contracts detrimental to the creditors concluded by the debtor prior to insolvency.

7.1.5. Fees of the liquidator, liquidation costs

Practical legal issues

- Conflicts regarding the fees of the liquidator:
  - The fee of the liquidator is subject to intense criticism from each stakeholder group. Liquidators believe that their fees are low in comparison with the amount of work they complete, particularly if they do not receive proper documentation from the debtor. On the other hand, creditors claim quite the contrary. We note that as the fee is a fixed percentage of realisations it depends very much on the value of the estate and workload.
  - Concern about the liquidator's remuneration may be linked to creditors' experience with the lack of transparency and information provided to creditors in the liquidation proceedings which results in creditors having less information about the activity of the liquidator in the given case.[25] Each stakeholder agrees that the above ambiguities in relation to the fees are to be resolved.
  - The ambiguous legislative framework and practice as to the legal status of the liquidator is one of the reasons for the conflicts in relation to IOH remuneration.
  - In practice, there are also disputes as to who is to bear the fees of the professionals (legal counsels, economists, accountants) who assist the liquidator. More specifically, whether these professional fees need to be covered by the liquidator's fee or they belong to the liquidation costs that are to be satisfied from the debtor's assets.

Potential solutions

- The remuneration structure for liquidators should be reviewed to take into account best practice and ensure that it provides the right incentives for performance.
- Once the legal status and the interests to be represented are clarified within the legislative framework and the practice, it must also be clearly set out how the liquidator's fee is to be shared among the Hungarian state, as the appointing entity, the creditors, whose interest the liquidator mainly represents, the liquidator itself and the debtor.

Practical legal issues

- Settlement disputes as to liquidation costs:
  - Creditors allege that liquidators attempt to account a number of inappropriate items as liquidation costs since these enjoy priority ahead of the other claims except for secured creditors. On the other hand, liquidators state that they also wish to avoid lengthy settlement disputes in this regard.
  - The challenge is that the clear and exact scope of the liquidation costs and the obligor of such costs are unclear. One practical example is the environmental mitigation costs. If a real property is affected by environmental damages, the liquidator needs to arrange for the recovery thereof before the sale of the property. Not doing so would render the sale much more difficult or impossible. Currently, in most cases, the liquidator would need to advance the costs of the recovery in absence of any other sources.

[25] We note that this issue does not apply as much in the bankruptcy proceedings as it does in the liquidation proceedings, since the trustee is not the ultimate manager of the bankruptcy proceedings.

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Potential solutions

- There should be greater scrutiny by the court and creditors of costs of the liquidator. In this respect reporting requirements by liquidators could be improved and liquidators required to obtain advance approval for the payment and/or incurral of certain costs.

7.1.6. Role of courts

Practical legal issues

- Formal review of liquidation filings:
  - The debtor can avoid the liquidation if it proves that it disputed the merit of the relevant claim in due course (please see section 5.1 (*Commencement and term of liquidation proceedings*) of the Legal background Chapter). Although previously the Bankruptcy Act did not even set forth any criteria that the disputing must be based on merit, creditors are of the view that it is still too easy for the debtor to avoid liquidation on the basis of the foregoing.
  - Liquidation judges only examine liquidation filings from a formal aspect, thus, there is no "real" insolvency test. If they believe that the debtor's disputing declaration is compliant with the Bankruptcy Act, they refuse the liquidation filing and refer the dispute to litigation.
  - The above issue most likely arises from the lack of authorization and investigating capacity of liquidation judges to conclude a material review of the civil law background of the dispute. However, it is a reasonable expectation of creditors that liquidation judges should at least "filter" the fictitious disputing of claims by debtors.
- Lack of capacity:
  - The number of acting liquidation judges is not proportionate to the volume of matters, particularly in Budapest where most of the debtors are located[26]. Approximately 300-400 liquidation matters are assigned to a liquidation judge in Budapest per year. This results in an increase in the duration of the proceedings, as well as the lack of capacity for judges to properly handle the matters. According to the banks' experience, there are too many liquidation proceedings with a duration of four years and.
  - In light of the above, judges are not in the position to properly oversee the liquidation proceedings, or to provide effective "day-to-day" supervision over the activity of liquidators.
- Inconsistencies with deadlines:
  - Creditors report that although the Bankruptcy Act sets forth procedural deadlines for both the parties and the court, judges do not typically adhere to any deadlines binding upon the court.
  - However, when two years lapse following the commencement of the liquidation (please see section 5.1 (*Commencement and term of liquidation proceedings*) of the Legal background Chapter), judges with a formal approach tend to quickly close liquidation proceedings without taking into account the ongoing settlement disputes between creditors and the liquidator.

Potential solutions

- Greater training for members of the judiciary in examining claims submitted claims (including any disputed claims) by debtors would help to identify any suspicious behaviour by debtors.
- Greater regulation for liquidators should also be considered, e.g., by establishing a dedicated regulatory entity, either a separate State agency or transforming the Hungarian Association of Insolvency Office Holders as a chamber (please see section 7.1.4 (*Role of the liquidators*) above) or otherwise providing for more regulation by a government entity.

Practical legal issues

- Reluctance in deciding against liquidators:
  - In practice, the procedure for raising objections (*kifogás*) does not seem to provide adequate protection for creditors. Firstly, the deadline to file an objection within eight days is relatively short and is strictly enforced by

[26] Liquidation matters are assigned to approximately 50 judges in Budapest.

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courts. At the same time, courts rarely observe their own deadline to decide upon the objection in an expedited proceeding.

- Secondly, the reason for the above delay usually originates from judges requesting that the given creditor indicates a specific provision of the Bankruptcy Act which was violated by the liquidator. However, since the obligations of the liquidators are not subject to sophisticated or detailed regulation in applicable law, the creditor is usually unable to fulfil this request.
- Finally, in a number of cases, judges have refused the objection and informed the creditor that it can sue the liquidator for damages. However, this is not a real alternative since that would be subject to a separate proceeding before an ordinary court with ordinary procedural deadlines.

Potential solutions

- More detailed regulation of the obligations of IOHs would enable creditors to better oversee the conduct of the proceedings (i.e., what steps the liquidator must exactly take and within what a timeframe) and enable creditors to file more successful objections against the liquidator by referencing a specific article of legislation which was allegedly violated by the liquidator.

7.1.7. Almost no chance for settlement

Practical legal issues

- Inflexible approach of certain creditors:

As mentioned in connection with bankruptcy, the tax authority is not in a position to accept any other settlement proposal but one which involves a 100% recovery of its claims.[27] In liquidation proceedings, the classification of claims is different from in bankruptcy proceedings. Usually there are no other creditors in the relevant group except for the tax authority and the tax authority's claim in practice forms a separate group for voting on any settlement. The settlement must be supported by the majority of the creditors in each creditors' group (please see paragraphs 5.3 (Registration of the creditors) and 5.4 (Creditors' meetings) of the Section "Legal background"). This results in the tax authority exercising a "veto" right on the voting of the settlement agreement.

- No prospect for the debtor's survival:

Notwithstanding issues connected with State aid, governmental authorities may not necessarily be interested in the survival of the debtor in liquidation. In most cases, debtors no longer have any assets at the commencement of the liquidation proceedings and "going concern" sales are extremely rare. In the current market conditions, there are few investors interested in buying companies under liquidation for the purposes of maintaining the operations of such companies.

Potential solutions

- There should be a wider scope of negotiations among each stakeholder and the State in order to work out a sufficient solution for the above issues.
- If the bankruptcy proceedings worked more efficiently in practice, more companies could avoid liquidation and preserve their assets. As a result, the number of "empty" companies would decrease in liquidation proceedings.

7.1.8. Ineffective provisions in terms of directors' and shareholders' liability

Practical legal issues

- Weak sanctions and evidencing issues regarding directors' liability:
  - The effectiveness of the entire liquidation proceeding is jeopardized if the executive officer of the debtor does not fulfil his obligation to hand over the documentation to the liquidator and to cooperate with the liquidator in every aspect. In this case, the liquidator will be unable to properly assess the scope of the assets and the related encumbrances or to reveal the reasons that led to the insolvency. The current sanctions (fine to be imposed on the executive officer, assumed liability in the case of a future litigation or being prevented from

[27] In Hungary, the Tax Procedure Act (Act. No. 92 of 2003) section 134 (2) explicitly prohibits the waiver of any tax claim towards a non-individual taxpayer. It remains possible to waive interest and any tax penalty.

Main issues preventing change and related possible solutions

taking similar roles in other companies) are, while rather serious in theory, but not sufficiently dissuasive in practice.

- The current legal framework for the establishment of the directors' liability (please see section 5.5 (*Directors' duties and liabilities*) of the Legal background Chapter) does not work effectively in practice. The proceeding can be initiated by the liquidator or any creditor, who hardly have any information or documents as to the executive officer's acts or omissions before the liquidation proceedings. Thus, it is extremely difficult for them to successfully evidence each and every condition set out in the Bankruptcy Act. Should they succeed, the executive officer can still be relieved, if he/she proves that he/she notified the shareholders of the financial difficulties and initiated the relevant measures of the shareholders.
- As a result, the liability of the executive officers is only established by the court in the most obvious cases (e.g., depleting the funds of the company even after the commencement of the liquidation, advancing loans to an affiliated party when the liabilities of the company already exceeded the value of its assets, or granting all the funds of the company as security for the payment of the purchase price under a sale and purchase agreement when fulfilment of the agreement was not at all feasible), but not in case the entire relevant debtor documentation is lost (which is usually a clear sign of frauds).

- Vague and unclear provisions regarding shareholders' liability:
  - The conditions for the liability for the fraudulent transfer of shares (please see section 5.6 (*Shareholders' duties and liabilities*) of the Legal background Chapter) do not appear to be reasonable. Liability may be triggered only if the accumulated debts of the debtor exceed 50% of the registered capital (*jegyzett tőke*) of the debtor. However, it is not the registered capital what provides reliable information about the financial situation of a company but the equity (*saját tőke*). A further pre-condition is that the above needs to be established from the interim balance sheet. This document is to be prepared during the liquidation and thus, already includes developments on which the liquidator has influence and not the previous shareholder. The previously effective provisions set out that the equity (*saját tőke*) was to be taken into account as a basis and the relevant date to be examined was the commencement of the liquidation. It is not clear why such previous provisions were changed in 2012.
  - The scope of "continuous adverse business policy" (*tartósan hátrányos üzletpolitika*) (please see section 5.6 (*Shareholders' duties and liabilities*) of the Legal background Chapter) is not properly defined in the Bankruptcy Act. Courts generally interpret "continuous adverse business policy" as being a long-term strategic plan with respect to the company controlled by such shareholder, which was against the company's interests. However, this is fairly difficult to be established in practice since a thorough review would require the courts to have not only legal but also economic and corporate governance knowledge.
  - In light of the above, notwithstanding the importance of the shareholders' liability, creditors rarely start the above proceedings due to the unclear conditions and the low chance for successful evidencing.

Potential solutions

- The legislative framework should elaborate more on the provisions of shareholders' and directors' liability on the basis of the feedback from stakeholders, especially where the shareholders and/or directors fail to hand over the underlying documentation.
- Evidencing difficulties may be solved, if:
  - the liquidators' powers were strengthened in terms of receiving information about the pre-insolvency activities of the debtor (please see section *Role of the liquidators* of this Chapter); and
  - the obligations of the liquidator to pass on such information to creditors were also strengthened (please see section *Role of the liquidators* of this Chapter).

8. OTHER NOTABLE POINTS

- Stakeholders highlighted certain other points that may be worth mentioning herein since they also raise concerns from the national economy's point of view and/or they impede the enforcement of creditors' rights.

Main issues preventing change and related possible solutions

8.1.1. Involuntary de-registration proceedings

Practical legal issues

- The increasing number of involuntary de-registration proceedings (*kényszertörlési eljárás*) (please see section 1.2 (*Terminology of insolvency proceedings*) of the Legal background Chapter) may also cause a problem from the national economy's point of view.
- Pursuant to the current legislative framework, the court of registration de-registers the affected companies without the involvement of any insolvency expert and in the absence of the underlying documentation.

Potential solutions

- The entire concept of involuntary de-registration proceedings should be reconsidered, particularly in terms of the lack of IOH participation.

8.1.2. Special regime for entities having strategic importance

Practical legal issues

- The most significant and valuable cases fall under the scope of this special regime set out in the Bankruptcy Act (please see section 6 (*Special regime with respect to entities having strategic importance*) of the Legal background Chapter). However, there are a number of issues in relation to these provisions, such as:
  - due to the vague criteria of "strategic importance", practically, any company can fall under this regime;
  - no remedies are granted against the government decision;
  - the retroactive effect is problematic in that debtors involved in ongoing bankruptcy and liquidation proceedings can also be qualified as having strategic importance;
  - these proceedings are even less transparent for creditors than ordinary proceedings; and
  - the Hungarian State is the owner of the liquidator company which is exclusively entitled to manage these proceedings, but the state can also appear as a creditor, creating conflict of interest issues.
- In light of the above, the unpredictable and anti-transparent nature of this special regime may be harmful for the creditors in terms of the exercise of their rights and also financially.

Potential solutions

- The deficiencies of the special regime should be remedied by legislation, particularly in terms of the lack of creditors' control and transparency.

8.1.3. Criminal aspect

Practical legal issues

- Banks experience an increasing number of fraud and corruption cases. The efficient exploring and criminal sanctioning of such matters is frequently impeded by the lack of relevant financial education and information of police officers and public prosecutors.

Potential solutions

- Not only the insolvency judges should receive a more complex education as to economic, accounting and other business-related matters, but also the police staff and the public prosecutors. This would facilitate the more effective exploring and criminal sanctioning of the deliberate decrease of the debtor's assets by the executive officer and/or the shareholders to frustrate the satisfaction of the creditors (*fedezetelvonás*).

8.1.4. New Civil Code related issues

Practical legal issues

- Certain provisions of the New Civil Code were also to be reflected in, and resulted in certain changes to the terms of, the Bankruptcy Act. Unfortunately, such adjustment of the Bankruptcy Act resulted in internal inconsistencies between different sections of the Bankruptcy Act. As a result, creditors are currently unsure as to:
  - the exact point after which they are not allowed to enforce their mortgage, charge or pledge in the liquidation proceedings. Now, this date may fall even before the commencement of the liquidation by the court; and

Main issues preventing change and related possible solutions

  - which provision of the Bankruptcy Act they should rely on in relation to their rights relating to the method of enforcement (e.g., via a private sale) of their security deposit (*óvadék*) after the commencement of the bankruptcy or the liquidation proceedings (please see section 5.10 (*Security interests, priority of claims*) of the Legal background Chapter). According to a newly inserted provision (Article 4/A), they cease to be entitled to enforce their security deposit e.g., via a private sale. However, other provisions (such as Article 38 (5)) remain unaffected which set out that the security deposit remains enforceable via a private sale within a limited timeframe.

- The New Civil Code terminated the possibility to establish call option rights to secure payment obligations (*biztosítéki célú vételi jog*). This seems to be justified for retail matters but not for corporate matters since banks have lost one of their most powerful tools for the enforcement of their claims.
- The provisions of the lien registry (*hitelbiztosítéki nyilvántartás*) cause the following issues:
  - If the pledgor files a release declaration with the registry and the pledgee does not confirm that it intends to maintain the pledge within 30 days, the registered pledge is automatically deleted from the registry. Financial service providers have needed to set up new, separate email monitoring systems to check any such release finings and act then accordingly. This provision is unfortunate, particularly for non-Hungarian pledgees for whom a Hungarian language email notification regarding the pending release filing submitted by its debtor(s) may not attract sufficient attention, and may give rise to potential abuses by pledgors. We understand that the Ministry of Justice is working on the fine-tuning of such legislation to ensure its effective operation and to prevent abuses.
- The new provisions relating to mortgages, charges and pledges are mandatory, preventing deviation from them by the parties to the security agreement. However, it is unclear whether the parties can validly include further rights and obligations (such as the usual ‘no disposal‘or ‘negative pledge’ provisions regarding the secured assets) in their security agreement which do not contradict the mandatory provisions of the New Civil Code regarding the creation of the security interests.
- As a consequence of the above ambiguities, creditors are not necessarily interested in the provision of new financing under the New Civil Code for the purpose of the refinancing of the existing debt. This impedes the successful restructuring of debt.

Potential solutions

- The New Civil Code should be amended, clarified and/or related official interpretations issued in accordance with the feedback received from the stakeholders in order to eliminate ambiguities.

Appendices

1. Appendix A
2. Appendix B
3. Appendix: C
4. Appendix: D
5. Appendix: E

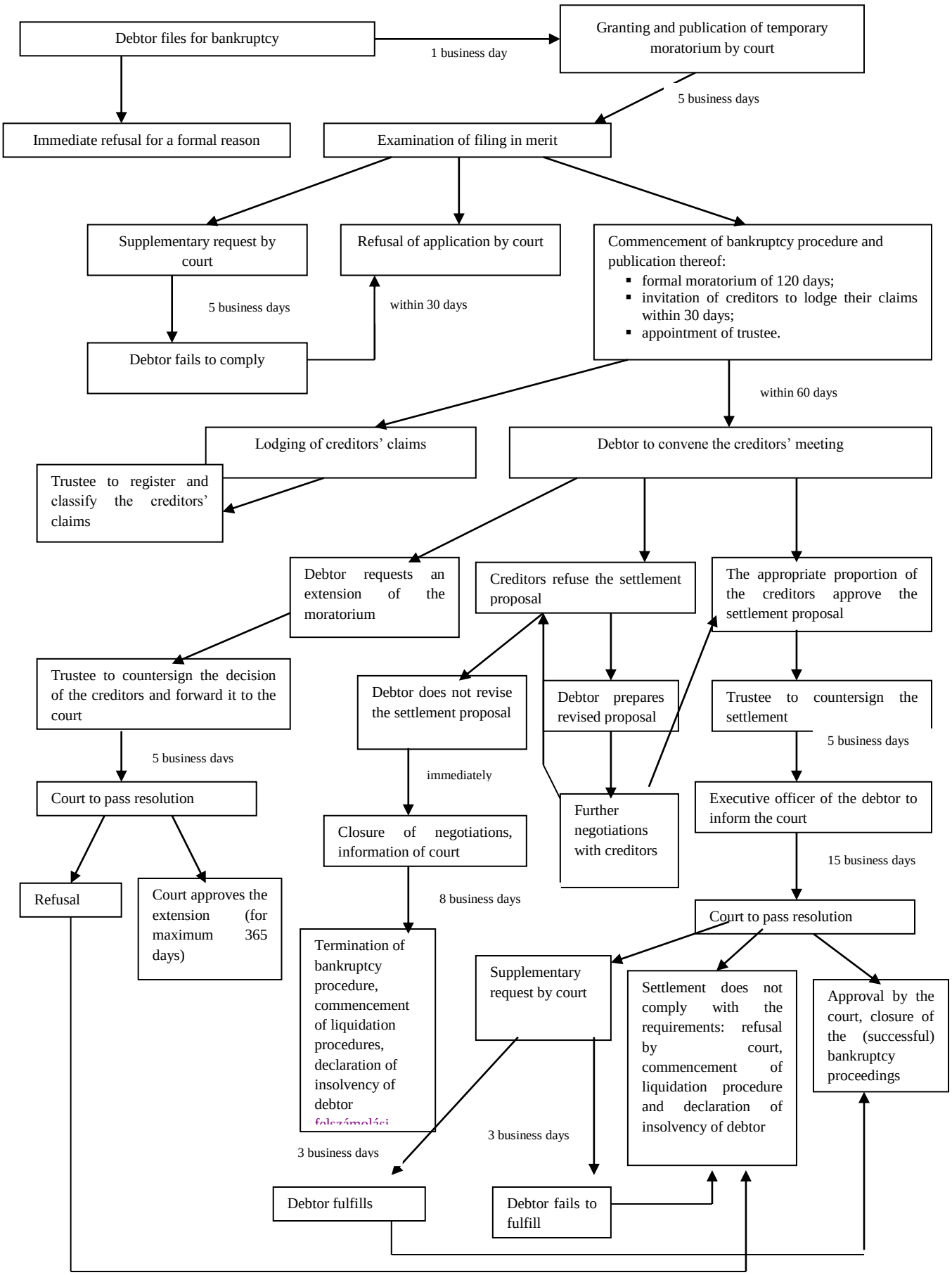
LIST OF RELEVANT LAWS AND REGULATIONS

- Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings;
- Act III of 1952 on the Civil Procedure;
- Act IV of 1959 on the Civil Code;[28]
- Act XLIX of 1991 on Bankruptcy and Liquidation Proceedings;
- Act LIII of 1994 on Court Enforcement;
- Act IV of 2006 on Business Associations;[29]
- Act V of 2006 on Public Company Information, Company Registration and Winding-up Proceedings;
- Act V of 2013 on the Civil Code;
- Decree having the power of an Act No. 13 of 1979 on Private International Law;
- Government Decree No. 225/2000 (XII. 19.) on the accounting aspects of the liquidation proceedings;
- Government Decree No. 250/2004 (VIII. 27.) on the detailed provisions of the delivery by court bailiffs;
- Government Decree No. 114/2006 (V. 12.) on the register of insolvency office holders;
- Decree of the Ministry of Justice No. 33/2009 (VIII. 26.) on the application forms relating to the filing for bankruptcy;
- Decree of the Ministry of Justice No. 38/2009 (VIII. 31.) on the formality and content requirements of the notification set forth in Article 40 of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings;
- Government Decree No. 237/2009 (X. 20.) on the detailed provisions relating to the public sale of the debtor's assets in the liquidation proceedings, as well as on the amendment of Government Decree No. 225/2000 (XII. 19.) on the accounting aspects of the liquidation proceedings;
- Government Decree No. 17/2014 (II. 3.) on the electronic sale of the debtor's assets in liquidation proceedings

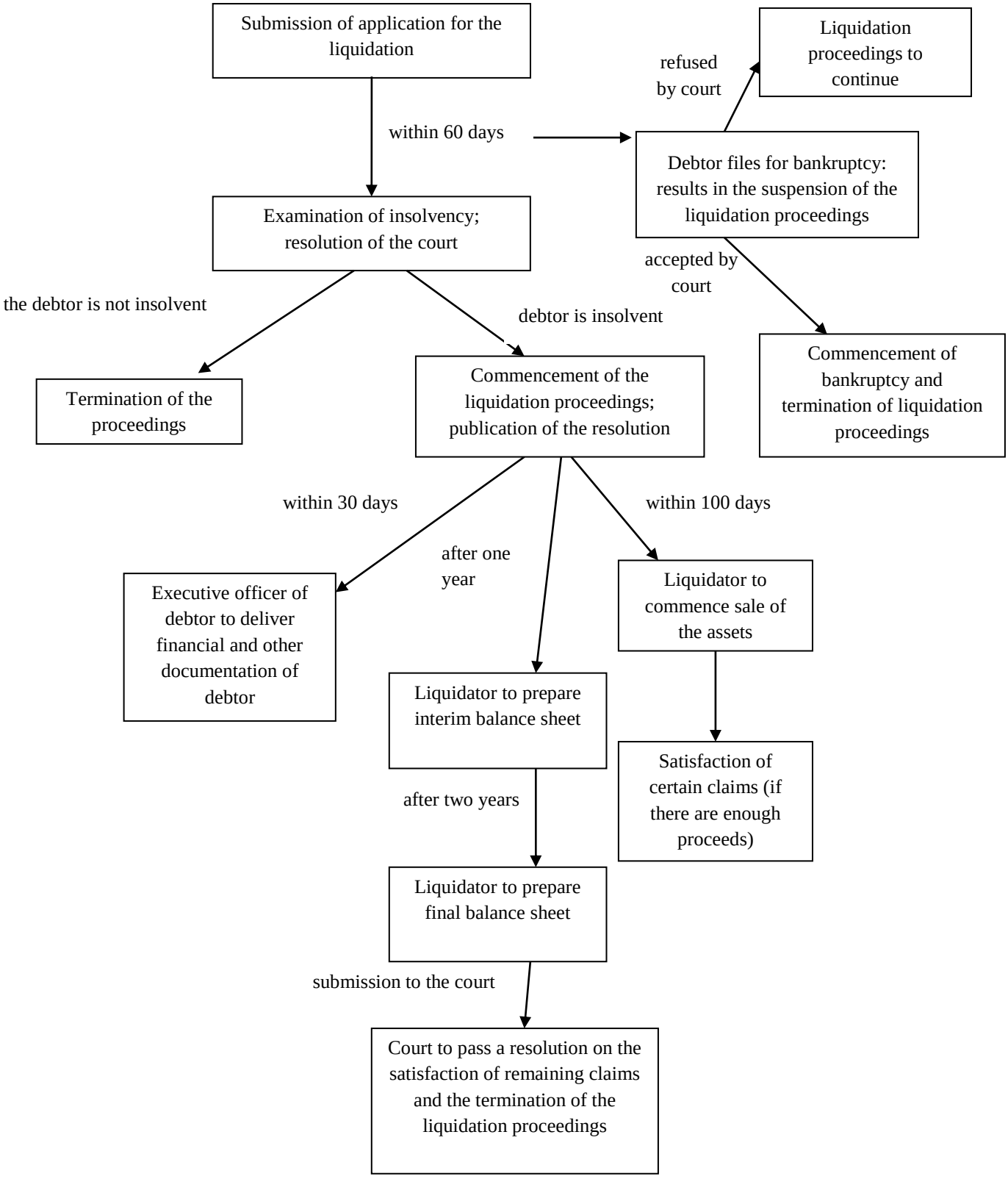
[28] We note that the New Civil Code (Act V of 2013) repealed the Old Civil Code. However, the Old Civil Code remains applicable to certain existing legal relationships, such as security agreements concluded under the previous regime.

[29] We note that the New Civil Code (Act V of 2013) incorporates the provisions relating to corporate entities. Therefore, the New Civil Code repealed the provisions of Act IV of 2006, which, however, remains applicable to companies established under the previous regime to a certain extent.

FLOWCHART OF THE BASIC STEPS OF THE BANKRUPTCY PROCEEDINGS



FLOWCHART OF THE BASIC STEPS OF LIQUIDATION PROCEEDINGS



LIST OF FINANCIAL, ACCOUNTING, TAX AND LEGAL INTERVIEW QUESTIONS

Key reasons for the current NPL situation	► Please describe the main observed drivers of the increase in NPLs by corporate clients. ► Please indicate the main types of restructuring products/solutions offered to debtors to keep the loans performing. ► Please indicate the main reasons why debtors default again within 2 years after restructuring by industry sector. ► Please mention any other triggers that have resulted in the increase of NPLs.
Key factors determining decision making on NPL portfolios	► Please present the approach used for restructuring/exit of bad loans. ► Please indicate the main factors that drive decision making related to NPLs.
Key barriers to NPL resolution	► Please provide the main financial, legal and taxation issues you encountered that have hindered the effective resolution (whether by security/loan enforcement, restructuring, bankruptcy or liquidation) and/or sale or transfer of NPLs. ► Were you able to solve these issues? How did you resolve them? ► Please express your opinion regarding other local barriers hindering the decrease of NPL levels.
Current tax environment and key accounting aspects (Hungarian GAAP and IFRS to the extent relevant)	► Please indicate the main changes in the accounting and tax environment, which could facilitate the decrease of NPLs and/or the sale and transfer of NPL portfolios. ► Please provide a list of other tax measures that you would propose to facilitate the resolution and/or sale and transfer of NPLs.
Legal questions	► In how many pre-bankruptcy (out-of-court) restructurings (carried out by way of contractual arrangements) is your bank involved per year? Please indicate the 3 most challenging issues in relation to such out-of-court arrangements (including in respect of any security/ guarantees, intercreditor and/or enforcement issues). ► Do you think any formal pre-bankruptcy restructuring proceeding would be beneficial in the Hungarian context? ► In how many bankruptcies (*csődeljárás*) and liquidation (*felszámolási eljárás*) proceedings have your bank been involved as a creditor per year? In your opinion, how could creditors achieve a better outcome or recovery rate in these proceedings? Could this be achieved by shorter timeframes, less or more judicial oversight, changes to sales processes or the process for agreeing a bankruptcy plan? ► Please indicate at least 3 main areas where you would strengthen the rights of creditors in bankruptcy and liquidation proceedings and in loan and security enforcement. ► Please indicate 3 measures which would help improve the performance and/or accountability of insolvency office holders and court bailiffs. In addition, please advise how you would improve the system for the appointment of the insolvency office holder ► Please indicate the 3 main practical reasons for the delays in liquidation proceedings. How do you think the length of these delays could be decreased? ► Please indicate a couple of provisions/concepts under Hungarian legislation which, in your opinion, will most likely cause issues in relation to: (i) the enforcement of security interests by the bank; and (ii) the enforcement of the bank's claims in the bankruptcy and liquidation proceedings.

Abbreviations

IOH	Insolvency office holder
R&D	Research and development
FTT	Financial transaction tax
VAT	Value added tax
NPL	Non-performing loan
FX	Foreign exchange
ROE	Return on equity
ROA	Return on assets
NBH	National Bank of Hungary
CAR	Capital adequacy ratio
SME	Small- and middle enterprises
NAMAC	National Asset Manager Company
AQR	Asset quality review
CoF	Cost of Funding
LTV	Loan to value
DSCR	Debt service coverage ratio
DSRA	Debt service reserve account
EU	European Union
IRR	Internal rate of return
AMC	Asset Manager Company (planned Bad Bank by the National Bank of Hungary)
IAS	International Accounting Standards
CIT	Corporate income tax
IFRS	International Financial Reporting Standards
TLCF	Tax losses carried forward
LBT	Local business tax
EC	European Committee
P&L	Profit and loss statement
UK	United Kingdom
Bankruptcy Act	means Act XLIX of 1991 on Bankruptcy and Liquidation Proceedings (as amended from time to time)
Civil Procedure Act	means Act III of 1952 on the Civil Procedure (as amended from time to time)
Court Enforcement Act	means Act LIII of 1994 on Court Enforcement (as amended from time to time)
New Civil Code	means Act V of 2013 on the Civil Code (as amended from time to time)
Old Civil Code	means Act IV of 1959 on the Civil Code (as amended from time to time)
Project	means the EBRD project relating to the analysis of the corporate restructuring and insolvency in Hungary
Report	means this white paper report relating to the Project