Bankruptcy Proceedings in Romania

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Introduction

With the fall of the Berlin wall, collapse of the Soviet Union, disintegration of Yugoslavia and division of Czechoslovakia, about 30 countries started down the road from a planned to a market economy. Among the more interesting of these countries is Romania, a middle sized Eastern European nation with a strategic position within what had once been part of the old Soviet Empire. Like all of these countries, Romania faced the problem of reorienting its economy from one of state owned and operated businesses to one of privately owned enterprises able to participate in the competitive world of free enterprise. One of the key aspects of this world is the process whereby inefficient businesses are weeded out and their remaining employees and assets reallocated to more productive uses.

This process requires a bankruptcy system, preferably an effective bankruptcy system, which facilitates timely and efficient liquidation or reorganization of troubled businesses. Having once had a market economy, Romania had the vestiges of such a system but it was essentially a dead letter under the planned economic system that prevailed during its post-World War II communist period. Once Romania threw off the planned economy yoke, it needed to reform both its political and economic systems in order to become a successful participant on the European continent. Herein we discuss this process that is not only interesting in its own right but also serves as a useful example of the issues that have been encountered by all of the similarly positioned countries. Our focus herein is on the development and operation of the new Romanian bankruptcy system but also touches on other related issues including the privatization process and Romania’s integration into the European Union.

Part I. The economic and political climate in Romania since 1990

The political environment

For the past 20 years, Romania has faced numerous political challenges. In the first seven years after the fall of the Berlin Wall and the collapse of the communist regime in all Eastern European countries, Romania was governed by a "central-left" party which so valued governmental stability that it refused to take any unpopular measures to restructure the economy. Nonetheless, it failed to keep its social protection promises. From a one-party system, Romania evolved in a couple of years to a pluralist system. In 1996, the opposition right wing took over, but had difficulty implementing the needed reforms quickly enough. As a result, the population could not see any concrete benefits. However, solid institutional anchors have now been established for the country's economic policies and the main political parties have reached a consensus regarding the EU enlargement process.

In 2000, Romania applied for EU membership and started implementing reforms. Policies focused on the functioning of the administration at local and regional levels, the strengthening of democratic institutions, and to facilitating Foreign Direct Investment (FDI) contributed to securing the EU accession and to reducing the gap in regional growth and development. Romania accessed to membership in the European Union in January 2007. Despite some shortcomings in its legal system, road infrastructure and delayed measures for tackling red tape, Romania managed to attract FDIs. Although Romania's political system has been characterized by bouts of political instability, the overall political situation has been stable. The implementation of EU laws and regulations still remains a challenge. Strict monitoring concerning corruption and judicial competence and financial sanctions from the EU remain in place. Romania is a liberal democracy and parliamentary republic. The end of 2009, however, saw a turbulent period in Romania's government, amid the worldwide financial crisis.

Macroeconomic and financial highlights

For the past two decades Central and Eastern European (CEE) countries have experienced an influx of reforms designed to strengthen the business environment. The collapse of communism and the imminent reentry of CEE countries into the world of unfettered international trade led to an increase in a global competition for labor force, investments and natural resources. The underdeveloped capital markets and low financial intermediation resulting from more than 40 years of centralized economies, rising unemployment after the quasi collapse of state-owned enterprises are only a few of the factors that led to this wave of change. The desire to rejoin the "Old Europe", inspired far-reaching reforms aimed at creating democratic societies and market economies. While almost all CEE countries have developed and strengthened their democratic institutions in a short period of time, market reforms have been tackled differently. To join the European Union (EU) these countries had to fulfill some fundamental requirements which captured the existence of a functioning market economy with a basic institutional setup, effective fiscal discipline, dynamic market entry and exit mechanisms, proper protection of property rights, appropriate contract enforcement and adequate economic policies aligned to the EU policies.

Spurred by the recent accession to EU, Romania's economic performance has improved significantly in the past decade. Although still at only 40% of Euro zone average GDP per capita, Romania has caught up at a remarkable speed in the last couple of years (see Table 1). Today, with a nominal GDP of around $161 billion and a GDP per capita (PPP) of $11,812, Romania is classified as an upper middle income economy by the World Bank.[1] Robust economic growth has been under way for the past 5 years. After reaching 6% in 2007, Real GDP growth

[1] Economies are divided according to 2007 GNI per capita, calculated using the World Bank Atlas method. The upper middle income economy are those with GNI per capita > $11,455.

accelerated to 7.1% in 2008 but dropped by 7.1% in 2009. The performance from 2004 through 2008 was driven by a surge in private consumption and gross fixed capital formation, following high real wage growth, increased FDI inflows and a record expansion in lending activity. The fall in domestic consumption by 8.2% and in exports by 5.5% in 2009 contributed to the fall in Real GDP by 7.1%. 56% of GDP is based on services, but industry and agriculture also have significant contributions.

Table 1. Selected economic indicators

	2004	2005	2006	2007	2008	2009
Population (mil)	21.7	21.6	21.5	21.5	21.5	21.5
Nominal GDP ($ bn)	75.5	98.9	122.7	166	200.1	161.1
GDP per capita ($US at PPP)	8,704	9,303	10,481	11,430	12,514	11,812
GDP real growth rate (%)	8.5	4.2	7.9	6	7.1	-7.1
Annual inflation rate (%)	11.9	9	6.6	4.8	4.4	5.6
Recorded unemployment rate (%)	6.3	5.9	5.2	4.1	4.4	7.8
FDI Inflows ($ US mil)	6,436	6,483	11,366	9,774	22,600	6,800
Current account balance ($US mil)	-3,869	-8,621	-12,785	-23,017	-24,809	-7,048
External debt stock ($US mil)	29,581	39,077	55,114	76,324	92,812	112,665
International reserves ($US mil)	16,096	21,595	30,211	39,956	39,468	45,520
FOREX RON:USD (avg)[2]	3.26	2.91	2.81	2.44	2.52	3.05

Source: Economic Intelligence Unit 2009, 2010 Country Reports

The double digit inflation rate that plagued Romania in the ‘90s, has decreased to single digits and remained there for the past five years. The implementation of direct inflation targeting regime since 2005 contributed to anchoring inflation expectation at a low level. After dropping to 4.4% in 2008, the inflation rate rose to 5.6% in 2009 due to higher global market prices for agricultural-food products and oil as well as increases in wages and loose fiscal policies. Private and public sector wage growth has outpaced productivity growth and thereby contributed to inflation. Although, interest rates have been kept high to curb consumption, they haven’t seemed

[2] RON is the Romanian currency.

to reduce consumption or the level of imports, but have had a negative impact on investments. However, in 2009 low world oil prices relative to 2007-2008, and falling international and domestic demand exerted downward pressure on prices.

A lack of consensus on reforms needed to facilitate the restructuring, recapitalization and privatization of the economy, together with a lack of bankruptcy and legal reforms resulted in an almost total absence of any foreign direct investment (FDI) until 1997. Thereafter Romania reached a level of political and economic stability which allowed the first privatizations to take place. On average, FDI inflows between 1997 and 2008 have remained strong and have covered on average 68.60% of the current account deficit. In 2008 alone, as the privatization program of state owned enterprises was coming to an end, FDI inflows reached $22.6 billion. These increased FDI inflows were in response to improved economic performance and EU accession prospects.

The increase in FDI intra-company loans has led to an increase of external debt from 39% of GDP in 2004 to over 60% of GDP in 2009. In March 2009, a stand-by agreement with the IMF was signed with emphasis on fiscal retrenchment and a reform of the pension system. Under a long term policy of borrowing to build up the foreign exchange reserves, the National Bank of Romania (NBR) has managed to service the debt without difficulty. The international reserves, which have increased substantially for the past 5 years, reached a level of $ 45.5 billion in 2009 and allowed the NBR to prevent excessive depreciation and to offset the widening current account deficit. Due to the financial crisis in 2008-2009, inflows of FDI fell by one-half to 6.8 billion, in 2009.

The 2009 *Doing Business World Bank* report highlights a set of regulations and patterns which can enhance or hamper the development of business activity. From an EU harmonization

point of view, in 2000 the EU agreed to track the cost and time of starting and respectively closing a business for all its members. The EU's goal is to inspire competition and allow potential investors to monitor progress and implement more effective business decisions. As suggested by Djankov et al. (2006), improvements in all *Doing Business* indicators, such as starting a business, dealing with construction permits, accessing credit, enforcing contracts, closing a business, protecting investors, paying taxes, registering property, are associated with an increase in economic growth.

According to World Bank's *Doing Business* 2005 and 2008 reports, compared to other economies with a functioning market economy, Romania's business environment has improved, moving from the 71st place in 2005 (out of 155 countries) to the 47th place in 2008 (out of 181 countries). Launching a business is faster and cheaper than in other neighboring countries while the number of steps entrepreneurs expect to go through to register a business is below the region average (see Table 2). Although the start-up formalities can be accomplished quickly, the protection of shareholders rights through effective corporate governance is still problematic. While the above mentioned indicators are associated with better economic and social outcomes, starting a business remains challenging compared to the process in OECD countries.[3]

[3] OECD member countries are: Australia, Austria, Belgium, Canada, Chile, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Turkey, United Kingdom, and United States.

Table 2. Starting a Business

Economy	Procedures (number)	Duration (days)	Cost (% GNI per capita)	Paid in Min Capital (% of GNI per capita)
Hungary	4	5	8.4	10.8
Czech Republic	8	15	9.6	31.8
Poland	10	31	18.8	168.8
Bulgaria	4	49	2	47.8
Romania	6	10	3.6	1.1
Latvia	5	16	2.3	16.9
Estonia	5	7	1.7	23.7
Lithuania	7	26	2.7	35.9
CEE Group Average	6	20	6	42
OECD	5.8	13.4	4.9	19.7

Source: World Bank, Doing Business in 2009

Contract enforcement has been simplified in terms of number of procedures compared to other CEE countries, but still, an average of 512 days is required to enforce a contract, which is somewhat longer than the average of 462 days for OECD countries (see Table 3).

Table 3. Contract enforcement

Economy	Procedures (number)	Duration (days)	Cost (% of claim)
Hungary	33	335	13
Czech Republic	27	820	33
Poland	38	830	12
Bulgaria	39	564	23.8
Romania	31	512	19.9
Latvia	27	279	16
Estonia	36	425	18.9
Lithuania	30	210	23.6
CEE Group Average	33	497	20
OECD	30.8	462	18.9

Source: World Bank, Doing Business in 2009

Closing a business in Romania takes on average 3.3 years, longer than the average for our selected CEE countries (3 years) and significantly longer than in OECD countries (1.7 years).

Although the costs of closing the business are not too high, the recovery rate associated with insolvency is very low at 29.5% compared to 68.6% for the OECD countries (see Table 4).

Table 4. Closing a business

Economy	Time (years)	Cost (% of estate)	Recovery rate (cents on the US dollar)
Hungary	2.0	15	38.4
Czech Republic	6.5	15	20.9
Poland	3.0	20	29.8
Bulgaria	3.3	9	32.1
Romania	3.3	9	29.5
Latvia	3.0	13	29
Estonia	3.0	9	37.5
Lithuania	1.7	7	48
CEE Group Average	3	12	33
OECD	1.7	8.4	68.6

Source: World Bank, Doing Business in 2009

The process for exiting a business is as important to a functioning market economy as is the process for starting and operating a business. In a market economy an effective bankruptcy system provides financially distressed firms with a timely and orderly exit mechanism which contributes to an effective reallocation of resources. Therefore, a nation's bankruptcy law can encourage or discourage entrepreneurial behavior in many ways. Ideally a bankruptcy system will incentivize managers to engage in risky businesses where but only where the expected rewards justify the risk taking. Such a system provides the opportunity for failed business managers to start again while reassuring the creditors that their debts can be collected, or at least a fair recovery will be had, should the borrower fail.

A well-functioning bankruptcy institution, as an efficient exit mechanism of financially distressed companies, is paramount to an efficient resource reallocation process and therefore contributes to the development of a healthy business environment. The Romania bankruptcy law

of 2006 replaced the one adopted in 1995 and provided Romania with a solid bankruptcy system similar to those of countries in the EU. The development of bankruptcy law in Romania is the main topic of this paper with emphasis on current practices and applications.

The privatization process

Similar to most other transition economies, the privatization process in Romania was quite heterogeneous and required more than a decade to be finalized. It began with corporatization of the state owned enterprises (SOEs). The legal conversion was completed by 1991, when the SOEs were divided into two groups: *regii autonome* (remaining SOEs) and *commercial companies*. The shares of the commercial companies were placed in the newly established State Ownership Fund (SOF) and five Private Ownership Funds (POFs). The former were required to be privatized within seven years (Romanian Privatization Law of 1991).

The three methods that dominated the Romanian privatization process were: management-employee buyout (MEBO), the mass privatization program (MPP), and sales to single investors. Although sales to single investors were intended to be the primary privatization method, they proceeded very slowly, being surpassed by the MEBO and MPP methods for most of the 1990s. According to Earle and Telegdy (2002), before 1998 domestic and foreign investors accounted for only 8.2 and 2.3 percent of Romanian privatizations, respectively. Alternatively, over a third of all industrial firms in the SOF portfolio had undergone MEBO transactions by 1998, with a mean employee stake of 64.9 percent (Earle and Telegdy, 2002).

Low domestic savings and reluctance of foreign investors were among major causes of insufficient demand for shares in commercial enterprises (Frydman and Rapaczynski, 1994). In order to overcome this problem and speed the privatization process, the SOF introduced voucher privatization, also known as mass privatization, which was carried out throughout 1995-1996.

The benefits of the program, however, were reduced by the large stake kept by the state and the highly dispersed group of private owners, with little ability to influence management.

At the end of 1998, the state was the largest owner in almost half of the companies, followed by insiders, who were the majority owners in 24.5% of the firms, and the MPP owners (14.2% of the firms). Outsider shareholders had a majority in only 12.6% of firms: domestic owners controlled 9.3% of the firms, and foreign investors were dominant in 3.3% of the firms (Earle and Telegdy, 2002). The favorable political and economic climate in Romania in the 2000s, however, has accelerated the privatization process and attracted many domestic and foreign investors. By 2006, 71.6% of GDP was generated by the private sector (Kvetan, 2007).

Given the new ownership structure of Romanian firms, where the state, as a major stakeholder, was gradually replaced by institutional and retail investors, new laws were required in order to help investors seek recovery of their invested capital in case the enterprise fails.

Part II. Law No. 85/2006

The Romanian Commercial Code of 1887 functioned as the legal base for bankruptcy proceedings in Romania for more than six decades. Although not repealed, it lost its validity after 1948, when Romania changed from a market economy to a centrally planned economy, and the state became the only stakeholder. Almost a century after it was signed into law, given the new political and economic changes that took place in Romania after December 1989, the Romanian Commercial Code of 1887 was abolished and replaced by Law No. 64/1995 Concerning the Proceeding of Judicial Reorganization and Liquidation (hereinafter Law No. 64/1995). In an effort to improve the bankruptcy proceeding, and as a response to Romania's ascension into the European Union and the ensuing need for harmonizing its legal system with

that of the European Community, in 2006 Romania passed Law No. 85 Concerning the Proceeding of Insolvency (hereinafter Law No. 85/2006), which replaced Law No. 64/1995.

The players in the insolvency proceedings

The syndic judge

Under Law No. 85/2006, the key player in the Romanian bankruptcy process is the syndic judge. Appointed by the Municipal Court in the jurisdiction in which the insolvent debtor is incorporated, the syndic judge has extensive powers. His/her responsibilities include, but are not limited to, opening and concluding the insolvency proceeding, appointing the judicial administrator and/or liquidator or confirming those selected by the assembly of creditors, supervising their activity, solving or monitoring the settlement of claims, watching over the debtor's assets and liabilities before a reorganization or liquidation agreement is reached, and supervising the liquidation process. Most importantly, based on the recommendation of the assembly of creditors and other parties with legal rights in the bankruptcy process, the syndic judge decides whether the debtor's business should be reorganized or liquidated, and suspends the debtor's administrative rights if it didn't declare its intention to reorganize.

The assembly of creditors and the creditors' committee

Once the insolvency proceedings are declared open, the assembly of creditors is convened by either the judicial administrator, the liquidator, the creditors' committee, or any creditor owed at least 30% of the firms' liabilities. At the recommendation of the assembly of creditors, the syndic judge approves a committee of three to five creditors that will become the creditors' committee. The creditors' committee has the power to analyze the debtor's activity and make recommendations with respect to the debtor's reorganization process. It can solicit the

dispossession of the debtor's management if the latter does not propose a realistic reorganization plan, and propose an administrator (the judicial administrator) to manage the debtor's business.

The special administrator

The general meeting of the insolvent debtor's shareholders/associates appoints the special administrator to represent their and the debtor's interests in the bankruptcy process. The special administrator has the right to propose a reorganization plan. After an agreement regarding the reorganization plan is reached, the special administrator, under the supervision of the judicial administrator, manages the debtor's activity. His/her responsibilities are reduced as soon as the debtor's management is dispossessed.

The judicial administrator

At the recommendation of the creditors' committee, the creditors owed at least 50% of the value of all creditors' claims elect the judicial administrator, whose role is similar to that of a bankruptcy trustee in the US system. Alternatively, the creditors can confirm the judicial administrator who had received a temporary appointment from the syndic judge. The judicial administrator must be an experienced insolvency practitioner who is insured against malpractice. After the syndic judge, the judicial administrator has the most important role in the bankruptcy process.

Within 30 days from his/her appointment, the judicial administrator must analyze the debtor's incorporating documents and economic activity and propose that either the simplified or the general insolvency procedure be used. Additionally, within 60 days from his/her appointment, he/she must examine the debtor's business and file a detailed report documenting the causes and circumstances that led to the debtor's insolvency, as well as the debtor's chances of reorganization or the reasons that prevent it from entering the reorganization process.

The judicial administrator has the right to propose a reorganization plan, convenes and presides over the meetings of the assembly of creditors and those of the debtor's shareholders/associates, collects account and notes payable, closes bankruptcy-related transactions, but most importantly, he/she supervises the debtor's estate, and takes over the management of the business when the debtor's management is dispossessed. The syndic judge has the right to penalize the judicial administrator for any wrong doing or delay in fulfilling his/her obligations in the insolvency process.

The liquidator

When liquidation is imminent, the syndic judge appoints a liquidator, who may also be the judicial administrator. Within 60 days from his/her appointment, the liquidator must examine the debtor's business and file a detailed report documenting the causes and circumstances that led to the debtor's insolvency, if such a report has not been provided by the judicial administrator. When a debtor enters the liquidation procedure, the syndic judge suspends its administrative rights and the liquidator takes over the management of its business. He/she receives and makes payments on behalf of the debtor, organizes and verifies the debtor's liabilities, and addresses the majority of the liability-related objections formulated by creditors. Most importantly, the liquidator seals the debtor's property, compiles an inventory of the debtor's assets, liquidates the debtor's assets and guards its estate, pending the distribution of its assets to the creditors.

The insolvency proceedings

Under the Romanian bankruptcy law, a firm is considered to be in the state of insolvency if it has stopped paying its financial obligations for more than 30 days. The insolvency proceedings start at the debtor's (voluntary) or creditor's/creditors' (involuntary) request, which

is filed with the Municipal Court in the insolvent debtor's jurisdiction. The debtor can file the bankruptcy petition either when the state of insolvency is deemed imminent, or within 30 days from the date it stopped paying its debt obligations. When the bankruptcy petition is filed voluntarily, the creditors have 10 days from the notification day to challenge it, and to file an application for registration of its receivables in the preliminary table of claims.

Alternatively, a creditor can file the application for opening the proceedings if the unpaid receivables are greater than RON 10,000 (modified to RON 30,000 in a later amendment to the law).[4] The debtor has 10 days to challenge the creditor's petition. If the debtor's motion is rejected, the debtor loses the right to solicit a reorganization procedure. On the other hand, in order to cover its damages in case the creditor's application is rejected, the debtor can request that the petitioning creditor(s) post a bond in a commercial bank of up to 10% of the value of all claims against the debtor. If the bankruptcy process is opened, the bond is returned to the creditor(s). If the bond is not posted timely, the case is dismissed. Once the legal requirements are met, the syndic judge pronounces the opening of the bankruptcy proceedings by initiating either the general or simplified procedure. The simplified procedure is analogous to the Chapter 7 proceeding in the US, whereas the general procedure is similar to the US Chapter 11.

The simplified procedure

The syndic judge initiates the simplified procedure when the likelihood that the debtor's activity can be reorganized is *de minimus* or when the debtor expresses its intention to open the liquidation procedure. The simplified procedure can also be used when the debtor falls under certain categories specified by the Law: it fails to file the documents necessary to start the insolvency procedure, its incorporating documents and/or accounting reports are missing, its

[4] If the liability stems from contractual labor obligations, it should be greater than six average salaries per economy.

directors and/or headquarters cannot be found, etc.   As soon as the simplified procedure begins, the syndic judge appoints a liquidator.

The general procedure

Once the bankruptcy procedure is declared open, the judicial administrator or the liquidator is responsible for notifying the debtor, the debtor's creditors and the National Office of Commerce Registry. Any appeal to the opening of the bankruptcy proceedings should be filed within 15 days from the notification day.

Within 10 days from opening the procedure, the debtor must file all documents concerning the company's activity, a complete list of its assets and liabilities, the names and addresses of all its creditors and its liabilities to each of them, a reorganization plan and a summary of the methods it intends to use in implementing its plan. If the debtor fails to comply with these requests or expresses its intention to open the liquidation procedure, the syndic judge starts the simplified procedure. Otherwise, the observation period continues until a decision regarding entering either the reorganization or liquidation procedure is made.

Under Law No. 85/2006, the judicial administrator, the liquidator, and the creditors' committee are entitled to cancel any transaction made by the insolvent debtor up to three years prior to the bankruptcy filing if the result of the transaction was to deplete the debtor's estate to the disadvantage of its creditors. This right is similar to the fraudulent conveyance provision in US law.

From the day the bankruptcy process begins, all judicial and extrajudicial proceedings followed to realize the claims on the debtor's assets; all penalties and interest related to the debtor's activity before insolvency; trading in the debtor's stock; and the statutes of limitation are suspended. Additionally, while in the bankruptcy proceedings, no interest or penalty of any

type can be added to the pre-existing liabilities of an insolvent debtor. An important exception from the rule concerning the suspension of judicial proceedings mentioned above applies to some collateralized debt instruments. Their holders may ask the syndic judge to cancel the suspension and sell the asset that constitutes the collateral when: (a) the value of the asset is fully covered by the value of all claims secured by it; (b) the asset is not instrumental in the success of the proposed reorganization plan; (c) its sale doesn't affect the value of other assets; (d) the asset doesn't provide proper protection for the secured debt obligation. The syndic judge may reject the creditor's/creditors' suspension request if the judicial administrator or the debtor proposes adequate protection measures against the depreciation of the asset value.

During the observation period, the debtor will continue its normal activities. If at the end of this period the debtor has not expressed its intention to reorganize, or the chances that the debtor's activity will be restructured are minimal, the syndic judge may suspend the debtor's administrative rights and pass them over to the judicial administrator.

The reorganization plan and procedure

A reorganization plan may be proposed by the debtor (with the approval of the shareholders/associates' meeting), the judicial administrator, or creditors who collectively hold more than 20% of the value of all creditors' claims. Exceptions are the debtors that were in insolvency proceedings or committed any legal frauds within the last five years. The reorganization plan must be voted by the Assembly of Creditors and then confirmed by the syndic judge. Under Romanian bankruptcy law, claims are classified into four categories (both for secured and unsecured debt) for voting purposes. A reorganization plan is confirmed by the syndic judge if more than half of the classes, including at least one impaired class, vote favorably, and the impaired class (classes) that rejected the plan will be treated fairly and

equitably if the plan is implemented. This means that, when liabilities are paid back, none of the classes that rejected the plan would receive less that it would have in case of liquidation, or more than the total value of its claims.

Before the plan is confirmed, the syndic judge may consult an insolvency practitioner to evaluate the plan's feasibility. Upon the plan's confirmation, the debtor, led by the special administrator and under the supervision of the judicial administration, must conduct its activity in accordance with the plan until the syndic judge either declares the insolvency procedure over and the debtor financially healthy, or closes the reorganization process and opens the debtor's liquidation. If the debtor does not conform to the plan or its activity causes severe financial losses, the judicial administrator, the creditors' committee, or the special administrator can request the syndic judge to dispossess the debtor and initiate the liquidation procedure.

The liquidation procedure

The syndic judge opens the liquidation process if: 1) the debtor challenges the involuntary filing for insolvency but the application is rejected by the syndic judge; 2) the debtor files for the simplified procedure; 3) the debtor expresses its intention to enter the reorganization process but doesn't propose a reorganization plan or the plan is rejected; 4) the debtor doesn't express its intention to enter the reorganization process; 5) none of the reorganization plans is accepted or confirmed; or 6) the judicial administrator, after documenting the causes of the debtor's insolvency and assessing the debtor's business, reaches the conclusion that the debtor cannot continue its activity. Once the liquidation process is initiated, the syndic judge dispossesses the debtor and appoints a liquidator who takes control of the debtor's assets and documents. The liquidator notifies all creditors, organizes and verifies the creditors' claims,

seals the debtor's property, makes an inventory of and liquidates the debtor's assets, or guards its estate, pending the distribution of its assets to creditors.

On behalf of the debtor and at its expense, the liquidator may hire an evaluator to assess the debtor's assets according to the international evaluation standards. After assets are evaluated, they are sold, either individually or in block, through public auction, direct negotiation, or a combination of the two. The debtor's liquidation is entirely managed by the liquidator under the supervision of the syndic judge.

Proceeds resulting from liquidation will be distributed to creditors in the following order of priority. In case of collateralized debt securities, upon the sale of the asset(s), secured creditors are entitled to be paid from the proceeds of the sale of their security, after all expenses related to the sale of the respective assets have been paid. If the sale's proceeds do not entirely cover the value of the secured creditors' claims, the difference will be treated as unsecured debt and will share pro rata with other unsecured securities belonging to the same class. Among the non-secured creditors, the first priority level belongs to the expenses related to the bankruptcy proceedings, followed by employee and other labor-related expenses. The next priority level is for the debtor's credits extended by financial institutions, and liabilities resulting from debtor's continuing activity after the opening of proceedings. Budgetary claims, claims related to individual debtors (merchants), unsecured bank loans, and general unsecured claims complete the list of liquidation priorities. If the sale's proceeds do not entirely cover the value of claims from the same class, the creditors will be satisfied pro rata, but not before the claims belonging to superior classes are satisfied in full.

Law No. 85/2006 vs. Law No. 64/1995

Although Law No. 64/1995 was "one of the best drafted bankruptcy laws in Central and Eastern Europe" (Bufford, 1997), its enforcement was not easy for several reasons. First, throughout the 1990s, given a slow privatization process (see **The privatization process** in **Part I**), most Romanian companies were state-owned and owed large amounts in back taxes. Filing bankruptcy petitions against these debtors would have caused substantial economic instability. Moreover, in the case of privatized firms, overdue liabilities to the state were converted into equity, thereby increasing the state's ownership in these enterprises. Second, quite often bankruptcy was used as a means of changing ownership in order to facilitate the transfer of state property into private hands. In many cases, during bankruptcy proceedings assets were sold to politicians, management, or other interested parties at less than their fair market value.

These shortcomings in applying the solvency law were not particular to Romania but common to other transitory economies in Eastern Europe. They were primarily attributed to the incipient stage of the privatization process in these countries throughout the 1990s. With the majority of assets still owned by the state, property rights were not as protected in emerging Europe as they were in more developed economies.

In spite of the significant economic and legal progress that Romania has made since 1989, poor management and business practices have prevented many Romanian enterprises from filing a bankruptcy petition in time to save their companies from liquidation. This may also be attributed to the difficulty of negotiating relief from indebtedness outside of the court rooms. For example, in 2009 only 1.8% of Romanian firms restructured their liabilities without going to court, compared to 14.7% in Hungary, or over 17% in Latvia and Lithuania.[5] Most bankruptcies were filed at the last moment by creditors desperate to recover as much of their investment as could be salvaged. Thus, about 95% of the companies that entered the bankruptcy process ended

[5] The World Bank Group, Financial Crisis - Enterprise Surveys.

up in liquidation. To dissuade this practice and reduce the number of liquidation cases, the new law encourages debtors to file for bankruptcy voluntarily if they deem the debt burden unbearable. If, while in bankruptcy the firm presents a viable reorganization plan, its existing liabilities will not incur interest or penalties. Given this new incentive, the number of firms voluntarily filing for bankruptcy has increased more than tenfold between 2006 and 2007 (see Table 5).

Table 5. The number of new voluntary vs. involuntary bankruptcy filings per year

Year	Voluntary (Debtor)	Involuntary (Creditors)	Both	N/A	Total
2004	20	48	0	10	78
2005	66	200	0	37	303
2006	350	1413	0	158	1921
2007	4049	6198	0	458	10705
2008	5408	9970	3	943	16324
2009[1)]	2754	4901	5	1171	8831

Source: Romanian National Office of Commerce Registry
[1)] Data available up to July 15, 2009

Through its simplified procedure, the new law, Law No. 85/2006, allows a much faster liquidation for the firms that express their intention to liquidate or have no real likelihood of reorganizing. It also provides the legal support to eliminate shady firms from the market quickly. Moreover, if the debtor challenges the petition filed by its creditors, and the syndic judge rejects it, the debtor is denied a reorganization attempt and will automatically enter the liquidation process. Shortening the insolvency procedure was the key objective of the new law. Table 6 shows that, even after controlling for the bankruptcy filings for which data on reorganization or liquidation were not available, the number of new liquidation filings was still significantly higher than the number of reorganizations in the mid- to late 2000s. Table 7 reports on the outstanding bankruptcy petitions since 1997.

Table 6. The number of new reorganization vs. liquidation filings per year

Year	Reorganization	Liquidation	Both	N/A	Total
2004	3	72	0	3	78
2005	5	272	1	25	303
2006	10	1498	8	405	1921
2007	41	6977	14	3673	10705
2008	55	9891	12	6366	16324
2009[1)]	14	3605	0	5212	8831

Source: Romanian National Office of Commerce Registry
[1)] Data available up to July 15, 2009

Table 7. The number of outstanding insolvency petitions, either in the reorganization or in the liquidation process, by year.

Year	Reorganization	Liquidation	Total
1997	9	1	10
1998	51	13	64
1999	215	247	462
2000	742	655	1397
2001	1807	902	2709
2002	2175	1407	3582
2003	1592	1616	3208
2004	1631	2285	3916
2005	2945	4906	7851
2006	2873	4721	7594

Source: Romanian National Office of Commerce Registry

Another significant change in Law No. 85/2006 is the increasing role of the Assembly of Creditors and the Creditors' Committee in ensuring better protection of the creditors' interests. Under Law No. 64/1995, the syndic judge had considerable discretion in following the creditors' requests on the reorganization/liquidation decision or on the nominations for bankruptcy administrators and managers. Under the new law, some of the syndic judge's administrative duties are transferred to the judicial administrator, liquidator, and creditors' committee, which

will closely monitor, make recommendations, and, in special circumstances even manage the firm's activity during the bankruptcy proceedings.

Part III. Case Study: S.C. Danubiana S.A., the tire factory

Built in 1959 as part of Ceausescu's industrialization program, by the end of 1989 S.C. Danubiana, S.A. becomes Romania's main tire manufacturer for tractors, trucks, and other industrial vehicles. In 1995 Danubiana is privatized by the State Ownership Fund (SOF), and Tofan Group SA becomes its majority shareholder. With a 100 million US dollar capital infusion from Nomura Securities (a London-based investment bank), in 1997 Tofan Group buys a majority stake in Victoria S.A. and Silvania S.A., two Romanian tire makers, specialized in tires for light trucks, buses and passenger cars. With these two new additions, Tofan Group controls nearly 80% of the internal tire production in Romania. At the end of 1990s, the king of tires, as Tofan Group was known, makes the last addition to its empire by acquiring S.C. Rotras S.A., a Romanian producer of giant tires for industrial vehicles.

Tofan Group's reign over the tire market in Romania is, however, short-lived. In 2001 it decides to sell its majority stakes in Victoria, Silvania and the recapped pneumatic tire maker Tofan Recap to Michelin, and maintains its dominant position in the Romanian tire market for agricultural and industrial vehicles by keeping Danubiana and Rotras. While considered a success at the time, the sale of Victoria and Silvania would be the beginning of the end of Danubiana and Tofan Group alike.

The problems at Danubiana started almost from the beginning. Due to difficulties in the agricultural sector, mining, and transportation in general, and at SC Roman SA and SC Tractorul SA, Danubiana's main domestic customers, in particular, the domestic market that used to absorb 80 percent of the company's output entered a downward trend. This forced Danubiana to turn to

a very competitive foreign market, and, since 1997, to export 80 percent of its production, primarily to the European Union and the United States. With slight setbacks, Danubiana's income increased steadily from 1999 until 2004 (see Figure 1).[6]

Romania's high import tariffs for raw materials but extremely low (if any) tariffs for finished products, and excessive tax policies put Danubiana at a disadvantage compared with its international competitors, and inflated Danubiana's already high production costs (see Figure 1). In order to cut its costs, Danubiana drastically reduced its work force from 2717 in 1999 to 1329 by the end of 2004, and 639 by December 2006.[7] Its costs continued to escalate, but the sometimes misguided reductions in work force caused a decline in technological discipline and product quality.

To revive its economic activity, Danubiana started taking a series of bank loans, most of which were secured with real estate assets from the company's portfolio. Overall, the firm's long- and short-term liabilities fluctuated significantly from 1999 to 2006, and peaked at 64 millions of RON ($20.16 millions) in 2001 and 59 millions of RON ($18.93 millions) in 2005 (see Figure 1).

Given significant changes in the tire markets, a volatile exchange rate, increasing utility and raw material prices, and considerable management errors, in 2004-2006 Danubiana amassed massive losses and piled up a significant amount of debt. Within these two years, several attempts were made to rescue the company. The first, involving a change in management, proved unsuccessful; the second, the effort to sell Danubiana to the Italian giant Pirelli, also failed.

On May 29, 2006, facing one of the biggest liquidity crises in its history, Danubiana, through its General Meeting of Shareholders decided to temporarily suspend production and

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[6] Figure 1 is based on Danubiana's selected balance sheet and income statement numbers provided by firmepenet.ro

[7] firmepenet.ro

implement a restructuring plan. According to Gelu Tofan, the CEO of Tofan Group, before the factory was closed in 2006 it was losing about 500,000 US dollars monthly and had accumulated liabilities to banks and suppliers in excess of $12 millions (Capital Magazin, June 16, 2006). The real number was, however, much higher. With close to 15 million euros ($19.80 millions) in debt, Danubiana owes approximately €8 millions ($10.56 millions) to creditors and €7 millions ($9.24 millions) to suppliers and the state. The restructuring plan involves a €20 million ($26.40 million) investment to modernize Danubiana's production lines. The capital will be obtained primarily by either selling a piece of land from the firm's portfolio or by obtaining a loan secured by that property. At the end of 2006 the value of the land, approximately 35 hectares, was estimated at €24 millions ($31.68 millions).[8]

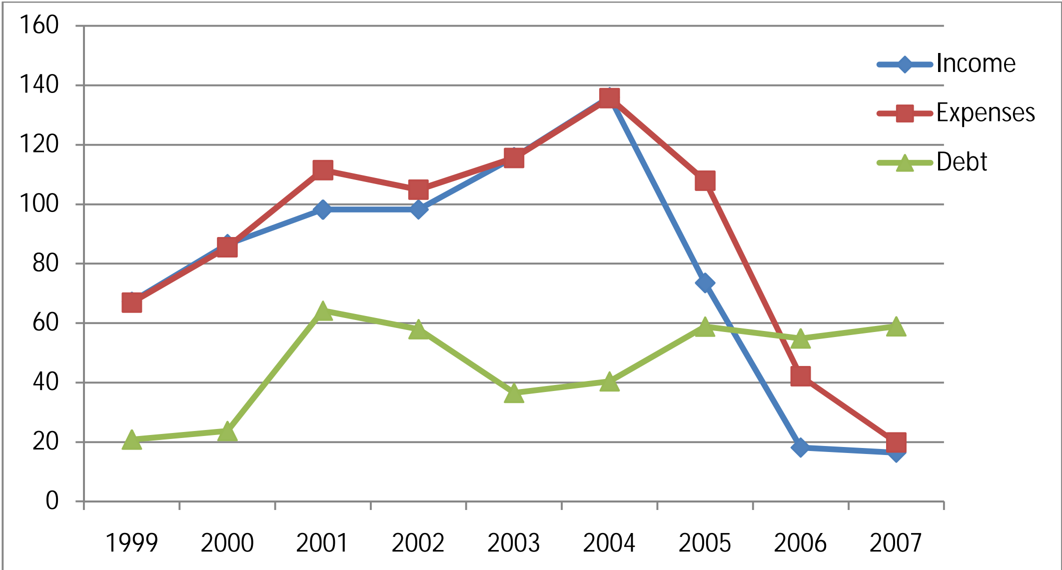
The insolvency of Danubiana becomes official on December 8, 2006, when, at the request of Wurfbain Nordmann BV, one of Danubiana's suppliers, the Bucharest Court, declares open the insolvency proceedings. Danubiana's liabilities to Wurfbain Nordmann BV were approximately 220,000 euros. The consulting firm Consulta 99 was appointed as the judicial administrator and George Adrian Tofan, the son of Gelu Tofan – CEO of Tofan Group, was voted on as the special administrator. Danubiana declared its intention to reorganize and proposed the reorganization plan mentioned above.

Ultimately the reorganization plan was rejected by the Bucharest Court, as being unrealistic. The €20 million the company needed to modernize its production lines in order to respond to the current demand in the tire market proved difficult to obtain. The company didn't find new lenders and the assembly of creditors voted against selling the 35 hectares of land to restart the tire production. Thus, on February 01, 2008, the Bucharest Court officially rejected

[8] "Danubiana invests 20 million euros in restructuring until 2009". Wall-street.ro, September 9, 2006.

Danubiana's reorganization plan and decided that the liquidation of the company should proceed. All Danubiana's later appeals were unsuccessful.

Figure 1. Danubiana's income, expenses, and debt (in millions of RON).



Conclusions

Romania's experience in moving from a planned to a market economy illustrates many of the issues encountered by the large number of countries that have traveled or are traveling down this road. While progress has been less than rapid with fits and starts, Romania is now operating with a functioning free economy. It is growing and becoming more and more of a player in the overall European marketplace with a level of per capita income within the range of its peers. It has successfully privatized most of its businesses and gained entry into the European Union. Among the important tasks that were needed to be accomplished to get where it now is, has been the development of an effective bankruptcy process.

The process outlined herein involves many of the similarities with the US system, including a mechanism for liquidation and reorganization; participation by the creditors; oversight by a specialized judge; a means of avoiding value destroying transactions (fraudulent conveyances); special treatment for collateralized claims; different treatment for different classes of creditors and an automatic staying of interest and penalties during the bankruptcy process. While bankruptcy law and practices are nowhere nearly as fully developed in Romania as in the US, the basic structure is in place. As a result, Romania is well positioned to grow its economy at a reasonably rapid rate within the EU.

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