THE WORLD BANK ECONOMIC REVIEW VOL. 10, NO. 3: 425-50

Hungary's Bankruptcy Experience, 1992–93

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Policymakers working on enterprise restructuring should take a close look at Hungary's experience with bankruptcy reform since 1992. This article provides detailed data on a randomly selected stratified sample of actual cases filed in the first two years after the enactment of the law. These data are supplemented with information obtained from interviews with judges, liquidators, and firms involved in the bankruptcy process to give an overall picture of the process in the first two years of its implementation. The bankruptcy process in Hungary has indisputably spurred institution building in the courts, the trustee profession, and the banks. It may also have succeeded broadly in separating viable from unviable firms. It did little, however, to further either deep restructuring or the exit of ailing firms. The changes in incentives and institutions that are needed to make bankruptcy work in transition economies invariably take time. Hungary's initiative, albeit imperfect, was a bold start toward reform.

As policymakers in both developing economies and economies in transition look for policies and processes to spur enterprise restructuring, they should take a close look at Hungary's experience with bankruptcy reform since 1992. Here we use the term "bankruptcy" for the entire process, and "reorganization" and "liquidation" for the two specific procedures provided in the Hungarian law. Although other countries have adopted innovative restructuring processes (see Gray and Holle forthcoming on the Polish bank-led conciliation process), Hungary's experience with formal bankruptcy law is indeed unique in the postsocialist world. Hungary adopted a tough new bankruptcy law in late 1991 that took effect January 1, 1992. It required managers of all firms with arrears of more than ninety days to file for either reorganization or liquidation within eight days (the so-called automatic trigger) and provided a rather sympathetic framework for them to do so. The law immediately resulted in a wave of filings, with some 3,500 filings in April 1992 alone (after the ninety-day grace period covered by the law). Over 22,000 cases were filed in 1992–93, a level far beyond the expectations of policymakers when the law was adopted (see table 1).

Although the level of activity has been enormous, detailed information on how the bankruptcy process has actually worked in Hungary has been scarce.

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Table 1. *Reorganization and Liquidation Processes of Hungarian Firms, January 1992 through December 1993*

Indicator	*Reorganization*	*Liquidation*
Number of filings	5,156	17,133
Number of firms		
State-owned enterprises	429	1,820
Cooperatives	965	2,768
Business entities	3,762	12,545
Limited-liability firms	2,959	8,927
Number of employees (percentage of firms)		
Over 300	6	—
51–300	24	—
50 or fewer	70	—
Status of cases as of December 31, 1993 (number of firms)		
Closed	4,627	a
With agreement	1,250	
Reversion to liquidation	1,377	
Administrative completion	2,000	
Pending	529	

— Not available.

a. Over 10,000 liquidation cases were completed by the courts in 1992 and 1993, but these included cases filed in earlier years under the previous law. Furthermore, over three-fourths of the completed cases were "administrative completions," that is, cases withdrawn or rejected on administrative grounds. Only a very small number of the 17,133 cases filed in 1992 and 1993 were completed by the end of 1993.

Source: Government of Hungary, Ministry of Finance.

Many views—both positive and negative—have been put forward regarding the impact of the law on enterprise restructuring in particular and economic growth more generally, but they have been supported by very limited reliable data. (For a negative view, see Bonin and Schaffer 1994.) This article helps to fill this information vacuum by providing detailed data on a randomly selected stratified sample of actual cases filed in the first two years following the enactment of the law. These data are supplemented with information obtained from numerous interviews with judges, liquidators, and firms involved in the bankruptcy process to give an overall picture of the process in the first two years of its implementation.

Bankruptcy law plays at least three important roles in market economies. First, it provides ailing firms with an orderly means of exit. Second, it shifts control rights over assets toward creditors and helps to reallocate assets to better uses through a combination of restructuring and liquidation. Third, it promotes the flow of credit in the economy by protecting creditors and serving as a final stage of debt collection. The first two roles work together: the threat of exit spurs restructuring, and the impossibility of restructuring spurs exit. The bankruptcy process should ideally be able to discriminate between unviable firms

and potentially viable ones that can be saved through restructuring. For enterprises able to cover operating costs out of current revenues but unable to cover debt service, reorganization provides an avenue to restructure debt burdens and thus continue in operation. It may promote such restructuring formally, as in the Hungarian reorganization procedure, or through informal debtor-creditor workouts undertaken to avoid formal bankruptcy. Firms unable to cover even operating costs are clear candidates for exit unless they can be fundamentally restructured to regain viability. The role of bankruptcy law in altering control rights over a firm is the subject of much recent literature in corporate finance. For further discussion and references, see Baer and Gray (1996).

In their emphasis on preserving jobs and production, policymakers in many transitional countries focus on these first two roles for bankruptcy law, as we do in this article. However, the third role is at least as important for economic growth. A well-designed bankruptcy process takes control over financially distressed firms before all assets have been misused or dissipated. It also gives creditors the information and power to use the remaining assets to maximize the potential for debt recovery, either by improving the firm's performance through reorganization or by liquidating the firm and satisfying creditors' claims to the extent possible out of sale proceeds. By giving creditors the confidence that debts can be collected, bankruptcy processes (and collateral laws prior to bankruptcy) facilitate the role of banks and other creditors in funding and monitoring investment in an economy and in exerting influence over enterprise managers. Without the ability to collect debts, banks will refuse to lend at all or will lend only to those clients they know well—and thereby become peripheral players in both resource allocation and corporate governance—or they will turn to the state for support when loans turn bad. Thus bankruptcy legislation is an important complement to, *not* a substitute for, disciplined macroeconomic policies and privatization and the hard budget constraints and corporate governance possibilities they create.

Considering these various roles of bankruptcy law, the major questions to be addressed include the following:

- What types of firms entered reorganization or liquidation, or both, in Hungary in 1992 and 1993, and why?
- What were the roles of the various actors in these processes (that is, debtor managers and owners, creditors, judges, liquidators/trustees), and why?
- How cumbersome were these processes in practice?
- What have been the direct effects of reorganization on the debt structure and operations of firms?
- What have been the direct effects of liquidation and reorganization on enterprise exit, privatization, and institution building?
- Has the process served reasonably well as a debt collection mechanism for creditors?
- How can the bankruptcy process be improved?

The bankruptcy process in Hungary has indisputably spurred institution building in the courts, the trustee profession, and the banks. It may also have succeeded in broadly separating viable from unviable firms. It did little, however, to further either deep restructuring or the exit of ailing firms. The changes in incentives and institutions that are needed to make bankruptcy work in transition economies invariably take time. Hungary's initiative, albeit imperfect, was a bold start toward reform.

I. The Legal Framework for Hungarian Bankruptcy

The Hungarian bankruptcy law of 1991 replaced legislation adopted in 1986 and provided Hungary for the first time with a modern legal framework, quite similar in structure to the U.S. bankruptcy regime (albeit with the addition of the controversial automatic trigger). Debtor firms could file for either reorganization or liquidation, but creditors could file for liquidation only. If debtors filed for reorganization, incumbent management could stay in place, and the firm received automatic relief from debt service and asset foreclosures for three months (with one-month optional extension). During this three-month period, debtor management was supposed to develop a reorganization plan and present it to creditors. The creditors' unanimous approval was required for the plan to be adopted; otherwise the case reverted automatically to liquidation. A firm with a successful plan could not file again for bankruptcy for at least three years. Trustees' and creditors' committees were not required in reorganization cases but could be organized at the discretion of creditors.

The liquidation process provided by the 1991 law was also in line with international norms. It provided for a liquidator to be appointed once the court reviewed and decided to proceed with a filed case. The liquidator was supposed to notify creditors, draw up a list of assets, sell the assets, and divide the proceeds among creditors in order of priority. (Liquidation costs came first, followed by creditors secured by mortgage, other creditors, and equity holders, in that order. Liens other than mortgages on real property had no priority over unsecured credit.) The entire process was supposed to be completed within two years. The law set compensation levels for liquidators and trustees, and regulations adopted concurrently with the law provided an annual licensing procedure for liquidators, setting out minimum capital requirements and professional qualifications.

Numerous important changes were made to the law in September 1993, drawing ostensibly from the first one and a half years of experience with the 1991 law. The unanimous creditor approval requirement was considered too tough, so it was replaced by a requirement of creditor approval by at least one-half of creditors representing two-thirds in value of outstanding claims. The automatic three-month stay on debt service was considered too generous and easy to abuse, and it was replaced by a discretionary stay that required the same level of creditor approval within fifteen days from the date of filing. This new creditor approval requirement made it difficult, if not impossible, in most cases for debtors

to obtain such relief from debt service, because creditors would not be likely to approve such a moratorium without seeing a viable reorganization plan. Liquidators' compensation was considered too low and was increased. To stem the unanticipated flood of cases, both the automatic trigger and the automatic reversion of failed reorganizations to liquidation were eliminated. Finally, the appointment of a trustee was made mandatory in all reorganization cases.

After the passage of the 1993 amendments, the number of reorganization cases declined dramatically, to a level of only about five cases a month by the end of 1994 for several likely reasons. First, the 1993 amendment removed both powerful "carrots" (the automatic stay) and powerful "sticks" (the automatic trigger), and the trustee requirement increased the costs and introduced potentially undesired outside controls into the process. Liquidators/trustees are licensed by the state and are not always considered by creditors to represent their best interests. Furthermore, at the end of 1993 a new out-of-court workout process, called debtor consolidation, was introduced in Hungary. Although description of this process is beyond the bounds of this article, suffice it to say that many debtors and creditors may have seen debtor consolidation as a substitute for reorganization under the bankruptcy law (see Szanyi forthcoming or Baer and Gray 1996). Finally, the general economic conditions of Hungary improved in 1994, and many of the worst firms may well have already been included in the flood of cases in 1992–93.

II. The Bankruptcy Sample

To gain insight into many of the questions raised earlier, we undertook a survey of 117 bankruptcy cases filed between April 1992 and September 1993. All were covered by the unamended 1991 law. They were filed in one of three courts—Budapest (where approximately one-third of all Hungarian cases were filed in 1992–93), Pest County, or Debrecen (a more rural location). The sample was limited to manufacturing firms and was stratified both by process and by size (see table 2). With regard to process, the sample was structured to favor completed reorganizations (63 cases) while still having a substantial number of liquidations, whether cases transferred from reorganization (28) or filed as liq-

Table 2. *The Sample of Firms in Bankruptcy, by Process and Size of Firm, Hungary, 1992*
(number of firms)

Process	*Large firms*	*Small firms*	*Total*
Completed reorganization agreements	36	27	63
Transfers from reorganization to liquidation	14	14	28
Liquidation filings	10	12	22
Withdrawals	0	4	4
Total	60	57	117

Source: Authors' calculations.

uidations (22). Four cases were filed as reorganizations but withdrawn before completion.

With regard to size, the sample was stratified to include both small and large firms on a roughly equal basis (57 small firms and 60 large firms). Large firms were defined either as firms taken from a list of Hungary's 603 largest loss-making firms in 1992 or as firms not on that list but with assets of more than 100 million forint (approximately US$1.25 million in 1992). We wanted to sample heavily from this list, which represented Hungary's biggest problem firms, in order to get a sense of how the process addressed these problems. If we had not stratified the sample to favor large firms, a totally random sample would have contained overwhelmingly small firms. Because the sample of large firms was taken from the list of loss makers, the large firms in our study are likely to have had worse average financial performance than a random sample of large firms that filed for bankruptcy. Actual cases were chosen at random, subject to these stratification criteria and to the willingness and ability of firms to participate. (Approximately 40 percent of firms approached for the study agreed to participate.) Data for each firm were collected both from court files (on average about one-quarter of all data) and from interviews with managers or liquidators, or both.

Sector and Ownership

Table 3 shows the breakdown in the sample by sector and by ownership, two variables not controlled in the stratification. The sectoral distribution is broad, with somewhat heavy representation by firms producing machinery and equipment. Ownership patterns support the prior expectation that larger firms tended to be state owned and smaller firms tended to be private. Table 4 shows the mean values for basic indicators for large and small firms at the time of filing for bankruptcy. All financial data cited in this study should be regarded as approximations. Data on assets, liabilities (particularly residual equity), and income are all questionable, given the enormous deficiencies in accounting in the transition environment. However, because the extent of accounting deficiencies within individual firms is unlikely to be correlated with other independent variables used in this analysis, we believe that such accounting deficiencies are unlikely to seriously compromise the overall findings of the study (which depend on relative comparisons among different categories of firms rather than absolute magnitudes).

Large and small firms had on average 625 and 37 employees, respectively (table 4). Although their overall level of debt (both long- and short-term) as a share of the reported book value of assets was similar and on average very high (146 percent), large firms tended to have a much larger share of bank debt and a somewhat lower share of debt to suppliers and government. The firms in our sample were worse-off financially than the average firm in bankruptcy, as is evident from a comparison of these numbers with data on bankruptcy cases collected by the Hungarian Central Statistical Office (CSO). According to CSO

Table 3. *Sectoral Distribution and Type of Ownership of Sample Firms, Hungary, 1992*
(number of firms)

Firm distribution	*Large firms*	*Small firms*	*Total*
Sector			
Transport equipment	0	9	9
Electronics and medical equipment	2	1	3
Machinery and equipment	19	19	38
Metals, plastics, and chemicals	14	9	23
Paper, wood, and printing products	5	7	12
Textiles, apparel, and leather	12	7	19
Tobacco and food	8	5	13
Total	60	57	117
Firm ownership			
State agency	29	6	35
State	13	7	20
Majority state-owned	1	2	3
Majority privatized	2	0	2
Fully privatized	4	0	4
Private, established domestically	4	33	37
Private, established as a joint venture	3	4	7
Private, established by foreign parties	1	0	1
Cooperative	2	4	6
Other	1	1	2
Total	60	57	117

Source: Authors' calculations.

Table 4. *Mean Values of Indicators for the Sample Firms, Hungary, 1992–93*

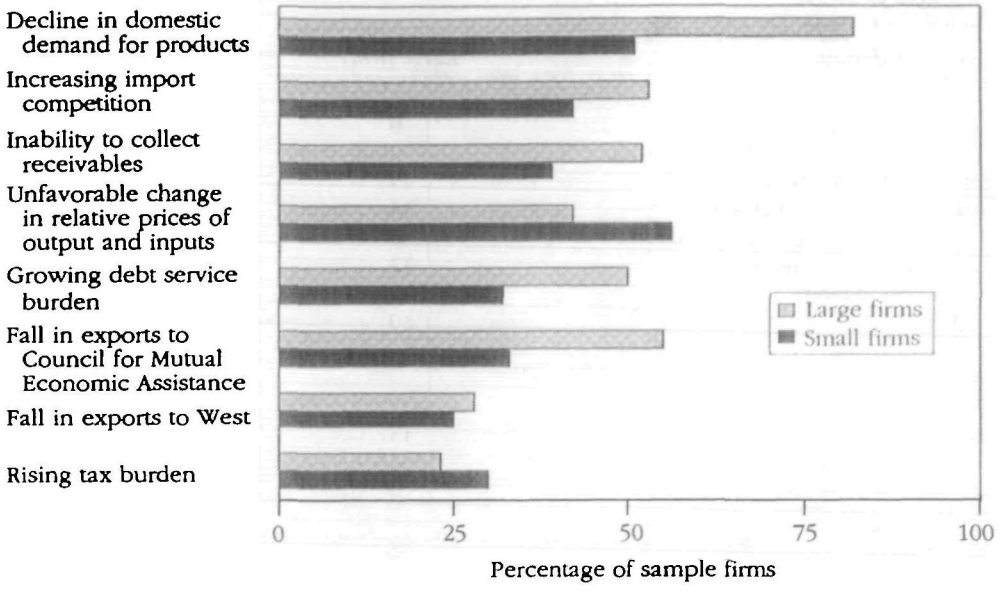
Indicator	*Large firms*	*Small firms*	*Total*
Number of employees	625	37	344
Total assets (book value) (millions of forints)	1,142	88	605
Total debt as percentage of total assets	145	147	146
Bank debt as a percentage of total assets	58	12	34
Payables to suppliers as a percentage of total assets	43	65	54
Government debt as a percentage of total assets	9	19	14
After-tax profit (loss) as a percentage of total assets	–33	–9	–21

Note: The values are for firms filing for reorganization or liquidation in the most recent fiscal year prior to filing (in most cases 1991). The data are for the 104 to 111 firms with valid answers out of the 117 firms in the sample described in the text. The sample contains 60 large firms and 57 small firms.
Source: Authors' calculations.

data, the average debt-asset ratio of firms that filed for reorganization in 1992 was 0.57, well below the average for firms in our sample.[1] Both large and small firms in our sample had a large residual of unclassified debt. In addition to credit from other parties (for example, owners or affiliated firms), some of this unclassified debt could well be misclassified suppliers' credits—for example, arrears to utilities. Little of it is likely to be bank credit.

1. We are indebted to Mark Schaffer for providing us with the CSO data.

Figure 1. *Reasons for Financial Distress in Sample Firms, Hungary, 1992–93*



Note: The data are for 117 manufacturing firms in bankruptcy in the sample described in the text. The sample contains 60 large firms and 57 small firms.
Source: Authors' calculations.

Reasons for Financial Distress

Reported external reasons for prebankruptcy financial distress in small and large firms are shown in figure 1, and summarize both prebankruptcy numerical data and subjective judgments reported in the questionnaire. Although firms report a wide range of external reasons for financial distress, decline in domestic demand for the products the firms produce appears to have been more important for large firms, which is not surprising given that many were state-owned firms producing goods that were obsolete or uncompetitive in the transition environment. Unfavorable relative changes in output and input prices and high tax burdens appear to be somewhat more important for smaller (mostly private) firms. In contrast with a common impression in Hungary, the decline in exports to the Council on Mutual Economic Assistance (CMEA), although important for both small and large firms, was by no means the primary reason for financial distress in this sample of firms. Of course, internal reasons for financial distress, such as weak management or poor accounting, are also likely to be very important in many cases but were not readily measurable in this survey.

III. The Bankruptcy Process in Action

The enormous number of bankruptcy filings in April 1992 is a clear indication of the effect of the automatic trigger that was introduced in the 1991 law.

Table 5. *Financial Distress in the Sample Firms at the Time of Filing for Bankruptcy, Hungary, 1992*
(percentage of total assets)

Indicator and process	*Large firms*	*Small firms*
Debt		
Completed reorganization agreements	70	104
Transfers from reorganization to liquidation	302	245
Liquidation filings	188	148
After-tax profits		
Completed reorganization agreements	-23	-3
Transfers from reorganization to liquidation	-54	-25
Liquidation filings	-34	-26

Source: Authors' calculations.

The survey highlights this effect: more than 95 percent of the firms in the sample noted the trigger as the immediate impetus for filing. Only six firms, all of them liquidation cases, did not cite the automatic trigger as the impetus for filing.[2] The main other reason cited was the creditors' attempt or threat to foreclose on collateral or otherwise collect debt. A total of sixteen firms cited this second reason (ten of which also cited the automatic trigger). Under the trigger, a firm could file for either reorganization or liquidation, and one goal of the survey was to find out the differences between firms taking these various routes (and those succeeding or failing at reorganization).

Table 5 shows key financial indicators at the time of filing for three categories of firms—those that exited the reorganization process with successful agreements, those for which reorganization cases were transformed into liquidations, and those that filed initially as liquidations. These figures indicate that the outcomes of the bankruptcy regime appear to have had some degree of rationality even as early as 1992. The debtors in the transformed cases were in much greater debt to all types of creditors than the debtors with accepted reorganization plans. The former also had much greater losses than the latter. Furthermore, debtors in transformed cases not only had fewer assets overall than debtors in firms with accepted reorganizations, but a higher percentage of their assets were inventories and receivables. The latter, in contrast, had more cash, real estate, and machinery and equipment—assets that are more likely to have a positive market value.

These data suggest that the reorganization process did have some success in separating viable from unviable firms. Although this is undoubtedly an important conclusion, our impressions of the process gathered from outside interviews of managers and liquidators from 1992 to 1994 may temper it. These impressions suggest two other possible reasons for the differences between accepted and rejected reorganizations—both of which infer that the latter were perhaps never intended to succeed. First, the 1991 law quickly and dramatically altered both the legal framework for bankruptcy and the responsibilities placed

2. These data are available from the authors.

on managers of bankrupt firms. It is very likely that many managers did not immediately understand the new law and its requirements, and thus filed for reorganization when they should have filed for liquidation. Second, it is widely believed in Hungary that some managers of state-owned firms spun off, or otherwise diverted, valuable state-owned assets, whether fixed assets, labor, or intangibles (such as contracts and goodwill), to subsidiaries or private firms. Furthermore, owners or managers of private firms can also direct valuable assets to other uses (or foreign bank accounts), leaving only shell firms to enter either reorganization or liquidation, or both. In an environment with poor information and underdeveloped watchdog institutions, it is exceedingly difficult to prevent such activity.

The practice of redirecting valuable assets or income flows is not unique to Hungary. Similar value stripping is widely reported to occur in Bulgaria, Ukraine, and other transitional economies that have been slow to privatize state assets. It can also be widespread in privatized firms if nonmanagerial shareholders have little ability to monitor managerial behavior (see World Bank 1996). Although the extent of value diversion is unknown and impossible to measure, it is generally accepted that it has occurred on a significant scale in Hungary. For in-depth discussion of the recombination of assets in Hungary, see Stark (1996). The survey attempted to get at the issue of prebankruptcy asset diversion by asking numerous and varied questions on the topic. Only a small number of firms reported major asset transfers in the three years prior to filing. However, this is a variable that managers may choose to hide and that liquidators may not have information about, and thus significant underreporting is likely. Many of the reorganization filings may have been undertaken by managers who had previously diverted valuable assets and were biding their time before liquidation. These managers could have filed directly for liquidation, but filing for reorganization first resulted in an automatic three-month delay. Such delay might have been helpful, for example, in avoiding a subsequent investigation of prior asset transfers by liquidators, who have the legal right to void transactions occurring within one year of liquidation filing. In sum, although some of the transformed cases may represent serious yet ultimately unsuccessful attempts to restructure, we believe that many of the cases represent either managerial misunderstanding or prebankruptcy value diversion.

Turning to liquidations, table 5 shows that firms filing for liquidation also had higher debt levels and greater losses than firms with accepted reorganization agreements, and their assets were also more concentrated in receivables and inventories. Again, the process appears to have pushed the worst firms into liquidation, although again prefiling value diversion in both public and private firms probably played some role in creating the financial distress in certain cases.

The Completion Time for Bankruptcy Cases

The flood of bankruptcy cases filed in 1992 and 1993 undoubtedly put a strain on Hungary's judicial institutions. The Budapest court in 1992 had only

eight bankruptcy judges handling more than 15,000 cases. It is perhaps somewhat surprising, therefore, that over 60 percent of the reorganization cases filed in 1992 were completed the same year, and that over 90 percent of the cases filed in 1992 and 1993 were completed by the end of 1993 (see table 1 earlier). Survey data on the average time required for various stages of the reorganization process further support the conclusion that the process was not unduly slow (see table 6). The average time required for an agreement to be finalized was approximately eight months for both large and small firms. On average the debtors presented their reorganization proposals about six weeks after the court's decision to proceed, or about eighteen weeks after filing. The period of negotiation between the presentation of the first plan and the final resolution of the reorganization cases averaged another four months. Unsuccessful cases (particularly those involving large firms) took somewhat longer than successful ones, although virtually all cases were completed within one year of filing.

Reorganization cases could proceed quite quickly, despite their huge numbers, because the level of involvement of courts and trustees was low. The judge's approval depended in most cases on the judge's finding that required information had been submitted with the filing. Once a judge approved a case to pro-

Table 6. *Time Requirements for Reorganization Cases, Hungary, 1992–93*
(average number of days)

	Completed reorganizations		*Cases transferred from reorganization to liquidation*		*All*	
Process	*Large firms*	*Small firms*	*Large firms*	*Small firms*	*Large firms*	*Small firms*
From filing to the court decision to proceed with the case	80	66	107	104	87	79
From court decision to proceed with the case to the submission of the first reorganization plan	39	48	55	30	43	42
From submission of the first reorganization plan to the final court decision	119	110	152	127	126	114
Total[a]	238	224	314	261	256	235

Note: The data are for ninety of the ninety-one reorganization cases in the sample with valid answers.

a. The total number is not an exact measure of the average duration of the bankruptcy process because the underlying number of cases changes from subperiod to subperiod.

Source: Authors' calculations.

ceed (which took on average about three months because of the courts' overload), the judge had little substantive involvement. The debtor and its creditors managed the process, and in this decentralized mode the process could proceed quite rapidly. In *none* of the ninety-five reorganization cases in the sample did the parties choose to involve a trustee in the process. This could be because of the extra expense involved (that is, the trustee fees), combined with the fact that trustees had to be selected from a preapproved list that might not have corresponded to the parties the creditors trusted. It could also simply reflect the relative passivity of creditors during this period (see discussion in the next subsection). This lack of demand for trustees brings into question the reasonableness of the 1993 amendment, which requires a trustee in bankruptcy cases.

The quickness of the reorganization process was not, however, characteristic of the liquidation cases in the sample (see table 7). Only one of the fifty liquidation cases in the sample had been completed by late 1994—that is, within the two years required by law. The average time between filing and the first disposition of assets was about thirteen months, and even this period is significantly underestimated because only about one-half of the firms had sold *any* assets when the survey was conducted.

A major cause for delay in the liquidation process, particularly in cases originally filed as liquidations, was the court's slowness in appointing a liquidator.

Table 7. *Time Requirements for Liquidation Cases, Hungary, 1992–93*
(average number of days)

	Cases transferred from reorganization to liquidation		*Cases filed as liquidations*		*All*	
Process	*Large firms*	*Small firms*	*Large firms*	*Small firms*	*Large firms*	*Small firms*
From filing or transfer from reorganization to the appointment of a liquidator	46	179	350	225	183	200
From the appointment of a liquidator to the formal notification of creditors	14	37	35	35	24	36
From the formal notification of creditors to the first disposition of assets	200	133	304	134	244	133
Total[a]	260	349	689	394	451	369

Note: The data are for forty-eight of the fifty liquidation cases in the sample with valid answers.

a. The total number is not an exact measure of the average duration of the liquidation process because the underlying number of cases changes from subperiod to subperiod.

Source: Authors' calculations.

This step alone took more than seven months for small cases filed as liquidations and almost a year for large cases.[3] Although this delay is perhaps not surprising, given the flood of over 10,000 liquidation cases in 1992 alone, it almost certainly had serious costs in some cases because of the vacuum of oversight and the opportunities for further asset diversion during that interim period.

It is interesting to note that courts took far less time to appoint liquidators in cases transformed from reorganization (particularly those with large firms) than in cases originally filed as liquidations, possibly because the previous exposure to those firms in the reorganization phase gave the courts (and the liquidators) the information and incentive to move quickly once the reorganization had failed. Indeed, in the case of large firms the total elapsed time between initial filing (for reorganization or liquidation) and the first disposition of assets in a liquidation was no longer for those firms that went through reorganization than for those that did not.

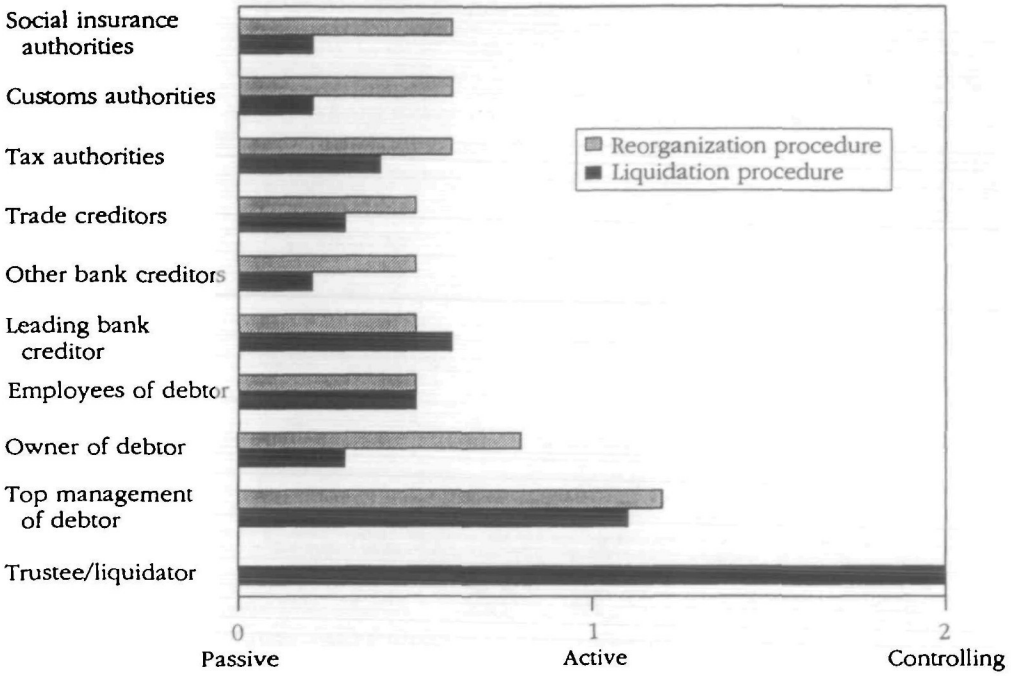
Who Controls Reorganization and Liquidation

A key to understanding the likely impact of bankruptcy in Hungary is to understand who controls reorganization and liquidation. The greater the control wielded by one party (be it debtor or creditor) over a process, the more likely that process is to benefit that party. In mature market economies, where information is relatively plentiful and open and where judicial processes are relatively well developed, bankruptcy is typically a fine balancing act between numerous competing interests, all of them quite actively defending their own interests. In transition economies, however, the situation is quite different. Information is far more costly, and judicial processes (and even notions of due process and fiduciary responsibility) are far less developed. As a result, some parties may have neither the means nor the power to defend their interests effectively. Furthermore, some of the parties to bankruptcy proceedings may not have strong incentives to collect debts aggressively. For example, state-owned firms or state-owned banks may be more inclined to turn to the state for compensation than to pursue debt collection through official legal means. This is particularly true if there is a history of repeated bank recapitalizations, as in Hungary (Baer and Gray 1996).

Figure 2 presents indicators of the relative participation of various parties in reorganization and liquidation. It is clear from these data that managers tended to be most powerful in reorganization proceedings, generally controlling the process, and that liquidators had virtually total control in liquidation cases (with managers still often in active roles). Banks and other creditors were sometimes active, sometimes passive, but virtually never in control of either process. Interestingly, banks do not appear to have been significantly more active than other types of creditors, whether trade creditors or government creditors. Another more general indicator of this relative lack of involvement of banks (particu-

3. This finding is probably somewhat biased by the large share of sample firms handled by the Budapest Court. This court was thought to be the most overloaded and thus the slowest in the country at that time.

Figure 2. *Distribution of Control of the Bankruptcy Process for Large Firms in the Sample, Hungary, 1992–93*



Note. The data are for the sixty large manufacturing firms in bankruptcy in the sample described in the text.
Source: Authors' calculations.

larly compared with their very active role in bankruptcies in mature market economies) is the very low percentage of cases (approximately 1.5) filed by banks through 1993 (table 8).

Several factors may explain the relative inactivity of creditors, particularly banks. First, creditors in Hungary, as in other transition economies, may lack the information and expertise to understand what is at stake and to actively oversee debtor management or liquidators, or both. Watchdog institutions, which can help provide information to creditors—such as accountants, credit rating services, securities regulators, or the press—are in their infancy in transition economies. (For further discussion of the institutions needed to support a market economy, and how they develop in transition settings, see World Bank 1996.) Our bankruptcy cases, all of which were filed in 1992, were some of the first ones.

Second, creditors may lack the incentive to be strong debt collectors, particularly if they are state owned (as all the large banks have been up to 1995 in Hungary) and perhaps expect future state assistance (as Hungarian banks repeatedly received between 1991 and 1995). Third, creditors often express doubt to this day that they can recover anything in the process. Although this is under-

Table 8. *Agencies Filing Liquidation Cases in Hungary*

Agency	*Petitions filed (percentage of total)*
Bank creditors	1.5
Government creditors[a]	13.0
Debtor firms	67.5
Others[b]	18.0

Note: The data are for all liquidation cases filed in Hungary in 1992–93.
a. Tax, social security, and customs offices.
b. Includes trade creditors, liquidators, and conversions from reorganization proceedings.
Source: Government of Hungary, Ministry of Finance.

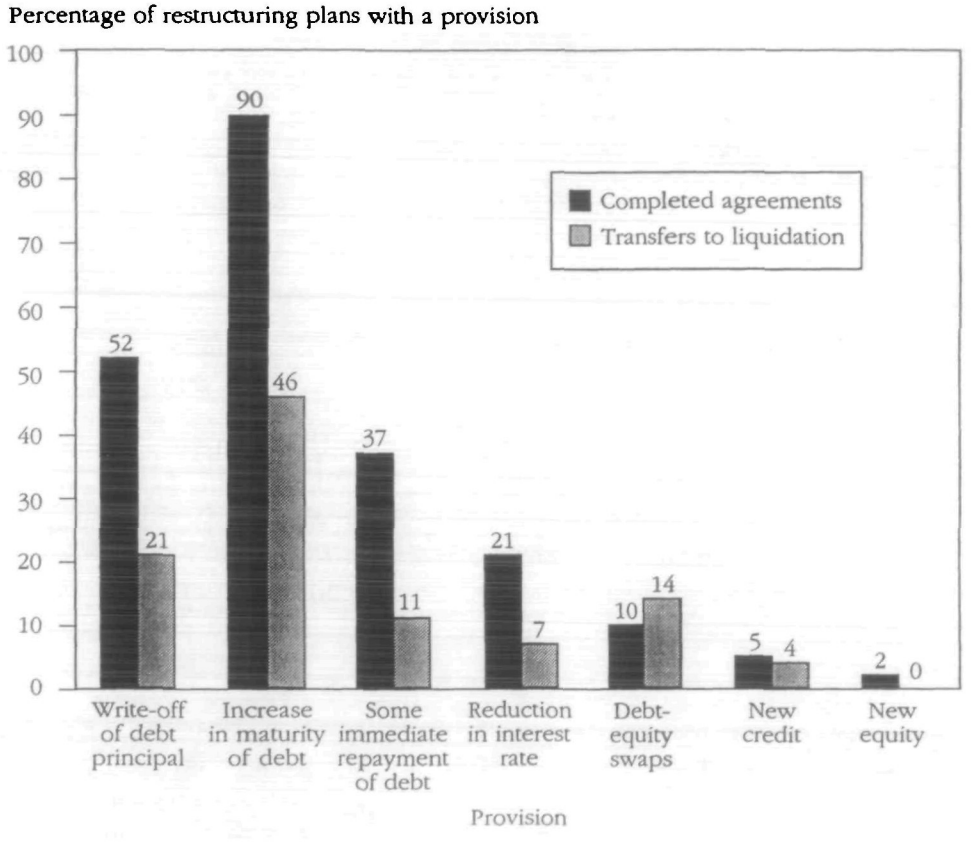
standable in the case of liquidation, given the power of liquidators to prolong the process and the priority given to liquidation costs over creditors' claims (discussed later), it is not clear why the reorganization process is seen as so unfavorable to creditors. Indeed, under the legislation in place in 1992 any creditor had the power to force firms into liquidation by refusing to agree to the reorganization plan (given the unanimous agreement requirement and the automatic reversion to liquidation), and thus on paper the power of creditors was very strong. This strong formal power lends further credence to the importance of the first two explanations.

The Direct Effects of Reorganization

The fundamental challenge of transition is enterprise restructuring, and the core question in our research is what effect the Hungarian bankruptcy process has had on restructuring in Hungarian firms. The effects on restructuring can be either direct or indirect, or both. Indirectly, the mere fact that bankruptcy became so widespread in 1992 probably spurred greater financial discipline in all firms. Although evidence clearly points to improvements in financial discipline, perhaps for this as well as other reasons, we did not attempt to assess these indirect effects (see, for example, Szanyi forthcoming). We did, however, attempt to assess the direct effects of the process on restructuring by studying the contents of reorganization plans and the changes in firm behavior and performance during and after bankruptcy (whether reorganization or liquidation).

FINANCIAL REORGANIZATION. The contents of the financial reorganization plans of the ninety-one cases of successful and unsuccessful (that is, transformed) reorganizations in the sample are summarized in figure 3. The data point to the relatively unsophisticated nature of the final plans. The overwhelming majority of accepted reorganization plans provided for either an extension of loan maturity (generally of one-half to two years) or a write-off of debt principal, including capitalized interest arrears (of on average about 13 percent in the case of bank debt and 20 to 30 percent in the case of debts to government and suppliers). About one-third of accepted plans provided for some partial immediate debt

Figure 3. *Contents of Reorganization Agreements of Sample Firms: Financial Restrucuring of Firms, Hungary, 1992–93*



Note: The data are for ninety-one cases of successful (completed agreements) and unsuccessful (transfers to liquidation) manufacturing firms in reorganization in the sample described in the text.
Source: Authors' calculations.

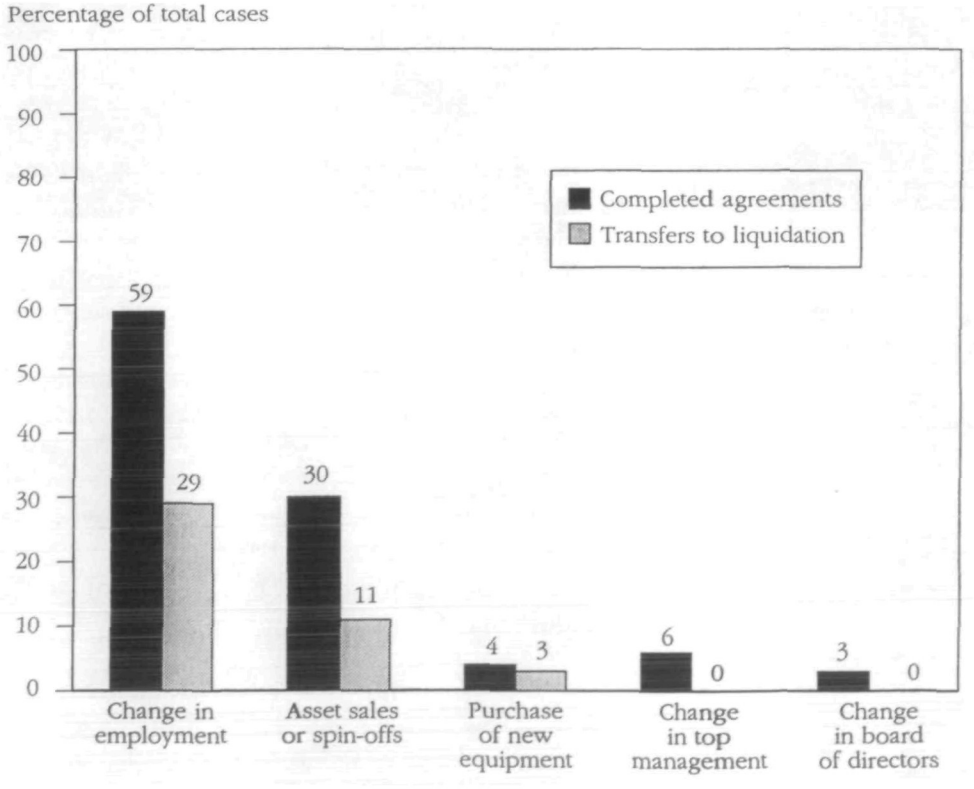
repayment (of widely varying percentage amounts), and 21 percent provided for a reduction in interest rates (figure 3). Six of the sixty-three accepted agreements provided for debt-equity swaps by one or more types of creditors, although there is evidence that most were never implemented. Only three of the sixty-three plans provided for new credit, and only one for new equity.[4] Overall, agreements for small firms contained fewer concessions than agreements for large firms, perhaps not surprising given small firms' less onerous financial condition at the time of filing, and probably their lower bargaining power as well.

4. The absence of new credit is not surprising, given that the Hungarian law gives no priority to such financing. In contrast, financing during reorganization is granted top priority under the U.S. Chapter 11 procedure. However, the situation may not be entirely analogous, as there are much tighter controls on asset disposition and cash flow under Chapter 11—making cash harder to come by—than in the Hungarian case.

It is clear from figure 3 that proposed plans in unsuccessful reorganizations (that is, those transformed into liquidations) contained fewer provisions overall than plans in successful cases. However, if a provision was included, its magnitude was often greater than in the case of successful agreements. The paucity of provisions further supports the conclusion discussed earlier that many of these cases were not filed with the intention to succeed in the first place. The relatively higher magnitudes of provisions when they *were* proposed may point to the likely absence of serious negotiations in many rejected cases.

OPERATIONAL REORGANIZATION. Most of the firms in the survey agreed or undertook steps to downsize during the reorganization period, as indicated in figure 4. Whether or not formally included in the reorganization plan, almost two-thirds of all firms with successful plans agreed or undertook steps to reduce employment (typically by one-quarter to one-third) and almost one-third agreed

Figure 4. *Operational Restructuring of Sample Firms during Restructuring, Hungary, 1992–93*



Note: The data are for ninety-one cases of successful (completed agreements) and unsuccessful (transfers to liquidation) manufacturing firms in reorganization in the sample described in the text.
Source: Authors' calculations.

or undertook steps to sell assets or parts of the firm. The bankruptcy filing was not necessarily the primary reason for such downsizing. Many of the firms were already downsizing before bankruptcy and may well have continued in any case. At a minimum, however, it is clear that bankruptcy did not provide a safety valve to stop downsizing. Nor did it spur management change. Only 6 percent of firms with successful plans agreed or undertook steps to change top management, and only 3 percent (or two out of sixty-three firms) committed to new investments or changes in the membership of the firms' oversight board of directors.

Although the operational changes were reported in the survey questionnaires to be part of the reorganization plans, it is likely that in many cases they were undertaken simultaneously but were not formally included in the plan. Large Hungarian state firms downsized dramatically in the early 1990s. The largest 150 manufacturing firms, for example, reduced their work forces on average by 47 percent from 1989 to 1993, in response to an average decline in sales of 60 percent (Balcerowicz and others forthcoming).

As in the case of financial plans, the operational restructuring plans were far less ambitious in the cases of unsuccessful reorganization, with fewer than one-half as many firms committing to or undertaking changes as in the group with successful outcomes. Again, this result likely reflects less commitment to *real* restructuring (and in some cases greater prebankruptcy value diversion) in this subset of firms.

In sum, analysis of the reorganization plans of firms that successfully emerged from Hungary's reorganization process indicates that the plans had significant, albeit rather unsophisticated, content. They were primarily focused on short-term debt relief and continued downsizing, and generally did not envision new investment, new management, or innovation. Creditors were clearly not imposing radical changes in business as usual on these firms, and control over firms' assets did not shift to new agents.

Recent literature in corporate finance stresses the importance of changing control rights over firm assets in times of financial distress. However, a number of authors, including Dewatripont and Tirole (1994), have suggested that control rights should not necessarily be shifted when an economy is subject to a systemic shock, because the cause of the bankruptcies may not have been poor management. Rather, workout processes are needed that keep control over productive assets in the hands of those who know how to use them. Such reasoning could arguably apply in the case of Hungary and other transition economies.[5]

INITIAL OUTCOMES OF THE REORGANIZATION PROCESS. What happened to the firms that emerged from the reorganization process with agreed plans? Outcomes to mid-1994 (on average about two years after filing) are shown in table 9. More than 90 percent of the firms on average—89 percent of the large ones and 96 percent of the small ones—were still in operation in mid-1994. The large

5. We are grateful to an anonymous referee for this point.

Table 9. *Outcomes through 1994 of Reorganization Agreements for Firms*
(percentage of firms)

Process category and firm characteristic	*Large firms*	*Small firms*
Firms still in operation in mid-1994	89	96
Restructuring		
Made new investments	14	7
Sold major assets	40	11
Had access to new bank credit	17	11
Changed top management	34	26
Significantly reduced employment	71	48
Made major changes in production profile	14	7
Financial performance		
Improved	49	63
Expect to make a profit in 1994	31	63
Anticipate having to file for bankruptcy or liquidation again in 1994 or 1995	31	11
Firms with improved financial performance		
More favorable price structure for outputs and inputs	5	15
Higher sales volume	74	40
Lower interest payments	16	0
Improved repayment rate on receivables	37	35
Improved inventory management	74	55
Reduced material expenses	74	40
Reduced wage bill	37	40

Note: The data are for thirty-six firms in the sample with successful reorganization agreements in 1992–93.
Source: Authors' calculations.

firms had made greater changes than the small ones since emergence from reorganization, which perhaps reflects their worse starting position. Of large firms, 71 percent reported having significantly reduced employment, 40 percent having sold major assets, and 34 percent having changed top management. Only 14 percent, or about one in seven, however, reported having made major changes in production profile, having made new investments, or having had access to new bank credits. About one-half reported improved financial performance, and about one-third expected to make a profit in 1994. However, another third expected to have to file for reorganization or liquidation again.

The major reported reasons for improved performance in firms reporting overall improvement were higher sales, reduced input costs, and improved inventory management. Lower interest payments were relatively unimportant despite the financial reorganization agreements. Perhaps these firms reduced debt liabilities but not necessarily actual debt service, if they were previously unable to service all of their debt. Even if actual debt service did not decline substantially, the debt reduction may nevertheless have led to greater opera-

tional efficiency if it resolved the debt overhang problem. The relative magnitudes for small firms were comparable to those for large firms, but the overall percentage of small firms that reported changes in various restructuring indicators was about one-half that of large firms. Yet, the overall improvement in financial performance was somewhat stronger for small firms than for large firms, probably because small firms experienced less serious financial distress prior to bankruptcy.

In sum, postreorganization performance appears to be primarily a story of belt-tightening combined in many cases with higher sales volume and better financial performance. Innovative restructuring appears to have been rare, as indicated by the low percentage of firms that reported major changes in production profile. Two-thirds of the firms that entered the process expected to survive, and one-third were reportedly already profitable in 1994. Taken together with the institutional strengthening engendered by the process, this is arguably a modest success story.

The Direct Effects of Liquidation

The original design of the bankruptcy law was envisioned as providing two avenues for ailing firms: reorganization and liquidation. However, it is clear both from the results of our study and from numerous discussions with liquidators and other involved parties that the liquidation process does not necessarily result in exit.

Of the fifty cases of liquidation in our sample (including twenty-two originally filed as liquidations and twenty-eight transferred from reorganization, see table 1), only one case (that of a small firm) had been completed by mid-1994, approximately the two-year deadline under the law. About 40 percent of the firms in our sample were still in operation two years after the original filing date (table 10), and the great majority of these had remained under the same management as existed in the firm prefiling. Larger firms (particularly those transferred from bankruptcy) were more likely to remain in operation than smaller firms. Furthermore, the overall percentage of workers expected to maintain jobs with the subsequent users of assets was about one-third for larger firms and slightly less for smaller ones.

In essence, there appear essentially to have been three broad types of firms involved in the liquidation process in 1992 and 1993: shell firms, which had few, if any, assets when liquidation was filed; small firms (mostly private), which were quite easy to liquidate and thus were often closed relatively quickly; and larger firms (mostly state owned) with significant assets, which were rarely closed completely during a liquidation proceeding.

Why did so many firms continue in operation during the liquidation process, despite the fact that liquidation was originally designed as an exit process? Data from the survey and from related interviews support the view that liquidators in large part saw their role as restructurers and privatizers, rather than simply as liquidators. They worked closely with the management of the debtor firm, and

Table 10. *Outcomes of Liquidation for Firms*
(percentage of firms)

Indicator	*Transfers from reorganization*		*Liquidation filings*	
	Large firms	*Small firms*	*Large firms*	*Small firms*
Firms operating as a going concern during liquidation	57	23	40	33
Firms remaining under existing management after liquidation filing	44	11	30	29
Claims expected to be recovered by				
Workers	100	60	62	64
Secured creditors	46	41	23	26
Unsecured creditors	17	2	9	6
Workers maintaining jobs with subsequent users of assets	36	11	36	33

Note: The data are for the thirty-three to thirty-nine firms with valid answers of the fifty firms in liquidation in the sample.
Source: Authors' calculations.

they tried to find purchasers of the firms in whole or in part, while preserving as many jobs as possible. One reason why this strategy was so common is the structure of compensation for liquidators: as long as the firm continued in operation, the liquidator was entitled to a fee of 2 percent of gross receipts; if assets were sold, liquidators were entitled to 5 percent of the sales price. Furthermore, the costs of liquidation included any costs incurred to keep debtor firms going during the liquidation process. The costs could include, for example, the fees of consultants hired to assist the liquidator. These costs had top priority, even above secured mortgage liens. Clearly there were financial incentives for liquidators to keep some firms in operation.

Although it was perhaps good news for some Hungarian workers and some parts of the Hungarian economy that the liquidation wave did not force the exit of firms, it was not necessarily good news for creditors or for firms seeking credit. Creditors reported that they had very little influence over the decisions of liquidators. The percentage of claims expected to be recovered by creditors (see table 10) was not low by international standards, although expectations were likely to overstate eventual recoveries. Banks generally claimed in interviews, however, that they expected in reality to recover very little, and only after years of delay while the liquidator negotiated as painless a restructuring and sale as possible for the firm.

Although the number of reorganization cases dropped dramatically after late 1993, reorganizations were indeed still occurring through the liquidation process. The liquidation process became a major route for the restructuring of problematic state-owned firms in Hungary. *What the system lacked then, and still lacks, is an efficient and dependable exit process on which creditors can rely as*

a final stage in debt collection. The weakness of exit, together with the problems of foreclosure on collateral at earlier stages of the debt collection process, almost certainly raises the cost of credit in Hungary.

Privatization and Institution Building

Although bankruptcy may not be an efficient reorganization or exit mechanism for firms in their entirety, it has been an important avenue for privatization and recombination of existing assets in the economy, either as parts of firms as going concerns or merely as individual assets (Stark 1996). The bankruptcy law has probably been one of the main stimulants of privatization in the Hungarian economy since 1992. Not only have the formal processes of reorganization and liquidation involved significant sales of assets, but the mere existence of these processes has created incentives for managers to spin off valuable assets into new entities (often partially or wholly privately owned) while leaving liabilities in problem firms to enter bankruptcy. Furthermore, in the case of state-owned firms, the liquidation process to date appears to be as much a privatization process as an exit one, because liquidators have put enormous efforts into finding private buyers for viable parts of these firms.

In addition, the impact of the bankruptcy process on institutional development in Hungary is, in our view, as important as its immediate impact on bankrupt firms. The bankruptcy process has stimulated the development of a cadre of professional trustees and liquidators with in-depth knowledge of techniques of financial and organizational restructuring. Hungary has been willing to license both foreign and domestic firms as liquidators, and the foreign participation has brought outside knowledge and expertise into the picture. It has also led to an increase in the number and commercial expertise of judges and in the sophistication of the banks' understanding and approach to debt collection. Such learning by doing, even if fraught with problems and mistakes in the early stages, may be the only way of building these important institutions of a market economy.

IV. Conclusions

Several broad conclusions can be drawn from the data and discussion we presented. First, *the bankruptcy process appears to have had some degree of economic logic in 1992 and 1993.* Better firms were more likely to enter and emerge successfully from the reorganization process, and worse firms were more likely to either fail in the reorganization process or file straight for liquidation. Furthermore, although the reorganization plans and related negotiations between debtors and creditors were not anywhere nearly as sophisticated as those in mature market economies, they did appear to address some core issues—debt restructuring, debt relief, and in some cases operational downsizing. There was scarce evidence of deep restructuring or of management change—a clear indication that the process was less than ideal.

But it was not a totally meaningless exercise with economically irrational or counterproductive results, nor did it result in the immediate forced closure of potentially viable firms. Given that Hungary's bankruptcy experiment was the first of its kind in the transition world, we can perhaps interpret this as a modest success.

Second, the experiment also supports the view that *judicial reorganization need not be slow and costly*. The first wave of reorganizations was handled surprisingly quickly, particularly considering the sheer number of cases, the novelty of the process, and the shortage of trained judges. This relative quickness is largely attributable to the decentralized design of the process. Once a case was approved by the court to proceed, the court had little role. The strict time limits laid out in the law also helped in assuring a relatively speedy resolution of cases.

With regard to speed and cost, it is very possible that the amendments in 1993 took a turn in the wrong direction in requiring the appointment of a trustee (chosen from the list of licensed liquidators) in all reorganization cases. Such a requirement made the process more bureaucratic and expensive. If creditors believe a trustee will help represent their interests, they should be given the option of appointing one (as provided in the 1991 law), but this need not be a requirement. Indeed, if the creditors are not motivated to look after their interests, it is unlikely that a trustee will do it for them effectively.

Third, the major delays in the process in our sample occurred not in reorganization but rather in liquidation. Much of this delay was attributable to slowness in the appointment of liquidators to cases, which led to significant opportunities for asset diversion. However, some of the delay was also attributable to the fact that *liquidation was to a large extent perceived by all parties more as reorganization than as pure liquidation*. This became even more true after late 1993, when the number of reorganization cases began a steep decline—that is, when liquidation appears in effect to have replaced reorganization as the primary restructuring process. Interviews with liquidators and firms confirmed that many if not most liquidators saw themselves as active restructurers, representing first of all the interests of employees or the public rather than the interests of creditors. Virtually all real firms (as opposed to shells or firms with minimal assets, of which there were plenty) stayed alive during the liquidation process as the liquidator looked for ways to privatize their viable parts. Although this situation may have been good for restructuring and privatization, it was not necessarily good for creditors, who felt powerless and unrepresented. It is no wonder that creditors would do almost anything to avoid filing for liquidation. In the end, this lack of a viable creditor-led exit and debt collection mechanism harms firms, because it increases the cost and reduces the flow of credit in the economy.

It was noted earlier that one important reason for which liquidators took their time to settle their cases was the structure of their fees. The Hungarian government should consider a change in the fee structure so that liquidators'

fees consist *only* of a fixed percentage (whether 5 percent or another figure) of proceeds from the final sale of assets. This rather simple change could have a major impact on the process, speeding it up without sacrificing the incentive to save viable going concerns and better aligning the interests of the liquidators with those of the creditors.

Fourth, although the bankruptcy process displayed some economic logic, *one should not assume that it operated as a similar law would in a market economy.* The incentives for creditors to pursue debt collection aggressively are not yet as strong in transition economies, such as Hungary, as in mature market economies. In the case of banks, for example, these incentives have been compromised by successive bank recapitalizations, which encouraged banks to turn to the state for assistance rather than depending primarily on the pursuit of problem debtors. Not only are creditor incentives somewhat weak, but the watchdog institutions that we take for granted in mature market economies—such as accountants, lawyers, judges and other court personnel, credit rating services, bailiffs—are still in their infancy. Thus, creditors find it extremely difficult to gather the information with which to defend their interests even if they are motivated to do so. The result is that bankruptcy processes (and what happens immediately before them) appear to be controlled to a far greater extent by debtor management in Hungary and other transition economies than in mature market economies.

What does such managerial control imply for the outcome of the bankruptcy process? In essence, it implies that these managers, and to some extent the debtor firms they manage, will gain more than they would if the process were better monitored and controlled by creditors. *A likely source of gain in Hungary appears to have been asset diversion or other value stripping prior to bankruptcy.* Valuable assets were transferred to separate firms prior to filing (and the records disappeared so the transfers were not later traceable by creditors, trustees, or liquidators), leaving the less valuable assets and the liabilities to enter the bankruptcy process. Interviews we undertook indicated that such asset diversion may have been quite common in 1992 and 1993, for both state-owned and private firms, although the survey was unable to capture this phenomenon on a wide scale (which is not surprising, given the secretive nature of such transfers). Creditors could also have been involved in asset diversion, by colluding with the debtor firm to transfer assets and thus repay that particular creditor prior to bankruptcy at the expense of other creditors. In mature market economies, such transfers in anticipation of bankruptcy are void or voidable by the trustee. They are by law also voidable in Hungary, but liquidators reported tremendous difficulty obtaining necessary evidence, mostly because of underdeveloped watchdog institutions.

It is not easy to control asset diversion, but certain policy steps can help. *The major need is to strengthen the incentives of creditors to monitor the process closely, and to improve their capacity to do so.* Creditors can be assisted in the short to medium term by

- Changing collateral and bankruptcy laws to put secured creditors clearly *first* in priority of recovery (even above costs of the proceedings)[6]
- Streamlining courts' and bailiffs' procedures to lower the costs of foreclosure on collateral
- Changing the compensation of liquidators (as described above) to align their incentives clearly with those of the creditors
- Changing bankruptcy regulations to require the appointment of a liquidator immediately after a case is filed, so as to eliminate the long period between filing and approval during which incentives for value diversion are at their peak
- Strengthening banking reforms and privatization to reduce bank ties to the state (and thus the expectation of state subsidies)
- Strengthening macroeconomic discipline and enterprise privatization to reinforce the incentives of trade creditors to actively pursue collection of their debts
- Avoiding alternative government-led workout programs (such as debtor consolidation) that may be perceived as backdoor avenues for state subsidization of debtors or creditors.

Finally, and more generally, it is important to recognize that developing the institutions of a market economy, particularly the watchdog institutions referred to earlier, is a massive task and necessarily takes time. It will be greatly facilitated, however, if tight macroeconomic discipline leads to hard budget constraints, and thus firms and banks *demand* these institutions because they no longer view the state as their automatic safety net in times of financial distress.

Was the Hungarian experience a success? Was the automatic trigger that set it off a good idea? The answer depends profoundly on expectations. On the one hand, the Hungarian bankruptcy process in 1992–93 was not nearly as efficient or effective as bankruptcy experience in mature market economies. This was inevitable, given the distortions in incentives and the weakness of institutions in the transition setting. On the other hand, it was a start in the right direction. The controversial automatic-trigger mechanism put in motion a process that helped change perceptions and stimulated needed institution building. It strengthened financial discipline in firms and furthered asset privatization and the building of a new profession of trustees and restructuring experts. Such a trigger is clearly not needed in mature market economies with diligent creditors, and it was arguably too draconian even in Hungary. Even if a trigger is adopted, a period of ninety days is almost certainly too short, given that it barely exceeds average payment periods in market economies. But some artificial trigger may nevertheless be useful in the very early stages of transition to help make bankruptcy a working reality and a viable option for creditors and debtors. The Hungarian bankruptcy experience should not be discarded but rather should be

6. A step in the wrong direction was Law No. 53, adopted in September 1994, that placed all government liens ahead of secured credit in priority of recoveries in cases of asset foreclosure.

strengthened through strong and broad complementary reforms toward a market economy.

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