## STUDENTS FORUM

# History of Development of Bankruptcy Law

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### 1. Origination of Bankruptcy Law

The development of bankruptcy in global legislation underwent numerous cardinal changes. Bankruptcy as a legal phenomenon was first introduced in Ancient Rome, known as "concursus" in Roman law. "Concursus" is a Latin word and means the gathering, assembling. This is how the gathering of several creditors before one debtor is characterized in Roman law. Under Roman law, for the non-payment of a debt, the debtor could be deprived of property and also could be made liable with their life and health.

Before II century B.C. non-payment of debt was considered illegal regarding any debtor. Bankruptcy as a complementing phenomenon of commercial activity emerged only later.

The first legislative acts on bankruptcy appeared in the middle of the sixteenth century. The first legal acts contained strict rules. It was only in the first half of the twentieth century that bankruptcy legislation mainly aimed at the fair distribution of a debtor's property to creditors, the release of debtor from payment of debt and allows him to restart everything.

The development of bankruptcy law coincides with the development of enforcement law because Roman classical law did not distinguish between enforcement of an individual creditor against his debtor and enforcement of many creditors against their joint debtor. Consequently the historical roots of bankruptcy law should be found in Roman law.

The self-sustaining legal system of bankruptcy, established later in Roman law, spread in various European countries. Roman law served as basis for the German bankruptcy law upon which was based the Georgian bankruptcy law.

The development of bankruptcy law is divided into two different periods. The characteristic of the first period of bankruptcy is a person's execution. For the creditor the subject of enforcement was a debtor personally, namely his liberty, body and even life. The debtor's property as a subject of enforcement was rarely mentioned. At that time the creditors will had primacy, which the government could not influence. The second period is the execu-

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tion of the debtor's property. Upon its introduction a creditor obtained the right of choice. In other words he could choose which of the two to enforce – person or property.

During the later period of Roman law the already established and sophisticated system of bankruptcy law widely spread and developed in many countries of Europe and first of all in Germany. In itself, time and practice has made some corrections.

Two different systems were established in medieval European bankruptcy law. Under the first system, established in the northern part of Italy, creditors enjoyed wide autonomy. In this system enforcement proceedings was entrusted to creditors who had the right to coerce physically a debtor in order to make the latter show his property. So a debtor was losing his disposal right on his property. Another system established in Spain was largely based on the initiative of judicial power. Under this system the reins of bankruptcy law were in the hands of the court whose function was to sell assets, liquidate property and satisfy creditors. Thus, under this system the court played a dominant role and enjoyed broad powers.

### 2. Bankruptcy Law in 19th Century

In the nineteenth century many European countries declined the system of bankruptcy law that in bankruptcy proceedings granted privilege to the court. In this regard the Prussian bankruptcy code of 1855 should be mentioned which served as basis for the German bankruptcy code of 1877, and later one for the law of Georgia on bankruptcy proceedings of 1996.

The Prussian bankruptcy law was modelled on the French bankruptcy law of 1807 that was included as a separate Book in Napoleon's *Code de Comerce*. The French bankruptcy law limited bankruptcy proceedings to entrepreneurs (merchants) i.e. only merchants could be made bankrupt. Creditors had the right to take part in the management of assets. Bankruptcy proceedings were initiated by a judge-commissioner of a commercial court who was also entitled to convene a first meeting of creditors and appoint a temporary bankruptcy commissioner at the creditor's suggestion.

The Prussian 1855 Code not only copied the principles of French bankruptcy but developed and sophisticated them. For example, the Prussian code did not limit proceedings only to merchants and applied its scope to non-merchants as well. As a matter of fact bankruptcy proceedings were universal enforcement proceedings that should have regulated all legal relations of an insolvent debtor. The court's functions and tasks were significantly reduced and limited only to supervision. It no more managed and sold assets. All these functions were carried out by a commissioner, who played a central role.

The German bankruptcy code of 1877 is extremely important for the Georgian bankruptcy law, which, in fact, underlied the Law of Georgia on Bankruptcy Proceedings of 1996. The German bankruptcy code is a lot more sophisticated than Roman law. The code contains

substantive and procedural bankruptcy laws and as a whole represents the law on property liability.

Together with the development of entrepreneurial law the German law was supplemented with entrepreneurial legal relations, although like French law it applied not only to merchants but to non-merchants equally. The law's function was to regulate legally proceedings and related relationships, whereas the creditors enjoyed the autonomy of bankruptcy proceedings. Upon opening of bankruptcy proceedings an insolvent debtor was deprived of the right to disposal of the property owned at the moment of opening of proceedings. This right was transferred to the bankruptcy commissioner but a joint debtor still remained as a holder of property rights.

German law gave rise to such fundamentals of bankruptcy as insolvency and over-indebtedness. Bankruptcy proceedings also differentiate creditors. There are debtor's personal creditors, who have claims against a joint debtor before opening of proceedings and persons entitled to claim for an object individually, who have obtained rights on particular assets before the opening of proceedings.

The industrial law statute of pre-revolutionary Russia mainly considered a physical person in relation to bankruptcy, although it acknowledged that a legal entity could be declared bankrupt as well. Before opening of bankruptcy proceedings creditors could request the stock-exchange committee or commercial court to resolve the issue of management of a debtor's affairs. The decision of the stock-exchange committee had to be approved by the court. The court used to make decisions quite quickly – summoned the debtor and heard his explanation about his inability to pay his debts. The court issued the judgment on the same day and if a debtor was declared bankrupt usually arrested him.

Under Russian industrial law there were three categories of bankruptcy cases: accidental bankruptcy, bankruptcy by negligence and false bankruptcy. In general, bankruptcy was caused by negligence. To deem bankruptcy as accidental or false certain circumstances had to be proved. Bankruptcy was deemed accidental if the debtor's insolvency was caused not by his guilt but because of various circumstances. For example flood, fire etc. in other words in exceptional occasions. Bankruptcy was by negligence if insolvency was caused by the debtor's guilt but without intention. Bankruptcy was deemed false when insolvency was related with intention and/or fraud. It was a criminal offence and if the court decided that it was a false bankruptcy, after a review of the case in the commercial court it was transferred to the criminal court.

Three publications in Russian and German were published about bankrupt debtors. Such announcements were published in the court's stock-exchange as well. From this moment the debtor's property sale was prohibited. All accusations on a debtor were submitted to the court. For three days creditors appeared in the court and in their presence the debtor swore to show all his property and become liable if he concealed them. Then the creditor, debtor and claimant went to the debtor's house to value his property. After the stocktaking was completed the judge and creditor assumed the obligation to manage the debtor's

property. When creditors were identified the judge convened a creditors' meeting at the bankruptcy board (*Конкурсное Правление*) that was a lower instance of the commercial court.

The rules of resolution of bankruptcy cases and of proceedings were applied throughout pre-revolutionary Russia and thus, in Georgia too.

### 3. Establishment of Bankruptcy Law in Post Soviet Union

Bankruptcy law has its historical development in Georgia and it had its own ways of establishment in Russia and Georgia. Bankruptcy law in Georgia originated in the 1930s. Bankruptcy as a legal phenomenon first appeared in Georgian law in 1931 in the Civil Procedure Code. The second annex of the Code contained "Rules on Insolvency of Physical and Legal Persons" comprising 7 Titles and 46 Articles. By its legal contents insolvency fully corresponded with the current meaning of bankruptcy. Thus, it could be said that the basis for the introduction of bankruptcy law in Georgia was the introduction of the phenomenon of insolvency.

Originally the Code stipulated subordination of insolvency cases. Such cases were reviewed by people's courts; In case of a legal entity – according to the location of their local governments and in case of a physical person – according to his/her permanent place of residence. It also mentioned the principle of prevention: if the case on the acknowledgment of a physical person as insolvent was brought before several courts all these cases would be transferred to the one that first acknowledged the debtor as insolvent or first instigated this case.

The court acknowledged the person as insolvent on the basis of its decision. This decision was published in the newspaper and notified to the relevant state registering body. The decision could be appealed within fifteen days. The Code also provided for the following group of persons entitled to lodge an insolvency case:

a) creditor holding an enforcement writ or enforcement order;
b) creditor stating that debtor's property is not sufficient to cover his debt;
c) debtor;
d) state bodies, being in charge for the regulation of the field related to the debtor's company;
e) prosecutor.

The basis of insolvency was an inability to pay debt. The cancellation of a debt payment was considered as a testimony. After acknowledging a debtor as insolvent the court offered only the state body to appoint one or several liquidators who would be entitled to manage and dispose of the debtor's property. The court defined the liquidation period, basically one year. The court applied to the same body to appoint "a special person" who would ensure the security of the company's property until the liquidators fulfilled their duty.

Some restrictions were imposed from the day of acknowledging a debtor as insolvent. Namely, alienation and transfer of debtor's property was prohibited, claims lodged against an insolvent debtor before the court were subject to suspension. The Code of 1931 also provided annulment of transactions, payments and alienations carried out by a debtor before being acknowledged as insolvent.

Assets were sold by liquidators under common supervision and control of state bodies who appointed the liquidators. The state body also approved the rule of sale of assets. After completion of liquidation and consideration of the creditors' claims, the liquidators specified the total amount of money received and its distribution to creditors. The calculations were submitted for approval to the court after which liquidators would give the creditors their money.

Moreover, the Code of 1931 stipulated special measures for saving the debtor from bankruptcy, which aimed to retain the company's existence, if in the interest of the state. For this reason, the court with the request of particular state bodies would set up a special department. If a debtor was already acknowledged insolvent, setting up such a department should not be requested.

Accordingly, the rules on insolvency provided by the 1931 procedures code do not differ from the current bankruptcy rules. In fact a debtor's insolvency is nothing more but contemporary bankruptcy which was caused by adoption of the Georgian Code of 1931 on the basis of Russian Civil Procedure Code of 1928; and, the Russian procedure code based on German bankruptcy code of 1877.

Existence of bankruptcy phenomenon in the Soviet Union during the 1920-30s was justified and acceptable even for the later soviet system because besides social companies there were private law entities such as the mixed joint stock company, limited liability companies and etc. However, later, when only state companies appeared in civil circulation as economic agents, no creditor could claim bankruptcy of such a company and could force its liquidation.

State companies were established and liquidated according to the people's common economic plan, under the decisions of relevant state and political party organizations. Consequently, private persons were not allowed to take any independent initiative not envisaged by this plan. This was the reason for turning bankruptcy into a legal phenomenon that useless for the socialist order. Therefore, bankruptcy was completely removed from civil procedure codes adopted in Georgia during the 1960-70s.

## 4. Bankruptcy law in independent Georgia

*1992 Decree on Bankruptcy of Enterprises*

After gaining sovereignty in the 1990s Georgia began to update and reinforce its law. Bankruptcy too became the subject of updating. On 8 September 1992 the Decree of the Council of State of Georgia on Bankruptcy of Enterprises was adopted. By adopting this Decree bankruptcy as a legal independent phenomenon regained its place in the legal system. However before its annulment on 1 January 1997 it had never been applied in practice and was a "dead born" law.

Non-application of the Decree on Bankruptcy in practice for four years now is related to many reasons. This was conditioned not only by grave political situation in the country, but also by the fact, that the Decree of 1992 fell far behind European standards of bankruptcy as a normative act, and was far from being perfect as it was drafted without taking other countries' experience into account.

The Bankruptcy Decree regulated only the issues of bankruptcy of enterprises. The list of enterprises was provided for in the Law of 1991on Basics of Entrepreneurial Activity. Thus, no other legal entity but an enterprise was deemed as an entity that could be made bankrupt. Another deficiency of the Decree was that it did not give a description of a debtor's property with which creditors would be settled and did not distinguish it from the property purchased after instigation of proceedings.

*Difference of Georgian Bankruptcy Law from Other Countries' Bankruptcy Law*

Bankruptcy as a legal phenomenon has different meanings in different countries. In some countries it aims to destroy economically a debtor, while in others in the contents of the notion of bankruptcy, the law expresses the desire to save the debtor from the economic point of view. The contents of the notion of bankruptcy might reflect a desire to foresee both. In some countries bankruptcy law is aspired to protect the claims of the debtor's creditors as much as possible on the basis of liquidation of all the debtor's assets. In other countries advantage is granted to an insolvent debtor who should be saved by taking rehabilitation measures. Bankruptcy in those countries where protection of debtor's and creditor's interests is an equal priority is also interesting.

As for Georgian bankruptcy law, it tries to ensure both the solution of economic and financial problems (rehabilitation) of a debtor being in a difficult economic situation and settle his creditors' claims as much as possible. However it should be mentioned that the priority of saving a debtor is put in the forefront. Saving a debtor means not so much as a legal entity's survival, but saving it as an economic unit.

Actually Georgian bankruptcy law is not only the law of liquidation of a debtor's property and settlement of creditors' claims through such liquidation but it is rather linked with putting in the forefront the issue of saving i.e. rehabilitating a debtor. In foreign countries bankruptcy and mediation laws are regulated either by different legal acts or by one legal act called Insolvency Law. Insolvency (German – *Insolvenz*) means inability to pay or the absence of payment resourses for a long period. Thus a general definition of a bankruptcy law could be worded as follows: bankruptcy law is a set of rules regulating the solution of economic and financial problems of a debtor being in a difficult economic situation and settlement of creditors' claims to maximum possible extent.

*Similarity of Georgian Bankruptcy Law with the Law of European Countries*

It is worth mentioning that on 25 June 1996 the Law on Bankruptcy Proceedings was adopted. By its contents and structure Georgian bankruptcy law resembles the bankruptcy law of European countries, especially of Germany that regulates both the issues of liquidation of a debtor's property and saving of a debtor's existence as a legal entity.

Georgian bankruptcy law is not only the law on liquidation of a debtor's assets, but it also contains the legal rules on mediation. Mediation law is a separate and independent phenomenon of bankruptcy law. It focuses only on saving a debtor, which is reflected in rehabilitation measures. Like contemporary European bankruptcy systems, Georgian bankruptcy law does not support the idea of economically destroying a debtor being in a difficult financial situation.

Rehabilitation is the set of economic, financial and other measures aiming at overcoming of financial problems, restoration of liquidity of a company and avoidance of liquidation. Rehabilitation can be carried out only with regard to debtor legal entities registered in accordance with the Law on Entrepreneurs; and if there is an agreement on rehabilitation with creditors or a valid ruling of a bankruptcy court on the approval of bankruptcy mediation. Rehabilitation can take place if it is really possible to avoid a company's liquidation.

Rehabilitation has a plan that should mention specific measures needed for restoration of a debtor's liquidity and time frames for payment of debts. Any change in the rehabilitation plan should be made with the consent of a creditors' meeting or creditors' committee. Rehabilitation is headed by a commissioner who is a natural or legal person independent from the debtor and creditors and who has relevant experience. A person engaged in the same or similar activity as the debtor should not be elected as a rehabilitation commissioner. A debtor nominates candidates for rehabilitation commissioner to the creditors and during bankruptcy mediation creditors elect the rehabilitation commissioner on a competitive basis. In such a case the consent of at least two thirds of creditors is needed.

The elected rehabilitation commissioner shall be approved by a court. He shall be elected for the term of rehabilitation and is liable before the debtor and creditors for the fulfilment of his duty. The rights of rehabilitation commissioner are: to implement rehabilitation plan, to manage and dispose debtor's property in accordance with the law and rehabilitation plan. With the consent of the creditors' committee a rehabilitation commissioner is entitled to dispose of the debtor's real estate and conclude transactions whose value exceeds 20% of the debtor's property. He has the right to carry out any lawful action in order to accomplish rehabilitation plan.

The rehabilitation commissioner is obliged to present a progress report and notify about the concluded transaction to the creditors' meeting or creditors' committee at least once a month, as well as if so requested.

Rehabilitation is deemed completed if the aim of rehabilitation is achieved. The court adopts the ruling on the completion of rehabilitation. The rehabilitation commissioner is entitled to request termination of rehabilitation from the court if he submits the report on non-achievement of rehabilitation aim and the consent of the creditors' committee on its termination.

**5. Conclusion**

After reviewing the historical development of Georgian bankruptcy law we may conclude that:

Origination and development of bankruptcy law in Georgia is closely linked with Russian bankruptcy law applicable in the middle of the nineteenth century, because for that period Georgia was the part of Russian empire. Since the Russian bankruptcy law was based on the German one the basis of Georgian bankruptcy law was also German law.

The development of bankruptcy law was accompanied by some breaches and violations in soviet times which lasted for seventy years and continued until the 1990s. During this period the rules of bankruptcy law practically could not be applied at all. After the collapse of the Soviet Union reapplication of bankruptcy law became possible in independent Georgia where economic relationships fundamentally changed. The law on Bankruptcy Proceedings was adopted on 25 June 1996.

Like the German bankruptcy law the Georgian one aims at a debtor's rehabilitation. It tries both to ensure a solution of economic and financial problems (rehabilitation) of a debtor being in a difficult economic situation and settle his creditors' claims as much as possible. However it should be mentioned that the priority of saving a debtor is put in the forefront.

At present, the practical application of bankruptcy law is not that efficient in Georgia. It needs further improvement by taking into account European experience that can be achieved by close cooperation of Georgian and European legal societies and experts.