PROTECTION OF RIGHTS OF SECURED CREDITORS IN THE BANKRUPTCY DEBTOR ASSETS SALES PROCEDURE

Abstract

Securing claims by way of real assets such as mortgage or chattel mortgage has great significance for the operation of banks and other economic entities. Opening bankruptcy proceedings over the owner of the real estate under mortgage or movable property under chattel mortgage has a significant impact on the process of exercising rights and the position of secured creditors. Bankruptcy framework in the Republic of Serbia limits their rights on the one hand, and provides extensive guarantees, on the other, by prescribing several specific institutes that additionally protect the rights of secured creditors in the procedures of bankruptcy debtor asset sales, which is the topic of this paper.

Provisions of the Law have been analyzed, positions of the judicial practice as well as opinions of the jurisprudence on secured creditors as a special category. Special attention was paid to the impact of the legal prohibition of individual enforcement for the settlement of claims from the assets that are under any burdens as well as the cancellation of moratorium. Significance of the right of the creditor to offset its secured claim against purchase price has been explained in detail in case of the best bidder (credit bidding) as well as the legal preemptive right on the subject of secured right or lien, in case of sales method by direct agreement. Also, rules were considered that condition the possibility of leasing assets under burden of the bankruptcy debtor with the consent of secured creditors.

Keywords: bankruptcy, secured creditor, moratorium, credit bidding, preemptive right, lease.

Sažetak

Obezbeđenje potraživanja realnim sredstvima kao što su hipoteka ili ručna zaloga ima veliki značaj u poslovanju banaka i drugih privrednih subjekata. Otvaranje stečajnog postupka nad vlasnikom hipotekovane nepokretnosti ili založene pokretne stvari, bitno utiče na postupak ostvarivanja prava i položaj obezbeđenih poverilaca. Stečajni okvir u Republici Srbiji s jedne strane ograničava njihova prava, a s druge strane pruža značajne garancije, propisivanjem više specifičnih instituta kojima se dodatno štite prava obezbeđenih poverilaca u postupku prodaje imovine stečajnog dužnika, što je tema ovog rada.

Analizirane su zakonske odredbe, stavovi sudske prakse, kao i mišljenja pravne nauke o razlučnim i založnim poveriocima, kao dve posebne kategorije obezbeđenih poverilaca. Naročitu pažnju usmerena je na uticaj zakonske zabrane individualnog izvršenja na namirenje potražovanja iz opterećene imovine, kao i na ukidanje moratorijuma. Značaj prava poverioca da prebije svoje obezbeđeno potraživanje sa kupoprodajnom cenom, za slučaj da je on najbolji ponudilac (credit bidding), kao i zakonsko pravo preče kupovine na predmetu razlučnog, odnosno založnog prava, u slučaju metoda prodaje neposrednom pogodbom. Takođe, razmotrena su pravila koja mogućnost izdavanja u zakup opterećene imovine stečajnog dužnika uslovljavaju saglasnošću razlučnih, odnosno založnih poverilaca.

Ključne reči: stečaj, obezbeđeni poverilac, moratorijum, credit bidding, pravo preče kupovine, zakup.

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Introduction

Bankruptcy proceedings in the Republic of Serbia have been prescribed by the Law on Bankruptcy [50] and are initiated by the petition of the creditor, debtor or liquidator as authorized petitioners (Article 55, paragraph 1). Adopting positive decision on such petition, in case the court determines the existence of one of prescribed legal bankruptcy conditions represents the opening of the bankruptcy proceedings [10, pp. 87-88]. Bankruptcy judge shall open bankruptcy proceedings by adopting a decree on opening bankruptcy proceedings that adopts the petition for initiating bankruptcy proceedings (Article 69, paragraph 1). All legal consequences of bankruptcy, including the prohibition of enforcement and settlement – moratorium shall come into effect by way of opening bankruptcy proceedings, and not by the initiation of proceedings by submitting the initial act – petition of authorized persons [11, p. 84]. The moratorium shall entail the prohibition of implementation of individual enforcement over the property of the bankruptcy debtor for the purpose of the settlement of claims of individual creditors and shall commence as a process and legal consequence on the date of opening bankruptcy proceedings or as an option – in case the court, in the prior bankruptcy proceedings, determines the security measure that contains the same prohibition that refers to the exercise of rights of secured creditors [12, p. 920]. Security measures (Article 62, paragraph 2, item 4) and moratorium (Article 93, paragraph 1) may be cancelled under the same conditions regulated by the provision of Article 93a and 93b [36, pp. 108-109]. The moratorium delays the deadline for debt payment by law [47, p. 585] to a certain phase of bankruptcy proceedings – the validity of the decision on the main distribution of bankruptcy estate (Article 143, paragraph 1), that is, until the sales of assets under burden in case of secured creditors. Satisfaction of secured creditors must be performed within five days from the date the bankruptcy administrator received the funds from sales of property, that is, the collection of claims (Article 133, paragraph 12), where the bankruptcy administrator shall be obligated to offer for sales each item of property that is subject to secured right or lien within six months from the validity of the decision on bankruptcy (Article 133a). The share of settlement of secured creditors is approximately 70% from assets remaining after the settlement of costs and liabilities of the bankruptcy estate [15, p. 105], and they do not have the right to claim default interest due to delay of the bankruptcy administrator in settlement [36, p. 196].

Legal consequences of opening bankruptcy proceedings over the owner of real estate under mortgage or movables under chattel mortgage, and primarily the moratorium, have a significant impact on the procedure of exercise of rights and position of secured creditors, regardless of the fact they do not lead to the cessation of real securities since, as a rule, they disable the implementation of proceedings of individual enforcement and settlement outside bankruptcy proceedings, thus limiting their rights.

The mortgage loses the property of adequate collateral if the owner of the real estate under mortgage is in bankruptcy, which leads to the classification of claims of the bank from debtors into the least favorable category D [29] and to the increase of the amount of required provisioning for estimates loss as per assets from balance sheet and off-balance items representing deduction from the basic share capital [30] with adverse effect on the bank's capital adequacy.

Therefore, it is necessary to provide additional protection of rights to this category of creditors in the procedure of bankruptcy debtor assets sale.

For this purpose, having in mind the significance of real securities, such as mortgage or chattel mortgage in the operations of banks and other economic entities, the bankruptcy framework of the Republic of Serbia prescribes several specific institutes that establish a special mechanism for protection and exercise of secured creditor’s rights. The value of lien lies in the fact that it provides the secured creditor with the option of settlement even when other creditors cannot be satisfied in full or at all, since the debtor does not hold sufficient assets to meet all the obligations [42, p. 35].

After the clarification of the legal position of secured creditors and the effect of moratorium, the most significant institutes and procedures have been reviewed that enable secured creditors to implement lien in bankruptcy proceedings from the value of assets under burden.
Separate creditors and pledge creditors as two categories of secured creditors

Law on Bankruptcy differs separate and pledge creditors as two categories of secured creditors. The criteria for differentiation are whether the creditor has or does not have claims that are secured by mortgage or pledge over the assets of the bankruptcy debtor, that is, whether the bankruptcy debtor is simultaneously the debtor of the secured claim or it is a third party.

Our bankruptcy law recognizes specially regulated situations when the owner of the movable under pledge or real estate under mortgage (pledge or mortgage debtor) [49, p. 20] and the debtor from the original transaction are not the same person, thus, the bankruptcy is initiated over the owner of assets, towards which the creditor has no claim from the original transaction. For example, from loan agreements, since this person established pledge or mortgage over its own property for securing creditor’s claim towards a third party – loan beneficiary. Such situations caused a number of issues and different interpretations in earlier court practice that were mostly removed by legal novelty from 2004 [51], by prescribing certain rules based on positions and solutions reached by court practice.

Separate creditor has claims towards the bankruptcy debtor that are secured by mortgage or pledge over the property of the bankruptcy debtor (lien) or legal right of retention or right to settle over items and rights registered in public books or registries and shall be entitled to a priority settlement from funds received from the sales of assets, that is, the collection of claims that form the basis of such right [2, pp. 205-221]. “One should keep in mind that the separate creditor shall be entitled to priority settlement only from certain items owned by the bankruptcy debtor, subject to lien or settlement right. There is no general lien over the entire property of the debtor and all income of the debtor that would weaken the position of the debtor” [22, p. 81].

When the litigation for the purpose of determination of the amount of secured right is ongoing, and the assets under burden are sold before the valid finalization of the litigation, it would be prudent for the bankruptcy administrator to pay to the separate creditor “the undisputed portion of claims secured by the right to priority in settlement” [36, p. 164]. “Existence of dispute regarding the order of settlement of separate creditors shall not affect the right of the buyer to register ownership right and erase the burden. The amount of available funds for the settlement of separate creditors shall remain the same in case of dispute on the order of settlement of separate creditors and in situations where there is no dispute on the order of settlement of separate creditors” [36, pp. 195-196].

On the other hand, pledge creditor has real estate collateral over the assets of the bankruptcy debtor (lien over items or rights of the bankruptcy debtor that are registered in public books or registries) but has no monetary claim towards the bankruptcy debtor that is secured by such lien. In legal theory such persons are named “pledge creditors with claims towards third parties” [38, p. 249]. Pledge creditors are not bankruptcy creditors and are not separate creditors, and they shall be settled in the maximum amount received from cashing in assets being subject to lien. Therefore, pledge creditors have the main claim towards third parties [43, p. 205], with the pledge over the property of the bankruptcy debtor as their own collateral.

“If a third party disputes the status of the pledge creditor and the pledge is registered in public books or registries, the third party may dispute the validity of the pledge instrument only in litigation. The bankruptcy judge may not decide on the nullity of the pledge statement. If the bankruptcy administrator or a third party disputes the validity of the pledge statement, the civil court shall adopt a decision on such matter” [37, pp. 128-129]. “If the bankruptcy administrator considers the lien non-existent, and it is a right registered in public books or registries, litigation shall be initiated seeking to determine the non-existence of such lien including the litigation for rebuttal of transactions” [36, p. 160]. It is a negative determination suit.

Establishment of mortgage over the real estate of bankruptcy debtor for the benefit of pledge creditors, for securing obligations of other persons, for example, claims of the bank towards third parties, has been qualified in court practice as unencumbered disposal, because the “pledger did not receive adequate counter-value” and
“pledger may not request any counter-act by a person benefiting from such disposal”, “even though there was no legal obligation for such disposal” [36, p. 171], which represents the act of causing intentional damage to the creditor that may be rebutted if taken in the last five years prior to the submission of petition for bankruptcy, in which case there is a rebuttable legal presumption that the pledge creditor had knowledge about the intention to damage other creditors (Article 123, paragraph 1).

Pledge creditors are recognized as parties in bankruptcy proceedings which was disputed in earlier court practice in a certain number of cases, with the argumentation that they have no claims towards the bankruptcy debtor. But the pledge creditors are not entitled to vote in the creditor’s assembly that is, “they may not vote or be elected in the creditor’s assembly and committee” (Article 49, paragraph 7) while separate creditors may participate in the creditor’s assembly only to the extent of their claims for which they are likely to appear as bankruptcy creditors (Article 35, paragraph 3), where at the first creditor’s hearing separate creditors chose one member of the creditor’s committee from their ranks (Article 38a, paragraph 1).

If the transfer of secured claim is executed during the bankruptcy proceedings (Article 117a), upon the submission of the request for correction of the final list of determined claims, the recipient shall be enabled to exercise the right of assignee – prior separate creditor, as the party in bankruptcy proceedings. Even though the novation from 2017 [52] cancelled the limitation related to the stage of bankruptcy proceedings in which transfer of claims is possible [15, p. 336], jurisprudence mainly implements interpretation that “submission of this request during bankruptcy proceedings for the acquirer is enabled until the validity of the decision on main distribution, after which time the transfer of claims in bankruptcy is not possible” [43, p. 208].

Other property rights at disposal of their owner may be subjected to lien. Provisions on the pledge on items may be applied to pledge on claims and other rights, unless prescribed otherwise [34, pp. 491-507]. Bankruptcy debtor has procedural standing to seek the collection of claims and litigate against the debtor of claim under pledge, after which, from the funds received, separate creditors shall be paid out that have collaterals over the claim of the bankruptcy debtor towards his debtor. Secured right should be recognized conditionally since the settlement of the separate creditor depends on the fact whether the bankruptcy debtor will succeed in collecting his claims [36, pp. 126-127].

Also, the subject of lien may be the right of claim of the pledger towards the debtor in the case where the pledge creditor is the debtor of pledger, except for claims whose transfer is prohibited by law and those related to an individual person that may not be assigned to others [53]. In this way, through the implementation of the pledged claim, in case the pledge creditor is the debtor of the pledger at the same time, a compensation is possible – offsetting of mutual, similar and due claims [48, p. 472] as one of the legally prescribed methods to cease the obligation.

Moratorium – legal prohibition of individual enforcement over the assets of the bankruptcy debtor

Initiating bankruptcy proceedings over the owner of real estate under mortgage or movables under pledge leads to important changes in the position and rights of secured creditors, regardless of the fact that it will not lead to the cessation of real estate collaterals. Because, by initiating bankruptcy proceedings, significant substantive legal consequences shall occur for the bankruptcy debtor and its assets, claims of creditors and transactions. Also, there are procedural legal consequences in proceedings the debtor is part of [39, p. 603] that lead to the mandatory cancellation of all court and administrative proceedings as well as the establishment of legal prohibition of enforcement and settlement against the bankruptcy debtor, that is, over its assets.

Monetary claim shall be collected in the procedure of individual or general enforcement [35, p. 436]. Individual enforcement shall be executed in the enforcement proceedings, while general enforcement shall be executed in the bankruptcy proceedings. The principle first in time, greater in right (prior tempore potior iure) is valid in the enforcement proceedings, while in the bankruptcy proceedings the creditors are settled at the same time and
concurrently [40, p. 404], implementing one of the main principles of bankruptcy – equal treatment of creditors (par conditio creditorum) [41]. Bankruptcy is an institute of simultaneous collective and proportional settlement of all creditors through general enforcement on the entire assets of the bankruptcy debtor, by which such debtor ceases to exist as a legal entity [46, p. 325]. In a situation where the assets of the debtor are so depreciated that the liabilities are higher than assets, conditions for settlement in bankruptcy proceedings arise, thus the principle of collective enforcement over the entire assets of the insolvent economic entity for joint and proportional settlement of creditors derogates the principle of priority of collection that is valid for enforcement proceedings, as the process for individual settlement. Bankruptcy proceedings enable joint and proportional settlement of creditors [3, p. 3]. This means that these two proceedings are mutually exclusive.

This is why one of the procedural legal consequences of initiating bankruptcy proceedings is the established prohibition of individual enforcement and settlement of creditors that leads to the inability of enforcement over the assets of the bankruptcy debtor and mandatory interruption of enforcement (Article 93), thus making court decisions and other enforcement documents lose their property of enforceability, but not the property of validity [16, p. 74]. The term “moratorium” in jurisprudence [28, p. 36] as well as court practice [36, pp. 108-109] is used to signify the prohibition of settlement and enforcement as legal consequences of initiating bankruptcy proceedings. The moratorium protects the bankruptcy debtor by providing it with the option to consolidate before the creditors start collecting their claims and by allowing the bankruptcy administrator to prepare the sales of debtor’s assets when the proceedings are forwarding in the direction of bankruptcy [4, p. 66]. Thus, the losses arising from bankruptcy for the creditors are evenly distributed among them if collected in the same payment lines [4, p. 64]. Prohibition to initiate, that is, the cancellation of enforcement proceedings has been established since the enforcement would favor only those creditors with an enforcement document [9, pp. 70-71].

Moratorium shall not be valid for enforcement that refers to the obligations of the bankruptcy estate and costs of the bankruptcy proceedings, that is, obligations incurred during the bankruptcy proceedings. Obligations arising during the proceedings shall be considered costs of bankruptcy proceedings, which are settled regularly and as priority, prior to the claims of creditors classified into payment lines, thus, their enforcement is possible [21, p. 151].

Hence, the bankruptcy proceedings have priority in execution over the enforcement if the debtor is subjected to both at the same time. Therefore, the enforcement, which is ongoing at the moment of initiating bankruptcy proceedings, shall be cancelled ex officio except in special cases when it entails a timely acquired right for separate settlement [44, p. 112]. Procedure legal consequence of the prohibition of enforcement and settlement against the bankruptcy debtor, that is, its assets, has been established with the purpose of not interfering with the even settlement of all creditors [23, p. 148], accomplishing the basic principle of protection of bankruptcy creditors enabling collective and proportional settlement of bankruptcy creditors (Article 3).

Prohibition of enforcement and settlement that occurs ex lege, as a consequence of initiating bankruptcy proceedings, shall primarily refer to ordinary – bankruptcy creditors, that is, persons that have unsecured claims towards the bankruptcy debtor on the day of initiating bankruptcy proceedings (Article 48) and to the exercise of rights of secured – separate and pledge, creditors, as two categories of secured creditors.

By initiating bankruptcy proceedings, the secured right is exercised only in bankruptcy proceedings, except in case of the adoption of a decision on cancellation of the prohibition of enforcement and settlement in line with the Law on Bankruptcy (Article 80, paragraph 2) [12, pp. 919-942].

Possibility of cancellation of the legal prohibition of enforcement and settlement at the proposal of secured creditor

Secured creditors may propose cancellation of the prohibition of enforcement and settlement for the purpose of collecting secured claim from the pledged assets of the
bankruptcy debtor, which is subject to a court decision. In case the conditions for moratorium cancellation are met, the secured creditors shall implement the settlement procedure individually and outside the bankruptcy proceedings, in line with general rules on settlement out of court or in court, therefore, in the same manner as if the bankruptcy debtor was not bankrupt [13, pp. 515-529]. Non-performing loan market is incentivized by enabling the secured creditors to individually implement claim collection procedures.

The novelty from 2017 [52] modified three former reasons for moratorium cancellation, and provisions that regulate them are distributed into new Articles 93a and 93b, while Article 93c contains mutual provisions for cancellation of security measures, that is, the prohibition of enforcement and settlement, and Article 93d regulates the consequences of failure to cash in property by secured creditors in a legally prescribed deadline.

The Law prescribes the duty of securing an adequate protection of assets and, as the reasons to cancel moratorium, prescribes the failure to adequately protect the assets or the depreciation of assets that are being secured (Article 93a). The possibility of cancelling moratorium related to the assets being subject of collateral has also been regulated, which is not of key importance for reorganization or the sale of bankruptcy debtor as a legal entity [24, p. 35] for the period of nine months, provided that the claim of the secured creditor is due in part or in whole and if the value of the asset in question is lower than the amount of secured claim (Article 93b).

“Creditors prove the acquisition of status of bankruptcy, i.e. separate creditors by adopting the final list of claims by the bankruptcy judge, in case their claims are determined, and in case they are disputed, by the adoption of the valid court decision based on which they can seek correction of the final list… Moratorium cancellation may be requested only after the adoption of the final list of claims, that is, conclusion on the list of determined and disputed claims.” [36, pp. 136-137]

A new model of secured creditors settlement was introduced (Article 93a-93e), improving the mechanism of the bankruptcy debtor’s assets cashing in. Secured creditors have an option to individually implement the procedure of individual settlement of their own claims from the assets in their pledge. Considering the procedure of cashing in assets prescribed by special laws and the actions that need to be taken in this procedure and court practice, nine-month period was set during which, after the cancellation of moratorium, individual settlement of secured creditors is allowed. In case secured creditors do not execute settlement in this period, this right shall be denounced from them by the reestablishment of moratorium, except in cases of submission of the petition to extend such deadline [12, pp. 919-942].

Discretionary authority of the bankruptcy judge to assess whether the assets are of key importance for reorganization or for the sale of the bankruptcy debtor as a legal entity has been cancelled, which is a condition of the decision on moratorium cancellation. It has been regulated that the judge shall not adopt any decisions on security measures cancellation, that is, the prohibition of settlement and enforcement, in case the bankruptcy administrator proves that the assets in question are of key importance for reorganization, or the sale of the bankruptcy debtor as a legal entity (Article 93b, paragraph 2). This introduced the obligation of proving the significance of property for the reorganization or the sale of bankruptcy debtor as a legal entity, and the burden of proof was transferred to the bankruptcy administrator, meaning that the law presumes the asset that is the subject of secured right or lien is not of key importance for the reorganization or sales of the bankruptcy debtor, but it allows that the bankruptcy administrator may prove otherwise (rebuttable legal presumption) [12, pp. 919-942].

The adopted new model represents the harmonization of domestic legislation with the Council Regulation (EC) No. 1346/2000 of 29 May 2000 on Insolvency Proceedings that recognizes and determines the specifics of the position of secured creditors, respecting their right to separate settlement from the value of assets under pledge [24, p. 36].

Credit bidding by separate or pledge creditor

The rules named “Credit Bidding by Separate or Pledge Creditor” (Article 136b) regulate the right of the secured
creditor to offset its secured claim against the purchase price in case such creditor is the best bidder (credit bidding).

Special rules for two possible situations have been prescribed – the first one, when the secured claim is higher than the purchase price, that is, its portion over which the right of priority is given to the secured creditor (for example, if a part of the asset is sold or the bankruptcy debtor as a legal entity, or if there are creditors with higher priority over the same real estate) and the second one, when the secured claim is lower than the purchase price, that is, its portion over which the right of priority is given to the secured creditor. In both cases the secured creditor shall be obligated to pay all expenses that have to be settled from the purchase price (appraisal, notices, legal obligations, etc. including the compensation for the bankruptcy administrator) in order to secure due collection. However, the "bankruptcy debtor shall bear all the costs of property tax over the subject of lien" [36, pp. 197-199].

Additionally, in the first case, the secured creditor as the buyer of property or of the bankruptcy debtor as a legal entity has an obligation to pay the remaining portion of the purchase price “from which there is no right of priority settlement” (therefore, the amount of difference between the portion over which the right of priority settlement exists and the total price) in order to secure the settlement of secured creditors of higher order of priority, that is, the collection of the price portion that belongs to the bankruptcy estate. Such situation occurs if, for example, on the same real estate, the separate creditor – buyer holds a mortgage of lower priority, second order mortgage, that secures its claim in the amount of EUR 100,000, and another creditor holds a first order mortgage established for securing EUR 20,000 claim, while the real estate was sold at EUR 90,000. In this situation the second creditor should settle first from the purchase price, for the entire amount of its claim, EUR 20,000, which means that the separate creditor – buyer, in addition to expenses, should pay another EUR 20,000 (“remaining portion of the purchase price from which there is no right of priority settlement”) and would be considered settled via offsetting in the amount of approximately EUR 70,000, less sales costs, while such creditor would settle for the difference to the full amount of claim (somewhat over EUR 30,000) as a regular creditor from the third payment order [5, p. 490].

Due to the principle of indivisibility related to the subject of pledge [6, p. 139] the mortgage shall include the real estate as a whole, even in case of its division [32, p. 463], including all the improvements in value of the property under mortgage, which is a consequence of the extensivity principle [45, p. 31]. Therefore, our opinion is that in the clarification of novelties an error occurred with the clarification of this institute since the obligation of payment of price difference in case that the secure claim exceeds the amount of the purchase price has been explained with the requirement to settle the creditor of the lower priority, that is, “to secure the settlement of secured creditors of lower priority” [24, p. 41], which does not make sense. If the buyer of the property (separate creditor) has claim that is higher than the purchase price, that is, it “exceeds” the price amount, then such creditor will settle through compensation to the amount of the purchase price (reduced for any expenses). Legally, it is not possible to use the price that is not sufficient to entirely settle the secured claim of the buyer of the property for settlement of other secured creditors “of lower priority” but only if there are creditors of higher priority compared to the secured separate creditor that is the buyer of the property [17, p. 81].

Maybe the sales costs could have been distributed more fairly and maybe such costs should have been divided proportionally to all mortgage creditors, in line with the value of claims to be collected from the purchase price.

In the second case, if the secured claim is lower (“will not reach the amount of purchase price, that is, the portion over which the priority of settlement exists”), the secured creditor shall be obligated to pay the difference to the full amount of the purchase price (that is, “difference between the secured claim and the full amount of the purchase price”).

Through provisions that regulate the sales procedure the separate creditor is not “released from deposit payment” that must be differentiated from the costs of sales, which are not paid, but collected primarily from the purchase price. Deposit payment is a condition for participation of the secured creditor in the sales procedure and if its bid
is the most favorable one, such creditor is pronounced the buyer and shall exercise rights from Article 136b [37, pp. 144-145]. The deposit shall be retained in case the separate creditor with the most favorable bid withdraws from the purchase.

“Bankruptcy administrator shall, in case of sales of property to the secured creditor by price bidding, prepare the settlement calculation as well as the calculation of sales costs. Creditors may object to the settlement calculation which is subject to the decision of the bankruptcy judge. Bankruptcy judge shall decide on costs, by way of special conclusion which may be subject to an appeal” [37, pp. 147-148]. Based on the rules stated, the “bankruptcy administrator shall call upon the separate or pledge creditor to execute the payment, otherwise it shall not be considered that the separate or pledge creditor met the foreseen sales terms” [37, pp. 147-148], which means that such creditor will not be announced a buyer but another most favorable participant in the asset sales process.

Application of credit bidding institute when the buyer of property under burden is the pledge creditor

Wording of Article 136b does not mention the pledge creditor even though it is stated in its headline: “Credit Bidding by Separate or Pledge Creditor” [5, p. 491]. Despite this omission, the credit bidding institute may be applied if the buyer of the property is the pledge creditor – that is, the creditor with lien over objects or rights of the bankruptcy debtor registered in public books or registries, that has no monetary claim towards the bankruptcy debtor that is secured by such lien, but towards third parties (Article 49, paras 5 and 6), since there is one basic difference between separate and pledge creditors – which is whether they have simultaneous monetary claim towards the bankruptcy debtor that is secured by mortgage or lien, over objects that are subjected to sales, or towards third parties. However, this difference does not exclude the application of the credit bidding institute to pledge creditors [15, pp. 448-449].

If the property buyer is an excluding creditor that has priority in settlement from the funds received through sales, such buyer would be entitled to compensate its secured monetary claim (towards a third party, not towards the bankruptcy debtor) from the amount of purchase price that is owed. Unlike general terms of compensation from the contract law, in case of application of the credit bidding institute the mutuality of claims of the secured creditor and the bankruptcy debtor, as the owner of the real estate under mortgage, is not a condition for compensation. Absence of mutuality, therefore, shall not prevent the compensation of the secured claim towards a third party with the price that the pledge creditor paid for the object under burden owned by the bankruptcy debtor.

Offsetting (compensation) as a basis of the credit bidding institute

Offsetting (compensation) is the basis of the institute of credit bidding by separate or pledge creditors. Jurisprudence considers compensation a form of payment [33, p. 131]. The purpose of offsetting is simplification of the procedure of fulfilment of mutual obligations with the purpose of avoiding double payments. Usually, it is a case of two monetary obligations where the compensation is an instrument of their regulation without utilization of cash [9, p. 75]. In the Serbian bankruptcy law, it is possible to compensate claims from unsecured creditors with the claims of the bankruptcy debtor under special terms (Article 82, paras 1 and 2) [14, p. 672].

Credit bidding provides the separate creditor with the right to compete in case of the sales of assets on which holds secured right and to use the amount of its claim instead of money to pay the price. In this manner separate creditors may control the sales of assets over which they hold secured rights [26] and react in case they feel the achieved price of collateral in public bidding, and their settlement, is not adequate. In other words, in case the opinion of the separate creditor is that the received price is low, such creditor may offer a higher price and after the transfer of ownership right such creditor may try to sell those assets for a higher price or retain those assets [25, pp. 111-112]. On the one hand, the outcome in case of price payment using claims or money is the same, as a rule. Let us presume that the separate creditor has a claim in the amount of one million dinars and that the assets over which secured right exists is intended for sale.
In case the received price is also one million dinars, for the purpose of simplicity of the example, and is paid in cash, the entire amount, after deduction of costs, would be used for settlement of the same separate creditor. In case the received price is “paid” using claims instead of cash, the outcome would basically be the same. The basis of this institute is, therefore, offsetting (compensation), since the separate creditor will offset its obligation to pay the purchase price against its monetary claim that is secured by mortgage over the real estate in question. The only difference is that the separate creditor bears the costs of sales in the second case. If the received price is lower than the amount of claim, the separate creditor, after paying sales costs, shall acquire the right to settle for the difference in the value of such amounts as the bankruptcy creditor. If the received price is higher than the amount of claim, the separate creditor shall only pay the difference between its own claim and the received price.

Without special provisions (Article 136b), offsetting of such claims and obligations according to general rules (Article 82) would be impossible, since they do not meet the regulated conditions, regardless of the fact that they are not explicitly included in cases when offsetting is not allowed (Article 83). As a counterargument to this position, one might state that general rules on the right to compensate claims in bankruptcy proceedings (Article 82) shall not apply to separate and excluding creditors that are entitled to priority in settlement from funds received from the sales of assets, that is, entitled to priority and separate settlement from the price received from the sales of real estate under mortgage or other assets of the bankruptcy debtor that are under lien. Therefore, a conclusion could be drawn that the application of the credit bidding institute was possible even before the novelty from 2017 based on general rules and principles of bankruptcy proceedings.

The institute of credit bidding itself is not completely new in the Serbian legislation. The Law on Enforcement and Security from 2011 (Article 130, paragraph 2): “if the buyer is the enforcement creditor whose claim does not reach the amount of received price on public bidding and if, considering its priority, such creditor could settle from the price, such creditor shall pay only the difference between the claim and the price received”, and also in the Law on Enforcement Procedure from 2004 (Article 128, paragraph 2). The important difference compared to bankruptcy is that in the enforcement proceedings the buyer may be not only the mortgage creditor, but also an ordinary, regular creditor, therefore, any enforcement creditor, but priority of such creditor compared to others shall be taken into account, primarily related to pledge creditors, since this is not a collective settlement, as the case is in bankruptcy, but individual enforcement and settlement of the enforcement creditor [17, p. 85].

**Preemptive right of the separate or pledge creditor in case of sales through direct agreement**

One of the consequences of initiating bankruptcy proceedings for the bankruptcy debtor is the termination of previously acquired preemptive rights (Article 75), both contractual and legal rights (for example, preemptive right of the co-owner of real estate or the neighboring agricultural land) [55], and simultaneous establishment of legal preemptive right for the benefit of secured creditors and their related persons on the subject of secured right or lien, in case of method of sales through direct agreement (Article 136d). “Preemptive right may be defined as the right whose holder is authorized, in case of sales of items to which the preemptive right refers to, to acquire such items prior to anyone else, through purchase in case conditions of sale are met that are determined by the owner of the item (seller)” [1, pp. 147-148]. Through the cancellation of previously acquired preemptive rights the collision with the legal preemptive right of secured – separate and pledge, creditors, over the subject of secured right or lien is avoided, that would occur had the stated consequence of bankruptcy proceedings initiation not been prescribed.

Hence, in addition to the transaction (for example, contract or last will and testament), the source of
preemptive right may be the law [33, p. 573], where the legal preemptive right is applied *erga omnes*. On the other hand, the contractual preemptive right is applied *inter partes*, thus, only related to the contracting parties (for example, seller and buyer from the contract on sales with preemptive right) and can be applied related to third parties only in case of negligence in particular case [33, p. 573].

When assets that are subject to secured right or lien are sold through direct agreement, the secured creditor may, within five days from the receipt of the notice of the bankruptcy administrator on proposed sale that must include all the terms of the sale that is proposed, including the price and payment method, notify the court and the bankruptcy administrator that it accepts to purchase the subject of sales under conditions from the notice (or more favorable conditions for the bankruptcy debtor) (preemptive right), where it must be stated whether the right (Article 136b) to compensate its secured claim with the amount of purchase price shall be exercised (*credit bidding*) [17, pp. 69-90]. This additionally protects its position in situations where there are no public announcements of the sales process (when the method of sales is not public bidding or public collection of bids), without damaging the bankruptcy estate, since such creditor, provided that it wishes to use this right, shall be obligated to offer the same terms as offered by the best bidder, at minimum.

The establishment of preemptive right for the separate creditor in case of sales through direct agreement, similar to the credit bidding, enables the separate creditor, in case that he is of the opinion that adequate price has not been received, to purchase the subject of sales under the same (or more favorable for the bankruptcy debtor) terms from the notice of the bankruptcy administrator on the proposed sales. In case the right to credit bidding is not exercised, the secured creditor shall, simultaneously with the statement on purchase, be obligated to pay the price agreed with the third party, or deposit it with the court, in line with the application of rules on the price payment deadline from the Law on Contracts and Torts – LCT (Article 528, paragraph 2) [54]. LCT regulates that the rules on sales with preemptive rights shall be applied accordingly to the legal preemptive right (Article 533, paragraph 4).

**Exercise of preemptive right through related parties**

Separate, that is, pledge creditor may exercise preemptive rights through related persons in the sense of the Law on Companies [56] with submission of evidence that such person is indeed related.

Considering a widespread practice of banks (as the most common secured creditors) to, due to regulatory limitations, establish special companies for the purpose of purchase of claims or assets that are collateral in cases of enforcement or bankruptcy, the banks are enabled in this manner to exercise the preemptive right through related persons, too.

Law on Banks [57] (Article 34, paragraph 2) prescribes collective limitations, that is, a limit of 60% of bank’s capital for investments into entities in the non-financial sector as well as fixed assets and investment real estate of the bank. The same regulatory limitation has been prescribed by the Decision on Bank’s Risk Management [31] (Item 60) that defines investment risks of the bank, stating that such risks include the risks of investments into other legal entities, fixed assets and investment real estate, as well as limitations according to which bank’s investments into one entity that is not in the financial sector may not exceed 10% of its capital, where this investment entails investments that result in the acquisition of shares or stock of the non-financial entity, and the total investment of the bank into entities which are not in the financial sector and fixed assets and investment real estate of the bank may not exceed 60% of bank’s capital, where this limit does not refer to the acquisition of shares for sales within six months from such acquisition. Hence, in assessing the investment limit, investments of the bank into non-financial entities (for example, if the bank founded a limited liability company, or acquired a share or stocks in a company during the process of reorganization through the conversion of claims of banks and other creditors into capital – shares or stocks in the bankruptcy debtor) shall be added to the investments of the bank into fixed assets and investment real estate [19, p. 74].
Cancellation of sales as a consequence of the secured creditor’s preemptive right violation

Law on Bankruptcy does not prescribe sanctions, that is, legal consequences for the violation of preemptive rights of secured creditors [20, pp. 34-38]. Hence, it can be concluded that general rules from LCT shall be applied (Article 527-532) that regulate sales with preemptive rights [15, p. 458]. Persons that hold preemptive rights in line with the law must be notified in writing on the intended sales and their terms, otherwise they shall be entitled to request the cancellation of sales (LCT, Article 533, paragraph 2). Therefore, the secured creditor with the legal preemptive right over the subject of secured right or lien shall be entitled to demand the cancellation of sales through direct agreement in case of failure to duly notify such creditor on intended sales and their terms [19, p. 76]. At the same time, the secured creditor shall be entitled, that is, he must demand that the asset is sold to him under identical terms, by way of a collective claim with the request for sales cancellation. Otherwise, in case the plaintiff (secured creditor) does not request the cession under the same terms, then there is no legal interest for a suit for sales cancellation which is a process obstruction and a reason for dismissal [35, p. 194].

According to legal opinion of the Civil Department of the Court of Appeals in Novi Sad from 26 May 2014, the probable cause of the claim of the holder of preemptive rights depends on the deposition of funds in the amount of monetary market value of the real estate: “Depositing cash in the amount of market value of the real estate simultaneously with the suit is the basis for probable cause of the claim of the holder of preemptive right for the cancellation of the real estate sales agreement and the request for selling the property to such holder under the same terms” [7]. Due to the violation of priority in the acquisition of rights that is the essence of the preemptive right, in this way, priority purchase right is activated, which is also included in this right. The priority purchase right occurs only if preemptive right has been violated by concluding a contract with a third person [1, p. 148]. “Preemptive right occurs where there is still no contract, and the priority purchase right occurs only after the conclusion of the valid sales agreement between the owner and the third party” [27, p. 1114].

The exercise of authority arising from preemptive right is related to strict legal, preclusive deadlines, whose expiry leads to the loss of preemptive right [1, p. 148]. Therefore, knowledge of the plaintiff about the transfer of ownership, that is, precise contract terms after the expiration of the objective five-year period from the transfer of such ownership to a third party is not legally relevant and has no significance related to the maintenance of such deadline, nor can it lead to the extension of such objective period.

Therefore, regardless of the fact that the duration of the legal preemptive right is not limited (LCT, Article 533, paragraph 2) unlike the contractual preemptive right that shall cease after five years from the conclusion of the contract (LCT, Article 531, paragraph 2), the right to protect the legal preemptive right of the separate or pledge creditor, that is, sales cancellation claim, shall be subjected to preclusive subjective six-month deadline starting on the day of receiving knowledge on such transfer, that is, precise contracted terms, where the preemptive right shall cease in any case upon the expiration of the objective five-year deadline from the transfer of ownership to a third party (LCT, Article 532).

The verdict of the Supreme Court of Cassation, Rev. 1788/2017 from 13 September 2018, adopted through the application of the Law on Real Estate Trade (Article 10, paragraph 2) that also prescribes a subjective-objective deadline, included a position on preclusive legal nature of the subjective deadline: “With the expiration of the subjective deadline of 30 days starting from the day of receiving knowledge about the conclusion of the real estate sales agreement, the owner of the neighboring plot shall lose the right and possibility to exercise the protection of preemptive right” [8].

According to jurisprudence, legal preemptive right is applied ergo omnes, while the contracted preemptive right is applied inter partes, that is, it can be exercised towards a third party only in case of negligence in a specific case [33, p. 576]. “Right of priority purchase can always be exercised in case of violation of the legal preemptive right, and in case of violation of the contractual preemptive right only if the
person to which the asset was sold was negligent, that is, if such person knew or should have known that preemptive right has been violated” [1, pp. 147-148]. Therefore, one could accept a position that negligence of the third party (buyer) is not a precondition for the adoption of the claim of the separate, that is, pledge creditor, as the holder of the legal preemptive right for the cancellation of sales and cessation of asset under the same terms. In this case the right to damage compensation towards the bankruptcy administrator and/or bankruptcy debtor would belong to a third party and it would be treated as an obligation of the bankruptcy estate [19, p. 79].

Consent of secured creditors for the lease of assets burdened by secured rights or lien

Leasing assets of the bankruptcy debtor burdened by secured rights or lien shall be considered a matter of utmost importance (Article 28, paragraph 1) and shall be conditioned on the consent of secured creditors (Article 28, paras 2-4), regardless of their value compared to the total value of bankruptcy estate [36, p. 120].

The bankruptcy administrator shall deliver the notice on the intent to lease to secured creditors and such action may be implemented only with the receipt of the approval of creditor that, in line with the application of rules of assessment of the probability of settlement for the purpose of voting at the creditor’s assembly (Article 35, paragraph 3), makes probable that his secured claims may be settled from the assets under burden in part or in whole (Article 28, paragraph 2). Therefore, the probability of settlement of the secured claim may be proved by secured creditors by delivering the appraisal of the value of assets that is the subject of pledged right prepared by the authorized professional (appraiser), not older than 12 months.

To avoid the possibility of abuse of this right by creditors that have no basis to expect any settlement from the value of such assets (if they are holders of the lower priority right), the consent shall be received only from the creditors that present the probability of settling their secured claims from assets under burden (in whole or in part). Therefore, the precondition for the use of this right is proving the probability (which represents a lower degree of evidence than certainty) of settlement from the property being subjected to leasing. Interests of secured creditors may differ depending on their position, thus the interest of some of them may be sales, while others may have interest in leasing [25, pp. 111-112].

Bearing in mind that secured creditors are justifiably interested in preservation of the subject of collateral of their claim and its earliest possible cashing in, their consent is required since these are transactions that include providing subject of pledge to a third person for use, thus, potentially, over time, its value may be depreciated for example, from regular use. Moreover, leasing will, de facto, delay cashing in of such assets (due to the fact that in this manner fixed monthly costs of bankruptcy proceedings are financed), which is contrary to the urgency principle of bankruptcy proceedings and legitimate interests of secured creditors that have no benefit from leasing, the benefit is attributed to the bankruptcy estate. Opposed interest of secured creditors on the one side and the bankruptcy administrator and regular creditors on the other are balanced by not denying the bankruptcy administrator to lease property burdened by secured right or lien, but such right is conditioned on the consent of secured pledge creditors [24, pp. 28-29].

In case of lack of declaration for any reason, that is, failure to submit to the court explicit written rejection of consent, a fiction of the existence of consent of secured creditors has been prescribed for the lease of assets under burden. Consent shall be considered given in case secured creditors fail to submit their statement related to the matter within eight days from the receipt of the written request of the bankruptcy administrator (LB, Article 28 paragraph 3). The law, therefore, prescribes the fiction that the consent was provided tacitly which is a deviation from the basic principle in law that silence does not mean approval (LCT, Article 42, paragraph 1).

Clarification of the draft of the law falsely qualified this institute as a “non-rebuttable presumption” [24, p. 29] even though it is a fiction since the law considers the consent given, even though actually it was not. Legal presumption has another role – it presumes a fact, that actually exists in reality, cancelling the requirement of proof, or in case of rebuttable presumptions, transfers the burden of proof to the other side.
This solution secures efficiency of consent provision process by imposing the obligation to act to non-consenting secured creditors, while the bankruptcy administrator is not obligated to actively pursue such consent, which may be a time-consuming process, especially in case of secured creditors that are companies with a complex structure of decision making, such as banks.

Consent of secured creditors has been introduced due to the issues in the application of prior bankruptcy framework that occurred in the instances of lease of assets burdened by secured rights. On the one hand, bankruptcy administrators were motivated to lease the assets of the bankruptcy debtor, thus covering the costs of bankruptcy proceedings. On the other hand, this prevents prompt cashing-in of assets of the bankruptcy debtor. Solutions that were in use before the novelties from 2017 prescribed receiving the consent from the board of creditors but, considering the fact the members of the board were exclusively bankruptcy creditors (except in the case where the board included creditors that were secured and bankruptcy creditors at the same time), the interest of such a board was, as a rule, leasing such assets. Such solution significantly harmed the interest of secured creditors.

The Law on Bankruptcy does not prescribe the legal consequence of leasing property without due notification of secured creditors or in the case where they explicitly deny providing such consent. Consent for contract conclusion is an institute of the contractual law. If third party consent is mandatory for contract conclusion, such consent may be provided prior to contract conclusion, as a permission, or after conclusion, as an approval, unless the law prescribes otherwise (LCT, Article 29). It can be concluded that the consent from the Law on Bankruptcy (Article 28, paras 2-4) is actually a permission, since it is provided prior to the lease agreement conclusion. Therefore, lease agreement shall not be valid if concluded without the consent of secured creditors. It is a completely null transaction (LCT, Article 103) since it contradicts the quoted regulations. More precisely, it is considered that such contract had never been concluded since the law prescribed prior consent – permission of the secured creditors “for contract conclusion”, that is, for taking “action” of leasing assets under burden.

Conclusion

Law on Bankruptcy distinguishes separate and pledge creditors as two categories of secured creditors. The differentiation criteria are whether the creditor has claims towards the bankruptcy debtor that are secured by mortgage or pledge over the assets of the bankruptcy debtor, that is, whether the bankruptcy debtor is, at the same time, the debtor of secured claim or it is a third party.

Legal consequences of initiating bankruptcy proceedings over the owner of property under mortgage or movables under pledge, primarily the moratorium, have significant impact on the exercise of rights and the position of secured creditors, regardless of the fact that they do not lead to the cessation of real estate collaterals, since, as a rule, they disable the implementation of the procedure of individual enforcement and settlement outside of bankruptcy, thus limiting their rights. Therefore, it was necessary to provide additional protection of rights to this category of creditors in the procedure of sales of assets of the bankruptcy debtor. For this purpose, having in mind the significance of real estate collaterals, such as mortgage or chattel mortgage, in the operations of banks and other economic entities, the bankruptcy framework in the Republic of Serbia prescribes several specific institutes establishing a separate protection mechanism and exercise of rights of secured creditors.

Amendments to the law from 2007 introduced a new model of settlement for secured creditors, enhancing the mechanism of cashing in the assets of the bankruptcy debtor. Secured creditors were now able to independently implement the procedure of individual settlement of their claims from the assets over which they hold lien. Nine-month period has been set during which individual settlement of secured creditors is allowed, after the cancellation of moratorium. In case secured creditors fail to execute settlement during this period, moratorium is reestablished.

The bankruptcy judge shall not adopt a decision on security measures cancellation, that is, prohibition or enforcement and settlement if the bankruptcy administrator is able to prove that the assets in question are of key importance for the reorganization or sale of the bankruptcy debtor as a legal entity. This introduces
the obligation of proving significance of assets for the reorganization or sales of the bankruptcy debtor as a legal entity, while the burden of proof has been transferred to the bankruptcy administrator.

Credit bidding provides the right for the secured creditor to, in case of the sales of assets under burden, bid and use the amount of its claim instead of cash to pay the price. In this manner secured creditors are able to control the sales of assets over which they hold lien and to react in case they think that the received price of collateral from public bidding, and their settlement, is not adequate. The basis of the credit bidding institute is compensation.

One of the consequences of initiating bankruptcy proceedings is the establishment of the legal preemptive right for the benefit of secured creditors and their related parties over the subject of secured right, or lien, in case of method of sales through direct agreement. This additionally protects their position in situations where there is no public announcement of sales, and without reducing the bankruptcy estate, since such creditor, in case it wishes to exercise this right, must offer at least the same terms as the best bidder.

Law on Bankruptcy does not prescribe sanctions for the violation of preemptive rights of secured creditors, which means that the general contractual law provisions shall apply that prescribe that persons holding preemptive rights by law must be notified in writing on the intended sale and its terms, otherwise they shall be entitled to demand sales cancellation.

Leasing assets of the bankruptcy debtor burdened by secured right or lien shall be considered an action of utmost importance and shall be conditioned on the consent of secured creditors, regardless of their value compared to the value of the total bankruptcy estate. Lease agreement shall not be valid if concluded without the permission of secured creditors.

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