WPS 1651

POLICY RESEARCH WORKING PAPER 1651

Bank-Led Restructuring in Poland

Bankruptcy and Its Alternatives

Cheryl W. Gray
Arnold Holle

Poland has neglected traditional "exit" processes for problem debtors, partly because of its emphasis on bank conciliation. Now that bank conciliation has expired as an option, Poland should shift its energies to improving corporate governance, fundamental tools of debt collection, and basic bankruptcy and workout processes.

The World Bank
Policy Research Department
Finance and Private Sector Development Division
September 1996

Summary findings

Poland's Enterprise and Bank Restructuring Program, adopted by Parliament in 1993, provided for the resolution of problem loans through workouts, liquidation, or loan sales. Here Gray and Holle examine how formal "exit" processes (the movement of labor and assets out of one organization into another or into unemployment) work in Poland.

They examine three traditional exit processes — court conciliation, bankruptcy, and the liquidation of state enterprises — and touch briefly on the alternatives of debt repayment and the sale of debt. They also examine how Polish firms slated for downsizing or closure differ from those selected for survival.

Traditional exit processes appear to have worked but with many flaws. Neither bankruptcy nor court conciliation as currently designed gives creditors enough control over firms in financial distress. Both could work much better if redesigned and if supported by better systems of collateral and debt collection. Suggested improvements in design need to be complemented by strong economic policies that give banks and other creditors powerful incentives to use these debt collection mechanisms.

The most problematic of the three exit processes is the liquidation of state enterprises, which is almost entirely controlled by debtors. This process is much slower than bankruptcy, and although on paper it is designed for solvent firms, it is often used to get around bankruptcy and keep debtor management in control of assets for as long as possible. The "loophole" of state-enterprise liquidation must be plugged if other processes are to work. It should be strictly limited to solvent firms or eliminated altogether, because it invites abuse.

Poland has neglected such traditional processes as bankruptcy and workout, partly because of its emphasis on bank conciliation. Now that bank conciliation has expired as an option, Poland should shift its energies to improving traditional, broadly applicable exit and workout processes rather than add new ones for selected types of firms. Special alternatives for selected firms tend to lead those firms to expect lenient treatment and thereby create a moral hazard that could stall further restructuring.

This paper — a product of the Finance and Private Sector Development Division, Policy Research Department — is part of a larger study in the department of Poland's Enterprise and Bank Restructuring Program. Copies of this paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Bill Moore, room N9-038, telephone 202-473-8526, fax 202-522-1155, Internet address bmoore@worldbank.org. September 1996. (38 pages)

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Produced by the Policy Research Dissemination Center

Bank-led Restructuring in Poland: Bankruptcy and its Alternatives

by

Cheryl W. Gray and Arnold Holle*

Policy Research Department
World Bank

* Cheryl Gray is Principal Economist, Policy Research Department, World Bank. Arnold Holle is with The Boston Consulting Group in London and is a consultant to the World Bank. Most of the work on the ground in Poland was carried out by a team of researchers at the Institute of Economics at Lodz University under the guidance of Anna and Stefan Krajewski. The authors would like to thank the Krajewskis for their support and advice. They would also like to thank Kenneth Xu, who provided excellent computer assistance in helping to analyze the survey data in Washington. The paper is dedicated to the memory of Herbert L. Baer, who worked closely with the authors in the design and early implementation of the survey until his untimely death in 1995.

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Bank-led Restructuring in Poland: Bankruptcy and its Alternatives

A change in incentives and risks faced by enterprises and their managers lies at the heart of the transition in former socialist economies. Financial discipline needs to replace soft budget constraints, and the entry of new competitors and exit of loss-making firms needs to become the rule rather than the exception. Only through financial discipline can product and capital markets impose financial discipline on managers, and only through "entry" and "exit" can markets select the most efficient producers.

The goal of this paper is to examine how formal "exit" processes work in Poland, a country at the forefront of the move from plan to market. "Exit", as used in this paper, refers to the movement of labor and assets out of an organization into another or into unemployment. This concept of exit encompasses both downsizing and closure of an enterprise.[1] A thorough study of exit processes should not look only at firms that exit, but also at those that do not. Indeed, one issue we examine is how Polish firms slated for downsizing or closure differ from those selected -- by the market or by administrative or political mechanisms -- for survival.

Our study of exit processes is part of a larger study on a far-reaching program of bank and enterprise reform adopted by the Polish government in 1993, the "Enterprise and Bank Restructuring Program" ("EBRP").[2] The goals of the EBRP were to rehabilitate and lay the groundwork for privatizing seven of the nine commercial banks that had been created out of the National Bank of Poland in 1989 and to restructure and privatize, under the banks' command, a group of financially troubled state enterprises. It required the banks to establish workout units and to take action by March 1994 to recover loans classified as doubtful or loss as of end-1991 (the so-called "base portfolio"). Five "resolution paths" were stipulated in the law. By the end of March 1994 (later extended to end-April), each bank was required to take action so that for each firm with a loan in the base portfolio either:

- the debtor had been fully servicing its debt for at least the last three months;
- a court or bank conciliation agreement had been concluded;
- the debtor had been declared bankrupt;
- liquidation had been initiated under the Privatization Law (i.e. privatization is pending) or under the law on SOEs (i.e. the enterprise is being shut down) ; or
- the debt had been sold on the fledgling secondary debt market.

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[1] Balcerowicz, Gray, and Hashi (1996).

[2] For a more in-depth description of the EBRP, see Gray and Holle (1996).

The first path, a return to debt service, was the only one that did not envision any exit and was intended essentially for healthy firms. The second, court or bank conciliation, was intended for potentially viable firms that could be successfully restructured through one of these two formal workout processes. Court conciliation was a little-used workout process in existence since 1934. Bank conciliation was a new and more flexible bank-led workout process introduced by the EBRP, to be available to banks and ailing firms for three years. The last path, sale of the problem loans on the secondary market, was intended to foster the transfer of the debt to parties with a greater willingness or ability to put pressure on the firm to repay.[3]

The two remaining resolution paths were more focused on exit than on restructuring. The third path, bankruptcy under Poland's 1934 bankruptcy law, envisioned the closure of the troubled firm under the direction of the court, and the distribution of its remaining assets to creditors. In theory, the firms in the worst financial state -- that is, those with debts exceeding assets and with liquidation value higher than value as a going concern -- should enter bankruptcy. The fourth path, liquidation, differed from the third in that it was supposed to be available only to solvent firms (those whose assets exceeded their debts). Liquidation under the privatization law was merely a form of ownership change, while liquidation under the state enterprise law envisioned closure of the firm under the direction of the founding body.

We examine below three formal workout and liquidation paths laid out in the EBRP -- court conciliation, bankruptcy, and state enterprise liquidation. This paper does not look at bank conciliation in detail; because of its innovative design and wide acclaim, it is the subject of a separate paper.[4] We also look briefly at the two other paths in the EBRP, repayment and sale of debt.

Sample Distribution: Resolution Paths and Banks

This paper is based on a survey of 77 firms that went through at least one of these five resolution paths -- court conciliation, bankruptcy, state enterprise liquidation, repayment, and sale of debt. These 77 firms are part of a larger stratified sample of 139 firms drawn from the universe of firms with debts to the banks larger than PZL 1 billion classified (based on the results of a 1992 audit of the banks) as doubtful or loss as of year-end 1991.[5] In the case of the seven banks that remained in state hands, this is the

[3] It was possible for firms to go through more than one resolution path. A firm could, for example, go from state enterprise liquidation into bankruptcy, or from court conciliation into bank conciliation (but not vice versa), and possible then into bankruptcy or liquidation.

[4] Gray and Holle (1996)

[5] The other 62 firms in the 139-firm sample went through bank conciliation. For a description of the origin -- both date and type -- of the debts of the 139 firms to the banks, see Gray and Holle (1996).

universe of firms and debts -- the latter defined as the "base portfolio" -- covered by the EBRP. For Wielkopolski Bank Kredytowy (WBK) and Bank Slaski, the two banks slated for early privatization, the names of firms or the size of the overall bad loan portfolio was not available to the authors. For the seven state-owned commercial banks, the base portfolio included 787 firms with loans totaling about PZL 16 trillion, or US$1.43 billion.

The overall sample of 139 firms includes 130 firms from the seven state-owned banks and 9 from the two privatized banks. The sample of 130 constituted about 17 percent of the total number of firms in the base portfolio of the state-owned banks. It was stratified to include some firms from each bank and at least 10 firms in each resolution path, with a special concentration on bank-led conciliation cases. Cooperatives, companies in the defense industry, and a few intensely political cases were excluded from the sample. To the extent possible, cases were drawn at random subject to these criteria.[6] Because it is difficult to find data and interview subjects in cases of completed bankruptcies and liquidation cases, our sample for these two resolution paths is composed primarily of cases that are still ongoing.[7]

The 787 firms in the base portfolio of the seven state-owned banks and the final sample of 139 firms are broken down by resolution path as shown in Table 1. We oversampled for bank conciliation cases (in terms of number, but not in terms of amount of bank debt[8]) because we wanted to study that process in depth. We undersampled for good clients, which are by far the largest EBRP group in terms of numbers. The percentage of cases in our sample from other resolution paths is similar to the overall percentage in the EBRP universe.

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[6] The selection was random in 6 banks for which the authors had access to a complete list of their base portfolios. The other state-owned commercial bank and one privatized bank chose the sample. The other privatized bank did not cooperate in the study.

[7] It is not clear a priori whether the selection of primarily ongoing cases creates a bias, and, if so, whether the bias is toward better or worse firms. We believe there is not likely to be a strong bias either way.

[8] If measured in size of bank debt, the bank conciliation sample is representative. Firms in the bank conciliation process owed 46 percent of the debt to banks in the base portfolio.

Table 1: The 139-Firm Sample by Resolution Path

Resolution path:	Share of 787 enterprises in "base portfolio"	Number of enterprises in sample	Share of sample	Number of banks from which cases were taken
Repayment / good clients[9]	40%	22	16%	6
Bank Conciliation	23%	62	45%	8
Court Conciliation	2%	10	7%	4
Sale of Debt	8%	10	7%	7
Liquidation	5%	12	9%	5
Bankruptcy	17%	23	17%	8
Other	5%	0	0%	

With regard to bank coverage, cases in all resolution paths were taken from at least 4 banks to try to get as broad and representative a view as possible of the EBRP program in Poland. However, there was some concentration in certain banks that were more cooperative than others. The breakdown by bank of the 139-firm sample, the 22 firms that repaid or became current on their loans, the 62 conciliation cases, and the 55 cases in other resolution paths is shown in Table 2. Six banks are well-represented in the 139-firm sample; from 14 to 32 cases were drawn from each (representing from 12 to 46 percent of their total EBRP cases). Three banks are clearly underrepresented, with only 6, 2, and 1 cases, respectively.

[9] There are three different groups of debtors in this category: Some debtors had not been late on their payments before 1992, but were categorized as bad debtors in order to increase the amount of the recapitalization. Another group paid their debt back in full, and a third became current on their payments.

Table 2: Distribution of Base Portfolio (787) and Sample (139)

	Financial condition*	Number of enterprises in base portfolio	Number of enterprises surveyed	Number of enterprises that repaid or became current	Number of enterprises in bank conciliation	Number of enterprises in other resolution paths
Bank 1	weak	72	14	1	7	6
Bank 2	adequate/strong*	111	32	3	18	11
Bank 3	strong	146	6	0	5	1
Bank 4	strong	N.A.	14	3	8	3
Bank 5	weak	69	32	6	11	15
Bank 6	strong	100	2	0	2	0
Bank 7	strong	131	19	4	3	12
Bank 8	weak/adequate*	158	19	5	8	6
Bank 9	strong	N.A.	1	0	0	1
Total		787	139	22	62	55

*Banks 2 and 8 are in the middle in our consolidated measure of financial condition. Banks 2, the stronger of the two (with a much higher capital ratio and more improvement in its capital position and loan portfolio), has been classified with the strong banks for purposes of our analysis. Bank 8 (which had an extremely high level of bad debts in 1991) has been classified with the weak banks.

Table 2 also categorizes the 9 banks into two groups, based on their financial condition in 1993 when final decisions were taken on the resolution paths of most base loans and when conciliation agreements began to be negotiated. Our sample of 77 cases in paths other than bank conciliation is divided approximately equally between weaker and stronger banks. Our assessment of financial condition is based on four indicators: (1) risk-weighted capital adequacy in 1993 (when the agreements were being negotiated), (2) change in risk-weighted capital adequacy 1991-93, (3) percentage of the 1991 loan portfolio rated doubtful or loss, (4) change in percentage of loan portfolio rated doubtful or loss 1991-93 (see Appendix 1). In our view, those banks which had adequate capital in 1993 or a relatively smaller 1991 bad loan portfolio to be worked out, or which had already shown an ability to improve either or both, were better placed to tackle the work-out effort successfully. The two privatized banks were automatically included in the "strong" category. They were the first banks to be privatized both because their situation in 1991 was clearly better than that of the other banks and because they were viewed to have better risk assessment and bad loan workout skills.

We would like to emphasize that the assessment of a bank as "strong" or "weak" does not necessarily reflect the quality of its management. The regional allocation of portfolios to banks made risk spreading particularly difficult for bank managers. The various banks inherited portfolios of differing qualities and clients with diverse futures, and they operated in regional economies with varying growth potentials. In the words of

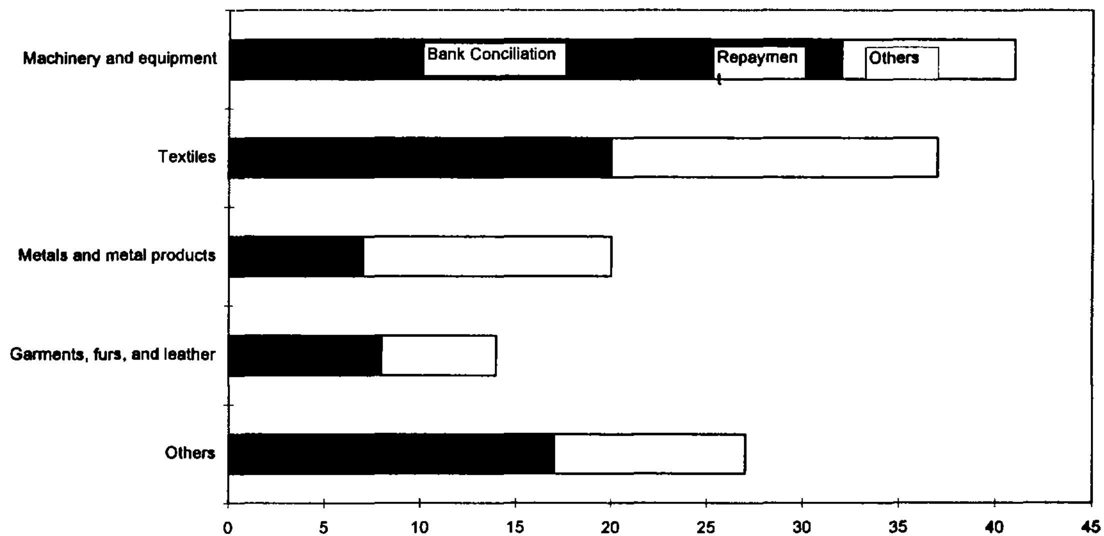
one bank manager: "A commercial bank with a substantial loan portfolio can only be as good as the financial standing of its clients."

Characteristics of Sample Firms

Sectoral Distribution.

Overall the decision for a firm to enter bank conciliation or one of the other resolution paths does not appear to have been heavily affected by the sector in which it operates. Figure 1 shows a breakdown of the 139-firm sample into three broad groupings: the 62 that entered bank conciliation, the 22 that repaid or became current on their debt, and the 55 that entered other resolution paths. While there is a significant concentration of all three among two broad sector groupings -- textiles and machinery and equipment, all sector groupings have firms in each samples. Bank conciliation is somewhat more common for firms in machinery and equipment and somewhat less common for firms in metals and the residual "other" sector category.

Figure 1: Sample distribution among industrial sectors



Amount of Debt.

Table 3 divides the base portfolio among resolution paths. While only 23 percent of firms entered bank conciliation, they accounted for 46 percent of the base portfolio. Enterprises in other resolution paths had far lower levels of bank debt on average -- between PZL9 billion and PZL17 billion per firm, compared with PZL41 for firms in bank conciliation.

Table 3: Share of Debt by Resolution Path for all 787 EBRP Firms

Resolution-path	Share of 787 firms (in number)	Share of base portfolio (in value)	average debt owed to main bank (end-91) --in bln zl
Repayment / good clients	40%	20%	15.1
Bank Conciliation	23%	46%	41.1
Court Conciliation	2%	1%	13.8
Sale of Debt	8%	7%	16.8
Liquidation	5%	2%	9.4
Bankruptcy	17%	10%	12.1
Other	5%	4%	13.8

Profitability and Employment.

Figure 2 shows the average operating profits in 1991 and 1992 and the average number of employees[10] of the firms entering different resolution paths. These two variables are significant explanatory variables.[11] Firms entering bank conciliation were on average more profitable in 1991-92 (with average operating profits of 1 percent) than firms in other paths. Those entering liquidation or bankruptcy were the least profitable, with average operating profits of -47 and -45 percent, respectively. Firms entering bank conciliation also had on average more employees (almost 1300 per firm) than firms in other paths. Those entering bankruptcy had the fewest employees (apart from the few firms whose debt was sold), but had still been quite large in 1991-92, with about 500 employees on average. In essence, the workout routes appear to have captured firms with reasonable prospects for successful restructuring and/or those that were large enough to make a political impact. This result is encouraging and shows that the process may have roughly succeeded in separating viable from unviable firms. However, the fact that firms in state enterprise liquidation were larger yet on average even more unprofitable than those in bankruptcy underscores the problems with the former process discussed later in the paper.

Reasons for Financial Distress

The causes of financial distress in the 62 enterprises entering the bank conciliation process differed little from those in the 77 enterprises going into different paths. The most commonly cited cause of financial distress -- named by almost 9 out of 10 firms in both groups as one of the 3 most important causes, and by almost one-half as *the* most

[10] Size of debt is to some extent a proxy for size of the firm and is therefore correlated with number of employees.

[11] See Annex 2 for logistic regression results. This pattern holds for both strong and weak banks.

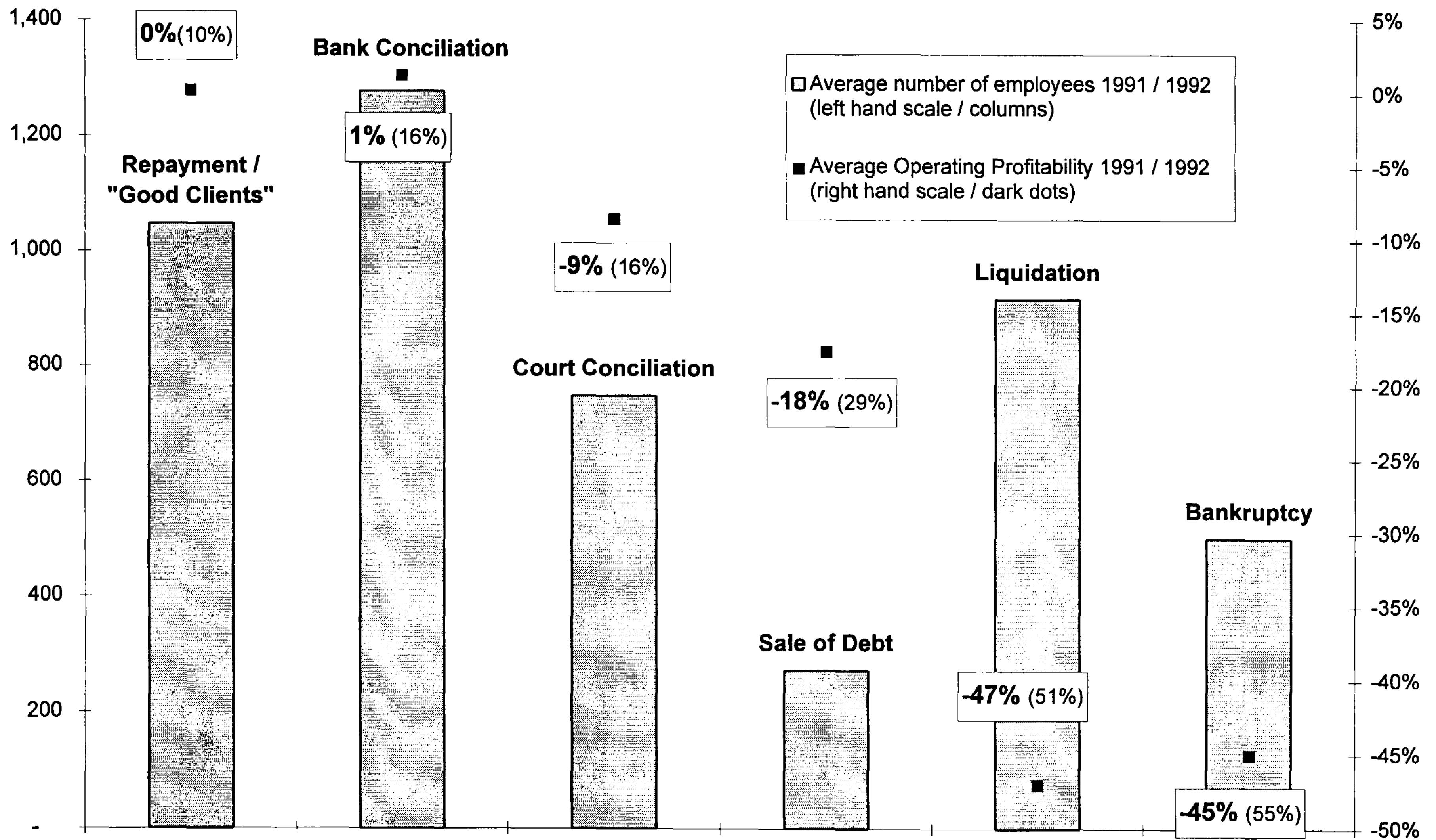


Figure 2: Average Operating Profitability and Number of Employees 1991 / 1992
(standard deviation in parentheses)
1,400
1,200
1,000
800
600
400
200
-
5%
0%
-5%
-10%
-15%
-20%
-25%
-30%
-35%
-40%
-45%
-50%
0%(10%)
Repayment /
"Good Clients"
Bank Conciliation
1% (16%)
Court Conciliation
-9% (16%)
Sale of Debt
-18% (29%)
Liquidation
-47% (51%)
Bankruptcy
-45% (55%)
Average number of employees 1991 / 1992
(left hand scale / columns)
Average Operating Profitability 1991 / 1992
(right hand scale / dark dots)

important -- was declining domestic consumption of the goods they produced. Indeed, total domestic consumption of the major product of the 77 firms declined on average by more than 40 percent between 1989 and 1991. The second most commonly cited cause, which affected about one-half of all firms, was an inability to collect receivables. A decline in exports to CMEA markets affected about one-third of the firms, and was cited as the most important cause by one-fifth. One-quarter to one-third of the firms noted increased import competition, increasing prices of inputs, or rising tax burdens as important.

These answers confirm that many of the firms in our sample were severely affected by the general downturn in the Polish economy in 1990 and 1991, either suffering a decline in sales themselves or having customers who were unable to pay their bills. A smaller but still significant percentage were affected by structural changes specifically attributable to transition -- including the realignment of prices, increasing import competition, and declining CMEA exports. While it is often hard to differentiate these two factors -- recession vs. transition-related structural change -- in practice, one might expect those firms citing structural reasons for their financial distress to have a lower likelihood of eventual recovery. No significant differences in reasons for financial distress appear to exist, however, between the firms in our sample that entered workout processes and those that repaid or were slated for closure.

Structure of Enterprise Debt

Figures 3 through 6 give a snapshot of the structure of debt in 73 of the 77 firms that entered resolution paths other than bank conciliation.[12] Although overall debt levels did not rise substantially in real terms in the early 1990s for firms in most resolution paths (Figure 3), the size of the debt relative to assets (Figure 4) and the structure of the debt (Figure 5) both changed dramatically. As a share of total assets, total debt rose on average from 65 percent in 1991 to 157 percent in 1994. Most of this increase reflected a decline in the real value of assets, due both to shedding of assets and to inadequate indexing for inflation.[13] With regard to the structure of debt, bank debt and payables to suppliers fell both in real terms and as a share of total debt, while government debt skyrocketed by both measures. Taxes and social insurance payables to the government more than doubled in real terms from 1991 to 1993. As a share of total assets, they increased from 12 percent in 1991 to 44 percent in 1993. In 16 cases the government (the tax office and ZUS) replaced banks or suppliers as the largest creditor (Table 4). At least 70 percent of these payables consisted of overdue tax and social insurance arrears.[14] The

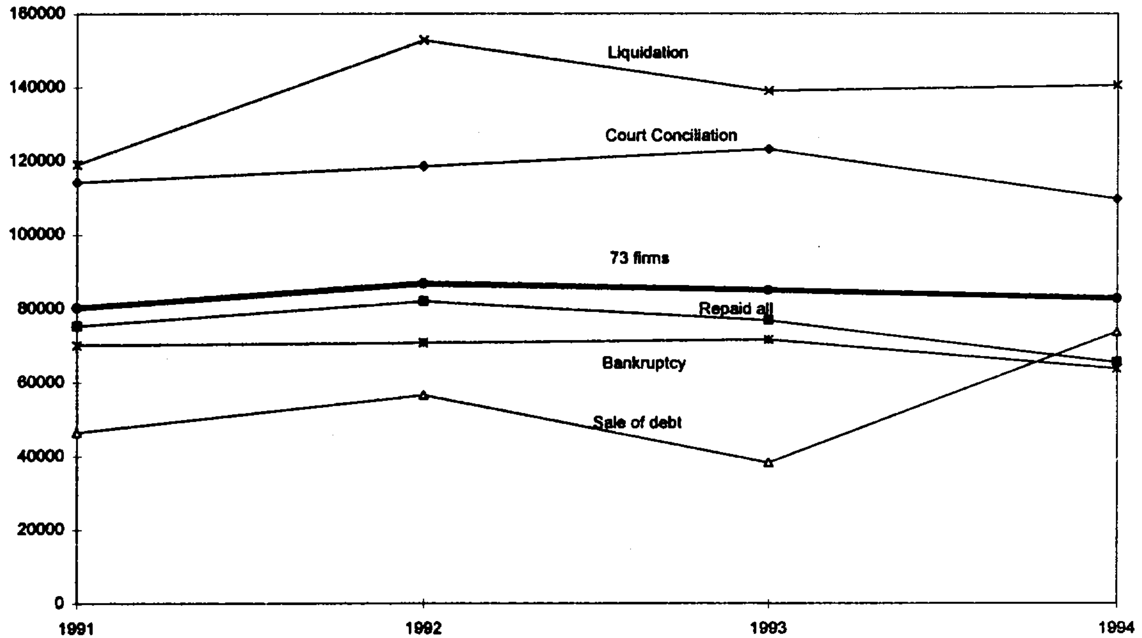
[12] Debt data were unavailable for the other 4 firms. For detailed debt data on firms in bank conciliation, see Gray and Holle (1996).

[13] Revaluation of assets during this period was allowed several times, with the extent of revaluation being largely at the discretion of firm management.

[14] We do not know the exact breakdown between current and overdue payables for all categories of taxes for all years. Of debts to the tax office and the social insurance agency at year-end 1993, 28 percent of

structure of debt did not vary dramatically among firms in the various resolution paths other than bank conciliation (Figure 6), although banks were somewhat more prominent in bankruptcy cases and suppliers were more prominent in court conciliation cases.

Figure 3: Average Debt by Resolution Path
(million real 1991 PZL)



payables were current and 72 percent were overdue (43 percent for more than one year). Because payments to ZUS were in general more likely to be made than payments to other tax agencies, an estimate that three-quarters of tax liabilities were in arrears appears reasonable.

Figure 4: Debt as a Share of Total Assets

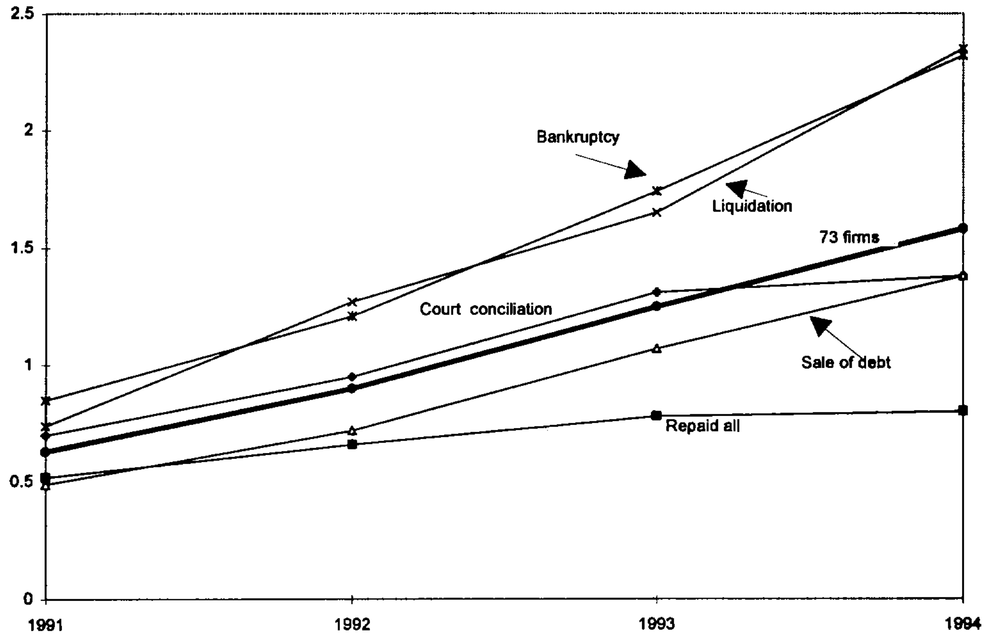


Figure 5: Debt Structure by Type of Creditor (73 firms)

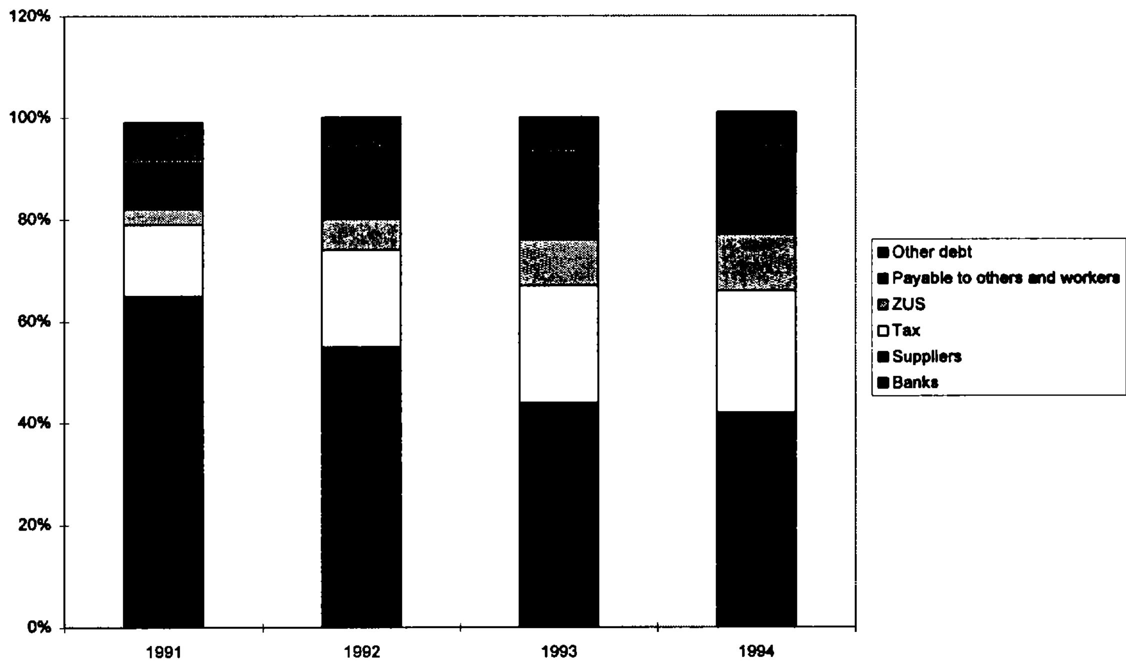
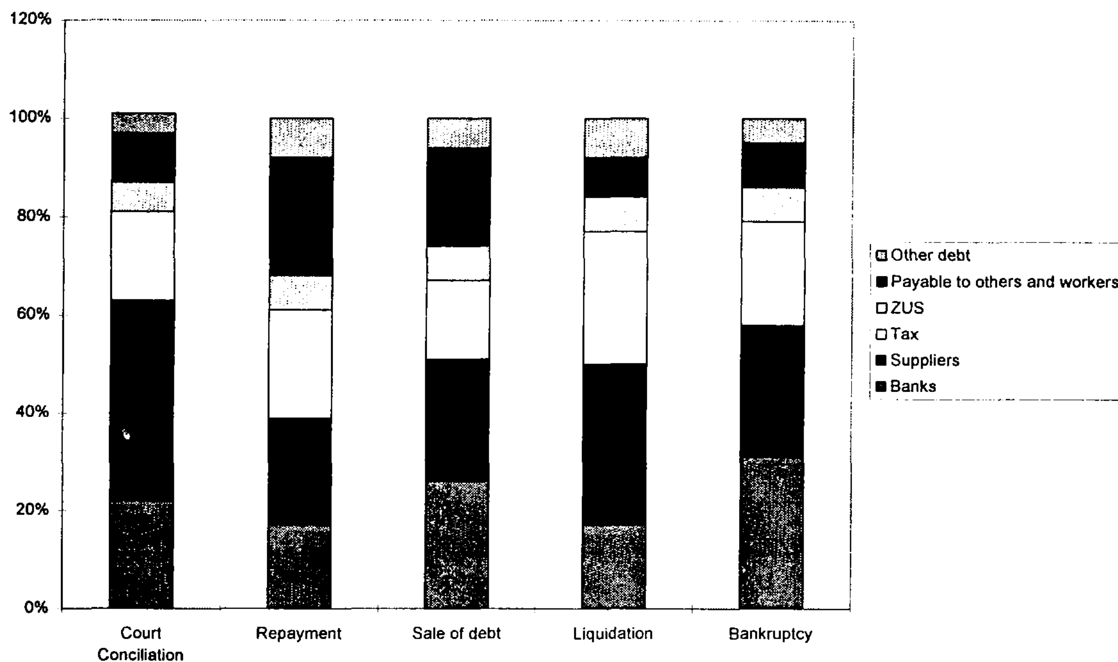


Table 4: Identity of Largest Creditor (66 cases)

	1991	1993
Banks	19	12
Suppliers	35	22
Tax	5	20
ZUS	0	1
Other	7	11

Figure 6: Debt Structure at the End-1992 by Resolution Path



These trends support the findings of other studies[15] that indicate that suppliers are among the first creditors to begin imposing hard budget constraints on firms in transition. As the suppliers themselves are squeezed by market pressures and cutoffs in subsidies, they begin to require payment in cash before they ship goods. State-owned banks also tighten their lending when subject to macroeconomic and market discipline. The biggest remaining source of "softness" in firms' budget constraints during the early stages of reform is likely to be the government, which has great technical and political difficulty

[15] See, for example, Fan and Schaffer (1993).

collecting tax and social insurance payments and thereby forcing financial discipline for problem firms.[16]

Court Conciliation

Design of the Process

Court conciliation (sometimes called "arrangement") is a workout process that dates from 1934. It was adopted simultaneously with the bankruptcy law of that year, and was designed to provide an alternative to liquidation for ailing firms that were able to restructure their debts with their creditors and continue in business. Court conciliation is a rather inflexible process when compared with more modern reorganization processes in mature market economies, and the Poles adopted the bank conciliation process in 1993 in part to avoid the inflexibility of court conciliation.[17] A debtor company can apply for a court conciliation only if it ceased to pay debt service "due to reasons that are exceptional and independent of it ... and insolvency is due to circumstances over which [it] had and could have had no impact."[18] Workouts under court conciliation exclude secured creditors and government creditors (such as tax and social security offices), and thus they cover only trade creditors and bank creditors (to the extent they are not covered by, or choose to forego, security interests). Because the procedure was designed to provide debt relief, the law envisioned only financial terms in the restructuring agreement; operational conditions -- such as changes in employment, investment, or management -- were not expected (although they presumably could be included if all parties agreed). Any agreement must be approved by a two-thirds majority (in terms of value of claims), or four-fifths for write-offs greater than 40 percent. Finally, only parties attending the proceedings are allowed to vote on the proposed agreement. It may be difficult for a debtor with many creditors to assemble the required majority in one place for the vote.

Once the debtor applies for court conciliation, the court must decide within two weeks whether to proceed. If it decides to open a case, the judge appoints a "judge-commissioner" and a "reorganization trustee". Incumbent management stays in control of the firm, supervised by the trustee, but must obtain permission from the judge-commissioner for all business activities outside the normal course. Secured creditors can be barred from foreclosing on assets if such foreclosure would hinder reorganization, and

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[16] The decision which creditor to pay can be an important one in financially distressed companies, sometimes handled exclusively by the Chief Executive. A number of managers in the survey expressed personal gratitude to the head of the local tax office, whithout whose help the enterprise would not have survived.

[17] See Annex 3 for a comparison of the two processes.

[18] Groszek (1993). The enterprise must have been operating for three years, have maintained adequate bookkeeping, and have not been in bankruptcy or prior conciliation within the past five years.

all creditors are barred from filing for bankruptcy or accepting debt repayments outside of a conciliation agreement.

The Process in Action.

Court conciliation lay on the books virtually dormant throughout the socialist period. It was brought to life in 1990 and filings expanded rapidly in 1991 and 1992. However, only a small share of applications led to actual conciliation cases, as most were either rejected by the court or settled out-of-court (Table 5).

Table 5: Applications for Court Conciliation in Poland, 1990-1992

	Applications	Considered of which:	Rejected	Otherwise "dealt with"	Procedure opened
1990	2	2	0	1	1
1991	76	24	8	8	8
1992	688	527	73	356	98

Source: Brol, 1993, p. 63.

Our sample had ten cases of court conciliation. Of these only two were initiated before bank conciliation was adopted as an alternative process on February 3, 1993. It is interesting that court conciliation continued to be used even after bank conciliation emerged as a feasible alternative. The application for conciliation was filed by the debtor. It appears that creditor pressure triggered the filing in about one-half of the cases, while the other half were filed because the debtor hoped to get debt relief or additional working capital (Table 6).

Table 6: What Triggered Court Conciliation?
(in number of firms)

	Most important reason	*One of the three most important*
Attempts or threats by creditors to foreclose on collateral	3	4
Inability of debtor to obtain additional working capital	2	6
Pressure by founding organ to deal with creditors	0	1
Threat by creditor(s) to sell their debt	1	5
Other (debt relief)	3	3
Other (creditor pressure)	1	1

The actual process of conciliation was quite rapid. Our ten cases took on average about six months from initiation to agreement, and another 19 days for the agreement to

take effect. Of the cases that were not appealed, court conciliation took only about 15 percent longer than bank conciliation from initiation to effectiveness.[19] This puts into question the view that court conciliation is necessarily too slow -- a major rationale behind the adoption of the bank conciliation process.

In almost all cases, two or three creditor groups were formed for purposes of negotiations. Small creditors, which held only 2-3 percent of the debt, usually formed a separate group. In contrast to bank conciliation, small creditors in court conciliations were more inclined to vote in favor of proposed agreements than large creditors. While this might be expected, given that they generally got more favorable treatment, small creditors did not react similarly in bank conciliations -- perhaps because they distrusted the objectivity of a process controlled by another creditor. In only one of our 10 cases was a creditors' council created to monitor the implementation of the agreement, and in practice it is unclear who (if anyone) carries out such monitoring. Although government claims are not included in court conciliation agreements, seven of our 10 firms negotiated separate agreements with ZUS (the social security agency).

Financial and Operational Outcomes

What were the outcomes of conciliation in our sample of cases? Our survey was conducted on average about two years after the agreements were signed; it is possible to gauge early impacts, although clearly the story is still unfolding in may of these firms. In terms of financial restructuring, court conciliations provided only for debt relief -- either write-offs or reschedulings (Table 7). There were in practice no debt-equity swaps or new credits as in some bank conciliations. Of the two forms of debt relief, court conciliation agreements had fewer write-offs (on average about 30 percent of debt) than bank conciliation agreements (on average about 60 percent). Small creditors received bigger write-offs than large creditors, but the difference was not as marked as in bank conciliations. However, reschedulings in court conciliations were more generous. On average they gave a grace period of 6 months for small creditors and 7 months for large creditors, more than 50 percent longer than under bank conciliation. The rescheduled loan period was some 2 years for small creditors and 4 1/2 years for large creditors, 100% and 50% longer, respectively, than in the case of bank conciliations. *Indeed, if one computes the net present value of the rescheduled loans for all classes of creditors, it appears that both processes yielded very similar benefits for debtors: about two-thirds of their debt was effectively erased in both processes.*

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[19] Our 62 cases of bank conciliation took on average 118 days from initiation to agreement, and on average 49 more days until effectiveness because of the need to obtain approval from the Ministry of Privatization (Gray and Holle, 1996). In the case of bank conciliation, many agreements were at least partially negotiated before the process officially began, while this is much less likely to have occurred in court conciliation. Thus, it is possible that the two processes were in practice equally rapid.

Table 7: Financial Conditions in Court Conciliation Agreements

	Weak banks		Strong banks		All banks	
Condition	# of cases	% of debt in conciliation	# of cases	% of debt in conciliation	# of cases	% of debt in conciliation
Write-off						
-large creditors	6	30%	1	37%	7	31%
-small creditors	6	8%	2	21%	8	12%
-one category	0		1	80%	1	80%
Increase in maturity of debt: # days between when agreement took effect and:						
-large creditors						
-first payment	6	340	3	328	9	336
-last payment	6	1780	3	1424	9	1662
-small creditors						
-first payment	5	149	3	192	8	165
-last payment	5	777	3	405	8	637
-one category						
-first payment	0		1	457	1	457
-last payment	0		1	1188	1	1188
Immediate partial repayment						
-large creditors	0	0	0	0	0	0
-small creditors	1	3%	0	0	1	3%
-one category	0	0	0	0	0	0
Debt-equity swap	0	0	0	0	0	0
New equity	0	0	0	0	0	0
New bank credit	0	0	0	0	0	0

In contrast to bank conciliation, there is no evidence that enterprises indebted to weak banks were treated more leniently than those indebted to strong banks. Indeed, the opposite was true in our sample, although its size is too small to draw firm conclusions. Also in contrast to bank conciliation, our regression results point to a significant positive relationship between the extent of write-offs and two other variables -- the operating profitability of the firm and its level of indebtedness.[20]

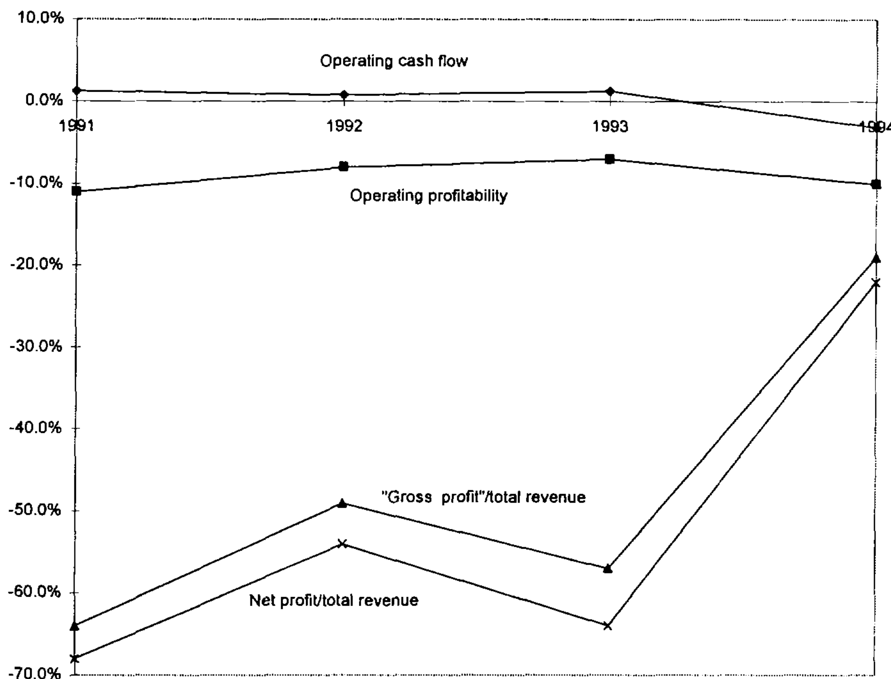
[20] The dependent variable Y was the percentage of total base portfolio debt that was written off. The best-fitting regression equation produced the following statistics for three dependent variables:

	parameter est.	t-statistic	P value
EO91 (1991 operating profits)	0.390	2.35	.10
DA91 (1991 debt/assets ratio)	0.434	3.45	.04
DUMMY (1=weak bank)	-.116	-1.90	.15

Two other dependent variables -- number of employees and number of days agreement was reached before April 30, 1995 -- were insignificant.

In terms of operational outcomes, the results of our small sample are disconcerting. Only in two of the 10 cases does it appear that the rescheduled debt will be properly serviced. The other eight firms continue to face difficulty in debt service. Two had subsequently concluded and two more were trying to conclude a bank conciliation agreement when they were interviewed in mid-1995; of the other four, three were trying to find other means of debt relief, and in one case bankruptcy proceedings have begun. Although reported gross and net profit margins had improved as firms were allowed to record debt write-offs as income,[21] average *operating* profits as a share of *operating* revenues of the ten firms had fallen from -8 percent in 1992 and -7 percent in 1993 to -10 percent in 1994. Clearly the performance of most firms had not improved as a result of the court conciliation.[22]

Figure 7: Profit Measures for Firms in Court Conciliation



In sum, the court conciliation process is inadequate as currently designed, primarily because of its inflexibility -- its exclusion of debt to government, its total emphasis on financial rather than operational restructuring, its high majority voting requirements (particularly in the case of large write-offs), its requirement that creditors be present to vote, and other provisions. But it is not fatally flawed. In a sample of 10 cases

[21] The same practice of recording write-offs as income inflated profit margins in firms subject to bank conciliation as well. See Gray and Holle (1996).

[22] It should be noted, however, that even in the U.S. some 90 percent of Chapter 11 cases eventually end up in liquidation. Saving even ten percent of firms -- and a significantly higher percentage of large firms -- could arguably be viewed as success.

it worked surprisingly speedily as a debt reduction device, although apparently less effectively as a restructuring tool. With amendments in design and greater resources devoted to monitoring agreements, combined with continued efforts to spur market-oriented behavior in banks, the court conciliation process could become a reasonable formal workout process for firms in financial distress.

Bankruptcy

Design of the Process

The Polish bankruptcy process, originally adopted in 1934 and amended in 1990,[23] is modeled on prewar European statutes and is designed as a liquidation process for insolvent firms.[24] A creditor, owner, or manager of a firm can petition the court for a declaration of bankruptcy.[25] The judge is generally supposed to open the case if the petition is complete and if the company has sufficient assets to cover procedural costs.[26] The judge then appoints an official trustee, who takes over management of the firm's assets. All debts immediately fall due, and all creditors are asked to file their claims. The trustee can continue to keep the firm in operation during bankruptcy if needed to preserve the value of company assets. The trustee draws up a balance sheet of the company and publishes a detailed list of debts. Interest stops accruing, except on secured debts, once bankruptcy is declared. Most setoffs of claims are no longer allowed, and the trustee can prohibit any new foreclosures on collateral. The district court sets the level of remuneration of the trustee, based on a recommendation of the bankruptcy judge.[27] The bankruptcy judge can appoint a creditors' council to help manage and dispose of assets, and must do so if 20 percent of creditors so request.

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[23] Regulation of the President of Poland of October 24, 1934 on the Bankruptcy Act as amended, Journal of Laws No. 14/item 87, 1990.

[24] The bankruptcy process does provide the possibility of a conciliation agreement among unsecured creditors, if priority creditors can be fully satisfied and if the firm submits a financial restructuring plan approved by two-thirds of these creditors in value of claims and one-half in number agree. A survey in 1993 found only one instance when such conciliation procedure had been used in the course of bankruptcy. Brol, 1993.

[25] Managers are by law required to file a bankruptcy petition within two weeks from the "debtor's failure to pay his debts" or they become personally liable to the creditors for any losses arising from failure to file (Groszek and Ciesla, 1993). A 1993 study found that this provision was violated regularly, with no consequences for firm managers (Brol, 1993). It is unclear whether any attempt has ever been made to hold a manager liable for failure to petition.

[26] The court has significant discretion as to whether or not to initiate a bankruptcy proceeding. Before deciding to initiate a case, the court can hold hearings and request testimony from the debtor, creditors, and other interested parties, and, in the case of state enterprises, from the workers' council, the founding Ministry, and the State Treasury. Coates and Mirsky, 1995.

[27] Remuneration generally ranges between 2 and 20 times the average salary in Poland per case (Coates and Mirsky, 1995). The trustee also receives reimbursement for all expenses.

The law as now designed has several major deficiencies. First and perhaps foremost, the priority list discourages any active involvement by non-government creditors in the bankruptcy process, because it makes it virtually impossible for banks and other creditors to recover anything.[28] Creditors often express the view that "the government always comes first." In fact, if the government and procedural costs do not consume the entire estate, it is likely that employees' claims will. Second, even with little expectation of recovery, creditors are asked to pay between 5 and 13 percent of the value of their debt as advance payment of court fees.[29] A third deficiency is that the law provides few means for a trustee or judge to void fraudulent transactions made by managers or owners, at the expense of creditors, prior to the bankruptcy filing.[30] Fraudulent transactions are indeed thought to be common,[31] and the legal system must find a way to identify and punish them if the bankruptcy process (or indeed any debt collection process) is to be credible.

The Process in Action

The number of bankruptcy petitions to Polish courts grew steadily in the early 1990s (Figure 8). Although most petitions were considered by the courts, it appears

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[28] The priority given to secured creditors in bankruptcy is extremely confusing (Baer and Gray, 1996). The bankruptcy law provides that secured creditors should be satisfied first, but subject to the rules on priorities of mortgages and liens laid out in the Polish Code of Civil Procedure. Pursuant to the Code of Civil Procedure, secured creditors come far down in priority, below procedural costs, payments to employees, taxes, and rents due on government-owned property. Furthermore, the government has an automatic lien over all property of any party in arrears to the government (for taxes, social security payments, or customs duties). This lien need not be written or formalized in any way to have priority. Since most problem debtors have large arrears to the government, this automatic lien severely impinges on the security provided by any other liens. Finally, non-bank secured creditors are at an extreme disadvantage under current Polish law, because all bank loans, whether or not secured, have priority over other creditors, even if the latter are secured.

According to the bankruptcy law, once claims secured by collateral are satisfied, the remainder of the assets (and any excess of proceeds from the sale of secured property over the value of secured claims) become the bankruptcy estate. This estate is then used to satisfy creditor claims in the priority specified in the bankruptcy law itself. According to this latter bankruptcy-specific priority, bank and trade creditors come behind (1) the costs of the proceedings (which include all amounts due to the court, the receiver, and employees for wages, severance payments, etc.), (2) taxes, and (3) social security contributions.

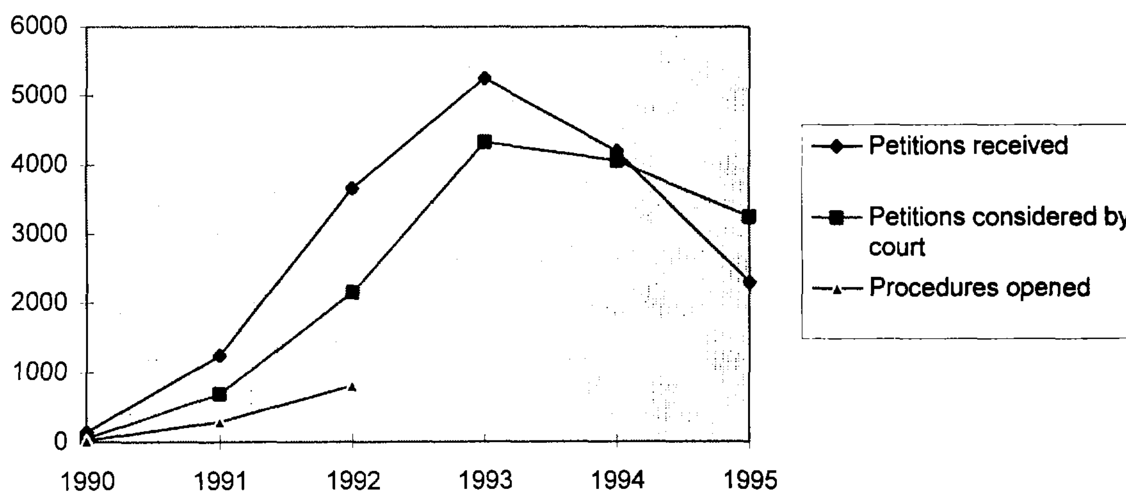
[29] Szlezak, 1993.

[30] The law provides only that *gifts* made within 6 months prior to filing can be voided. It does not extend to sales or other types of contracts (even if they contain an element of gift through underpricing). There is also a possibility to void fraudulent transactions made prior to filing, but such a process is extremely difficult to implement because it requires proof of *intent* to defraud. Furthermore, in 1970 a number of actions, such as purposefully reducing the value of a creditor's claim by paying back selectively or not keeping adequate accounting records, were decriminalized, and this makes it more difficult for judges and trustees to detect and void prior fraudulent actions.

[31] Brol, 1993; Sak and Schiffman, 1994, Coates and Mirsky, 1995.

that more than one half were rejected (in most cases because the petitions were incomplete or assets insufficient to cover costs). Although most petitions and opened cases concerned small private firms, a significant number involved state enterprises (Table 8), either filed directly as bankruptcies or transformed from state enterprise liquidations or court conciliations. Given the poor treatment of secured creditors under priority rules and the requirement for creditors to deposit money for costs up front, it is not surprising that about two-thirds of all cases appear to be filed by the debtor.[32]

Figure 8: Bankruptcy Petitions and Cases by Year, 1990-1995



[32] In 1991 and 1992, 67 and 60 percent of all cases, respectively, were filed by the debtor firm itself. Brol, 1993, p. 63.

Table 8: "**Exit" Process for Polish State-owned Enterprises**

Bankruptcies (pending or completed as of 3-31-94)	602
Liquidations* (cumulative through end-95)	1,289
Of these:	
Completed	332
Converted to bankruptcy	441
Taken over by Rural Property Agency**	51
Pending**	465

* Article 19, State-owned Enterprise Law
Source: Baer and Gray, 1996; Blasczyzk 1995

The implementation of the law is severely hampered in Poland, as in all transition settings, by institutional weakness. The courts are understaffed, underfunded, and undertrained, and they lack support from related professions -- such as trustees, accountants, lawyers, bailiffs, investigators, or prosecutors -- that provide critical information gathering and enforcement functions in more established market economies. A 1993 study of 80 bankruptcy petitions found that the proceedings were begun and completed as expected (with assets being divided among creditors) in only 15 cases.[33] The other petitions were either rejected (because of incompleteness or lack of funds to cover costs) or withdrawn. The study concluded that, while some of the cases were legitimate instances of economic downturn, many were fraudulent in nature. Most assets with any value had been sold or otherwise disappeared before the petition for bankruptcy was filed or considered by the court. However, investigations of possible crimes were extremely rare, presumably in large part because of the absence of resources or information to prosecute cases.

Our 139-firm sample contained 23 enterprises in bankruptcy, which owed debts to eight of the nine commercial banks. As noted in Figure 2, these firms were in considerably worse shape than the other 116 firms, with average operating losses of nearly 50 percent of sales in 1991 and 1992. Creditors were not as passive against these enterprises as against those that later entered bank or court conciliation proceedings. In 19 of the 23 cases, debt collection actions had already been taken before the filing of the bankruptcy petition. The date of filing in our sample ranges from June 1991 to April

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[33] Brol (1993).

1994. Eight cases were filed before the EBRP law was adopted on February 3, 1993, and 6 cases were filed in April, 1994, just before the EBRP's extended deadline for dealing with base portfolio debt. Four of the 23 had previously been in state enterprise liquidation.

Our sample is split evenly between filings by the debtor and filings by creditors. The debtor firm filed in 9 cases and its "founding body" (representing the state treasury as owner) in three. Five cases were filed by a bank creditor, five by a supplier, and one by the tax office. Creditor filings in our sample are much higher than average (see above), in part because of the linkage of our cases with the EBRP and the requirement that banks take action to work out bad debts in EBRP firms.

The filing was protested in three cases, twice by the debtor and once by the founding body. The filing of a protest does not appear to have held the process up significantly. On average the court opened the bankruptcy proceeding three months after the bankruptcy petition was filed; only one case was severely delayed, languishing for 14 and a half months before the court opened the proceeding. A trustee was appointed in all cases immediately upon the opening of the proceeding. In all but one case, the judge appears to have selected the trustee independently; in one case the choice of trustee may have been influenced by incumbent management via the "founding body". The trustee filed a first report on average after three months and made the first disposition of assets a few days later.

Only two of the 23 cases had been completed at the time of our survey (on average more than two years after the court decision to proceed). Trustees in the other 21 cases were asked how long they expected their cases to take in total. Two thought their cases could be completed within 2 years, 11 expected it would take 2-3 years, and 8 thought they needed at least three years. If these expectations are accurate, the average length of a bankruptcy case would be about three years. The most commonly cited reasons for delay were unclear ownership rights -- particularly of real estate (mentioned by 13 firms), and the lack of buyers for the assets (14 firms).

Financial and Operational Outcomes

Although the phenomenon is much less marked than in Hungary,[34] even in Poland it appears that bankruptcy-liquidation can be an avenue for enterprise restructuring in certain cases. Eighty percent of our sample of firms continued to operate as a going concern after bankruptcy had been declared, but only for one year on average. Five of 23 were still in operation when the firms were surveyed in mid-1995. From 1992 to 1994, those firms had seen sales revenues fall by 14 percent (after accounting for inflation), real operating profits fall by 78 percent, and employment fall by 38 percent, but wages for

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[34] Gray, Schlorke, and Szanyi, 1996.

remaining employees had risen by 25 percent in real terms. Three expected improved operating results in 1995, two even operating profits. One company in particular did so well that it settled with its creditors in a bankruptcy conciliation, emerged from bankruptcy, and is now operating under old management.

A major function of bankruptcy is to transfer control over assets to new agents -- or new *private* agents in the case of transition economies. Three-quarters of the assets that had been sold, leased, or transferred by the time of our survey had indeed gone to unaffiliated private parties. In 19 of the 23 cases the trustees had attempted to sell all or part of the firm as a going concern, and it appears that roughly 40 percent of the fixed assets of these firms will survive as part of a going concern.

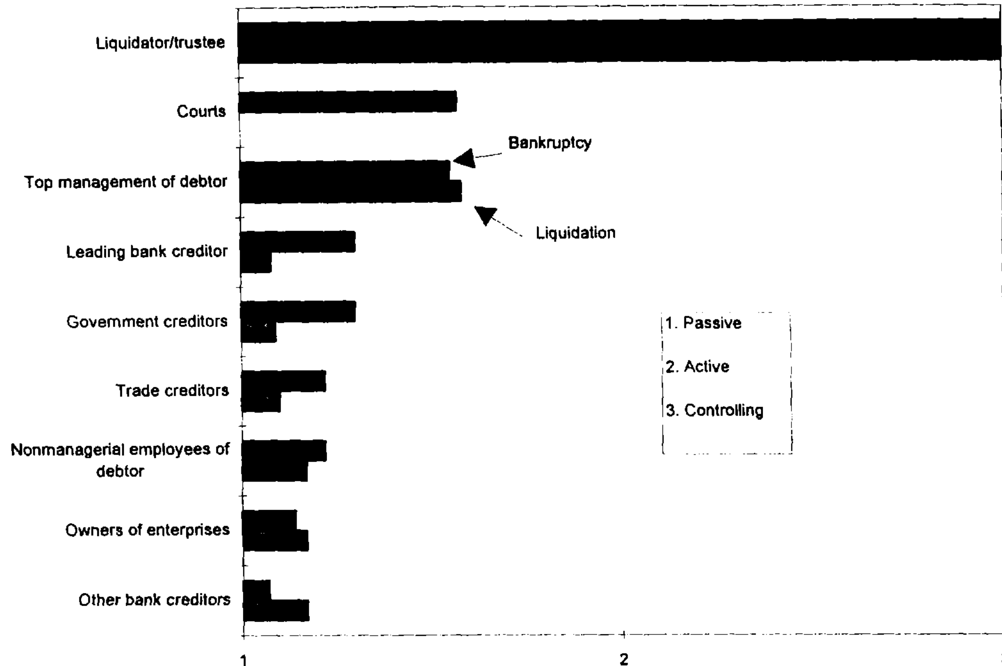
The major losers in Polish bankruptcy are creditors, even secured creditors, because of the many claimants with higher priority. The trustees interviewed anticipated that gross recoveries from asset sales would equal on average about 25 percent of the value of assets in the opening balance sheet. A full 80 percent of these recoveries were expected to be consumed by bankruptcy expenses and severance payments to workers. In all but one case employees' severance claims were expected to be fully satisfied (Table 9). But banks were expected to receive nothing in 10 cases and be fully compensated in none. Suppliers, in the lowest priority class, will recover nothing in three-quarters of all cases, and on average were expected to recover roughly 7 percent of their claims.

Table 9: Schedule of creditor satisfaction in bankruptcy cases

	Percentage of claims satisfied				
Lowest creditor group at least partially satisfied:	Employees	Social insurance	Government	Banks	Suppliers
Employees (N=1)	**70%**	0%	0%	0%	0%
Social Security and Government (N=9)	100%	**32%**	**25%**	0%	0%
Banks (N=6)	96%	39%	34%	**21%**	0%
Suppliers (N=6)	100%	92%	87%	43%	**24%**
Average percentage of claims satisfied	*98%*	*49%*	*43%*	*17%*	*7%*

Bankruptcy is in theory one mechanism through which control rights over a firm shift to its creditors in times of financial distress. As seen in Figure 9, creditors have more involvement in bankruptcy than in state enterprise liquidation but the level of involvement is still less than that of debtor management.

Figure 9: Average Involvement of Various Creditor Groups



What do these results say about the workings of the Polish bankruptcy system? Like court conciliation, it is a flawed but not fatally flawed process. A change in the order of priorities is desperately needed to give creditors an incentive to file and oversee cases. Fortunately, a new collateral law that will eliminate the automatic lien of government and will give secured creditors much higher status is likely to be adopted soon. In addition, a major effort is needed to build institutional capacity in the courts, the trustee profession, and related investigative and prosecutorial arms of government, in order to detect and punish fraud in the bankruptcy process. Poland has a beginning on which to build, but much remains to be done.

State Enterprise Liquidation

Design of the Process

Article 19 of the Polish State Enterprise law provides for the liquidation of state-owned companies.[35] Although this law, adopted in 1981, is a legacy of the socialist legal system, there is no evidence of Article 19 having been used before transition began in 1990. Under Article 19, creditors may initiate the liquidation of a

[35] This should not be confused with Article 37 of the Privatization Law, which provides a privatization route called "privatization through liquidation". Privatization through liquidation is not an exit process in our meaning of the term and is not included in our study.

state-owned borrower by petitioning the governmental entity charged with exercising ownership control (the "founding body"), or the founding body may initiate the procedure (if they obtain the authorization of the Ministries of Privatisation and Finance). The law specifies several criteria that justify (but do not require) a liquidation filing, including inability to pay the obligatory dividend to the state treasury and negative after-tax earnings. Only companies that are still solvent (that is, whose assets exceed their debts) are in theory eligible for this procedure. However, many of the companies in liquidation prove to be insolvent, and many ultimately end up in the bankruptcy courts.

Liquidation is a process controlled by owners and managers. The founding body appoints a trustee charged with drawing up a balance sheet and list of liabilities and selling off the assets in whole or part. There are no restrictions on who may serve as liquidator, and appointment of the incumbent manager as the liquidator has reportedly been quite common. Creditors have means to influence the process. Nevertheless, they may prefer Article 19 liquidation to bankruptcy because the costs of realizing collateral are lower and because liquidation affords an opportunity to neutralize the superpriority of state claims.

The Process in Action

Liquidation under Article 19 has been widely used in Poland since 1990, with almost 1400 firms having entered the process and about 57 percent of these having completed it or been moved into bankruptcy (Table 8). Data on 853 cases filed in 1990-1992 indicate that about three-fourths of the cases are relatively small firms (under 200 employees), and only 9 percent are relatively large (over 500 employees).[36]

Table 10: Liquidations started and completed between 1990 and 1995[37]

Year	Petitions	Refused	Accepted	Liquidations completed	Filings for bankruptcy
1990	58	0	20	0	0
1991	538	24	512	22	18
1992	314	15	322	80	127
1993	237	13	228	108	143
1994	160	4	155	101	25[38]
1995	60	4	52	21	[128][39]
Total	**1367**	**60**	**1289**	**332**	**441[40]**

[36] Groszek and Ciesla, 1993.

[37] Meller, 1996, citing data from the Ministry of Privatisation.

[38] By September 1994.

[39] By inference for the period October 1994 to end 1995.

As can be seen from Table 10, the number of petitions for liquidation per year has been declining since 1991. This probably reflects both the turnaround in the Polish economy and the likelihood that the worst firms have already exited. However, the number of liquidations converting to bankruptcy has been quite steady. This could signal a realization by liquidators that some firms that filed for liquidation have insufficient assets to cover their debts; alternatively, in the absence of careful oversight by creditors, liquidators or managers could conceivably divert some assets of firms in liquidation to new owners, leaving state entities to enter bankruptcy with debts but few assets.

Although the number of new petitions is falling and the number converting to bankruptcies is steady, the backlog of unfinished cases has grown every year. At the beginning of 1996 almost 600 open cases -- already in process over 2 years on average -- still remained to be resolved.

Three previous surveys -- covering 12[41], 26[42], and 22[43] firms, respectively -- looked at the liquidation process in action. The first two looked primarily at what happened to the assets of liquidated firms. They found that most assets were sold, if possible at auction. Moveables were quite easy to sell, real estate much harder. Although discounts were often large, many of the assets were eventually put to use in new private firms, and may employees were able to keep their jobs with the new owners. Creditors were likely to be the major losers in the process. No clear schedule existed in most cases for satisfying debt claims, and many irregularities occurred -- aggravated by the fact that liquidators were in most cases the managers themselves.

The third survey, of 22 firms, looked at a sample of liquidations of relatively small Warsaw-area firms. In contrast with the earlier studies, this survey found few examples of liquidators having a prior relationship with the company.[44] Creditors did not initiate the liquidation in a single case; all cases were initiated by the founding body or company management. In stark contrast to our results (see below), creditors were fully satisfied in 15 of the 22 cases in this survey. It is possible that the outcomes of these 22 cases were significantly better than average outcomes from liquidation in the country as a whole. Not only were all 22 in the Warsaw area (where the administrative infrastructure for liquidation is better), but most companies were service rather than manufacturing firms and were relatively small (with 68 employees on average). We doubt that the

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[40] Blaszczyk, 1995.

[41] Research by J.M. Dobrowski, M. Federowicz and J. Szomburg for the Gdansk Institute for Market Economics, discussed in Groszek/Ciesla, 1993.

[42] Groszek and Ciesla, 1993.

[43] Meller, 1996.

[44] The phenomenon of the manager being appointed liquidator may have been more common in 1991 and 1992 than in later years.

conclusions of this prior study -- that liquidation is a better option for creditors than bankruptcy -- apply in the country as a whole.

Our sample includes 12 cases of state enterprise liquidation. With average operating losses of over 60 percent in 1991 and 1992, these firms were in worse financial situation than firms in any other resolution path. They were also the first to be dealt with. Liquidations began on average in July, 1992,[45] more than 8 months before the average starting date of bankruptcy cases and about 1 1/2 years before the average start of bank conciliation cases. Despite their terrible condition, the enterprises entering liquidation had seen very little pressure from creditors. Only one-sixth had been subject to any debt collection action prior to the beginning of liquidation -- a far lower proportion than firms in other resolution paths. Perhaps this is explained by their early starting date, as creditor passivity was most marked in the beginning years of transition.

Our sample confirms that liquidation is a debtor-driven process. Of the twelve cases in our sample, managers of the debtor firm filed the petition for liquidation in eight cases, the workers' council of the debtor firm in three, and the "founding body" in one. Although respondents reported various reasons for filing for liquidation rather than bankruptcy (Table 11), none of the 12 firms was fully servicing its debts at the time of filing. This, together with the small role played by the founding body in initiating cases, strongly suggests that liquidation has in practice been an alternative mechanism to deal with insolvent companies rather than what it was originally intended to be -- a means for the state to close solvent state enterprises.

Table 11: Reason for placing firm in liquidation rather than bankruptcy

-number of cases

Reason	***Most important reason***	***One of the three most important***
Firm was servicing all its debts	in no case	in no case
Firm had high net assets	2	4
Creditors expected to receive more under liquidation	2	6
Creditors wanted to restructure firm	2	6
Management wanted to restructure firm	3	6
Other	2	2

Our survey reinforces the conclusion of earlier studies that creditors have no real influence over the process. Liquidators were appointed quickly, on average three days after liquidation proceedings began. In three-fourths of all cases the debtor chose the liquidator. In the remaining firms the founding body controlled the selection. In no case did creditors influence the choice of liquidator.

[45] The earliest liquidation filing in our sample was in June 1991, and the latest in January 1995.

The liquidators in our sample were able to move much faster at the beginning of the process than the trustees in our sample of bankruptcy cases, perhaps because liquidators knew the companies better. Liquidators filed a first report in 51 days on average, more than a month faster than bankruptcy trustees. The first disposition of assets occurred eight and a half weeks into the process, as compared to fifteen in bankruptcy cases. But the liquidation process then slowed down, and on average our liquidation cases are expected to take longer to finish than our bankruptcy cases. The five completed cases in our sample took on average more than three years to complete.[46] Liquidators in the seven unfinished cases expect their companies to be in liquidation for four years and eight months on average -- more than 50% longer than average bankruptcy cases. Why is the process in the end so slow? Eleven of twelve liquidators cited the lack of buyers for the assets, and six cited confusion in ownership rights, particularly of real estate. The compensation formula for liquidators may also play a role; because compensation is on a flat-rate monthly basis and is not tied to revenues from asset disposition, liquidators have little incentive to complete the process.[47]

What happens in the interim? Four-fifths of our firms (the same proportion as in bankruptcy) continued to operate as going concerns after liquidation had begun, and one-half were still in operation (far more than in the case of bankruptcy) when the firms were surveyed in mid-1995 -- on average three years after filing. From 1992 to 1994 sales had fallen 49 percent in real terms in these firms, and operating profit (also after accounting for inflation) had fallen by 11 percent. Employment had fallen by 45 percent, but real wages per employee for those still employed had risen by 76 percent.

Outcomes

Liquidation is in part a process of privatization, whether of firms as going concerns or of their assets. Liquidators tried to find buyers of parts of the firms as going concerns in three-quarters of our cases. It appears that nearly 40 percent of our firms' fixed assets will survive as part of a going concern. Insiders of the firms appear to be in subsequent control of about 20 percent of the assets sold, leased or transferred by these firms by mid-1995. That is roughly twice the level of insider privatization as under bankruptcy. As in bankruptcy, the majority of assets (64 percent) were subsequently controlled by non-affiliated private parties.

While liquidation may be an important avenue for privatization, creditors are big losers. They are recovering very little from liquidation in our sample of firms. Liquidators expect gross revenue from asset disposition to equal on average 19 percent of the value of assets in the opening balance sheet. But in eight of our twelve cases for which data are available, liquidation expenses and severance payments are estimated at

[46] The quickest was a little faster than two years, the longest took four years almost to the day.

[47] In the prior study of 22 Warsaw cases, liquidators were paid on average 9 to 16 million zloty per month, a multiple of what bankruptcy trustees typcially receive.

double this amount -- some 38 percent of opening book value. Banks are expected to recover only 6 percent of the value of their claims on average,[48] and suppliers only 3 percent (Table 12). In two-thirds of our cases bank creditors and suppliers are expected to receive nothing.

Table 12: Schedule of creditor satisfaction in liquidation cases
(Percentage of claims satisfied)

Lowest creditor group at least partially satisfied:	Employees	Government	Social Security	Banks	Suppliers
Employees N=3	**93%**	0%	0%	0%	0%
Social Security N=1	100%	**10%**	0%	0%	0%
Government N=4	100%	13%	**11%**	0%	0%
Banks N=1	75%	12%	10%	**12%**	0%
Suppliers N=2	100%	100%	100%	13%	**15%**
Average percentage of claims satisfied	*96%*	*25%*	*23%*	*7%*	*3%*

In sum, while state enterprise liquidation is on paper a means for government owners to close solvent companies, it appears in practice to be used more commonly as a means for debtor management to bypass bankruptcy and maintain control over the disposition of assets of insolvent firms. Because it impedes the ability of creditors to recover their debts, it undercuts the potentially important governance role that creditors can play -- and do play in mature market economies -- over firms in financial distress.

Other Resolution Paths

The other two resolution paths taken by some firms in our sample are repayment and sale of debt. As noted earlier in Figure 2, firms in our sample that repaid their debt or became current on debt service had on average over 1200 employees and zero profits in 1991/92, while firms whose debt was sold were generally small and unprofitable (with average profts of -18 percent).

Repayment

Twenty-two of the firms in our sample were classified as having either fully repaid or become current on their debt to their lead bank. When we took a closer look, we found that 4 of these firms had in fact never been in arrears,[49] and thus only 18

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[48] If the average bank creditor recovers 6 percent of outstanding claims four and a half years after the beginning of the process, the net present value of the creditor's recovery is 2.2 percent of its face value on the day the liquidation procedure began.

[49] These three were presumably included in the base portfolio either by mistake or to shore up the amount of the recapitalization.

actually fit the category (14 having repaid in full and 4 having become current on debt service). Some of these 18 firms repaid as early as 1992, others not until the summer of 1994. On average it took approximately 6 months to clear arrears, starting from the date that payments to the lead bank were resumed. About 80 percent of the amounts repaid went for principal, 20 percent for interest. Repayments were all in money rather than in equity or assets.

While the lead bank was repaid in full, other creditors did not fare as well. Of the 18 firms, four cleared no arrears to trade creditors and 11 cleared them only in part. Five cleared no arrears to government creditors, and nine cleared them only in part.

When asked how they obtained the funds that financed the repayment, five of the 18 firms cited new borrowings from banks or other creditors as the most important source. Although lead banks were not allowed by law to give new credit to firms with debt in their base portfolios, other creditors were not legally barred from extending new credit. If this same ratio of 5:18 were to hold for all firms in the base portfolio, this would imply that over 200 firms paid back old loans with new loans -- arguably not the intention of the EBRP. Two firms disposed of assets to pay back their loans, one received cash support from government, and the other 7 cited operating profits (i.e. retained earnings) as the most important source of funds for repayment.

The 18 firms that repaid were not only better than other firms in our sample at the beginning of the process, but they have fared somewhat better since. Sales revenues rose on average by 1 percent (in real terms) from 1992 to 1994, and operating profits rose 15 percent. The level of outstanding debt dropped by 18 percent. Employment in those firms fell on average by 22 percent during those two years, and the average wage rose 68 percent. This is the only resolution path in our sample with firms that report rising sales and profits.

Sale of Debt

In theory sale of debt is an interesting and innovative alternative to traditional debt collection routes. It allows banks to rid themselves of problem debt without resorting to costly negotiations or judicial procedures, and to put it in the hands of firms or individuals better able to deal with it. There are several hypothetical reasons why such parties might want to purchase bad debt from banks. First, they may be more willing or able than banks to collect the debt. Second, they may be customers of the debtor firm who can use such debt to pay for goods and services. Third, they may wish to swap the debt for equity and take control of the debtor firm. Under any of these scenarios sale of debt can increase financial discipline and improve corporate governance in debtor firms.

In practice, however, sale of debt was perhaps the least successful path of the EBRP. Banks had little incentive to sell their debt. One reason involved taxes: the losses on such sales (that is, the difference between book value and sale price) were not deductible from income for tax purposes, while write-offs of debt under other forms of restructuring were deductible. Thus, a sale of debt for 40 percent of its book value (a high price in such markets) would "cost" the bank as much as a 100 percent write-off of bad debt. Another disincentive was the strong aversion to debt sales by debtors; if the bank thought any continuing relationship with the client was even a remote possibility, they would find it difficult to take a step so disliked by the client.

Not only were the incentives of banks weak, but so were those of potential purchasers. Purchasers faced the same problems as banks with debt collection -- slow judicial procedures and low legal priority under collateral and bankruptcy laws. In addition, the ability to use debt to pay for purchases from debtor firms was extremely limited in practice; although debt could be sold without the consent of the debtor under Polish law, the purchaser of the debt could not use it to pay for goods and services provided by the debtor without the latter's consent. Finally, as noted earlier, the automatic approval for debt-equity swaps envisioned under the EBRP was blocked in practice by the Ministry of Privatisation, making it unlikely that purchasers could gain control of debtor firms.

Our sample included ten cases of debt sale. Only six were successful sales; the other four were unsuccessful attempts. Although the motivations behind the successful cases were not entirely clear, indications are that three were attempts (by employees or competitors) to get control via debt-equity swaps, one involved a customer who wanted to use the debt to pay for purchases from the debtor firm, one was a purchase of debt by local government as a form of subsidy, and one was a buyback of debt at a discount by the debtor itself (not allowed by law but difficult to stop in practice). On average the bank took three and one-half months to complete the sale and received 23 percent of the face value of the debt (with a range from 7 to 59 percent in the six cases). Our survey and related interviews with banks and firms confirmed the view that debt sales are not yet easy-to-use or widely-accepted alternatives to more conventional debt collection routes in Poland.

Summary and Conclusions

The Enterprise and Bank Restructuring Program adopted by the Polish parliament in early 1993 provided numerous avenues for banks to resolve their bad loan problems. An earlier paper surveyed the innovative bank conciliation (i.e. workout) process. This paper has looked at three traditional "exit" processes -- court conciliation, bankruptcy, and state enterprise liquidation, and has briefly touched upon debt repayment and sale of debt as alternatives under the EBRP.

From a broad perspective, many aspects of the EBRP appear positive. The program was innovative in design and was seriously implemented without fraud or corruption. It was an important catalyst in spurring creditors to take action against bad debtors, and there appears to have been rough economic logic in the division of firms among resolution paths. Better off and/or larger firms tended to repay their debt or enter bank conciliation, while weaker and/or smaller firms tended to go into bankruptcy or liquidation.

Looking in greater detail, the traditional exit processes appear to have worked, but with many flaws. Our sample of 10 court conciliation cases were concluded in about six months on average -- about the same as the time required in our bank conciliation cases. Firms in court conciliation received smaller debt write-offs but greater extensions in debt maturity than firms in bank conciliation. On a net present value basis, the extent of debt relief under the two processes looks similar. In contrast to bank conciliation, the extent of write-off in our court conciliation cases was positively correlated with two other economic variables, the operating profitability of the firm and its level of indebtedness. With regard to outcomes, the subsequent performance of firms in court conciliation did not improve, and in 8 of 10 cases they continue to have problems servicing their debt.[50]

Poland's bankruptcy and related legislation has major weaknesses in design and implementation, most notably the low priority given to secured creditors, the institutional weakness of the bankruptcy courts and related professions, and the difficulty that judges and trustees have in identifying and curbing fraudulent behavior. Bankruptcy in inevitably a slow process, and in our sample of 23 cases the process was expected to take on average about 3 years. Creditors have little involvement in the process (but still more then in state enterprise liquidation). They were expected to recover very little of their original claims in our sample of cases (on average 17 and 7 percent for banks and suppliers, respectively), but, again, still more than in state enterprise liquidation.

[50] Although it is still early to judge outcomes, initial indications are that firms in bank conciliation may not have seen much improvement either (Gray and Holle, 1996).

Neither bankruptcy nor court conciliation as currently designed give creditors sufficient control over firms in financial distress.[51] Both could work much better if redesigned, however, and if supported by institutional development in the courts and related professions and by better systems of collateral and debt collection more generally. Court conciliation could be redesigned in several ways to increase flexibility. Government claims could be included in the process. A lower majority could be required for approval of a workout agreement -- not varying with the extent of debt write-offs proposed. All creditors could be allowed to vote (whether or not present). And more financial and operational restructuring options could be available for inclusion in restructuring agreements. Creditors' rights under bankruptcy could be strengthened by rearranging priorities to put secured creditors first, by reducing up-front fees, and by giving courts and trustees greater powers and resources to uncover and punish fraudulent transactions. Any improvements in design need to be complemented, however, by strong economic policies that give banks and other creditors powerful incentives to use these debt collection mechanisms.

State enterprise liquidation is perhaps the most problematic of the three formal processes. It is almost entirely controlled by debtors. In most cases debtor management chooses the trustee -- and in some cases even serves as trustee. In our sample of 12 cases, state enterprise liquidation is proving to be significantly slower than bankruptcy. Firms continue in operation far longer than in the bankruptcy process, and more assets eventually end up under the control of managers and employees of the original firm. It appears that the process, though on paper designed for solvent firms, is often used in practice as a way to get around bankruptcy and keep debtor management in control of assets for as long as possible. Creditors are the big losers. They have no power, and in our sample of cases were expected to recover almost nothing (6 and 3 percent for banks and suppliers, respectively). The "loophole" of state enterprise liquidation needs to be plugged if the other formal processes are to work as intended. It should be strictly limited to solvent firms. If this is not feasible, the process should arguably be eliminated altogether because of the abuse it invites.

The EBRP included a nonbureaucratic market-based alternative to these formal processes -- sale of debt. In practice, however, it appears to have played a very limited role. Few sales were attempted and even fewer concluded. Tax disadvantages and debtor antipathy appears to have undercut banks' incentives to sell, and the difficulty of using debt to "pay" for purchases or swapping debt into equity appears to have undercut potential purchasers' incentives to buy. While a secondary market for debt can in theory be an effective and nonbureaucratic means to increase financial discipline in problem firms, it will take some time -- and probably a change in tax and other rules -- to build such a market in Poland.

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[51] Both appear more successful as avenues to transfer control over assets to new, private parties.

The EBRP also allowed firms to repay or become current on debt and thereby avoid other resolution paths. A large number of firms (about 40 percent) did repay. In the 18 cases that repaid arrears of the 22 in that category in our sample (the other 4 having never been in arrears), almost 40 percent appear to have used retained earnings to repay, while 28 percent appear to have borrowed new money to pay back old debt -- a result not necessarily in accord with the goals of the EBRP.

When looking at the Polish experience, and that of Hungary and other transition economies as well,[52] one could well argue that policymakers should focus on improving traditional and broadly-applicable exit and workout processes rather than adding new ones for selected subsets of firms. The traditional processes -- formal and informal workout processes and bankruptcy -- are needed in any case. Judges need not be heavily involved in all aspects of these processes (and, in the case of workouts, more decentralization is generally better), but some oversight by courts is arguably needed to insure due process in the treatment of all parties. Special alternatives for selected firms -- whether bank conciliation in Poland, "debtor consolidation" in Hungary, or enterprise "jails" elsewhere -- tend to suffer from the same general problem: they lead those firms to expect lenient treatment and thereby create a moral hazard that may stall further restructuring. Our survey has buttressed our belief that Poland has neglected its traditional processes, in part because of its emphasis on bank conciliation. Now that bank conciliation has expired as an option, it should shift its energies to improving these fundamental tools of debt collection and corporate governance.

[52] Gray, Schlorke, and Szanyi (1996), World Bank (1996).

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Annex 1: Data used for bank categorization

Underlying data:

	Category	Equity as a share of risk-weighted assets, 1993[53]	Change in equity as a share of risk-weighted assets 1991 to 1993	Bad loans as a share of loan portfolio 1991	Change in bad loans as a share of loan portfolio 1991 to 1993
Bank 1	weak	-1.2%	-14,0%	31%	+13%
Bank 2	weak	-4.4%	-3.2%	high	large increase
Bank 3	weak/adequate	-6.6%	+2.6%	60%	-38%
Bank 4	adequate/strong	8.5%	+5.1%	41%*	-4%*
Bank 5	strong	21.2%	+17.9%	41%	-13%
Bank 6	strong	strong	privatized	low	privatized
Bank 7	strong	6.6%	+8.3%	28%	-10%
Bank 8	strong	10%**	strongly positive	28%	-3%
Bank 9	strong	strong	privatized	17%	privatized

* Data not available for 1991; 1992 data used instead.

**Data not available for 1993; 1992 data used instead

Rankings:

	Category	Equity as a share of risk-weighted assets, 1993[54]	Change in equity as a share of risk-weighted assets 1991 to 1993[55]	Bad loans as a share of loan portfolio 1991[56]	Change in bad loans as a share of loan portfolio 1991 to 1993[57]	Total
Bank 1	weak	1	1	2	1	5
Bank 2	weak	1	1	1	1	4
Bank 3	weak/ adequate	1	2	1	3	7
Bank 4	adequate/ strong	3	3	1	2	9
Bank 5	strong	3	3	1	3	10
Bank 6	strong	3	3	3	3	12
Bank 7	strong	3	3	2	3	11
Bank 8	strong	3	3	2	2	10
Bank 9	strong	3	3	3	3	12

[53] Excluding recapitalization bonds received at the end of 1993.

[54] Negative = 1; Positive up to 10% = 2; Positive of 10% or more = 3.

[55] Decrease = 1; Increase up to 5% = 2; Increase above 5% = 3.

[56] Over 40% = 1; 20-40% = 2; Below 20% = 3.

[57] Increase = 1; Decrease up to 10% = 2; Decrease of 10% or above = 3.

Annex 2: Logistic Regression Results

A logistic regression was run to test the significance of operating profitability and number of employees in explaining the resolution paths taken by the 139 firms in our sample. The coefficients and their chi-square values are indicated below. The positive coefficients for operating profit and number of employees for paths 1 and 2 indicate that firms with higher operating profits or more employees are clearly more likely to repay or enter bank conciliation than to "exit" via bankruptcy or state enterprise liquidation. The high chi-square values and low P-values confirm that these two variables are highly significant. The chi-square and P values for path 3 are lower, indicating that there is not a highly significant difference between the firms that enter court conciliation and those that exit. (The coefficient for operating profit has a P-value just over 10 percent, however, making it marginally significant.)

Resolution Path: Values *relative* to bankruptcy/liquidation (chi-square, P-values in parentheses)			
	1: Repayment/ good clients (relative to 1)	2: Bank conciliation (relative to 1)	3: Court conciliation (relative to 1)
Intercept	-.77* (2.86, .091)	.05 (.02, .895)	-1.49** (6.08, .014)
Operating profit (EBIT)	5.75** (10.81, .001)	6.33** (19.83, .000)	2.95 (2.70, .101)
Number of employees 1992	.001* (3.72, .054)	.001** (6.55, .011)	.001 (1.20, .273)

* P-value less than 10 percent.

**P-value less than 2 percent.

Annex 3 :

Comparing Poland's Two Formal Workout Processes

	Bank Conciliation	**Court Conciliation**
Legal basis	Law of February 3, 1993	Presidential Decree of October 24, 1934, as amended in 1990
Valid until	March 18, 1996	indefinitely
Pertains to:	majority state-owned companies	all businesses
Application made by:	Debtor	Debtor
Application made to:	Bank holding at least 20% of the debt of the debtor; 10% if that debt is larger than one billion old zloties	District Court of the debtor
Liabilities excluded	social insurance (ZUS), wage claims, personal withholding taxes payable by firm, secured creditors	all those excluded in bank conciliation plus taxes, fines and fees to government authorities
Secured creditors	can either take part in agreement or accept security in full satisfaction of their claim.	same
List of creditors in theory put together by:	Debtor	Debtor
List of creditors in practice put together by:	Bank	Judge
Restructuring Plan in theory prepared by:	Debtor	Debtor
Restructuring Plan in practice prepared by:	Bank	Unknown
Debt-equity swap	encouraged	allowed
Voting	all creditors, whether at meeting or not	all creditors at meeting, minimum 50% for quorum
Required majority	Creditors with 50% of claims; tax office has to vote with lead bank	Creditors with two-thirds of claims, or four-fifths if write-off larger than 40%
Effectiveness	After signature from Ministry of Privatization	After court approval
Supervision by	Creditors' council	Trustee
chosen by:	Creditors' assembly	Creditors' assembly
In case of non-compliance	Bank can either reimburse other creditors for their losses or apply to court for agreement to be unwound	A creditor or the trustee can apply to the court, which can then hold a trial to unwind the agreement.

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