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RESEARCH ARTICLE

# Unprotected Consumers in the Digital Age: The Consumer-creditors of Bankrupt, Abandoned, Defunct and of Zombie Companies

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The aim of this article<sup>1</sup> is to draw the attention of comparative scholars, researchers and policy-makers to the inferior position of consumer-creditors in bankruptcy proceedings, a topic that escaped attention during the development of financial protection of consumers in Europe. Consumers may become creditors if they prepay certain goods or services that remain undelivered following bankruptcy of a retailer or service-provider. The problem that results is that consumer-creditors are treated as unsecured creditors in bankruptcy law, who rank very low on the priority ladder and are doomed to recover only a small fraction of their claims, if anything at all.

In order to fill the vacuum, the article attempts to map the real dimensions of the consumer-creditor problem first by outlining the spectrum of bankruptcy cases involving consumer-creditors and the threats to consumers inherent to abandoned and defunct companies that are usually left without assets creditors could collect upon. This includes case studies of major recent bankruptcies caused by appearance of new technologies (e.g., the collapse of UK Farepak due to appearance of Internet-based competitors) and linked abuses (web-fraudulent schemes).

The second part of the article provides an overview of the regulatory responses, ranging from the prescriptive approach of US law implementing limited high priority to consumer-creditors in bankruptcy proceedings in the 1970s, the 2016 multi-pronged proposals of the UK Law Commission, to the specific regulatory responses of selected post-socialist systems, like the blocked accounts introduced by Croatia and Serbia, the forced deletions of Hungary and the special tax imposed in Slovakia.

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**Keywords:** Consumer creditor; bankruptcy proceedings; abandoned and zombie companies; bankruptcy statutory priority; credit card chargebacks; digital age

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The UK Law Commission:

*“Consumers, who are classed as unsecured creditors [in bankruptcy], are very near the bottom of the list for repayment and frequently receive nothing. Consumers are also often unaware of the legal situation, and in some cases, conflicting information from administrators further confuses the situation.”*<sup>2</sup>

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<sup>1</sup> The article was also presented at the International Conference “The Responsible Consumer in the Digital Age. International and Nordic Perspectives on Financial Consumer Protection”, organized in 2018 by the Centre for Enterprise Liability, Faculty of Law, University of Copenhagen.

<sup>2</sup> Quoted from the webpage of the UK Law Commission, Consumer Prepayments on Retailer Insolvency, Project website at <http://www.lawcom.gov.uk/project/consumer-prepayments-on-retailer-insolvency/>. Accessed 19 Jan. 2019. More documents were produced as part of the process. For our purposes the following are of relevance: 1. Consumer Prepayments on Retailer Insolvency No. 368 (2016) (hereinafter: UK Law Commission Report 2016); 2. Consumer Prepayments on Retailer Insolvency – Summary (2016) (hereinafter: UK Law Commission 2016 Report Summary); 3. Consumer Prepayments on Retailer Insolvency – Consultation Paper No. 221 (2015) [hereinafter: UK Law Commission 2015 Consultation Paper]; and 4. Consumer Prepayments on Retailer Insolvency – Consultation Paper, Executive Summary No. 221 2015 (hereinafter: UK Law Commission Executive Summary 2015).

## 1. The Problem Stated

### 1.1. Who is the Consumer-Creditor and Why does He Deserve Special Protection?

There are numerous situations in which a consumer may unwittingly turn into a creditor in bankruptcy<sup>3</sup> proceedings, independent of which jurisdiction is observed. In fact, many of us might have already lost money that was paid to a retailer for certain goods or services to be delivered in the future, because the retailer or supplier of services went bankrupt.

The key problem surrounding modern bankruptcy systems is that consumers become unsecured creditors in bankruptcy proceedings, who rank at the bottom of the hierarchical ranking of bankruptcy law; below more classes of preferential<sup>4</sup> and the claims of secured creditors and above the holders of equity (i.e., shareholders). As the distribution of the bankruptcy debtor's (retailer's or service provider's) assets (estate) are distributed in the ranking set by bankruptcy law, unsecured creditors get paid only if all of the higher-ranking classes have first been paid in full. Usually, very little is left to unsecured creditors that represent the most numerous class of creditors with substantial (often the largest pool of) claims. Consequently, the consumers of failed retailers share the fate of large claimants, such as the public utilities, most of the suppliers, or such wages and other employee benefits that do not have a preferential status. Additionally, as unsecured creditors are treated equally (*pari passu*), they are entitled to what was left in proportion to their claims. As a result, consumer-creditors get very little or nothing.

Non-bankruptcy protections could also be taken into consideration, as consumers could sue based on general contract or tort law. Yet, even if they prevail in court, their claims would still rank as unsecured claims in bankruptcy proceedings. Therefore, in many cases it does not pay off to litigate. Another problem is, as the UK Law Commission noted, "[...] consumers are also often unaware of the legal situation, and in some cases, conflicting information from administrators further confuses the situation."<sup>5</sup> Consumers may not have the resources, time and even the courage to participate in bankruptcy proceedings either. As in most cases their individual claims are relatively small, it would not even pay to devote time and energy to protracted bankruptcy proceedings.

These may also be the reasons why the problem has been noted by lawmakers, though the tens of thousands of small claims can amount to a systemic risk and may become even a political issue – as it occurred during the 2006 collapse of the UK savings club Farepak that “*was particularly emotive as thousands of financially vulnerable consumers stood to lose nearly a year’s worth of Christmas savings.*”<sup>6</sup>

Irrespective of the fact that most legal systems have no special cure for consumer-creditors today, the problem is far from being limited to those few jurisdictions that have already reacted with some tools offered by law. The United States is one of the countries that mobilized law to tackle this specific problem. The US Congressional Report from 1977, described the central issues surrounding the problem of consumer-creditors as follows:

*“A consumer [who] pays money on a law-away plan<sup>7</sup> or as a deposit on merchandise, or that buys a service contract or a contract for lessons or a gym membership, is a general unsecured creditor of the business to which he has given money. Very few consumers are aware of their status as general unsecured creditors. If the merchant involved files under the bankruptcy laws, the consumer is usually left holding the bag. Though he assumed his deposit was tantamount to a trust fund, he gets nothing from the estate of the debtor, because the assets available provide little return to unsecured creditors.*

<sup>3</sup> As the English legal terminology differs radically in the jurisdictions covered as far as bankruptcy/insolvency law is concerned, this paper will use the term ‘**bankruptcy**’ and ‘**bankruptcy proceedings**’ to refer to all kinds of bankruptcy/insolvency proceedings. This coincides with US terminology, which is one of the main jurisdictions herein. The reader is well-advised to note that therefore the term ‘bankruptcy’ herein is not limited to bankruptcy proceedings of consumers, what otherwise would be the case under UK law and other systems that have taken over the UK nomenclature. Likewise, ‘insolvency’ will not be limited to bankruptcy proceedings of companies only.

<sup>4</sup> The topmost class of preferential claims, the designation of which varies from jurisdiction to jurisdiction, normally includes various taxes and duties payable to the government, wages and other employee benefits (typically up to a predefined level), and the costs of bankruptcy proceedings (e.g., court fees, bankruptcy practitioner and expert remuneration).

<sup>5</sup> Quoted from the project’s website page. See n 1. Accessed 19 Jan. 2019.

<sup>6</sup> See n 1, UK Law Commission Report 2016, para 1.4., page 1.

<sup>7</sup> Black’s Law Dictionary defines layaways as follows: “*The seller sets the goods aside and agrees to sell them to the consumer at an agreed price in the future. The consumer deposits with the seller some portion of the price of the goods, and may agree to other conditions with the seller, such as progress payments. The consumer receives the goods once the full purchase price has been paid.*” Bryan A. Garner (editor-in-chief), BLACK’S LAW DICTIONARY (Deluxe 7<sup>th</sup> ed., 1999).

*Because of his ignorance and his inability to bargain with a retail merchant, he is unable to do a credit investigation or obtain special terms from the merchant, as a true creditor may do.*<sup>8</sup>

Of all bankruptcy proceedings, liquidations present the real threats to consumer-creditors and the discussion will primarily be related to them. Although consumer-creditors may lose also in reorganization (restructuring) proceedings, their fate in the context of such proceedings is left to a separate study because a successful reorganization means survival with meaningful property remaining for the debtor. Yet, many of the findings of this paper apply to them *mutatis mutandis*.

The above considerations *a fortiori* apply to abandoned and defunct businesses, which are usually left without assets that creditors could collect upon. Consequently, the position of consumer-creditors in their case is even worse than in bankruptcy proceedings, whereas a fair chance of recovering a fraction of their claims exists, especially in case of successful restructuring proceedings. In most instances, the legal system cannot do anything else, but to strike off abandoned and defunct businesses from company registers, formally ending their agony and those of linked creditors.

Zombie companies are companies that merely vegetate rather than grow and thus could go bankrupt or be abandoned any time. Or as put by Hugh Pym, chief economics correspondent of BBC News in 2012 “... ‘zombie companies’ make enough money to survive, but not enough to invest in new opportunities.”<sup>9</sup> These deserve attention in this context as potential threats to consumer creditors, because they may easily become bankrupt with any major crisis. No analysis aiming to assess the real dimensions of the consumer-creditor problem focused upon in this paper should therefore leave them out of the scope.

## **1.2. Why are the Existing Protections Insufficient?**

Admittedly, *some* protection is available to consumer-creditors in every system. The issue is rather that they are often inadequate.

For example, whenever bank cards are used, at least in the case of Visa and MasterCard as the most frequently used systems in Europe, the rules on chargebacks may ensure recovery for consumers relatively quickly and cheaply. Besides the dilemma whether consumers are properly informed about these possibilities,<sup>10</sup> it is an issue that chargebacks often provide limited relief only and not to all affected consumers. This occurs because a card chargeback is actually a “*voluntary protection provided by card schemes*<sup>11</sup> [...] which allows the card issuer to ask the merchant acquirer to reverse a payment made by card.”<sup>12</sup> That the voluntary chargeback is insufficient is strongly supported by the fact that, for example, in the UK, there is an additional layer of statutory protection of consumers provided by section 75 of the Consumer Credit Act 1974, which is however subject to a minimum and maximum monetary limit.<sup>13</sup> In other words, while the statutory scheme is limited monetarily, the card schemes are subject to rules set by the scheme companies themselves and do not grant protection in each and every situation.<sup>14</sup>

The sums that have been or may be lost by consumers when their retailers go bankrupt and which have not been made by cards or are not recoverable through chargebacks however, are hardly negligible.

<sup>8</sup> HR Report No. 595, 95 Cong, 1<sup>st</sup> Sess 188 (1977). The above excerpt is quoted as well by William T. Vukowich, ‘Consumer and Fraud Victim’s Claims in Bankruptcy: Constructive Trusts and the Consumer Priority’ (1988) 1988 Norton Annual Survey of BankrL, at 2. [Hereinafter: Vukowich 1988].

<sup>9</sup> The term ‘zombie company’ is still primarily a term used in media rather than legal scholarship yet it is being accepted by the latter as well. Moreover, it properly expresses the gist of the problem it is attached to. See e.g. Hugh Pym, ‘Zombie’ companies eating away at economic growth,’ (13 Nov. 2012) BBC News, article available at <<https://www.bbc.com/news/business-20262282>>; accessed 13 October 2018. For a law review using the term see e.g. Xuan-Thao Nguyen, ‘Zombie Patents and Zombie Companies with Patents’ (2017) 69 Fla. L. Rev. 1147. See also OECD, Breaking the Shackles: Zombie Firms, Weak Banks and Depressed Restructuring in Europe, Economics Department Working Papers No. 1433 (16 Nov. 2017).

<sup>10</sup> The UK Law Commission Report 2016, for example, noted that “*the chargeback scheme needs to be better known and understood.*” Ibid para 7.3., at 63.

<sup>11</sup> UK Law Commission Report 2016, para 7.2., at 62.

<sup>12</sup> Ibid para 7.9(2), at 64.

<sup>13</sup> Ibid table 3, at 65.

<sup>14</sup> Besides the above-mentioned, the other key differences between the two avenues of consumer protection are: 1/ while chargebacks are voluntary and contained in the scheme of Mastercard and Visa, the other has a statutory basis; 2/ while chargebacks apply to both, credit and debit cards, the statutory scheme provides protection only for credit cards; 3/ while in case of chargebacks only the amount paid by the card can be recovered, the other avenue allows even for recovery of damages (consequential loss); 4/ while in case of chargebacks the claim must be made normally within 120 days of the day when delivery was expected, the statutory scheme provides for a six years (Scotland: 5 years) limitation, and last but not least, 5/ the bearer of loss in case retailer insolvency is not the same (in none is the consumer, however). Ibid table 3 at 65.

Quantitative data necessary to realize that is unfortunately lacking, but some exceptions, such as the recent UK Law Commission Report from 2016 clearly confirms that. For example, in the 2006 collapse of the retailer Farepak, £37 million of about 100,000 consumers was at stake.<sup>15</sup>

The Law Commission added that similar or even severer problems could be generated by new technologies without specifying what exactly was of concern.<sup>16</sup> One might refer to Blockchain-based systems spreading while this paper is being written, of which cryptocurrencies are well-known examples. These often, indeed, involve consumers as the “clients”. The key problem relating to its use is that their exact legal status in case of the cryptocurrency scheme’s collapse is not clear; opinions are divided on whether they should be treated as creditors or rather as owners. If the position of the US Securities and Exchange Commission (SEC) would prevail, they would be treated as ‘investors’ in the equity of the scheme issuing certain types of cryptocurrencies.<sup>17</sup> To put it differently, they would be treated as owners. Should that be the case, the consumer-investors would be treated as equity holders (owners), who rank in bankruptcy proceedings even after unsecured creditors on the last rung of hierarchical ladder of bankruptcy law.

Lastly, with the exception of the claims recoverable through chargebacks, the position of consumer-creditors is contingent on how efficient the administration of bankruptcy proceedings is in a country. Although the ‘4–5 cents recovery on a dollar claim on average’ is a formula<sup>18</sup> that may be applied *mutatis mutandis* for all jurisdictions covered herein,<sup>19</sup> the outcome might be different in less developed bankruptcy systems. Due to inefficient administration of bankruptcy proceedings, as in China and in many post-socialist CEE jurisdictions, consumer-creditors often have zero recoveries compared to more developed and efficient bankruptcy systems.

These issues confirm that it is essential to discuss whether special protections for consumer-creditors would be justified.

### 1.3. Why is the Consumer-Creditor Problem Escaping Attention?

The lack of interest in the topic is due to a number of factors that vary from state to state. These include lack of empirical data, path dependency separating rather than connecting bankruptcy and consumer law scholars, as well as overarching policies (e.g., higher importance afforded to employee claims).<sup>20</sup> Even where noted, the problem did not reach the threshold necessary for triggering regulatory responses. In this respect, it is sufficient to examine the most esteemed works of internationally renowned scholars, either of bankruptcy<sup>21</sup> or consumer protection law<sup>22</sup> to see that there are no discussions on consumer-creditors’ treatment in bankruptcy.

What may be concluded nevertheless is that where the inferior and insecure position of consumer-creditors was noted, it occurred because the retailers or service-providers of prepaying consumers went bankrupt. Where dealt with, it was a topic for bankruptcy, rather than consumer protection scholars.

<sup>15</sup> Ibid para 5.1., at 44.

<sup>16</sup> Ibid para 7.3., at 62.

<sup>17</sup> SEC Release No. 81207 of 25 July 2017, Report of Investigation Pursuant to Section 21(a) of the Securities Exchange Act of 1934: the DAO. The DAO was a German unincorporated entity which sold 1.15 billion DAO tokens in April and May 2016 for a total of \$ 150 million. The Blockchain-based system was, however, hacked on 17 June 2016, when an unknown hacker (attacker) diverted about one-third of DAO tokens to an address controlled by the hacker.

<sup>18</sup> See JS Ziegel, ‘the New Personal Property Security Regimes – Have we Gone too Far?’ [1990] 28(4) Alberta LRev 739. (The article is based on the Canadian Ziegel-Garton study from 1988, focusing on business bankruptcies in Toronto industrial zone, and found that while on average unsecured creditors recover four to five cents on a dollar, the recovery of secured creditors was about 45 cents.)

<sup>19</sup> As far as the UK is concerned, as per the data of the Society of Practitioners of Insolvency (data from 1997–98), “on average 75 per cent of cases return nothing to unsecured creditors and in only 2 per cent of cases can they expect to receive 100 per cent returns.” Cited by Gerard McCormack, *Secured Credit under English and American Law* (Cambridge University Press 2004), at 7. This was confirmed in the UK Law Commission Report 2016 which stated that “returns through the statutory hierarchy of payments on insolvency are usually derisory.” See UK Law Commission Report 2016, para 7.1., at 63.

<sup>20</sup> In Europe generally, employee claims rank high on the bankruptcy hierarchy of priorities. This applies even to the most secured creditor-favouring UK system. This policy is then properly reflected in the Law Commission 2016 Report, Recommendation 4a, which proposes (as one of the possible protections) affording of a preferential ranking position to consumer-creditors, which would rank below the claims of employees yet above those of holders of floating charges (i.e., the most important secured creditors). UK Law Commission Report 2016, Recommendation 4a, at 116.

<sup>21</sup> Wood, one of the leading and internationally renowned English commercial lawyers, talking of the priority conflict of secured creditors with the main classes of unsecured preferential creditors does not even mention consumers; lists only the costs of enforcement of a security, taxes, employee wages and benefits, claims in tort for injury and death and environmental clean-up costs. Philip R Wood, *Comparative Law of Security Interests and Title Finance* (2<sup>nd</sup> edn, Sweet & Maxwell, 2007), para 14–033.

<sup>22</sup> See e.g. Hans-W Micklitz, Jules Stuyck and Evelyne Terryn (gen. eds) with Dimitri Droskout (coord. ed), *Cases, Materials and Text on Consumer Law* (1<sup>st</sup> ed, Hart Publishing, 2010).

Talking of the disinterest, especially in continental European jurisdictions, it is important to underline the intensive bankruptcy stigma as well.<sup>23</sup> The pervasive impact of the bankruptcy stigma was mentioned by the EU Commission many times, but not related to consumer-creditors, for example in its Communications from 2004, 2007 and 2008, as well as in its Recommendation of 2014.<sup>24</sup> Bankruptcy stigma is a multi-faceted phenomenon that, among others, affects how efficiently a bankruptcy system works in a country, which impacts the recoveries of consumer-creditors.

Furthermore, it also affects how citizens and businessmen think of bankruptcy as a risk corollary to doing business and what their attitude is towards their bankrupt business partners, including their directors and managers. It is due to the intense stigma that suppliers may cease doing business with a company that becomes or has once been declared bankrupt because they erroneously presume that if a company has once become bankrupt, its directors and managers had allowed that to happen, the same is doomed to reoccur in the future as well.<sup>25</sup>

The intense stigma and the corollary negative perception of bankruptcy should be attributed as well that businessmen – who as ‘creditors’ are supposed to be key players in bankruptcy – refuse to participate in bankruptcy proceedings. Among others, they resist to cooperate with the insolvency practitioner and the tools available to the bankruptcy court to compel them are very limited. For example, in Hungary, they often refuse to hand over the financial reports and disclose key data to the bankruptcy practitioner or they fulfil these duties with substantial delays or incompletely.<sup>26</sup> Yet, as they are necessary for the administration of bankruptcy cases from the start to the end of the proceedings, the price of the subsequent harm and damages are then paid by the creditors, for whom the protection of bankruptcy law is in existence.

These concerns were referred to by the EU Commission, which noted: *“as part of the general lack of societal appreciation and understanding of entrepreneurship, business distress or even business failure is not yet sufficiently understood as a normal economic development and an opportunity for a new start.”*<sup>27</sup> As a consequence of the negative perception of bankruptcy, bankruptcy law is not necessarily among the most favoured subject in law schools and among scholars on the Old Continent. Furthermore, topics that stretch over bankruptcy and consumer law seem to have escaped attention partly because bankruptcy law scholars themselves rarely venture into domains that cross the boundaries of the rather technical bankruptcy law. It is interesting that, for example, bankruptcy-related publications only briefly mention the negative impact of bankruptcy stigma (if at all) and even then, they do not discuss it, given that ‘bankruptcy stigma’ is an interdisciplinary topic more in the bailiwick of sociologists and social anthropologists.<sup>28</sup>

<sup>23</sup> On bankruptcy stigma generally see Tibor Tajti, ‘Bankruptcy Stigma and the Second Chance Policy: The Impact of Bankruptcy Stigma on Business Restructurings in China, Europe and the United States’ (2017) 6(1–2) China-EU LJ, at 1.

<sup>24</sup> See, Commission communication of 1st of October 2004 Community guidelines on State aid for rescuing and restructuring firms in difficulty (2004) OJ 244, p 2–17; Commission communication of 5 October 2007 Overcoming the stigma of business failure – for a second chance policy – Implementing the Lisbon Partnership for Growth and Jobs (COM 2007, 584); Commission Communication of 25 June 2008, Think Small First” – A Small Business Act for Europe (COM 2008, 394) and Commission Recommendation of 12 March 2014 on a new approach to business failure and insolvency (2014) OJ L 74/65.

<sup>25</sup> As per the EU Commission 2007 communication, 47% of citizen would be reluctant to order from a previously failed Business and 51% would never invest in businesses in financial difficulties. The negative consequences (stigma) reaches even the family members in 25% of cases and in about 15% of cases leads to relationship breakdown. In the end, as a result of the very intense stigma (in particular in Continental European countries), only a fraction of failed entrepreneurs makes a second start. Ibid 2007 EU Commission Communication, at 4.

<sup>26</sup> László Juhász, a Hungarian bankruptcy scholar, found it important to mention in his two-volume treatise that „[i]n practice, directors and managers [of insolvent businesses] often fulfill their statutory duties with delays and incompletely.” László Juhász, *A magyar fizetésképtelenségi jog kézikönyve* (Novotni Publishing, Miskolc, 2014), at 444. Additionally, “insolvency practitioners (trustees) often complain that they have no legal tools for finding the assets of the bankruptcy debtors because of why [one of the latest amendments of] the Bankruptcy Act empowered them to enter the premises of the debtor to check its property.” Ibid at 445.

<sup>27</sup> Ibid at 3.

<sup>28</sup> As far as Germany is concerned, it is worth quoting the caveat of Reinhard Bork, who wrote that although “[i]t may be tempting to disregard this factor [i.e., the stigma] as non-serious, but any earnest attempt to construct an efficient [bankruptcy] restructuring law must take it into account until there is evidence of a wide-ranging and sustained change in popular mentality.” See Reinhard Bork, *Rescuing Companies in England And Germany* (2012, Oxford University Press), para 2.12. Similar concerns were expressed by Gerard McCormack related to the UK and Europe generally: “On the stigma’ point, it is very difficult to find hard empirical evidence but within Europe as a whole, including the UK, there is certainly the opinion that stigma exists and that this works as a deterrent to entrepreneurial initiative.” See G McCormack, ‘Apples and Oranges? Corporate Rescue and Functional Convergence in the US and UK’ (2009) 18 Int. Insolv. Rev. 109, 114.

## **1.4. Roadmap to the Article: Aims and Goals, Methodology Issues and Limitations**

### **1.4.1. Aims and Goals**

As pointed out above, the aim of this paper is to draw the attention, both of comparative scholars and policy makers to the inferior position of consumer-creditors in the context of bankruptcy proceedings. Instead of vouching for legislative action on the level, for example, of the European Union, the intention is rather to explain why first targeted empirical research is needed at this stage.

To support the claim that consumer-creditors deserve more attention, the article illustrates not only the main regulatory responses (in force or proposed) offered by contemporary comparative law, but also provides a selected number of empirical case studies. In referring to these case studies, it is suggested that the problem is not only a contemporary one, but also a problem whose dimensions go beyond our presumptions and deserve closer attention.

As far as the empirical case studies are concerned, they represent a variety of empirical evidences, ranging from bankruptcy of retailers, caused by the appearance of Internet-based competitors to abandoned condominium construction projects: each linked by the same insecure and inferior position into which consumer-creditors are pushed by the collapse. In addition, the current regulatory responses are also discussed, alongside with the mentioned recommendations of the UK Law Commission from 2016. These readily prove the very existence and the depth of the problem.

For this reason, the central part of the article is divided into two parts: the first containing the case studies, including the findings of various reports, the facts of available court cases and further empirical evidences from media or repositories of consumer protection agencies. The second part focuses on the present and planned (UK) regulatory reactions and the methods with which the problems and phenomena have been approached in the examined jurisdictions.

This requires a cautious step-by-step approach, starting with empirical research, because the main reasons why businesses go bankrupt or are on the verge of bankruptcy in great numbers differ in Europe. While the 2016 UK Law Commission report points primarily to conventional retailers going bankrupt, due to the appearance of Internet-based rivals and other faster changing technologies, in the former socialist states of Central and Eastern Europe, this is related to other reasons as well, which link to the uncompleted structural reforms, lack of business experience, incapacity to deal with the challenges of globalization, dysfunctional enforcement and bankruptcy systems, and corruption. The causes, consequences and modalities of the consumer-creditor problem, in other words, significantly differ on the Old Continent. The problem is present everywhere, but not exactly in the same form.

### **1.4.2. The Legal Systems within the Purview of the Article**

Considering these differences and referring to the goal of providing an overview of the problem not limited to a few major jurisdictions only, the paper uniquely focuses not only on the UK and the US as two of the most developed legal systems in this respect, but also on China and examples from a selected number of Central and Eastern European countries. The juxtaposition of these systems aims to address the differences, including the existence of idiosyncratic problems and solutions.

The selection of jurisdictions was motivated by the following factors. First, the US was chosen, because it is country where special rules were introduced for the protection of consumer-creditors in the context of bankruptcy already in the 1970s; a policy change that resulted from a series of scandals and concomitant investigations. In Europe, a similar in-depth and comprehensive empirical studies occurred only in 2015 with the UK Law Commission Project and the recommendations that are awaiting legislative responses. The difference is that while the 2016 UK project was primarily driven by bankruptcies and problems generated by new technologies, the US encounter with the problem in the 1970s was not. For emerging economies, which are exposed today not only to challenges posed by technological changes, the 'hard-copy' era experiences remain of equal importance. This justifies taking into consideration the US of the 1970s.

Secondly, another significant point was what materials were available in English language. In this respect, besides sources from the UK and the US, the English media reports on Chinese developments and the increasing number of English language sources on Chinese law were of equal relevance. Media reports devoted to China today are dominated by information on the over-indebtedness of a large portion of Chinese population (essentially the credit card-users), as well as the systemic problem generated by the significant number of zombie companies.

Thirdly, the decision to elaborate on the few Central and Eastern European systems (i.e., Croatia, Hungary, and Serbia) is motivated by the fact that the author of this paper is proficient in the languages spoken in

these countries. Although some materials are available in English, the majority of the materials exists in the respective native languages only.

### 1.4.3. Methodology Issues, Limitations

The reach of this paper is limited however, and not only due to the language proficiency of the author. First and foremost, the literature on the problem of consumer-creditors is extremely scarce. This includes even the UK and the US, which correspond to the systems where scholars have covered the problems of consumer-creditors the most. For example, Sweden also passed laws aiming at the protection of consumer-creditors about a decade ago and is a country where the English language is widely spoken by scholars, yet no English sources could have been found specifically on how this jurisdiction resolved the problems of consumer-creditors.

In Hungary, Croatia or Serbia, scholarly papers, and empirical studies could rarely be found on topics from the domain of bankruptcy law, which entails that the problem of consumer-creditors has not been compelling yet. This applies even to publications in the local languages.

In this respect, it is important to mention that before 1990, during socialism, bankruptcy law did not exist, and even if there was a bankruptcy statute, it was not applied. That the precarious position of consumer-creditors was not even noted in this region is also due to the fact that there are no problem-specific laws on consumer-creditors in those major jurisdictions, such as Germany or France, that usually serve as models for the CEE systems. The impetus did not come from the EU either, the bodies of which hardly encroach on new territories of law in the absence of support of the economically strongest Member States – for which consumer-creditors have not become high priorities as of yet preserving the already mentioned “Brexiting” UK and some Scandinavian limited responses.

Besides that, there are generally no empirical studies either, whereas sporadic statistical or quantitative data is limited to, for example, the numbers regarding the started and completed bankruptcy proceedings in a calendar year. As these tend to be limited and do not go beyond pure reproduction of sheer numbers, one should be cautious in drawing wide-reaching conclusions based on them. However, in certain respects they can be exploited, because often they are the only available empirical data one could depart from in research. Next to that, the inter-disciplinary nature of the topic is also an issue, because experts in consumer-protection law normally do not have the knowledge in bankruptcy law, which could be claimed vice versa for bankruptcy lawyers' expertise in consumer law. Nevertheless, for proper comprehension of the problem, reasonable expertise is needed in both. It suffices to research the leading textbooks on these fields to realize that publications on consumer protection contain very little on bankruptcy and the same could be said of writings related to the other discipline.

Finally, admittedly the empirical case studies reported below may look unorthodox to some readers, especially if they are not supported by references to traditional sources of law used by legal scholars. It is important to acknowledge that in case of such novel phenomena as, for example, the below-discussed zombie or defunct companies time is needed until analyses devoted to them would reach the pages of leading law journals. Initially, it is often the case that reports of investigative journalists, rather than supreme court judgments, are available on such topics.<sup>29</sup> Consequently, a careful approach should be applied to them until they become properly scrutinized and analyzed by courts and scholars. In fact, these new topics and the seminal nature of this article is what should make the following elaboration informative and useful.

## 2. Synopsis of Selected Empirical Studies and Court Cases

While reading the cases, the reader should bear in mind the following. First, they illustrate not only the contexts in which the problem of consumer-creditors may emerge, but also its dimensions and nature. Secondly, although most examples are recurrent themes in more than a single jurisdiction, some may be idiosyncratic to a few only. For example, while the Christmas-saving schemes to be dealt with below are frequently used in the UK, they are essentially unknown in Hungary and its neighbouring countries, whereas remotely resembling business patterns might be identified. Likewise, while we will approach the semi-completed condominium projects in China that should not lead to the conclusion that identical scenarios are unknown elsewhere.

<sup>29</sup> That retailers fall and this is a process rather than an ad hoc-type development could easily be seen from following the media news. For example, while finalizing this paper, IrishCentral reported on the voluntary liquidation of the famous Irish fashion brand Oral Kiely (established in 1963), closing not only its retail stores in London and Kildare Village, in Ireland, but also the brand's commerce site, Orlakiely.com. See IrishCentral, 20 Sept. 2018, at <<https://www.irishcentral.com/business/irish-fashion-brand-orkiely-goes-into-voluntary-liquidation>>, accessed 4 Nov. 2018.



Finally, the most important figure in this context is that the volume of various pre-payment schemes generating consumer-creditors has increased together with the development of internet-based commerce. Consequently, the consumer-creditor problem is to a certain extent the product of technological changes, although it cannot be attributed entirely to it. Rather, they coexist with more traditional schemes leading to the same outcome, as it will be illustrated hereafter, specifically by the US regulatory reactions from the 1970s (the 'hard copy' era) and the recent semi-finished condominium construction projects in China.

### 2.1. The United Kingdom

The discourse on consumer-creditors did not start with the 2016 Law Commission Report in the UK. As the 1982 Cork Report "*rejected greater protection for consumers, noting that consumers typically lose small and affordable amounts while the effect on suppliers can be catastrophic,*"<sup>30</sup> it was only the more recent insolvencies of high-profile retailers, making consumer-creditors lose millions, initially starting a reaction in the opposite direction. The result of the process is the Law Commission Report along with a set of recommendations submitted to the Parliament in 2016; for the time being awaiting the Government's response that realistically may turn out, only after all the Brexit-related issues have been settled.<sup>31</sup>

As it was determined by the Law Commission, the nature of the transactions that make unsecured creditors out of consumers in bankruptcy proceedings vary. The Law Commission compared for example Christmas savings schemes and payments made by debit or credit cards. Although the first is similar to savings account and the latter is a loan, that did not prevent the Law Commission to rely on them to underline the inferior position of consumer debtors. In fact, there is a single common denominator for each of the classes that triggered the attention of the UK Law Commission: in each case the collapse of the retailer or service-provider ends in bankruptcy with consumers becoming unsecured creditors normally recovering only a small fraction of their claims. The same could be said of the other examples examined here: the semi-finished and abandoned condominium construction projects or the unidentified consumer-victims of abandoned companies. In other words, although the nature of the transactions and the causes are not the same, and the possible solutions may also differ, in each of these cases the quintessential problem is the position of consumer-creditors as unsecured creditors being ranked at the bottom of the bankruptcy hierarchy.

The high-profile insolvency that attracted particular attention in the UK was the collapse of the **Farepak Christmas Savings Club** in 2006. The scheme allowed low-income families to save money to purchase Christmas gifts by contributing small sums (some interest-earning) each week to Farepak, which were then turned into vouchers or hampers.<sup>32</sup> Allegedly, the biggest creditor of Farepak – then the HBOS Bank (now part of the Lloyds Group) – had forced the directors not to reveal anything about the financial problems of Farepak. This meant that consumer-savers continued payments (totalling £1 m per week) until the collapse of the company.<sup>33</sup> While savers had on average about £400, the highest savings reached £2,000.<sup>34</sup> Given that the savers were treated in insolvency law as unsecured creditors and the Bank was a secured creditor, the result was that the Bank's £31 m loan was repaid in full, whereas consumer-creditors received in contrast only 15p for every pound they saved. Another legal issue was that while the outstanding debt towards consumer-creditors amounted to £37 million, the related court cases generated about £20 m in legal fees for the taxpayers.<sup>35</sup>

The collapse of the **Comet Group** in 2012 is even more illustrative of the impact the development of internet commerce is causing to traditional-style retail businesses. Comet Group, founded back in 1933, has had a stunning history as an electrical retail chain operating in the UK until about 1984. As market leader and an attractive takeover target, it was taken over by Kingfisher in the same year. The drastic explosion of the online market of the 21<sup>st</sup> century, however, made Kingfisher sell the remainder of the once glorious

<sup>30</sup> See UK Law Commission, the Work of the Law Commission – Incorporating the Twelfth Program (Dec. 2015), at 10.

<sup>31</sup> See the webpage of the UK Law Commission n 1 stating that "We laid our report before Parliament on 13 July 2016 and await the Government's response."

<sup>32</sup> See e.g. Hilary Osborne, 'Farepak Victims to get Compensation of £8 Million' *the Guardian* (6 July 2012), available at <https://www.theguardian.com/money/2012/jul/06/farepak-victims-get-compensation> and Jonathan Russell, 'Farepak Trial Collapse: Whos' to Blame?' *the Telegraph* (23 June 2012 issue), available at <https://www.telegraph.co.uk/finance/newsbysector/banksand-finance/9351237/Farepak-trial-collapse-whos-to-blame.html>. Both accessed 5<sup>th</sup> May 2018.

<sup>33</sup> See Rupert Neate, 'Farepak Collapse Caused by Banks, Says Judge' *the Guardian* (21 June 2012), available at <https://www.theguardian.com/business/2012/jun/21/farepak-collapse-caused-bankers-judge> accessed 5 May 2018.

<sup>34</sup> UK Law Commission 2016 Report Summary, para 4.6., at 12.

<sup>35</sup> *Id.*

business to an investment firm for a nominal value of £2 in 2012. Administration (insolvency) proceedings have opened against Comet already on the 1<sup>st</sup> of November of the same year.

As the accounting firm Deloitte – appearing in the resulting insolvency proceedings – emphasized, the key factor behind Comet's collapse was that Comet lost the battle “*with online retailers which have far lower overhead costs and can offer cheaper products.*”<sup>36</sup> The 2008 global financial crisis has just further exacerbated the critical position of the company. The uncertainty caused a domino effect to suppliers and other potential financiers who refused to extend credits during the peak Christmas period, which forced Comet to stop its activities.<sup>37</sup>

Comet is mentioned in the Law Commission's report, because it involved the suspension of gift vouchers upon the opening of the administration (insolvency) proceedings.<sup>38</sup> More specifically, vouchers amounting to £4.7 m remained in circulation upon the opening of administration proceedings.<sup>39</sup> Although they became potentially redeemable later, they raised the attention of regulators, because gift vouchers were issued in 15 out of 20 large-scale insolvencies in the UK, making over £7 m of vouchers in circulation worthless.<sup>40</sup>

The problem is that the holders of vouchers emerged as unsecured creditors, who do not enjoy special protection under UK law. Therefore, whether they can recover any claims depends on the financial health of the issuer company. In turn, other classes of consumers held vouchers that were secured by bonds or other securities, or the financial conditions of the insolvent company allowed full or partial repayments. In case of Farepak, for example, although consumer-creditors were in the position to recover 50p in the pound, 70% of the payment for this stemmed from special compensation funds in case of which “*it took six years for these payments to be distributed.*”<sup>41</sup>

The Law Commission's findings noted that consumer-deposits were held by retailers in the furniture and home improvement sectors (i.e., furniture, bathrooms and fitted kitchens) as well. Six of such retailers were investigated and it was found that the total amount of prepayments held by them reached £60 m.<sup>42</sup>

The above-mentioned UK cases illustrate the risks the arrival of the internet age had on ‘*the real-world retailers,*’ the collapse of the business model of which continues to generate numbers of consumer-creditors. Inevitably, the above were not the only UK instances where technology pushed businesses operating in the non-digital world into the bankruptcy abyss.<sup>43</sup>

## 2.2. The United States

The idea to provide special protection to consumer-creditors through the so-called ‘consumer priority rule’ in 1978 – to be discussed below in more detail – did not arise from a vacuum. The US was also confronted with a variety of bankruptcies generating attention and occasionally even public outrage in the 1970s, whereby the era was characterized by a little amount of consumer protection laws. Unlike the 21<sup>st</sup> century UK cases, they were the product of fraudulent trading practices, rather than technological advancements. Many of these represent particular types of prepayment cases.

One such bankruptcy case was filed against **Shield International Corporation** in 1970, which was not only a mail order seller of books, records and horoscopes, but also “*well known to consumer protection agencies as a firm that, for more than a year, had cashed customer's checks without sending them any merchandise.*”<sup>44</sup>

<sup>36</sup> See the article in *the Telegraph* (no author indicated), ‘Comet Collapse: Deloitte Blames Internet and Lack of First-Time Home Buyers’ (2 November 2012). Available at <<https://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/9652085/Comet-collapse-Deloitte-blames-internet-and-lack-of-first-time-home-buyers.html>>. Accessed 5 May 2018.

<sup>37</sup> Ibid.

<sup>38</sup> See *the Telegraph* (no author mentioned), ‘Comet Gift Vouchers Suspended as Chain Collapses into Administration’ (3 Nov. 2012). Available at <<https://www.telegraph.co.uk/finance/newsbysector/retailandconsumer/9653058/Comet-gift-vouchers-suspended-as-chain-collapses-into-administration.html>>. Accessed 5 May 2018.

<sup>39</sup> See Lorraine Conway, ‘Consumer Prepayments (Deposits, Gift Vouchers, etc.) on Retailer Insolvency’ House of Commons Library, Briefing Paper No. CBP 6540 (20 Dec. 2016), at 4–5.

<sup>40</sup> UK Law Commission Consultation Paper – Executive Summary 2015, para 2–26, at 8.

<sup>41</sup> UK Law Commission Report 2016, para 5.1., at 44.

<sup>42</sup> UK Law Commission Consultation Paper – Executive Summary, para 2.27–2.29, at 8.

<sup>43</sup> Charlotte Jee, ‘the UK's Best-Known Brands Bankrupted by new Technology’ (*Techworld*, 1 May 2018), at <<https://www.techworld.com/picture-gallery/apps-wearables/eight-big-companies-bankrupted-by-new-technology-3611714/>>. Accessed 27 May 2018. Some from the list include the electronic retailers MAPLIN (bankruptcy February 2018) and HMV; Toys R Us (Febr. 2018); the film and video-game rental BLOCKBUSTER (bankruptcy Sept. 2010); the US film photo giant KODAK (bankruptcy Jan. 2012); and the book and music retailer BORDERS (bankruptcy 2011).

<sup>44</sup> Philip G. Schrag and Bruce C. Ratner, ‘Caveat Emptor – Empty Coffer: The Bankruptcy Law has Nothing to Offer’ (Nov. 1972) 72/7 Columbia LRev 1147, 1147. [Hereinafter: Schrag and Ratner 1972].

In the bankruptcy proceedings, the bankrupt-company listed 4,616 consumer-creditors; i.e., those who have paid in full, but received nothing.<sup>45</sup> As before 1978 consumers were “*truly forgotten parties in bankruptcy proceedings*,”<sup>46</sup> the traditional scenario developed: on the one hand, only 87 out of 4,616 filed a proof of claim and on the other hand, neither class of consumer-creditors received anything.<sup>47</sup>

Although this case could be considered outdated from the perspective of the digital age, one should not forget that in emerging systems that exist without any or with some rudimentary bankruptcy and consumer protection laws, similar scenarios can occur even today – without the law intervening. In general, creditors may expect recoveries in bankruptcy only if the bankruptcy system works because only that may ensure that assets will be available for distribution to creditors. The more efficient a bankruptcy system is, the higher the chances of unsecured creditors (including consumer-creditors) of getting recoveries is.

For example, the bankruptcy trustees (insolvency administrators) could recover substantial amounts through avoidance law, from transactions that were concluded before the opening of bankruptcy proceedings. The best example is the US ‘Madoff Victim Fund’<sup>48</sup> which proves that a working bankruptcy avoidance law means a lot; its webpage indicates the number of victims paid and the amounts distributed on a daily basis. Although the Madoff case is about investment into a Ponzi scheme rather than consumer-prepayments to retailers, it shows that bankruptcy law may have teeth.

Notwithstanding that more recent cases are available, the most telling examples stem from the peak period of US concern over consumer prepayments. Another important US case from 1972 illustrating that is the insolvency case of the **FAS International Corporation**,<sup>49</sup> where prepayments were made for various courses, offered by a group of renowned correspondence schools operating under the umbrellas of the company. About 114,000 consumers from all over the US had prepaid the full or partial price. The corporation resorted to bankruptcy proceedings after its fraudulent selling tactics were revealed by an investigative journalist and the resulting rapid deterioration of its financial position.<sup>50</sup> Had it not been for the interference of investigative journalists, the scheme presumably would have continued for a longer period of time, plundering even more from vulnerable consumers.

Although the introduction of high preferential bankruptcy ranking to consumer-creditors in 1978 seem to have turned the tide, new cases are not unheard of either. In the 2012 bankruptcy case of **U.S. Fidelis, Inc.**,<sup>51</sup> two brothers (Atkinsons) with criminal records organized the debtor-company for ‘*telephonic direct-marketing of vehicle service contracts*’ (VSC). These VSCs, involving third party financiers and insurers covered the costs of any potential repairs on vehicles purchased by the consumers. The schemes were popular, presumably because the credit-worthiness of the consumer-clients were not checked. Eventually, the brothers were in the position to sell 650,000 VCS contracts in the period of 2004–2009. Interestingly, it raised no suspicion that the contracts themselves were not concluded by the corporation organizing the schemes themselves, but by a third party.

The voluntary bankruptcy proceedings were opened in 2010 after the third-party financier announced that it would stop financing the scheme. This occurred after more than four years during which the brothers used the corporation as their own personal cash machine. The total claim of consumer-creditors amounted to \$14.1 m.<sup>52</sup> These details are of relevance, because they show that in case of fraudulent schemes, in lack of due-time reaction of duly empowered and dedicated agencies, the fraudsters may be in the position to claim the money of consumers virtually uninterrupted, hide the collected assets and eventually escape by filing for bankruptcy proceedings.

<sup>45</sup> Ibid.

<sup>46</sup> Ibid at 1149.

<sup>47</sup> Ibid at 1148.

<sup>48</sup> The webpage is at <<http://www.madoffvictimfund.com/>> and is run under the auspices of the US Department of Justice Asset Forfeiture Distribution Program (i.e., taxpayers money is engaged to ensure more efficient recoveries). On the day of the last visit (14 Oct. 2018), 28,045 victims from 121 countries received payments in the value of about \$ 1.3 billion.

<sup>49</sup> *In Re FAS Int'l Corp.*, No. 72 B 128 (S.D.N.Y., filed petition Feb. 8, 1972) cited by Schrag and Ratner 1972, at 1150.

<sup>50</sup> Ibid at 1150.

<sup>51</sup> *In Re U.S. Fidelis, Inc.*, 481 B.R. 503 (Bkrtcy E.D. Mo. 2012) (Chapter 11 reorganization). The judgment in the case, reproduced on one-hundred pages, is in and of itself a proof of its complexity. The central issue concerned whether three of the consumer-creditors had a right to object to a Chapter 11 confirmation plan of liquidation of the debtor corporation – what was decided upon in the negative by the court. The plan otherwise ranked the claims of all consumer-creditors as Class 6 entitled to pro-rata distribution of available cash.

<sup>52</sup> Ibid.

### 2.3. Hungary

Consumer-creditors have not become a policy or a scholarly issue in Hungary yet. Bankruptcy law, similarly to German bankruptcy law (as the primary source of inspirations for Hungarians) provides for no special protection to consumer-creditors: they are treated as unsecured creditors ranking at the bottom of the hierarchy of claims. However, insolvencies of retailers have occurred in this country as well, with consumers losing part or all of their prepayments. Given that the very problem of consumer-creditors is essentially undetected, it should not come as a surprise that there is no data on the number of consumer-creditors either. In fact, besides the case studies below, it is only the data of the Hungarian Consumer Protection Agency that might be resorted to as the most reliable source of information. Notwithstanding the vacuum, the following cases demonstrate that the core of the problem focused upon in this paper exists in this country as well.

One should bear in mind as well that unlike the UK or the US, bankruptcy law works less efficiently in this country; in particular avoidance laws seem to be impotent. As a result of this, the prospects of unsecured creditors to recover something in bankruptcy in this country are considerably lower than in the more efficient systems;<sup>53</sup> a deficiency the other post-socialist systems are suffering from, too.

We should start by pointing out how limited the powers of consumer protection authorities are. In the lack of explicit mandates to investigate, penalize or prohibit problematic practices affecting consumer-creditors, they only have two limited powers only: on the one hand, they can provide instructions on the available legal solutions to consumers and, on the other hand, they can warn them about the problematic practices of certain retailers and of the concomitant threats to them. These 'soft agency powers' are obviously far away from the high priority afforded to consumer-creditors in US bankruptcy law and proposed by the UK Law Commission Report 2016.

For example, in the case of web shops like *ematrix.hu* and *bemutatoterem.hu*, the Agency was limited to warn the public that trading with these retailers is risky, as their stocks have been seized by the tax authorities for the crime of tax evasion.<sup>54</sup> The Agency reacted similarly in the case of Baumax home store, which decided to leave the Hungarian market in the second quarter of 2015. Here, the consumer complaints were primarily linked to warranty claims that arose after closure.<sup>55</sup> As Baumax was acquired by the company OBI, the warranty obligations of Baumax were taken over by its legal successor. Had this not been the case, consumers with warranty claims might have been left empty handed.

Although the Agency instructions point to the fact that these contract-based prepayments are in the bailiwick of courts and can thus be litigated, it is striking that they fail to warn the consumer that launching a court case may not pay. What the Agency fails to properly accentuate in its warnings is that usually only a small fraction (if anything) of the consumer claims and the funds invested in litigation can be recovered if the retailer becomes bankrupt in the meantime or if it ceases to function and leaves no assets the final court judgement could be enforced upon.

Chargebacks, subject to terms and conditions known in other European countries are resorted to in Hungary as well, given that the same cards are in use in this country as elsewhere in Europe. Refund claims are settled via the bank that holds the consumer's account, which normally passes a decision within three to six months.<sup>56</sup> Chargebacks played a major role, for example, in case of the bankruptcy of some airline

<sup>53</sup> See, in particular, the World Bank Doing Business 2016 Report, at 85, on the 'ease of resolving insolvency'. According to these data, insolvency proceedings normally last about two years on average in Hungary and cost 14.50% of the bankrupt's estate. As a result of the high costs, the most likely outcome of bankruptcy proceedings is that "the company will be sold as piecemeal sale." This places Hungary on the 65<sup>th</sup> place out of 189 countries. Although the recovery rates of unsecured creditors are not specified in this report, those of the secured creditors are about the same as the ones in Canada or other western systems as they were 41.70 cent on a dollar. The data have somewhat improved by 2018, as World Bank Doing Business indicators placed Hungary on the 62<sup>nd</sup> place as far as the ease of resolving insolvency is concerned. See World Bank, Doing Business 2018 – Reforming to Create Jobs <<http://www.doingbusiness.org/content/dam/doingBusiness/media/Annual-Reports/English/DB2018-Full-Report.pdf>>, at 166. Accessed 3 Nov. 2018.

<sup>54</sup> Nemzeti Fejlesztési Minisztérium [Ministry of Economic Development], Kockázattal jár az alábbi webáruházakból való rendelés! [It is Risky to Order from the Webshops Listed Below]. Available in Hungarian at: <<http://fogyasztovedelem.kormany.hu/node/7673>>. Accessed 30 June 2018.

<sup>55</sup> Nemzeti Fejlesztési Minisztérium [Ministry of Economic Development], Mi lesz a bauMaxban vásárolt meghibásodott termékekkel? [What will Happen to Defective Goods Purchased in Baumax?]. Available in Hungarian at: <<http://fogyasztovedelem.kormany.hu/node/7808>>. Accessed 30 June 2018.

<sup>56</sup> Information received from the Hungarian National Development Ministry. Document (in Hungarian language) on file with the author.

companies (e.g., the 2015 case of the Lithuanian Lituania).<sup>57</sup> Yet, chargebacks, as it is generally the case, do not necessarily assure refunds to all consumers in Hungary either.

There are, however, numerous cases that remained unreported, even by investigative journalists that are typically at the forefront of discovering abuses and other irregular business practices in Hungary. Hence, for concrete examples one has to have access to concrete bankruptcy cases, whereas some of the files are only accessible if one is a party to a case. Legal scholarship is unfortunately lagging behind the developments; what is not characteristic only to Hungary in the region.

One unreported bankruptcy case,<sup>58</sup> involving a small-scale novice **local distributor of KIA cars** going bankrupt and **lost consumer-prepayments** is a paradigm of the post-2008 global financial crisis era for two peculiar corollary features of the underlying business pattern. The first was that the value of the loan extended by a third-party financier for purchase of a passenger car was expressed in Swiss Francs (CHF) even though it was payable in monthly instalments in the local currency, (Hungarian Forints, HUF) according to the applicable official exchange rate on the maturity date. This has proved to be a disastrous business model, because once the spill over effects of the global financial crisis reached Hungary in the late 2008 and early 2009, the monthly instalments payable in HUF drastically increased due to the unfavourable exchange rates of a country that was on the verge of becoming bankrupt.<sup>59</sup> Nothing indicates that the scheme was fraudulent. Rather, it illustrates that similar unexpected bankruptcies of retailers, wholesalers, agents or distributors may occur whenever a major global or regional crisis occurs, as it was the case with the 2008 Credit Crunch.

Otherwise, the foreign currency-denominated loans were at that time the predominant financing pattern tolerated by the regulators. These were not the exceptions, but the rules in those days. In fact, the overwhelming part of mortgage-backed housing loans were of this sort, not only in Hungary, but in many of its neighbours (Romania, Croatia, or Serbia). The collapse of the mortgage system eventually forced the Hungarian government to interfere with a series of extraordinary measures to soothe the economic and political tensions though the saga went on before courts up until today. The latest development is the European Court of Justice judgement of 20 September 2018 in Case C-51/17 made on the request for preliminary ruling of the Budapest Regional Court in the case between the largest domestic Hungarian bank OTP Nyrt and its factoring subsidiary versus the individuals Teréz Ilyés and Emil Kiss.<sup>60</sup>

The second novelty, in a sense expressing the innovativeness of Hungarian businessmen was that the distributor employed a peculiar financing scheme called '*12 × zero instalments.*' According to this scheme, in exchange for almost a double-than-normal down-payment,<sup>61</sup> the distributor was to pay the monthly instalments in lieu of the client for the length of one calendar year directly to the third-party financier Santander Bank (presuming that the exchange rate remained below a prefixed sum). In addition, the client was given the option to offer the car for repurchase by the distributor and attain access to a new one at a discount.

As one may suspect, the distributor suspended the payments towards the third-party financier and declared bankruptcy (moreover without informing the clients) after a few months upon the conclusion of the contract in June 2008. Thereafter, the scenario known from other jurisdictions arose: bankruptcy proceedings were opened with the consumer-creditors ranking at the bottom of the bankruptcy hierarchy of claims and chances of minimal recoveries.

The owners of the otherwise small-scale distributor refused to cooperate with the bankruptcy practitioner. Not only that substantial time was needed for the bankruptcy court to reach the owners, but they have failed to hand over the financial reports and documents required by the law.

As the bankrupt company was nothing more than a shell without assets, most presumably eventually neither the banks having top priority, nor the consumer-creditors ranking extremely low received anything. The conditional formulation is due to the fact that data on the effectuated distributions in bankruptcy proceedings are not public data. The creditors participating in the proceedings only get the court's decision who is entitled to how much but are not informed about who has concretely been paid how much.

<sup>57</sup> Nemzeti Fejlesztési Minisztérium [Ministry of Economic Development], Az Air Lituania légitársaság működésének leállításával kapcsolatos fontos információk [Information on the Stoppage of Operations by Airline Lituania]. Available in Hungarian at: <<http://fogyasztovedelem.kormany.hu/node/8345>>. Accessed 30 June 2018.

<sup>58</sup> Case No. 10. Fpk. 01-2010-101/13 decided by the Court of the Capital Budapest (Liquidation Division), files with the author, as one of the consumer-creditors.

<sup>59</sup> While, for example, the Swiss Franc-HUF exchange rate applied for the August 2008 instalment was still low (141,34 HUF/CHF), that increased by December the same year to 171,02 HUF/CHF and then to 216,41 HUF/CHF (July 2010), and 244,38 HUF/CHF in February 2012.

<sup>60</sup> ECLI:EU:C-2018:750.

<sup>61</sup> Concretely, while the normal downpayment was 410,000 HUF, the higher one referred to above was 700,000 HUF.

Moreover, as none of the creditors – including consumer-creditors – is freed by law from the payment of fees for filing their claims in bankruptcy proceedings, which is a precondition for participation in bankruptcy proceedings, these had to be paid in notwithstanding that one could have suspected that these were *a priori* doomed to be lost. Such filing fees are known in other jurisdictions as well, given that it is the debtor and its creditors that should cover the costs of bankruptcy proceedings and not the state budget. The crucial difference in this respect is that in countries where the bankruptcy system is inefficient, the bankruptcy estate often is insufficient to cover even the costs of the proceedings themselves.

These technical details are needed here to point out that besides the slim chances of recovery, the bankruptcy system that is ignorant of the position of consumer-creditors additionally makes their participation in bankruptcy proceedings next to impossible through technical rules, as the ones on court fees.

#### **2.4. The People's Republic of China**

Proclaimed to be a socialist (communist) state although having introduced many market economy elements, China is facing problems known not only in the West or CEE, but has its own idiosyncratic ones as well. Moreover, even the cases that seem to be similar to the ones in the West routinely appear in clothes peculiar to China. In other words, this country deserves attention because it faces problems that are of relevance to our discussion here, from the over-indebtedness of a large percentage of the population due to excessive credit card usage, the magnitude of business bankruptcies to the threats inherent to the thousands of zombie-companies.

One recent example involving consumer-creditors, little spoken of in English sources, concerns unfinished condominium construction projects with private companies as constructors and consumers prepaying (advancing) the purchase price, often in more stages. The scenario is simple: the future apartment owners have to make meaningful prepayments, not only to conclude the very purchase contract, but are often expected to advance further instalments during the subsequent stages of construction. In a significant number of cases, however, the construction companies stopped the works half-way and resorted to bankruptcy. In other cases, they simply abandoned the business and disappeared with the collected moneys. As a result, the putative owners were left without both: their apartments as well as their prepayments.

Similarly to other jurisdictions, these putative owners are in the eyes of Chinese bankruptcy law unsecured creditors ranking at the bottom of the priority hierarchy.<sup>62</sup> What makes their position worse in China is the deficient bankruptcy system, thanks to which the constructor-companies could easily abuse the system by being in the position to easily launch and procrastinate bankruptcy proceedings with the ulterior motive of prolonging their existence, evading payment of their debts or performance of their contractual obligations.<sup>63</sup>

Nothing in bankruptcy law provides special protections to consumer-creditors in China and participation in the proceedings is also a precondition for getting any recoveries. What is distinctive of China is that if companies of interest to local governments were at stake, these have been routinely saved through debt-for-equity swaps or other politically motivated, yet often economically irrational solutions that were crammed down on the creditors.<sup>64</sup> While the literature is focused on the macroeconomic impact of these distortions, one could hardly spot a writing that would document the losses sustained by consumer-creditors, the number of whom presumably could – at least in China – be numbered in tens of thousands.

The Chinese examples deserve mention, because – as contemporary examples – they show that patterns and problems tend to be repeated in emerging systems of other continents as well. Moreover, notwithstanding of China's receptiveness of all good 'western' legal models, a policy that has left its imprint on the developments in the legal arena in the last decade, lessons have not necessarily been learned. Yet, the key point is that the consumer-creditor problems in the context of bankruptcy proceedings have grown to major problem in China as well.

<sup>62</sup> Interestingly, it seems that some protection was introduced by the Supreme Court of China (position released on the 20<sup>th</sup> of June 2002) interpreting the construction contracts-related Article 286 of the 1999 Contract Law. The Court took the position that consumer-creditors should get first priority in case of semi-finished or abandoned residential construction projects. This position was applied at least in a 2017 case by the High Court of Anhui Province (2017/249). As these are reported only in Chinese language, it is not clear whether this position applies in the context of bankruptcy proceedings unreservedly as well.

<sup>63</sup> See e.g. Liu Mingkang and Chuyi Wei, 'Towards a better Future for Chinese Bankruptcy Law: Problems and Potential' (2017) *Int'l Company and Commercial Law Review*, 450.

<sup>64</sup> *Ibid.*

### 3. Regulatory Reactions Exemplified

The insecure and inferior position of consumer-creditors has attracted attention in few countries so far, led by the US and the UK. Consequently, although no exact list appears to be available internationally, it seems that most bankruptcy laws possess no tailor-made rules. This is the case, for example, in Germany as one of the major civil law systems, where due to the already mentioned generally applicable priority rules consumer-creditors are treated *pari passu* with other unsecured creditors in bankruptcy and could expect only fractional recoveries in bankruptcy, if anything at all.

Notwithstanding the small number of laws that have picked up the regulatory gauntlet, even the few jurisdictions covered herein offer an interesting variation of tools, which are worth to take a look at in the following. As we will see, the solutions may, but do not have to be offered by bankruptcy law.

#### 3.1. The Prescriptive Model: the United States

The US represents the model, which introduced explicit bankruptcy rules for the protection of consumer-creditors already in the 1970s. As it will be examined in more detail below, it elevated the claims of consumer-creditors to the level of preferential creditors. As a result, the recovery rates of consumer-creditors have increased, although exact quantitative data are not available. This approach could conveniently be referred to as the prescriptive method.

##### 3.1.1. Pre-1978 Theories Enhancing the Recovery Rights of Consumer-Creditors

Two theories were available for the protection of consumer-creditors before the 1978 bankruptcy reforms in the US, both of which based on trust law: constructive trusts<sup>65</sup> and trust-like devices offered by some State laws. They have survived but without having morphed into generally applicable rules. Rather, they have been available only in bankruptcy cases with consumer-creditors and the involvement of fraud or other wrongdoings. Furthermore, they have been resorted to exceptionally by courts, when justice could not be provided to prepaying consumers by other means.

Constructive trust is a trust imposed by the court and not created by the agreement of parties; wherefrom stems the designation of 'constructive'. Such trusts have been traditionally imposed "*on property that has been acquired by fraud and for other, traditional equitable reasons*"<sup>66</sup> to remedy grave injustice. As Baird put it, "[c]onstructive trust cases involve victims of some egregious fraud."<sup>67</sup> If such trust is imposed on property held by the bankrupt debtor and the egregious fraud was caused by such debtor, the property is deemed to be held in trust for "*those creditors ... who were the victims of the debtor's wrongdoing*."<sup>68</sup> The victims of fraud could also be prepaying consumers. The property subject to a constructive trust does not become part of the bankruptcy estate and hence is to be given back to creditors to the benefit and protection of whom the trust was imposed by the court.<sup>69</sup> Therefore, the prepaying consumer-creditor would get the asset itself instead of the minimal recovery as an unsecured creditor.

The utility of constructive trusts is the highest in cases involving clear instances of fraud, a reason for which equity has always given relief. Yet, the mere failure to disclose to customers that the company is in financial trouble notwithstanding of what it continues accepting deposits or prepayments, has not necessarily been found by courts as sufficient for imposing a trust.<sup>70</sup> Consequently, the line that exists between fraudulent and non-fraudulent behaviour of debtors creates uncertainties, which make constructive trusts less useful to consumer-creditors. This deficiency is the reason why the consumer-debtors' ranking has increased to a higher level by explicit statutory rules to provide a more efficient and generally available remedy.

In addition to constructive trusts, some State laws provide protections in the form of statutory trust-like devices. The features of these vary, considering that they are introduced by statutes for some very specific purposes. The 1982 Illinois case *In Re Teltronics, Ltd.*,<sup>71</sup> involving consumers who were defrauded

<sup>65</sup> As the Black's Law Dictionary defines, a constructive trust is "[a] trust imposed by a court on equitable grounds against one who has obtained property by wrongdoing, thereby preventing the wrongful holder from being unjustly enriched." It is often termed as 'implied trust,' involuntary trust,' or 'remedial trust.' This version of trust is therefore sufficient to provide protection, for example, to defrauded prepaying consumers, who could as a result ask for the separation of the asset in question from the bankruptcy estate of the debtor retailer.

<sup>66</sup> Wukovich 1988, n 7, at 4.

<sup>67</sup> Douglas G. Baird, *the Elements of Bankruptcy* (Foundation Press, New York, 2010), at 112.

<sup>68</sup> Wukovich 1988, n 7, at 4.

<sup>69</sup> This is recognized by section 541(d) of the US Bankruptcy Code.

<sup>70</sup> See, e.g., *In Re Faber's Inc.*, 360 F.Supp. 946 (DC.D. Conn. 1973).

<sup>71</sup> *In Re Teltronics, Inc.*, 649 F2d 1236 (CA7, 1981). Cited by Wukovich 1988, n 7, at 5.

by the debtor that had collected prepayments for watches that remained undelivered, could be a good illustration. Here, based on the Illinois Consumer Fraud and Deceptive Business Practices Act,<sup>72</sup> a special receiver, financed by taxpayers, could have been appointed by the attorney general to protect the interests of defrauded consumers by collecting their properties. In the case, the receiver was appointed a month before bankruptcy proceedings were opened against the debtor and was successful in collecting more than \$800,000. The bankruptcy trustee sued the receiver for turnover of the collected funds, what was refused by the bankruptcy court, because the receiver was properly empowered by State law to undertake the attacked actions unaffected by bankruptcy laws.<sup>73</sup>

These trust-like devices, similarly to constructive trusts, are only available in very specific situations and when special statutes providing for them have been enacted. They are, unlike the high bankruptcy priority rule, thus only of limited utility to consumer-creditors.

While the applicability of constructive trusts by civil law countries is a topic yet to be explored (notwithstanding the trend of introducing trust, or trust-like legal institutions into these systems),<sup>74</sup> the 2015 UK Law Commission proposals do include them, noting that they are “*fraught with difficulties*.”<sup>75</sup> In particular, the corollary legal costs would be high as “*holding all prepayments in trust would deprive businesses of their working capital as they would have no way to access the funds until the goods or services were provided*.”<sup>76</sup>

In the US, they remain available to protect consumer-creditors, albeit only on exceptional basis.

### 3.1.2. The Prescriptive Model: Heightened Consumer-Creditor Priority through Explicit Rules in the US Federal Bankruptcy Code

On top of constructive trusts and trust-like devices established by some State laws, a new capped consumer priority rule of general application was added to Section 507(a) of the Bankruptcy Code in 1978.<sup>77</sup> This denoted that US law gave recognition to the inferior position of consumer-creditors by affording them a high priority position in bankruptcy proceedings through an explicit provision added to the Bankruptcy Code. Without this rule, as already highlighted above, consumer-creditors would rank at the bottom of the bankruptcy hierarchy as unsecured creditors and with extremely low recoveries, if anything at all. Following the new priority rule, they were elevated to the uppermost ranking class of preferential creditors. Typically, this<sup>78</sup> ensures substantially higher consumer recoveries on average.

However, this exception was introduced subject to certain preconditions and a monetary limitation. The monetary cap was the product of a compromise between the Senate and the House,<sup>79</sup> the underlying consideration of which revolved around the realization that although “[c]onsumers merit somewhat better treatment than other creditors but they should not be allowed to exhaust an estate to the prejudice of other creditors.”<sup>80</sup>

Besides the monetary cap, three other preconditions were imposed by bankruptcy law. The first two aim to ensure that only consumers are eligible. This is achieved, on the one hand, by limiting the priority only to ‘individuals’ at the exclusion of corporations and other business vehicles, and on the other hand, by limiting

<sup>72</sup> Ill. Rev. Stat. ch. 121 & frac 12, § 261 et seq.

<sup>73</sup> Vukovich 1988, n 7, at 5.

<sup>74</sup> See e.g. Tibor Tajti and Robert Whitman, ‘Common Law Trusts in Hungary and other Continental European Civil Law Systems’ (Spring 2016) 49/3 John Marshall LRev.

<sup>75</sup> See e.g. UK Law Commission Consultation Paper 2015, paras 5.8 and 5.9., at 16.

<sup>76</sup> Ibid para 5.8.

<sup>77</sup> Initially, the Bankruptcy Code accorded sixth priority to consumer-creditors, which subsequently moved to the seventh priority and is now in Section 507(a)(7) and reads: “[The following expenses and claims have priority in the following order] ... Seventh, allowed unsecured claims of individuals, to the extent of \$2,850 for each such individual, arising from the deposit, before the commencement of the case, of money in connection with the purchase, lease, or rental of property, or the purchase of services, for the personal, family, or household use of such individuals, that were not delivered or provided.” Initially, the monetary cap was set at \$900. See e.g. Vukovich 1988, n 7, at 1.

<sup>78</sup> The qualification of ‘normally’ must be added here because the high priority ensures recovery to consumer-creditors only if sufficient assets are available for distribution, which may not always be the case. For example, there is no bankruptcy system without ‘no asset’ bankruptcy cases, a special class of bankruptcy cases which require simplified and quick conclusion of bankruptcy proceedings. In case of these, normally the debtor has no assets even to finance the costs of the bankruptcy proceedings and none of the creditors is willing to step in with financing.

<sup>79</sup> While the House was for a higher cap (\$2,400 limit), the Senate vouched for a \$600 limitation, moreover, with a further limitation according to which the beneficiaries of the priority should be only families with incomes of maximum \$20,000. Vukovich 1988, n 7, at 4.

<sup>80</sup> Vukovich 1988, n 7, at 4.



the claims only to those *'for personal, family, or household use.'*<sup>81</sup> The third limitation reduces the applicability of the priority to claims of restitutionary nature, which must stem *"from the deposit ... of money."*<sup>82</sup> Consequently, these provisions generated a few new controversies.

One of the key dilemmas arising even today, forty years after the introduction of Section 507(a), revolves around what the interpretation of the word 'deposit' should be. For example, should unredeemed gift cards qualify as deposits for the purposes of this section?<sup>83</sup> The case law is inconsistent. In 2005, for example, the 9<sup>th</sup> Circuit held, in the *In Re Salazar* case,<sup>84</sup> that payment in full for specified goods (in the case: purchase price for a pool that had remained unfinished by the time the bankruptcy proceedings against the debtor were launched) satisfies the 'deposit' definition.<sup>85</sup> As opposed to that in the 2016 Delaware case *In Re City Sports Inc.*, \$1.18 million of pre-paid consumer gift cards being at stake, the court was of the opinion that, given that the transaction was completed as a single transaction, *"the consumer received exactly what he/she bargained for and [thus] no additional actions were required to close the transaction."*<sup>86</sup>

### 3.2. The *Lege Ferenda* Multi-Legged Model: the United Kingdom

The above-mentioned UK Law Commission Report 2016,<sup>87</sup> a 159 pages long document came forward with **five sets of recommendations** for the protection of consumer-creditors, each consisting of multiple steps. These are reactions to various problematic areas involving consumer-creditors, as detected in the UK. Some of these may present less concerns in some other jurisdictions; like **Christmas savings schemes** that are little known in Hungary, for example.

Two of these are related to two specific segments of the market or two specific types of prepayment methods. While the first includes the already mentioned 'Christmas and similar savings schemes', the second concerns **chargebacks**<sup>88</sup> that appear in cases where credit or debit cards are used. As far as saving schemes are concerned, the main recommendation is protection through trust arrangements or insurance.<sup>89</sup>

The position of **chargebacks** is more complicated, because the terms and conditions of chargebacks are contained in the so-called 'schemes of rules' of Visa and MasterCard, as the two most widely used card schemes in the UK.<sup>90</sup> In other words, this area is to a great extent, based on industrial regulations that are not only complex, but to a certain extent non-transparent as well. This is why the UK Law Commission noted that the *"chargeback scheme needs to be better known and understood"*<sup>91</sup> and recommended *"to increase information about chargebacks."*<sup>92</sup> What is important to highlight here is that chargebacks do not ensure full refunding in each and every situation. This is irrespective of the fact that – as reported by the UK Law Commission<sup>93</sup> – in case of the collapse of some UK retailers, millions of pounds have been refunded exactly through chargebacks.

These two sector-specific recommendations are then supplemented by a third *open end prong* that proposes giving the power to the Secretary of the State *"to require protection of consumer prepayments in sectors which, in the opinion of the Secretary of State, pose significant risk to consumers."*<sup>94</sup> This approach takes into consideration the possibility of the emergence of the prepayment problem in novel contexts as well.

The fourth set of proposals follows the path of the US, because it recommends a higher priority status in insolvency proceedings to a limited number of consumer claims.<sup>95</sup> The preferential ranking position should be *"below preferential claims of employees, but above those of the floating charge."*<sup>96</sup> The limitation is that the rule would apply only to consumers that have made prepayments of £250 or more during the six months

<sup>81</sup> Ibid at 2 with reference to the text of Bankruptcy Code Section 507(a)(7).

<sup>82</sup> Ibid at 3 with reference to the text of Bankruptcy Code Section 507(a)(7).

<sup>83</sup> See, e.g., Justin R. Alberto and Gregory J. Flasser, 'Solving the Gift Card Conundrum' (Dec 2016) 35-DEC American Bankruptcy Institute Journal, 32. [Hereinafter: Alberto and Flasser 2016].

<sup>84</sup> *Salazar v. McDonald (In Re Salazar)*, 430 F.3d 992 (9<sup>th</sup> Cir. 2005).

<sup>85</sup> Alberto and Flasser 2016, n 80, at 33.

<sup>86</sup> Ibid, at 33.

<sup>87</sup> UK Law Commission Report 2016.

<sup>88</sup> For the findings on chargebacks – based on UK experiences – see Chapter 7 of the UK Law Commission Report 2016, at 62 ff.

<sup>89</sup> Ibid recommendation 1a, at 115.

<sup>90</sup> Ibid, para 7.4., at 62.

<sup>91</sup> Ibid, Chapter 7 on Chargebacks, at 62.

<sup>92</sup> Ibid, para 7.3, at 62.

<sup>93</sup> In case of the collapse of the UK retailer Comet the refund estimates through chargeback were £2.1. million. See UK Law Commission Report 2016, para 2, at 62.

<sup>94</sup> Ibid, Recommendation 2a, at 115.

<sup>95</sup> Ibid, Recommendation 4a and 4b, at 116.

<sup>96</sup> Ibid, Recommendation 4a, at 116.

immediately prior to the opening of the insolvency proceedings, “*either in a single transaction, or in a series of linked transactions.*”<sup>97</sup>

The fifth and final recommendation aims to protect the prepaying consumers by changing the rules on transfer of ownership on prepaid goods. The central point is that ownership would transfer at the time the contract is made.<sup>98</sup>

One should bear in mind that the thrust of the Law Commission’s recommendations is a *volte face* that would transform the UK system from a self-regulatory to a statutory law-based system for this specific sector.<sup>99</sup> Should that happen, the UK would join the US in recognizing the precarious position of consumer-creditors explicitly and providing them with specific legal protections not leaving this task to ad hoc and voluntarily applicable solutions, as it was with constructive trusts and the card company schemes, as described above. Such approach is also the expression of the recognition that besides employees or environmental protection, consumer-creditors as well deserve closer attention and stronger protections in bankruptcy proceedings.

## **4. Mapping the Real Dimensions of the Problem: Consumer-Creditors of Insolvent, Abandoned, Defunct and Zombie Companies**

### **4.1. Why are Bankrupt and other Types of Troubled Companies of Importance?**

As the focus is on the position of consumer-creditors in the context of bankruptcy proceedings, one could conclude that for mapping the true dimensions of the position of consumer-creditors in bankruptcy proceedings of their retailers or service-providers, *only* the data and information concerning the number, nature and outcomes of concluded bankruptcy proceedings should be taken into account. Indeed, although not all bankruptcy cases involve consumer-creditors’ claims, it could be assumed that quite a number of them it does. Whether they are marketing their products directly or through agents and distributors, whether they are construction companies or are engaged in other types of business activities, these businesses have as clients not only other businesses, but also consumers who may, indeed, prepay their goods or services.

Therefore, the data on the number of bankruptcy proceedings (commenced and completed in a year, and their typology) is important, because it illustrates the position of consumer-creditors. However, this data is insufficient, because consumers also lose out in other types of troubled companies, ranging from abandoned, defunct to more idiosyncratic variants as companies with blocked accounts. Moreover, it is reasonable to pay closer attention to the so-called zombie-companies as well that are on the verge of becoming bankrupt, if one would like to make a realistic estimate of the real dimensions of the problem.

Such a holistic picture would be important not only in assessing the true dimensions of the consumer-creditor problem, but also to adequately remedy the gaps that are generated by path dependence and other deficiencies of consumer protection laws. One should take into account that consumer organizations, as a rule focused on classical consumer protection problems,<sup>100</sup> do not necessarily understand the bankruptcy process and consequently rarely if ever raise their voice in defence of consumer-creditors in the bankruptcy proceedings. Consequently, the voice of consumers, as stakeholders, is hardly heard in discussions aiming at mitigating the bankruptcy system. The most notable recent exceptions are the 2016 project documents of the UK Law Commission.

Bearing the above in mind, we will add besides bankrupt companies all these other categories of enterprises to our ensuing analysis.

### **4.2. On the Importance of Context**

The socio-economic environment of the countries within the scope of this paper is significantly different. For this reason, a caveat on the importance of the context is necessary. Legal, economic and social differences of relevance to our subject exist not only between western and eastern systems. In Central and Eastern Europe (CEE) for example, there is a gap between those countries that have joined the European Union (EU and those that remained outside of it, because accession accelerated reforms on all levels – including strengthening consumer protections.

<sup>97</sup> Ibid, Recommendation 4b(3).

<sup>98</sup> For the details see UK Law Commission Report 2016, at 117.

<sup>99</sup> Ibid, para 3.1, at 20.

<sup>100</sup> There is no consensus on what consumer law exactly extends to and hence the phrase ‘classical consumer protection’ is imperfect as well. Still, orientation points can be found and thus, for the purposes of this paper, the areas focused upon by the leading European text and case law book of Hans-W Micklitz, Jules Stuyck and Evelyne Terryne, *Consumer Law – Cases, Materials and Text* (Hart Publishing, 2010) would be taken as ‘classical areas of consumer protection law;’ in particular, various aspects of sales of goods, provision of services and products liability.

As far as bankruptcy law is concerned, while bankruptcy has always been part of western capitalist systems, it has become a major socio-economic and political issue only during the last few decades – not only in CEE, but in China as well. During socialism, businesses, typically owned by the state were routinely bailed out by the government using taxpayers' money; a practice that changed to the contrary, whereas now bail-outs are not the rule, but rather the exception. In other words, during socialism, there was no need for bankruptcy laws. In CEE, this changed after the fall of the Berlin Wall when these once socialist regimes began their transitory process, aimed at reintroducing market economies. China introduced its bankruptcy laws inspired by western patterns a bit later: the first modern bankruptcy law had been enacted in 1986, which was then replaced by a brand new one in 2006.

Notwithstanding the changes, it is reasonable to say that bankruptcy as such is still relatively new in these countries. It should not come as a surprise therefore that these systems have failed to take cognizance of the precarious position of consumer-creditors in bankruptcy proceedings, which is a very specific bankruptcy problem not covered by most western legal systems either. As already hinted at, Hungary and other CEE countries that have traditionally taken German law as the most important source of inspirations for legal reforms, could not learn about the problem from German law, simply because German bankruptcy law has not acknowledged consumer-creditors either. In these countries, additionally, the bankruptcy systems continue to suffer from defects, many of which present systemic problems that overshadow those of consumer-creditors.<sup>101</sup> It is of relevance as well that for many European bankruptcy systems, it is rather the employees who deserve extra protection and not the consumers.

The Western Balkans is peculiar because the Balkan wars postponed the reforms and the restructuring of these economies. For example, privatization in Serbia began after the 2005 amendment of the Privatization Act only.<sup>102</sup> Consequently, although the data on abandoned and defunct companies is scarce and hardly any data on zombie companies is available, most of the businesses that remained in the so-called societal-ownership ("*društvena svojina*") do qualify as one of these. They survive as no government is willing to take the risk of social unrests that may come as a result of unemployment. Yet, these businesses may collapse at any time. This applies as well, though to a differing extent, to Bosnia and Hercegovina, Macedonia, Montenegro and Serbia.

### 4.3. What the Data on Bankruptcy Cases Suggest

The number of annually launched and completed bankruptcy proceedings is significant in each of the jurisdictions covered, both east<sup>103</sup> and west.<sup>104</sup> While the efficiency of administration of bankruptcy proceedings differs significantly, inevitably affecting also the recoveries of consumer-creditors, the position of consumer-creditors remains extremely weak in each country that lacks special protection. It is also important to note that there is a difference in the number and completion of in and out-of-court restructurings; where the chances of consumer-creditor recoveries are higher than in case of liquidations. In this respect, it

<sup>101</sup> See e.g. *DanCake S.A. v. Hungary*, ICSID case No. ARB/12/9, in which the arbitral tribunal decided against Hungary because of the inappropriately conducted bankruptcy proceedings in Hungary.

<sup>102</sup> See Vojin Drašković, 'The Knjaz Miloš Affair and a Loophole in Serbian Takeover Law' in Stefan Messmann and Tibor Tajti (eds), *The Case Law of Central and Eastern Europe: Leasing, Piercing the Corporate Veil and the Liability of Managers & Controlling Shareholders, Privatization, Takeovers and the Problems with Collateral Laws* (European University Press, Bochum, Germany, 2007), at 432 ff. See also Tijana Kojović, 'the Privatization Process in the Republic of Serbia: Legal Framework' (2001) 8/2–3 *Journal of East European Law* (Columbia University, New York).

<sup>103</sup> The number of active bankruptcy proceedings against business companies in Serbia on 5<sup>th</sup> of June 2018 is 2,084 as per the official governmental statistics available at <[http://www.alsu.gov.rs/bap/upload/documents/statistika/BrojPredmeta\\_Po\\_Sudovima\\_lat.pdf](http://www.alsu.gov.rs/bap/upload/documents/statistika/BrojPredmeta_Po_Sudovima_lat.pdf)>. For Croatia, the data for 2016 were available, according to which in that year 18,811 new bankruptcy proceedings were started, 20,821 were completed and 14,523 were in progress. See the Statistical Bulletin of the Croatian Ministry of Justice at <<https://pravosudje.gov.hr/UserDocsImages/dokumenti/Pravo%20na%20pristup%20informacijama/Izve%C5%A1%C4%87a/Statisticki%20pregled%20za%202016%20godinu.pdf>>. In Romania, the National Trade Register Office of the Ministry of Justice publishes data on bankruptcy at <<https://www.onrc.ro/index.php/en/statistics?id=252&lg=en>>. As per these, while in 2017 altogether 2,526 bankruptcy cases were in courts, until 30<sup>th</sup> of April 2018 that number was 2,965.

<sup>104</sup> As for our purposes only business bankruptcies and in particular liquidations are of relevance as those types of bankruptcy proceedings in which consumer-creditors may lose their claims, the data for the two covered jurisdictions are the following. As per the data available on the website of the Administrative Office of the US Courts the number of business bankruptcy filings for year 2017 in the US was 23,443. See at <<http://www.uscourts.gov/news/2017/07/21/june-2017-bankruptcy-filings-down-28-percent>>. Accessed 4 Nov. 2018. Note that this number include also reorganization filings yet which are lower than the number of liquidations.

The estimated company insolvency rate for the UK for year 2017 are: 17,243 for England and Wales, 856 for Scotland and 302 for Northern Ireland. Data of the UK Insolvency Service at <<https://www.gov.uk/government/statistics/estimated-company-insolvency-rate-in-the-united-kingdom-january-to-december-2017>>. Accessed 4 Nov. 2018.

is commonly the case that while reorganization and restructuring-focused proceedings work best in the UK and the US, all the other systems are only at the beginning of learning how to deal with that.<sup>105</sup>

Nevertheless, even with the lack of data on the losses of consumer-creditors, one may safely presume that more than 'nickels and dimes' of a few individuals (consumers) are at stake in the large number of annually completed bankruptcy proceedings. This may also be deduced from the little amount of data publicized in a selected number of post-socialist CEE countries; some being referred to herein as well.

#### **4.4. The Real Threats to Consumer-creditors: Abandoned, Defunct and Companies with Blocked Accounts**

##### **4.4.1. Delimiting the Various Classes of Troubled Companies**

Various classes of troubled companies may be differentiated for the purpose of this paper. As the structure of national economies, as well as the health of the respective business sectors may differ significantly, it should not come as a surprise that the used designations and their connotations differ notwithstanding the overlaps. Thus, the Croatian company with blocked accounts may, but must not be at the same time an abandoned or defunct enterprise. Likewise, what the Slovaks call a zombie-company is normally a defunct business, contrary to western perceptions for which a zombie is only a company that cannot grow, but otherwise functions as a going concern. These nuances must be considered when reading this section.

What is important is that these troubled businesses represent such business vehicles that have not gone through bankruptcy or dissolution proceedings. This makes the position of consumer-creditors of abandoned companies worse, compared to those that went through properly conducted bankruptcy proceeding, because the latter have at least a predictable end, possibly with some recoveries. As opposed to that, in case of abandoned and defunct companies, the agony can go on forever with no prospect of any recovery whatsoever.

**Abandoned companies**, as the designation suggests, are by their owners and officers; often without any assets left to be resorted to by creditors. They are mere shells, skeletons without assets, which is why often no creditor finds it even worth initiating bankruptcy or dissolution proceedings against them. This occurs because initiating bankruptcy proceedings would require advancement of money to cover the costs of the proceedings, which are, in no-asset cases, doomed to be lost ab initio. Not infrequently, the owners (members) and the officers of these cannot be (easily) tracked down, making not only access to financial and other documents, but communication impossible too.

The designation '**defunct companies**' is also in use. These may be abandoned businesses, because the attribute 'defunct' can also be a reference to a company which is inactive for some reason, yet not abandoned. In the UK, for example, defunct companies are sometimes companies that went through insolvency or dissolution proceedings.<sup>106</sup> This nuance is of importance, because if proper bankruptcy proceedings have been conducted, data and documents on the bankrupt debtor remain available, which is often not the case with abandoned companies. Without documents the claims of consumer-creditors may disappear without trace.

If an abandoned company is left with no assets and without the financial and other documents needed for conducting bankruptcy proceedings, what the law could do remains extremely limited. For example, according to the UK Companies Act 2006 (CA 2006), the company registrar is entitled to strike off a troubled business that satisfies the definition of '*defunct company*', if it turns out that it is not carrying on business activities or is not operating, subject to specific proceedings.<sup>107</sup>

**Companies with blocked accounts** should also be mentioned as a peculiar sub-class of troubled businesses. These can also be abandoned or defunct companies. Regulatory reaction was triggered,

<sup>105</sup> For a synopsis of the present situation in Europe and the EU Commission's related efforts see the Proposal for a Directive of the European Parliament and of the Council on preventive restructuring frameworks, second chance and measures to increase the efficiency of restructuring, insolvency and discharge procedures and amending Directive 2012/30/EU as of 22 Nov. 2016, COM(2016) 723 final.

<sup>106</sup> A special category of 'defunct companies' should be distinguished in the context of UK law as well. Namely, there is a specific Register of Defunct Companies that has been published periodically from 1934 on under the auspices of the Stock Exchange Council yet going back in time until 1825. Most of the companies listed herein were removed as a result of liquidation or dissolution. See W.B. Stephens, *Sources for English Local History* (Cambridge, 1981), at 131.

<sup>107</sup> CA 2006, sections 1000 and 1001. According to these provisions, if the registrar has a reasonable cause to believe that the company is not operating, it *may* dispatch a communication to the company to that effect and give 14 days to respond. If it does not receive answer within 14 days, it *must* send out a second communication referring to the first one and add that if no response shall be received within another 14 days, the company will be stricken off from the register, with an info on that published also in the official Gazette. According to section 1024 the registrar may be requested to restore the registration within 6 years from dissolution.

for example, in Serbia<sup>108</sup> and Croatia,<sup>109</sup> to a large extent because many of the companies to which the measure of blocking of accounts was applied, were *not* abandoned or defunct companies, but rather businesses whose management exploited the opportunities offered by inefficient court enforcement and bankruptcy systems. They simply realized that it is profitable not to pay debts on time, that the law is slow to react, and they have found ways not to move all their income through their bank accounts. The laws were passed, because such practice of dodging payment of debts reached extremely high numbers and it became a systemic problem that not only undermined the trust in the legal system, but harmed the national economies as well.

This phenomenon of dodging payment of debts is not widely spoken of in more developed economies today. In fact, it can be considered as something very unusual. However, the problem undoubtedly exists in these systems, only in lower numbers and in the milieu of a much more efficient court enforcement and bankruptcy system, which then ensures that there is no need to pass a *lex specialis* to deal with these types of problems. Yet, if not only a few but thousands of reported cases surface in a country, as it was the case for example in Serbia and Croatia, a problem-specific regulatory reaction becomes inevitable.

As per these laws, the bank accounts of businesses dodging payment of their debts could be blocked, based on the decision of a court, agency or other competent governmental body, because they are neither in the position, nor willing to pay their debts, as they become due. Blocking may ensue without parallel opening bankruptcy proceedings. This because, unlike bankruptcy proceedings, that are time consuming and require cooperation from the side of the debtor company, as well as the majority of its creditors, these peculiar tools of law ensure quick reaction and do not suppose cooperation of the debtor and involvement of the creditors. The idea is to force the debtors to pay their debts voluntarily or initiate and participate constructively in bankruptcy proceedings by preventing them from using their bank accounts.

The number of debt-dodging companies could not have decreased significantly during a year or two since the passage of the mentioned laws allowing for blocking of accounts in Croatia or Serbia. Consequently, these continue to cause headaches to regulators. The new laws are not without their defects either. In Serbia, for example, the rule according to which bankruptcy proceedings are initiated automatically, if the accounts of a company were blocked for more than a year was quashed by the Serbian Constitutional Court in 2012.<sup>110</sup> As a result, these firms continue to hover in the economic space. The forced privatizations of some of these within bankruptcy proceedings, following a special action plan of the Serbian government achieved only partial results.<sup>111</sup>

Similar solutions have been introduced in Croatia, where the Financial Agency (FINA)<sup>112</sup> compiled statistics and was in charge of launching bankruptcy (liquidation) proceedings against companies with blocked accounts for more than 120 days. However, this duty of the agency was introduced only with the 2015 amendments of the Bankruptcy Act. Consequently, before this change in 2015, indeed, Croatia did have thousands of companies with 'indefinitely' blocked bank accounts against most of which no bankruptcy

<sup>108</sup> Serbia added a special Chapter X (sections 150–154) to its Bankruptcy Act 2009 (Official Gazettes 104/2009, 99/2011, and 71/2012) specifically devoted to this problem. The Title of the Chapter should speak for itself: "Special Proceedings in case of Long-Term Payment Incapability" [in Serbian: Poseban postupak u slučaju dugotrajne nesposobnosti za plaćanje]. The chapter was annulled by the Serbian Constitutional Court's decision US 83/2014. The register of bankrupt companies as well as the text of the Serbian Bankruptcy Act could be found on the website of the Serbian Ministry of Economy (<http://priv.gov.rs>). It needs to be added that as per the Law on Payments of Legal Entities, Entrepreneurs and Physical Persons (Zakon o obavljanju plaćanja pravnih lica, preduzetnika i fizičkih lica, Official Gazette No. 68/15) all companies must have accounts opened with duly licensed banks or other financial organizations. The presumption of the system is thus that all the income of companies must go through one of these bank accounts within the purview of the National Bank.

<sup>109</sup> The first Croatian Law on Enforcement on Bank Accounts passed in 2010 (Zakon o provedni ovrhe na novčanim sredstvima, published in the Croatian Official Gazette [Narodne Novine] Nos. 91–10 and 112–12) was replaced by a new one passed in 2018 (Official Gazette 68/2018). Hereinafter: Croatian Act on Blocking Accounts.

<sup>110</sup> Decision of the Serbian Constitutional Court No. IUz-850/2010 as of 12 July 2012. As per section 150 of the Serbian Bankruptcy Act (quashed by the Constitutional Court) the Serbian National Bank was to inform all bankruptcy courts, during the last day of each calendar month, of the identity of legal entities who have stopped and failed to pay their debts for the period of more than a year. The bankruptcy court having jurisdiction had then the duty to start ex officio the so-called 'preliminary bankruptcy proceedings' (prethodni stečajni postupak).

<sup>111</sup> As per the Serbian Government's Action Plan of 2015, 188 larger Serbian firms were foreseen to be privatized in bankruptcy proceedings. Yet bankruptcy proceedings could have been opened only against 55 of them by 2016 given that there was no interest whatsoever for the rest of them by private investors. See e.g. the short report by G. Vlaović and M. N. Stevanović of 7<sup>th</sup> of February 2016 'Sa spiska za stečaj u postupku tek svaka treća firma' in the weekly Danas at <<https://www.danas.rs/ekonomija/sa-spiska-za-stečaj-u-postupku-tek-svaka-treća-firma/>>. Accessed 22 June 2018.

<sup>112</sup> See the website of FINA, the Croatian Financial Agency at <https://www.fina.hr/Default.aspx?sec=1134> with English pages as well.

proceedings have been launched. This solution is still in existence though the Agency has failed to consistently file for bankruptcies in every problematic case.

The above should be distinguished from **fictitious companies** that are established for conducting activities different from the registered ones, often of criminal nature.<sup>113</sup> As these companies present problems that do not fall within the scope of this paper, they are not included in the present analysis.

#### 4.4.2. Abandoned and Defunct Companies: Regulatory Reactions Exemplified

Little is known about abandoned and defunct companies as not only empirical data, but scholarly publications are scarce in this domain. Two hypotheses could be postulated. The first is that efficient conduct of bankruptcy proceedings in a country inevitably affects also the number of abandoned companies. If businessmen know that the bankruptcy system works, and can be trusted, they'll resort to it in larger numbers, instead of simply leaving the ruins of their businesses without assets. If, on the other hand, it is generally known that the bankruptcy system is dysfunctional,<sup>114</sup> then most creditors will not even bother losing time and money by participating in bankruptcy proceedings. Unlike criminal or administrative proceedings, participation in bankruptcy proceedings by creditors is not a must in modern bankruptcy systems. It is a different question that failure to participate normally could mean losing even those claims (money) that could be recovered within bankruptcy proceedings.

The second implication flows from this. Based upon the more intense bankruptcy stigma and the deficiencies of the bankruptcy system, the number of abandoned companies typically is proportionately much higher in the CEE post-socialist countries than in the developed western jurisdictions. The Hungarian data may be representative for the other post-socialist systems of the region as well.

In Hungary, besides special summary bankruptcy proceedings, special fast-track proceedings – named as 'forced deletions' (*"kényszertörlés"*)<sup>115</sup> – have been introduced to eliminate abandoned and defunct companies from the market. These are similar to the UK registrar's right to strike out defunct companies. Yet, to properly show and prove that abandoned and defunct companies present major threats to consumer-creditors, the data on the number of bankruptcy versus forced deletion proceedings should be crossed.

The available Hungarian statistical data can be approached in the following way.<sup>116</sup> While, for example, in 2017 the number of bankruptcy liquidation proceedings in progress was 8,248 and the number of bank-

<sup>113</sup> Fictitious companies have been investigated recently in Bosnia and Herzegovina. About 500 such companies were found and were established by founders from various Arab countries, Russia and Ukraine. See Er. M./Klix.ba, *Rezultat istrage: U BiH posluje 500 fiktivnih firmi u vlasništvu arapskih državljana Rezultati akcije* [The Result of the Investigations: 500 Fictitious Firms Owned by Citizens of Arab States Exist in BiH], as of 9 Dec. 2016 available at <<https://www.klix.ba/vijesti/bih/rezultat-istrage-u-bih-posluje-500-fiktivnih-firmi-u-vlasnistvu-arapskih-drzavljana/161209014>>, and *"Nekretnina": Firme prijavljene na fiktivnim adresama, stranci kršili imigracione propise* [The Results of the Action 'Immovables': Firms Registered on Fictitious Addresses, Foreigners Breaking the Immigration Laws] news of 14<sup>th</sup> of December 2016 available at <<https://www.klix.ba/vijesti/bih/rezultati-akcije-nekretnina-firme-prijavljene-na-fiktivnim-adresama-stranci-kršili-imigracione-propise/161214052>>. Both accessed 30 June 2018.

<sup>114</sup> One of the few internationally renowned experts of Hungarian bankruptcy law, Andrea Csóke, for example, began her article with the following concise qualification of the Hungarian bankruptcy system: "In Hungary, everybody has known for years that the insolvency system does not work. The system is very expensive and ineffective, but nobody is prepared to do anything about it, to think about changes or to decide basic issues." This excerpt should speak for itself. Andrea Csóke, 'Preservation Measures in Hungarian Insolvency Proceedings' in Heinz Vallender, *Regulations and Measures of Protection in National Legislations within the European Union* (INSOL Europe, Nottingham-Paris, 2011), 89–95, at 89.

<sup>115</sup> Forced deletions are regulated by Act No. V of year 2006 on Company Publicity, Court Company Registration and on Final Accounting (*"2006. évi V. törvény a cégnyilvánosságról, a bírósági cégeljárásról és a végelszámolásról"*). Section 9/B(1)(a) of this Act, for example, foresees that an officer or controlling person of a company that was liquidated or forcibly deleted from the Company Register and yet after which unpaid creditor claims remained, may be prohibited to serve as a company officer or to acquire a controlling stake in a company. As per section 9C, this measure may be imposed for the maximum of five years. The Act was amended recently and some measures aimed at extending to more types of companies and making the deletion of these companies even simpler stepped into effect on the 1 July 2018. In particular, from now on there is no need to appoint an external liquidator but the tasks are to be fulfilled by the incumbent management. Moreover, the proceedings is to be filed with the tax authorities, which is to inform the competent bankruptcy court thereafter.

Note that some translations, instead of 'final accounting' used the English term of 'winding up.' This, however, may not properly reflect the true contents and may be misleading. English lawyers, for example, use 'winding up' as synonymous with 'liquidation'. However, in Hungary, 'forced deletions' are distinct from liquidation proceedings that are even regulated by a different act, the Act No. XLIX of year 1991 on Reorganization and Liquidation Proceedings (*"1991. évi XLIX. Törvény a Csődeljárásról és a Felszámolási Eljárásról"*), as amended.

<sup>116</sup> The referenced data are available, in Hungarian language, on the website of the National Office for Courts (*"Országos Bírósági Hivatal"*) at <<http://birosag.hu>>. The statistical data are in the Yearbooks (*"Statisztikai évkönyvek"*) from 2009 on. While the

ruptcy reorganizations was as low as 136, the number of finalized ‘forced deletions’ reached the astonishing number of 9,253. These ciphers should be compared with those from 2015 to see that the problem is hardly of cyclical nature, but is a systemic defect that hardly will die out in and of itself in the near future. Concretely, in 2015, while the number of liquidation proceedings in progress was 25,928 and the number of reorganizations merely 36, there were 27,634 new and 20,817 finalized ‘force deletion’ cases. This means that the number of abandoned companies, which disappear from the market without properly and fully conducted bankruptcy proceedings remains constantly extremely high in the country. In case of these usually there are no creditor recoveries whatsoever. These creditors losing the value of their claims may include also consumer-creditors, the number of which is unknown given that besides the annual number of these summary proceedings no statistical data are available.

Slovakia’s reaction to the systemic problems caused by abandoned and defunct companies was different: it managed to substantially ease the tensions by introducing a special license tax in 2014.<sup>117</sup> The central goal of this measure was to combat abuses of the entity-form, for example, by merging a large number of companies to prevent launching of bankruptcy proceedings against them or to create obstacles for the collection of their debts. These often included abandoned and defunct businesses, which sometimes are referred to by Slovak scholars as zombie-companies contrary to western uses of this designation. In Slovakia, this designation would primarily mean companies involved in such fraudulent, or suspicious company transactions today,<sup>118</sup> rather than companies that merely cannot grow.

## 4.5. The Potential Threats to Consumer-creditors: Zombie Companies

### 4.5.1. What are Zombie Companies?

Zombie companies could be defined in a few words as **unviable enterprises**. Zombie companies have been defined as well as ‘*low-productivity companies having high debt ratios*’ and as the contrasts of the so-called ‘*gazelles*’.<sup>119</sup> A somewhat longer definition affirms that a zombie is “*a company that merely survives due to the constant refinancing of its debt and, despite re-structuring and low rates, is still unable to cover its interest expense with operating profits, let alone repay the principal.*”<sup>120</sup>

Even though these references and definitions are correct, the problem is that the meaning of the term itself, the perception of this phenomenon and the problems they generate may differ from country to country. This indeterminacy is further exacerbated by the lack of empirical data and research. While there are some estimates on the size of the zombie-company segment of the economy in some western countries, no information exists on the exposure of consumer-creditors to this specific type of risk.

### 4.5.2. Short History of Zombie Companies

The available publications on zombie companies normally point only to the few countries we will mention below, however, what should not lead to the conclusion that zombie companies do not exist elsewhere. Often, some aspects of the topic are discussed under differing designations though the central problem is that the pertaining literature is scarce. Unfortunately, this also means that there is neither quality data, nor analyses on how these have affected consumer-creditors in the context of our discussion.

In the US, for example, the term ‘zombie company’ “*surfaced in 2008 when many companies were kept alive by constant bail-outs or interest-only repayments on their loans rather than capital repayments.*”<sup>121</sup> Often, these were recipients of the Troubled Asset Relief Program, (TARP) yet this is a fact that should not lead to

data on bankruptcy and reorganization proceedings are in the files devoted to bankruptcy law (“*csőd és felszámolás*”), the ones on ‘forced deletions’ in the folder on companies (“*cég*”). See at <<http://birosag.hu/kozerdeku-informaciok/statisztikai-adatok/2017-evkonyvek#>>. Accessed 30 June 2018.

<sup>117</sup> As per section 68(6) of the Slovak Commercial Code, the court may struck out a company, for example, if no general meeting has been held in a calendar year or the company has failed to submit financial statements for, at least, two successive calendar years. See also the column by Redakcia Podnikajte.sk, *Po zavedení daňových licencií stúpol počet likvidácií firiem dvojnásobne*, as of 9<sup>th</sup> of February 2014, available electronically in Slovak language at <<https://www.podnikajte.sk/pravo-a-legislativa/c/1230/category/ukoncenie-podnikania/article/stupol-pocet-firiem-v-likvidacii.xhtml>>. Accessed 30 June 2018.

<sup>118</sup> See generally Jana Duračinská, *Povinnosť lojality jediného spoločníka spoločnosti s ručením obmedzeným*, in: 2017: Vybrané výzvy v slovenskom práve obchodných korporácií, Olomouc: Iuridicum Olomoucense, 2017, at 39–61 [online].

<sup>119</sup> Andrew G Haldane, *Productivity Puzzles*, speech at London School of Economics (20 March 2017), page 16. Mr. Haldane is the chief economist of the Bank of England.

<sup>120</sup> This description – obviously reflecting the recent cheap credit years of Europe (loose monetary policy) – comes from under the pen of Daniel Lacalle in his article *The Rise of Zombie Companies – And Why It Matters* as of 8<sup>th</sup> of August 2017 available at <<https://mises.org/profile/daniel-lacalle>>. Accessed 30 June 2018.

<sup>121</sup> Quoted from John Baguley, *Fundraising and Zombies: A Guide to Charity Management* (Matador – Troubador Publ., Leicester, UK, 2017), at 169. [Hereinafter: Baguley 2017].

the conclusion that all recipients were zombies. How have consumers been affected, what have they lost and under what circumstances in these cases in particular escaped attention. In the post-Credit Crunch era, the attention was focused on the financial world resulting among others, in the creation of the Consumer Financial Protection Bureau (CFPB) in 2010 by the Dodd-Frank Wall Street Reform and Consumer Protection Act<sup>122</sup> providing protection of consumers in the financial sector.

In the UK and in the U.S. the definitions of Zombie Companies are, as they both revolve around companies that survive because they “*manage to attract new funds faster than their debts can pull them under.*”<sup>123</sup> The number of UK zombies in the year of 2013 was estimated to be between 100,000 and 227,000;<sup>124</sup> the numbers varying depending on who the estimates stemmed from.

Yet, as the sources suggest, the expression ‘zombie company’ first emerged in Japan in the 1990s, in relation to the role zombie banks played in making zombie companies survive. The banks were criticized as the generators of “*astonishing waste of capital.*”<sup>125</sup> The Japanese vicious circle was described by Mitsuniro Fukao as follows: “[I]ncreasing loan losses from bankrupting borrowers weaken[ed] the bank’s capital base; under-capitalized banks start[ed] to hide losses and firms continue[d] to operate with deposit-taking zombie banks under forbearance of regulators.”<sup>126</sup>

In present-time China zombie companies have come into the focus during the era of President Xi Jinping (i.e., starting from 2012), when “*getting rid of the so-called zombie companies*”<sup>127</sup> was elevated to one of the central elements of the supply-side reforms. The characteristics, dimensions and the gravity of the problem differ significantly from those in other parts of the globe. Inherited from socialism, the Chinese zombies have become a major concern, not only for sustaining losses for years and failing to declare bankruptcy, but because they were taking resources from prosperous businesses.<sup>128</sup> The problem could hardly be resolved within a short period of time, because the number of employees which may lose jobs as a consequence is staggering and could amount to political risks of unseen dimensions.<sup>129</sup>

Another peculiarity of China is the important role of local governments that, on the one hand, are expected to implement the reforms, but which, on the other hand, are often more interested in bailing out the companies located in their territory for fear from unemployment and the shrinking local tax base. In China, the key problem for the government is not the position of consumer-creditors, but rather the unemployment that bankruptcies would generate, given that China, as it used to be with every socialist-communist system, full employment was among the top priorities as opposed to consumer protection ranking very low (provided it was a policy goal at all). In this respect, the exponential growth of online commerce may bring eventually to the surface the problem of consumer-creditors relatively soon as well.

## 5. Conclusions and Questions for the Digital Era

In conclusion, European lawmakers and those concerned with consumer protection have to reconsider the problem of consumer-creditors and how to manage it, not only in various bankruptcy proceedings, but also when their claims disappear in the sea of abandoned and defunct companies. The consumer-creditor problem presented is a serious one that it can be equally, if not more, detrimental to consumers than variations of unfair marketing practices within consumer law. While there is a meaningful protection in case of the latter, in much of Europe, the protection is limited or non-existent in case of the central topic of this paper.

That these present real problems should not be questioned, as illustrated by the case studies above. It has to be acknowledged as well that the gap that divides insolvency and consumer protection law seems to make proper assessment of the dimensions of the risks consumers face in much of Europe hard. Perhaps, the time has arrived for both consumer and bankruptcy law scholars to pay more attention to the consumer-creditor problem as canvassed above.

<sup>122</sup> Publ.L.111–203, H.R. 4173 [2010].

<sup>123</sup> Baguley 2017, n 118, at 169.

<sup>124</sup> Ibid, Baguley referred to the UK Institute for Turnaround (IFT) and its estimates for the year 2013 that calculated with 100,000 zombies. The higher number was put forward by Nick Hood, ‘the Inexorable Rise of Britain’s Army of the Walking Corporate Dead’ (2013) 6 Corporate Rescue and Insolvency 180. Hood was referred to by Vanessa Finch and David Milman, CORPORATE INSOLVENCY LAW – PERSPECTIVES AND PRINCIPLES (Cambridge, 3<sup>rd</sup> ed., 2017), n 3, at 1.

<sup>125</sup> Economist, 8 October (2005:11).

<sup>126</sup> Mitsuniro Fukao, ‘Financial Market Efficiency: A Comparative Perspective’ in Dongchul Cho, Takatoshi Ito and Andrew Mason (eds), *Economic Stagnation in Japan: Exploring the Causes and Remedies of Japanization* (Elgar Publ., 2018), page 139.

<sup>127</sup> Kjeld Erik Brodsgaard and Koen Rutten, *From Accelerated Accumulation to Socialist Market Economy in China* (Brill, 2017), 160.

<sup>128</sup> Ibid.

<sup>129</sup> Only in the coal, steel, aluminium, cement and glass industries, according to a report of the China International Capital Corp from January 2016, out of the current 10 million jobs about 3 million were foreseen to be cut over a three-year period. Id. at 160.



That some of the problems mentioned above – like the Christmas savings plans – are not universally known throughout Europe, but are rather idiosyncratic problems that seem to affect only some countries does not justify dodging the topic either. Indeed, the fact that their causes are linked to contemporary technological advancements and corollary socio-economic changes makes them particularly relevant for all. The fall of Farepak and other retailers that were forced out of the market by the Internet-linked competitors and thanks to new technological developments is undoubtedly the precursor of the times that are downing on us. Logic would dictate that similar risks to the ones covered above are to reappear in the future as well due to the penetration of novel technological advancements into more and more segments of our economies and societies, including alternatives to traditional trading patterns. How many more Farepaks and retailers will fracture as a result and how much consumers will lose is hard to predict.

Existent policy priorities and concrete legal solutions aimed at protecting certain classes of creditors deemed to be vulnerable, should also be given a second thought to. If higher statutory ranking for consumer-creditors in bankruptcy is not acceptable, because of policies favouring employees, but at the same time it is acceptable that goods that have been prepaid by consumers do not become part of the debtor's bankruptcy estate and consumers acquire ownership immediately, the preferential employee priorities in bankruptcy in effect would be false. This because while consumers would be paid in full, or partially, as the goods owned by them would be separated from the estate, the employees' recoveries will depend on the size of the estate and the entirety of claims having higher priorities. In other words, the policy rhetoric and reality on real bankruptcy recoveries would not match.

What should be clear is that without efficient responses, we risk that the new age, unprecedentedly and increasingly driven by technological changes, will result in consumers being trapped in the same insecure and inferior bankruptcy situation as the one discussed in this paper. Stated differently, in the style of Hans Christian Andersen, the famous Danish story-teller: the problem will endure, the consumers will remain unprotected, only the setting, the 'clothing' will change, which – due to its increased complexity – we risk not even to notice, let alone understand.

## Competing Interests

The author has no competing interests to declare.

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