Lowering the volume of assets of companies before their entry into insolvency proceedings

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Abstract

The study concerns the significance and validity of the information available in the area of insolvency proceedings in the Czech Republic, including data made public by multinational institutions. On the basis of these data, two conclusions are reached. Firstly, relevant statistical figures are available only in relation to the introductory phases of insolvency proceedings. Thanks to the existence of the insolvency register, this area is covered in very high quality; it can therefore be said that the present statistical system is basically essentially sufficient as regards information on insolvency proposals and the manner in which these proposals are handled. The main problem, however, is presented by all other phases of insolvency proceedings about which we have practically no information whatsoever. But it can be deduced from the data that is available that the main problem of insolvency proceedings in the Czech Republic is the fact that businesses entering into the phase of bankruptcy have already been emptied in the vast majority of cases and their assets are not sufficient to finance even standard insolvency proceedings. The work also contains certain proposals in the area of legislative changes, which could lead to a gradual change in this situation.

Keywords: insolvency, bankruptcy, statistics
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1 PROBLEMS WITH STATISTICAL DATA IN THE CR

Even though insolvency trials are a very fundamental economic phenomenon, comparatively little real investigation has been devoted thereto. They are often researched more from the position of philosophy of law, but we devote relatively little attention to their real functioning in real relationships and especially the impacts of the general efficiency of these trials on the national economy of a given country (Richter 2008, pp. 27 – 64; Smrčka 2013, pp. 99 - 131).

When critically observing the sum of our knowledge on the effect of insolvency law, we necessarily have to admit that statistics, for instance, provide us with scant possibilities of becoming informed as to the real results of insolvency trials and the extent to which active participation therein is interesting from the creditor's perspective. To put it more precisely, we do not know much as to when (under what precise conditions) the creditor loses interest in participation in an insolvency trial. There is an inner contradiction between two divergent aspects of the situation. On the one hand, what is at issue is how the creditor is able to assess its possibilities to enforce its receivables or at least a part thereof. On the other hand, a problem arises with expenses that need to be outlaid during receivable enforcement trials. From the perspective of a creditor who is not secured and therefore has a lower likelihood of enforcing its receivables, the outlay of further transaction costs are clearly counter-productive. Put another way – if it is probable that I will through insolvency proceedings recover, say, two percent of my receivable at an amount of one million crowns (in other words, CZK 20,000.00), I will obviously not be willing to outlay practically any real money for my participation in insolvency proceedings. The economic absurdity of the opposite is evident. Many people are repeatedly surprised by the fact that many creditors do not express interest in

an insolvency trial, which is often considered suspicious or mysterious. In the vast majority of cases, however, this behaviour is rational and reasonable, and limits the increase of already realised losses.

If we want to look at the efficiency of insolvency processes from a scientific point of view, we are in many respects in the situation of a blind man put in a place where he once stood, but which he remembers only vaguely. At present, we have no statistically substantiated notion as to how individual subjects in insolvency proceedings react. Necessary data are not observed. If they do appear, they are figures that can be cast into doubt in various ways insofar as we cannot be certain as to their origin.

This applies fully to information contained in regular publications of the World Bank and International Finance Corporation issued under the title *Doing Business* (Schönfeld, Smrčka 2012, pp. 330; Kislingerová 2012, 113 – 113) as well as data published by the Minister of Justice of the Czech Republic.

1.1 Available information on insolvencies in the CR

In principle, we can always divide information on insolvency proceedings into two categories. The first of these is clear to a considerable extent – this is the number of commenced insolvency proceedings and perhaps some information on their course, for example, the entire duration of the proceedings. In our Czech conditions, we have available information from private companies that observe the insolvency register for professional reasons. These include, among others, Crediterform and the Czech Credit Bureau.

Tab. 1 –Number of filed bankruptcies, Source: Creditreform, http://web.creditreform.cz/cs/content/press/information/Insolvenzen_2012.pdf

Year	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	20077	2008	2009	2010	2011	2012
Number of bankruptcies	808	1,251	2,022	2,000	2,491	2,473	2,155	1,728	1,411	1236	1245	1,115	1141	1553	1601	1778	1899

Note: Since 2008, according to the Insolvency Act (182/2006 on Bankruptcy and Ways of its Settlement Coll.), previously according to the Act on Bankruptcy and Compensation (328/1991 Coll.).

The number of declared bankruptcies especially is part of the information processed in this manner; furthermore, the number of filed insolvency proposals according to the category of the bankrupt, the regional jurisdiction of the insolvency proposals, the number of insolvencies per one thousand registered commercial companies, the number of insolvencies according to the dominant subject of enterprise of the bankrupt and certain others. As we can see, these are the kinds of data that are detectable either precisely at the moment of filing an insolvency proposal or, thereafter, simultaneously to the ruling on bankruptcy, perhaps with the ruling on the manner in which the bankruptcy is to be settled. In reality, however, they say nothing about the real duration of insolvency proceedings from the filing of the proposal to individual actions and especially to closing acts of the proceedings – for instance, the court's approval of the closing report of the insolvency administrator or to the deletion of the commercial company from the commercial register.

Much information on insolvency proposals and about how they are settled is provided by the Ministry of Justice in the Czech Republic, even though we can in no way consider the manner in which this information is made public to be standard. While private companies make public new information always for the preceding month, the ministry issues most statistics quarterly and some only for the whole calendar year. Moreover, the placement of this information on web pages and their accessibility in general in no way correspond with the significance of insolvency proceedings.

In the second category, we have covert information, whereas much of it is unusually necessary so that the course of insolvency proceedings may be known. In reality, however, we

presently do not know the answers to many truly fundamental questions. To mention a few: What is the average yield from bankruptcies for secured and non-secured creditors? What are the administrators' compensations, what are the administrator's expenses? What is the usual amount of secured and non-secured receivables? What is the number of these receivables? How long do the individual acts of the insolvency proceedings take? And there are many more. These data are unavailable to us.

At least theoretically, some of them can be obtained from international comparisons published regularly in the publication Doing Business, issued by The World Bank and International Finance Corporation. The critique of these data has already been mentioned, and these comparative data are in fact interesting only from the perspective of international comparison; otherwise they have basically no information value.

This assumption of usefulness when comparing stems from the assumption that the data of these statistics are gathered the same way in all countries, whether in international comparisons or in individual years. It would then be burdened by roughly the same error; that is, mutual comparison of countries would be objective both mutually and in the development in time, but without being able to claim the real truthfulness of such figures.

1.2 The state of insolvency proceedings according to accessible data

We have already mentioned above the development of numbers of declared bankruptcies (commercial companies + entrepreneurs), which is one of the standard outputs provided by private companies. Of course, it is always interesting to compare the number of these really declared bankruptcies with the number of filed insolvency proposals.

Tab. 2 – Insolvency proposals in the CR, comparison with declared bankruptcies and permitted debt clearances, Source: insolvency register, Creditreform, http://web.creditreform.cz/cs/content/press/information/Insolvenzen_2012.pdf

Year	Commercial companies (proposals	Declared bankruptcies	Consumers (proposals)	Permitted Debt clearance	Total (proposals)	Total (bankruptcies+reorganisation+debt clearances
2008	3, 418	1, 141	1, 936	628	5, 354	1, 775
2009	5, 255	1, 553	4, 237	2, 145	9, 492	3, 711
2010	5, 559	1, 601	10, 559	5, 829	16, 118	7, 449
2011	6, 753	1, 778	17, 600	10, 620	24, 353	12, 415
2012	8, 398	1, 899	23, 830	17, 993	32, 228	19, 909

Note: Only proceedings according to Insolvency Act (182/2006 on Bankruptcy and Ways of its Settlement Coll.), proposals for commercial companies may be repeated

The table clearly shows the considerable disproportion between the total number of proposals and real, continuing insolvency proceedings. In the case of insolvency proposals that natural persons file on themselves in the form of personal bankruptcies, it is understandable that the ineptitude of certain consumers to enter into bankruptcy and carry out debt clearance will manifest itself – whatever the reasons may be. In this case, the considerable disproportion between the number of proposals and the number of real permitted debt clearances is not particularly surprising. But in the case of proposals for declaring bankruptcies of commercial companies and entrepreneurs, we see a much more pronounced state. In 2012, only 22.6 percent of cases of proposals for declaration of bankruptcies were obliged by the court and the proceedings continued. Meanwhile, in the first year of the effect of the Insolvency Act (2008), over 33% of proposals ended in bankruptcy (in the other years, this ratio was: 2009 – 29,6%,

2010 – 28,8%, 2011 – 26,3%). As we can see, this is a strongly decreasing trend, in which there are an increasing number of cases that the courts will refuse to hear.
The statistics of the Ministry of Justice are comparatively more detailed, containing from a formal perspective practically sufficient substantiations for discussions concerning the first phases of insolvency proceedings – unfortunately there are no attempts at registering and making public time and evolutionary aspects of insolvency proceedings.
As can therefore clearly be seen, available data on insolvency proceedings provide us with a serious overview on the number of filed proposals, the settlement of these proposals in the first phase, i.e. whether the proposal is overruled, whether declaration of bankruptcy results, and if so, what method of settlement is then selected from the side of the insolvency court. But these statistics tell us absolutely nothing of any substance regarding the other fates of insolvency proceedings and especially their results.
From these numbers, we can then deduce a very rapid rise in numbers of insolvency proceedings, especially in the category of natural persons. At the same time, we can see that the dynamic of growth is decelerating, which is given, among others, by a high foundation from the previous years.
Tab. 3 – The development of inter-annual numbers of insolvency proposals and the development of numbers of declared bankruptcies and permitted reorganisations and debt clearances, always in percentages. Source: insolvency register, Creditreform, own calculations http://web.creditreform.cz/cs/content/press/information/Insolvenzen_2012.pdf

Year	Change in number of insolvency proposals (personal bankruptcies)	Change in the number of permitted debt clearances	Change in the number of insolvency proposals (commercial companies)	Change in the number of declared bankruptcies	Change in the number of approved reorganisations
2009/08	+ 126.7	+241.6	+ 53.7	+ 36.1	+ 116.6
2010/09	+ 149.2	+ 171.8	+ 5.8	+ 3.1	+ 46.2
2011/10	+ 66.7	+ 82.2	+ 21.5	+ 11.1	-11.6
2012/11	+ 45.9	+ 56.2	+ 24.4	+ 6.8	0.0

Note: Only proceedings according to Insolvency Act (182/2006 on Bankruptcy and Ways of its Settlement Coll.), proposals for commercial companies may be repeated

As can be seen in Table 3, the growth of data on insolvencies is decelerating in the absolute majority of categories, which should suggest that the peak of this wave of insolvency is drawing near.

2 THE POSSIBILITY OF INTERPRETING AVAILABLE DATA

As we have asserted above, interpretation in the Czech Republic of available statistic data on insolvency proceedings is not given much space as the structure of data refers especially to the very beginning of insolvency proceedings; information on the course of insolvency proceedings is either very sparse or, more precisely, is not documented whatsoever. Nevertheless, data available to us enables to draw some interesting conclusions anyway.

2.1 Dynamic growth of proposals do not cause a rise in numbers of bankruptcies

We especially notice the marked difference between the number of insolvency proposals filed on commercial companies and entrepreneurs and between the number of really declared

business failures settled by bankruptcy or reorganisation. The following table will show us this difference consistently.

Tab. 3 – The number of filed insolvency proposals and the number of really declared bankruptcies and really permitted reorganisations. Source: insolvency register, Creditreform, own calculations http://web.creditreform.cz/cs/content/press/information/Insolvenzen_2012.pdf

Year	Commercial companies (proposals)	Declared bankruptcies	Permitted reorganisations	Difference between proposals and continuing cases	Ratio between continuing cases to proposals as a whole
2008	3, 418	1, 141	6	2,271	33.6
2009	5, 255	1, 553	13	3,689	29.8
2010	5, 559	1, 601	19	3,939	29.1
2011	6, 753	1, 778	17	4,958	26.6
2012	8, 398	1, 899	17	6,482	22.8

While the extent of the difference between filed proposals and those cases that (in the cases of commercial companies and entrepreneurs) reach bankruptcy or reorganisation constantly grows very dynamically in time, the ratio of bankruptcies and reorganisations of the entire amount of insolvency proposals, on the contrary, continuously falls in time, throughout the duration of the effect of the Insolvency Act.
Statistics do not really enable us to ascertain the reasons as to why this occurs.
According to data by the Ministry of Justice that is available on specialised web pages (http://insolvencni-zakon.justice.cz/downloads/statistiky/Statisticke_udaje_za_rok_2012.pdf), a total of 32, 649 insolvency declarations were issued in 2012 (proposals concerning citizens, commercial companies and entrepreneurs). At least so many insolvency proceedings were commenced (seven more insolvency proposals were filed, but it was not possible in some cases to identify the debtor, or they suffered some other impassable fault, due to which they could not even be made public). Only 20, 700 rulings in insolvency, however, were issued; in the remaining almost twelve thousand cases, the court either denied or overruled the proposal (§ 142 to 144 InsA.). Denial is more an issue of formal defects in the submission. Denial occurs especially due to lack of debtor property and there were a total of 1,391 such cases in 2012. In this area, the statistics of the Ministry of Justice does not enable one to correctly distinguish between individual proposals, i.e. which proposals by natural persons were denied or overruled and which proposals against commercial companies or entrepreneurs met a similar fate – we do, however, know that in cases appealing to §144, we focus on commercial companies and perhaps entrepreneurs.
A lack of property, the type which would, according to the court's evaluation, not even suffice to cover the costs of the insolvency proceedings is a growing phenomenon which is obviously most marked and economically the most significant aspect of the general situation of insolvency as we can come to know it from available statistics.

2.2 The speed of proceedings are increased by cases of emptied companies

Besides these cases, where a lack of property is recognised immediately (whereas among the creditors, none can be found that would lay down the deposit necessary for continuing the proceedings), there are also a considerable amount of proceedings where the bankruptcy of a debtor is declared, bankruptcy is the selected method of settlement, which is subsequently annulled for lack of property, the type of which quite clearly cannot serve towards any relevant satisfaction of creditors.

The present state of statistical probing does not enable us to research this question more precisely as we do not have at our disposal any data that could be used in an appropriate manner and subsequently interpreted.

While research was being conducted at the University of Economics in Prague, a sample of approximately 720 cases of insolvency proceedings took place in the second half of 2012, representing about one tenth of the entire number of proceedings commenced after the Insolvency Act took effect until October 2012. Analysis of this sample and established realities at the given time (January 2013) is just underway; we can, however, assert that at least half of declared bankruptcies have either been stopped while in progress due to lack of property, or these bankruptcies are closed with the monetisation of property practically covering the costs of the proceedings and the creditors are satisfied only marginally or not at all.

If we then connect the fact that roughly 30 to 50 percent of insolvency proposals against commercial companies and entrepreneurs do not even reach the phase where bankruptcy is declared, and if we add the reality that of declared bankruptcies, at least half do not even yield any kind of satisfaction to the creditors, we can contend that a crucial problem of the whole insolvency mechanism is the simple fact that entrepreneurial subjects or entrepreneurs enter into insolvency proceedings at a time when their property is thoroughly insignificant in view of their liabilities.

We see thanks thereto an interesting phenomenon which could be interpreted as a positive fact, but which is actually a major problem. The existence of a large number of emptied firms, where the insolvency administrator relatively rapidly surmises that there are no significant assets therein, creates an optical impression of markedly accelerated insolvency proceedings in contrast to proceedings having taken place according to the old Act on Bankruptcy and Compensation. The actual acceleration of the proceedings is considered a major plus of the new Insolvency Act; the question remains, however, as to how real is this acceleration in cases where bankruptcy is really underway and where property exists that is significant for the creditor.

2.3 Costs connected with the existence of empty companies

In any event, there exist considerable costs for the state connected with the fact that many emptied companies enter an insolvency trial and, during the hearing, some of them even get past a declaration of business failure and commencement of bankruptcy. Each individual action incurs significant costs, both on the court system and also the services of insolvency administrators, including preliminary insolvency administrators. Current statistics do not, however, enable us to express these sums more precisely as we do not know any more concrete data. For instance, we do not know the number of cases and how much money is paid out to insolvency administrators from state resources in such cases where the proceedings have commenced, but it is only subsequently discovered that the debtor's property is irrecoverable or cannot be monetised. Debtors are then not usually summoned to pay a deposit for insolvency proceedings, whereas costs do, however, arise; and in the closing report, these costs are put down to the state's account.

Of course, the creditors' expenses are much higher; they lose considerable resources in the context of insolvency proceedings, both from the principal of their receivables as well as unenforced interests, fines and other fees, but also from the title of their transaction costs connected with enforcing receivables, even if they are unsuccessful. Not even here are we able to ascertain anything in broader detail on the basis of available data as we do not in fact even know the entire volume of enforced receivables or the amount of transaction costs, nor do we even know the average satisfaction of secured and non-secured creditors.
As we have mentioned, the comparative statistics of the World Bank and International Finance Corporation are somewhat worthless in this regard owing to the fact that their data are evidently inaccurate and do not correspond to practice in the Czech Republic whatsoever.

Tab. 4: Duration of proceedings from declaration of bankruptcy and creditor yields (in the CR), Source Doing Business 2012, http://www.doingbusiness.org/custom-query

Year	**Duration of insolvency proceedings (in years)**	**Creditor yields from debtor bankruptcy (% of receivables)**
2002	9.2	15.4
2003	9.2	15.4
2004	9.2	16.8
2005	9.2	17.8
2006	9.2	18.5
2007	6.5	21.3
2008	6.5	20.9
2009	6.5	20.9
2010	3.2	55.9
2011	3.2	56.0

We naturally have entirely fundamental doubts in the case of these data especially as to the parameter of creditor yield from debtor bankruptcy, where even a perfunctory glance at the data from the sample of insolvency proceedings shows that it is thoroughly inconceivable that yields in the vicinity of over fifty percent of the receivable could be reached. In reality, one could even place doubts that such a yield can be attained even by secured creditors; a similar notion is practically absurd in the case of non-secured creditors.

3 CERTAIN CONCLUSIONS STEMMING FROM ANALYSIS OF AVAILABLE DATA

The basic conclusion which we can express in relation to the statistical data which we have at our disposal in the context of insolvency proceedings is that these proceedings are in many aspects unknown to us and we are therefore unable to define their course or their efficiency. What we can be certain of, however, and which available figures clearly lead us towards and substantiate, is the assertion that the vast majority of commercial companies or entrepreneurs that reach the phase of insolvency and fulfil a certain criterion for declaring bankruptcy as expressed by the Insolvency Act in §3 do not possess any relevant property at the time when insolvency proceedings are commenced that could enable effective conducting of insolvency proceedings.
This finding could lead us to several completely different conclusions, whereas strong arguments could conceivably be advanced for all of them as well as their subsequent utilisation in practice, that is, to taking certain legislative steps towards a change in practice.

On the one hand, we can express the thesis that the creditor is in a position which it took voluntarily and with knowledge of all risks stemming therefrom. It is thus its obligation to act in such a way so as to eliminate this risk and to have its receivable under adequate control. In other words, we thereby say that the creditor has a primary responsibility to take heed of timely and maximally effective enforcement of its variables.

If we omitted a number of variants between both extremes, we can define a completely opposite second approach. On the contrary, the primary responsibility would arise therefrom for the debtor to make certain that it would be able to ensure repayment of the creditors' receivables in all cases and that it conduct its financial management, including incidental and timely declaration of bankruptcy, in accordance with those responsibilities.

Both of these different poles of the possible spectrum of views have their justification and are truthful in a certain way. But both have their problems. The first of these, of course, is that in the creditor's case, it is in its basic interest to attend to the repayment of its liabilities. From the perspective of the debtor, however, we can speak of such a need only at a time when the debtor assumes its further operation in the economic system, thus when it is worth its while to repay the receivable from a medium to long-term outlook. If its situation is already unsustainable, interest in repayment of its own liabilities cannot be expected and it can only be forced to do so under the threat of penalties. This is the basic difficulty when relying on the motivation of the debtor.

As we know, moreover, the creditor's position in many cases does not enable effective management of receivables due to objective reasons; likewise, the creditor in many cases does not have sufficient knowledge as to the situation of the debtor as necessary information is unavailable. There is also the question of costs for compensation of the information asymmetry. The debtor has the maximum amount of information as to its situation from the principle of its functioning; it therefore does not carry further costs. If the creditor truly wanted to compensate such a broad and quite fundamental information asymmetry, then significant expenses would have to be outlaid and, what is more, they would have to be expended throughout the existence of mutual financial relationships.

Similarly, we know that besides an evident bankruptcy, when the debtor is unable to repay its liabilities in the full amount, on time and over a long period, which effectively makes public its bankruptcy, there exists also a situation of latent bankruptcy, when the debtor need not be unable to repay, but its liabilities exceed its assets. It is thus over-indebted. This fact can remain hidden from the creditors for a long time.

For these reasons, it is apposite to consider heightened protection of creditor rights when faced with debtors. Special attention is called for regarding the definition of over-indebtedness and possibly newly defined penalties against responsible persons representing the debtor if these persons do not react adequately to the development of the situation and thereby interfere in the creditor's rights in a way against which the creditor cannot adequately protect itself.

Therefore, if we wanted to draw some conclusions from the developments in insolvency proceedings in the Czech Republic from the way which we can know them on the basis of currently known data, one of them must necessarily be the assertion that the asymmetry of information between the creditor and debtor plays too large a role in the Czech insolvency system and puts the creditor at a disadvantage in a significant way.

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