The preservation of bankrupt businesses; experiences from the Czech Republic*

*L. Smrčka***

Abstract:
This work analyses the development of insolvency law in the Czech Republic since 2008, when the Insolvency Act came into effect. On the basis of statistic data on insolvency proceedings, it finds that at least one goal towards which the legislation was aimed has not been achieved – the support of financial rehabilitation procedures when settling the bankruptcy of a debtor. As regards such criteria as average duration of insolvency proceedings or yield for creditors, the situation has substantially improved, but remains worse than what is average in OECD countries. Based on analyses of the course of insolvency proceedings the author deduces future potential and suggests certain procedures which could be used to achieve substantially more interesting results from debtor bankruptcies for both secured and non-secured creditors.

Key words:
Insolvency Act, insolvency proceedings, financial rehabilitation principle of settling bankruptcy, liquidation method for settling bankruptcy,

JEL Classification: G33, G34

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** L. Smrčka is with the Faculty of Business Administration, University of Economics, W. Churchill Sq. 4, 130 67 Prague 3, Czech Republic (phone: +420-224-098-656; fax: +420-224-098-649; e-mail: smrckal@vse.cz).

1. The Intentions of Legislators in the CR

At the time when the legislative assemblies of the Czech Republic accepted Act No. 182/2006 Coll. *on Bankruptcy and Methods for its Settlement*, one of the main aims of the new legal amendment was an attempt to create an environment in which considerably more insolvency proceedings would end with the preservation of the business and its remaining in operation. The reasons for this endeavour were both economic and social.

The economic reason can be roughly described as a conviction on the legislator's part concerning the general economic benefit of reorganisation (the financial rehabilitation procedure for settling bankruptcy). According to this reasoning, financial rehabilitation enables especially the continuation of a business's activities; this should mean that a business's contribution to the creation of the economic gross domestic product is preserved. From this perspective, the legislator arrives at the assumption that the financial rehabilitation procedure for settling bankruptcy has a less negative effect on the development of the economy than the liquidation procedure.

The social reason is closely connected with the economical one. Rehabilitation is meant to preserve employment in a business and thus prevent negative impacts both on the business's workers as such and on the state social system.

Naturally, both of these notions can be strongly contested. As far as the economic reasons are concerned, the main question which arises is what competitive ability products or provided services have when it has been empirically proved that the debtor is unable to cover his liabilities, which in all probability stems directly from the business's inability to create adequate resources for covering liabilities. But then two things are uncertain: firstly, whether it is at all possible to keep a business in operation, and secondly, whether the preservation of a business's operation in economically justified. If we look at the social reasons, retention of employment is in fact an interesting and undeniably strong argument; nevertheless, the question remains whether such a procedure is sensible and whether it truly generates the expected benefit (Blazy and others 2011). The answer to both queries is simple – it is a matter of decision on the parts of the creditor or creditors and their economic considerations. In this sense, the legislator's desire takes a back seat.

However, from this it follows that the legislator's options to influence the creditors' decisions are necessarily extremely limited. Czech legislature has tried to achieve this by creating a technically unobstructed mechanism for implementing reorganisation, and debtors are to a certain extent favoured should they wish to implement reorganisation as a mechanism for settling bankruptcy. The legislator, however, only went so far as to enable reorganisation and reduce the risks for creditors connected with reorganisation insofar as the creditors can, in the event that they approve the reorganisation, take full control over the reorganised business and control the entire process. In this sense, Czech legislature did not resolve to undertake any revolutionary experiments.

2. Impacts of the New Legislation

The act took effect in its main parts as of 1 January 2008. During the more than four years of its real effect, however, there have evidently been only a marginal number of reorganisations, and the use of the financial rehabilitation procedure is no more frequent than was the use of similar procedures (settlement) in the previous act.

Table 1 Proposals rejected due to insufficient debtor assets, filed bankruptcies and permitted reorganisations (2003 to 2007 according to the old act, and from 2008 according to the new act, highlighted yellow)

Year	Proposals rejected due to insufficiency of assets	Filed bankruptcies	Permitted reorganisations (settlement)
2003	627	1719	9
2004	889	1435	6
2005	1159	1230	6
2006	1536	1238	7
2007	1986	1104	11
2008	668	651	6
2009	1768	1660	14
2010	1571	1948	19
2011	1441	2229	17

Source: Ministry of Justice CR, http://www.insolvencni-zakon.cz/

As the table shows, the number of permitted reorganisations may be higher in comparison to permitted settlements (the procedure in the old legislation), but there is no significant change in their ratio in relation to filed bankruptcies. If we use 2007 and 2011 as a reference, 2007 actually saw an increase in the ratio of permitted settlements to permitted bankruptcies in comparison to 2011.

From this angle, therefore, we can describe the new Czech legislation as unsuccessful insofar as it fell short of the above-mentioned intention to implement the financial rehabilitation principle when settling the bankruptcy of a business.

In spite of this, the new legislation did bring several interesting changes in other areas, especially in the relatively substantial reduction of time for hearing an insolvency proposal from the time when it is submitted to the final settlement of the insolvency proceedings. Creditor expenses connected with the process of insolvency proceedings were also lowered, and there has clearly been a relatively significant increase in the financial fulfilment which can be claimed by creditors. This, however, applies especially to secured creditors; as far as non-secured creditors are concerned, their situation has remained similar, which means extremely poor.

Table 2 Duration of insolvency proceedings, expenses for proceedings and yields from proceedings (2011)

Country	Duration	Expenses (% from yields)	Yields (% from investment)
CR	3,2	17	56,0
OECD (average)	1,7	9	68,2
Finland	0,9	4	89,1
Germany	1,2	8	53,8
Italy	1,8	22	61,1
Poland	3,0	15	31,5
SR	4,0	18	54,3
Sweden	2,0	9	75,8
UK	1,0	8	88,9
USA	1,5	7	81,5

Source: Doing Business 2012, http://data.worldbank.org/indicator/IC.ISV.DURS?page=1

Table 2 shows the state at which the Czech economy arrived in comparison to other states in 2011; it does not, however, offer a comparison with the past. In this connection, it must be emphasised that World Bank statistics show that the average duration of the insolvency process in the Czech Republic was an unbelievable 9.2 years – even as late as 2002. A

reduction to seven years was then achieved; and finally, this source states that the duration of insolvency proceedings in the Czech Republic has been 3.2 years since 2010. Similarly, the creditor could speak of an increase in the yield from bankruptcy from a mere 15.2 percent (2002) to the present 56 percent. This improvement was achieved progressively, but only in 2010, with the close of the first proceedings (conducted according to the new act) was there a qualitative jump from a level of almost 21 percent to roughly the present value.
In this sense, we can say that the new legislation in the Czech Republic met its aims when it significantly increased creditors' chances for reasonable financial fulfilment in cases of debtor bankruptcies. On the other hand, we must note that, in comparison to average values for OECD countries, we can see that the Czech Republic still lags behind insofar as the achieved values not only do not come close to matching those of the best states, but they do not even compare to the OECD average.

3. Using Reorganisation as a Solution for Bankruptcy

In the context of insolvency proceedings, relatively frequent changes occur during the course of these proceedings; these can be statistically mapped only with difficulty; and even then, the results attained by using these methods diverge somewhat from what was originally intended by the legislator. Thus, according to findings concerning reorganisations permitted in 2010 (Richter 2011), five proceedings from a total of 19 permitted reorganisations transformed into bankruptcies still before the approval of reorganisation plans. This means that the attempt to make use of the rehabilitation method floundered, whatever the reasons may have been. The case of *Oděvní podnik* is interesting from the economic perspective: Prior to its bankruptcy, it was the largest clothing manufacturer in the Czech Republic, a major employer, and a crucial business in the regional context. While company's largest creditor proposed reorganisation as a solution for its bankruptcy, the court accepted the proposals of smaller creditors, who cast doubt on the position of this crucial creditor, who was subsequently not permitted to exercise certain creditor rights. In reaction to this, he refused to finance the reorganisation and the result was a rapid transition to bankruptcy. Only after more than a year, courts of higher instances arrived at the conclusion that the entire insolvency proceedings had been conducted incorrectly; the economic damages caused during that time, however, precluded any return to reorganisation. On the other hand, a part of *Oděvní podnik's* assets was sold as a whole as functioning production, so it cannot be said that all business activities ceased or that all original employment positions were made redundant.
If we take into account also data from 2008 and 2009 (see table 3), we can see that, out of twenty permitted reorganisations over the two years mentioned (the first two years of the Insolvency Act's being in effect), four cases were transferred to the classical solution, i.e. bankruptcy. Bankruptcy is generally considered the so-called liquidation method, which means that its aim is the monetisation of the debtor's assets in the shortest time, whereas the key aim is to provide creditors with the highest possible financial fulfilment from the debtor's assets.

Table 3 Comparison of statistic parameters - 2010 vs. 2008-2009

Observed parameter	2010	2008-2009
Number of permitted reorganisations	19	20
Debtors under the test of size	3	1
Debtor insolvency proposals	9	18
Moratorium	3 (0 before)	2 (0 before)

Present filing of insolvency proposal and proposal for reorganisation	3	7
Creditor decisions and manner of settlement	12	14
Limiting of debtor's dispositional authority	10	3
Conversions to bankruptcy	5	4

Source: Richter 2011

Moreover, not even analyses of implemented reorganisations (Richter 2010, Richter 2011) answer the question as to the amount of times reorganisation really led to maintaining the operation of a business and to employment. Mechanisms defined by the Insolvency Act (Kotoucová 2010) need not necessarily move in the direction of financial rehabilitation, but may be aimed towards the liquidation of the business in question. In contrast to bankruptcy, reorganisation enables creditors to time the sale of the business's assets more effectively and have still stronger control over this process than would be the case in bankruptcy.

But in the same way that reorganisation can in fact serve to liquidate the company in the same way as bankruptcy, or the financial rehabilitation of reorganisation can transform into bankruptcy, bankruptcy can serve the purposes of reorganisation, which means it can enable the preservation of a business's production or operation. In a case where the debtor's business is sold as a whole to a single interested party, who continues the activities of the business, often maintaining relatively similar employment in the business as was the case prior to the bankruptcy, the result of the bankruptcy could be the financial rehabilitation (preservation of production), not liquidation, of the business (selling of assets). In this context too a real case from the Czech environment can serve as an example. We are referring to the bankruptcy of *Sazka*, the largest lottery company in the country. Here, the creditors (specifically, the new owners of older outstanding debts, who gradually bought these outstanding debts from banks and bond holders) implemented settlement through bankruptcy proceedings, in which the business was sold as a whole, without interrupting its activities in any significant way; it even managed to maintain its privileged market position.

These cases necessarily provoke thought as to whether the division of mechanisms (used to settle bankruptcy) into liquidation and financial rehabilitation makes sense, as economic reality inevitably tends to use methods which are more advantageous for creditors or the part of creditors who are able to make timely use of the mechanisms offered by legislation and optimise their positions in the process of insolvency proceedings.

4. Economic Reasons Behind the Non-use of Financial Rehabilitation Procedures

It is then clear that it is in principle irrelevant whether the law in a certain sense precisely defines the financial rehabilitation procedure in the context of insolvency proceedings (or at least a procedure which should lead to a debtor's financial rehabilitation, as the legislator would have it); of greater importance is the issue of whether the creditors have a reason to attempt the financial rehabilitation of a debtor's bankruptcy, or whether such a procedure is economically pointless from their points of view, or perhaps too risky, lengthy, legally uncertain and so forth. We can also define the situation by asking whether a debtor's financial rehabilitation may bring greater benefits than his liquidation. If so, it will probably be of little importance whether the appropriate legislation contains a particular provision – if the creditor could benefit more from financial rehabilitation, this would truly be a frequent solution for the bankruptcy of a debtor. The task of legislation is, then, only to create a legal framework, but a framework flexible enough for the creditor to proceed according to his needs. The role of statutes and the courts system is therefore to reduce general and legal risks directly associated with insolvency proceedings.

From this point of view, however, statistics from the first years of using the Insolvency Act in the Czech Republic are very clear. There is no meaningful use for the financial rehabilitation procedure as such. This can be proved not only by the small number of permitted reorganisations (especially when bearing in mind that a significant percentage of them gradually transform into bankruptcies), but also by the essential disuse of other mechanisms which serve to protect the debtor and are meant to enable his recovery.

We are referring mainly to the moratorium (i.e. protection from the creditor), a procedure which prevents creditors from enforcing outstanding debts from a debtor for a certain amount of time, whereas the debtor can during this time consolidate or negotiate with the creditors; after abandoning the moratorium, he can use the gained resources to prevent a further move in the direction of bankruptcy. This mechanism is used only minimally.

If we put this fact under analytical scrutiny, we necessarily arrive at the view that the reason for the disuse of this mechanism is the fact that there are practically no debtors whom the moratorium could help. Throughout 2011, there were twelve cases of debtors who requested a moratorium, whereas three of these concerned moratoria prior to the start of insolvency proceedings and nine were moratoria connected with the insolvency proceedings as such. Of these twelve attempts, the court permitted only six moratoria (Ministry of Justice 2012). 2011 was the fourth year of the functioning of the whole system according to the Insolvency Act, which means that it is not possible to explain the situation by saying that creditors and debtors do not have the necessary information or that they have not had an opportunity to "explore" its possibilities. The only truly logical interpretation of the situation is the conclusion that businesses that are bankrupt or on the verge of filing for bankruptcy are in such a hopeless state that neither the moratorium nor reorganisation makes any real sense.

5. Real Possibilities for Financial Rehabilitation Procedures

Of course, we can debate the issue that the parameters of such procedures as the moratorium or reorganisation are poorly set in the legislation itself, and that this is the reason why their use is best passed over in silence. But in that case, we should have information on this from the market, which is not happening – no information has emerged which would attest to the fact that the diction of the law precludes the implementation of certain steps which would be beneficial from the perspective of the economy as a whole.

In reality, it is quite clear that the main problem in the Czech insolvency environment is the fact that most businesses which enter insolvency proceedings are not actually bankrupt due to their inability to pay (insolvency), but as a result of over-indebtedness, i.e. at the time when proceedings are commenced, their assets are worth less than the debtor's liabilities. It is then impossible to expect a higher yield for the creditor and it is impossible to even assume that the bankruptcy could be resolved by the reorganisation and financial rehabilitation of a business. The creditors would accept such a course of action only if the business were able to compete and, therefore, if it were able to generate cash flow in the corresponding amount. The fact that the business is over-indebted, however, suggests that its ability to generate the necessary cash flow and competitive ability have been insufficient for a long time. It is probable that the management and proprietors of the business try, through further liabilities (whether connected with banks, or paying its suppliers late and at once), to hide the fact that the business is incapable of further existence. There are numerous reasons why the proprietors and management proceed in this manner: Most of the time, there is an endeavour to gain personally by continuing the business's activities, or at least reduce personal losses in the time gained (Richter 2008); there is a considerably lower incidence of certain specific situations connected with sudden changes in the economic environment or even with various forms of

external attacks (Ristvej, Zagorecki 2011); a consequence of over-costly investments which were not completed in time could also be involved (Sieber, Hnilica 2011). But this does not change the fact that such a course of action logically results in a lower yield (from outstanding debts) for the creditors.
If the entire insolvency system is to aim towards increasing yields for creditors, acceleration of insolvency proceedings and, among others, also strengthening the possibilities to settle bankruptcy through reorganisation (i.e. the financial rehabilitation of the business), then the main problem appears to be ensuring a condition in which businesses will enter bankruptcy proceedings substantially sooner than is the case at present, i.e. at a time when their liabilities are at a lower level than their assets.

5.1 The potential of insolvency law reforms

In reality, the excessive lengthiness of insolvency proceedings or the insufficient yields generated by these proceedings is a problem for creditors not only in the context of the Czech economy – unsatisfactory results are achieved in numerous other countries, such as Germany or Italy. Attempts towards reforms thus regularly appear in numerous states; and for this reason, it can be said that insolvency law has in the last few decades become an extremely lively and dynamically developing field.
In the Czech environment, a vision of relatively substantial reform of insolvency law has emerged in the last year; this would primarily be based on a new definition of the concepts of over-indebtedness as it is contained in the Insolvency Act (Hnilica, Ševčík 2012; Schönfeld, Smrčka 2012; Kislingerová 2012). If we simplify the problem somewhat, the regulation of indebtedness is presently set at one hundred percent of the business's assets, as responsible entities from the company management or from among the business proprietors (if they are members of statutory bodies) are obliged to file a proposal in court to commence insolvency proceedings in cases of over-indebtedness, in a situation when the businesses' liabilities exceed its assets. The act also contains certain inhibiting supplements when, after calculating the value of the assets, it is possible to take into account future yields and the progress of further enterprise. However, in such a situation the regulative significance of this provision practically disappears: Even though it is already known to the responsible entities that the businesses liabilities exceed its assets, they can nevertheless explain their failure to file an insolvency proposal by asserting that there was a justified assumption that economic management would improve. It is then practically impossible for the creditors to demand (from the debtors) some form of satisfaction or compensation for damages arising from the continued activity of the company, as it is practically impossible to prove that the diction of the law was fulfilled.
But this means that a hidden bankruptcy such as this need not be reported by the debtors, as the responsible entities are in no danger of being called to account for negligence.
Changing the definition of over-indebtedness involves two steps. The first is the removal of ambiguous passages in the law and retaining the simple obligation of filing an insolvency proposal. This means that an implementation of only this change would result in members of statutory bodies and other entities being obliged to take the necessary measures as soon as they become aware of the business's liabilities exceeding the value of the business's assets. Of course, another difficulty emerges here – that of the manner in which the business's assets are to be monitored for this purpose and how they are to be calculated. The present law does not deal with this problem in any way, and this definitely has to be changed (Schönfeld 2011).
The second step (and this is truly a radical intervention into insolvency law) is the notion of reducing the entire regulative limit of indebtedness; this means that over indebtedness would

not occur when liabilities are equal to or exceed assets, but as soon as a limit of, say, eighty percent of the asset value is reached.
The logic of this change is clear. If (at the given time in the Czech environment) secured creditors gain eighty to ninety satisfaction for their outstanding debts and non-secured creditors three to five percent of their outstanding debts, then one of the reasons for this inappropriate state must be the fact that the business's assets sold in the context of bankruptcy do not meet expectations, that is, their market value proves to be lower than what was assumed. This does not necessarily occur because a debtor overvalues his assets which are used to provide collateral for a loan. It generally applies that the largest number of bankruptcies occur in times of crisis or relatively soon after a recession. This is also a time when asset values generally decrease, and where assets needed for business are concerned (for instance, factory buildings or machines, then this drop is still more marked than in other areas (Schönfeld 2011). This is why these assets have a substantially lower value when they are monetised than when they were accepted as collateral. This is an objective fact which leads to loans being over-secured, when creditors require collateral at the outset which far exceeds the value of the loan. This state of affairs leads to a range of problems in relations between banks and debtors.

5.2 Arguments supporting stricter regulation

If we consider certain basic postulates to be logical and indubitable, then tightening the regulations for the volume of accepted loans against the entire assets of the business appear to be possible and appropriate. These postulates are primarily:

- the conviction that in cases of outstanding debts, the creditor is on the side of the relationship which the law should support and protect; the law should therefore secure appropriate possibilities for him to be able to effectively enforce his outstanding debts,
- in comparison to secured creditors, the position of non-secured creditors is unjust in its very principle; non-secured creditors are unable to secure their outstanding debts from the very principle enabling the functioning of economic relationships and the mechanisms which generate these outstanding debts – it is not a result of recklessness or laxity on their parts (at least not in the vast majority of cases),
- if the state sets a system for insolvency proceedings, in which individual mechanisms for enforcing outstanding debts are precluded and replaced by collective enforcement, then at least some of the rights of individual creditors are necessarily encroached upon,
- by the very implementation of the principle of insolvency law in the context of the legislative process as an instrument of collective enforcement, the state power assumes part of the responsibility for the results of insolvency proceedings, albeit only on a moral level. In fact, this responsibility arises towards those creditors who would otherwise lay claim to their outstanding debts through their own efforts and methods according to individual rules for enforcement (but due to the filing of an insolvency proposal they are prevented from so doing, given the fact that the ruling of the state power and legislator precludes the possibility of individual enforcement at such a moment).

If we are the witnesses of a state of affairs in which the aims of the new legislation in the field of insolvency proceedings were not met, despite all the legislator's efforts, it is fitting to discuss further reforms and changes. The implementation of new regulations for accepting liabilities from the debtors' sides could ensure:

- higher financial fulfilment for secured creditors, where financial fulfilment could probably reach as high as one hundred percent,

- considerably higher financial fulfilment for non-secured creditors,
- pressure would be exerted on management and other responsible entities on the debtor's side, as the financial management of debtors and their capital structures would have to adapt to the new definition of over-indebtedness; it would probably lead to considerable strengthening of use of checking mechanisms and analytical procedures when implementing investment aims.

6. Conclusion

The financial crisis and credit crisis which hit developed countries and the majority of world economies in 2007 to 2010 showed that numerous traditional relationships in modern economies are in need of reform and revision. One of the paths forward is a return to non-regulated relationships and allowing substantially more space for natural interaction between economic subjects, but this path has proven to be politically impassable in the long term. Another possibility is the constant implementation of new regulative principles based on present regulations, but regulation systems implemented at the end of the last and the beginning of our century have shown themselves to be of little effect. It seems that tightening these regulations will not have the necessary effect.

The third possibility is the implementation of new types of regulations which would set certain limits within economic systems. The basic paradigm of thought for such a manner of regulative activity is not the limitation of certain procedures in their particulars, but a general setting of the legal framework so that their possible use would not ultimately damage economic subjects other than those who contravene the regulations.

It is precisely from this third conception that the notion of regulating indebtedness in relation to entire assets arises, i.e. a new definition of over-indebtedness or a reduction of the limit for defining hidden bankruptcy. This conception arises from the awareness that bankruptcy or immanent or unavoidable bankruptcy can for a relatively long time be masked from business partners and creditors, which leads to a situation where, in a relatively short time, over indebtedness becomes so marked that insolvency proceedings involve significant losses for the creditors.

A crucial moment for implementing this regulation is primarily ensuring that the debtor's responsible entities are truly forced to file an insolvency proposal in time; for example, in a situation when the business's liabilities reach eighty percent of the business's assets. Here it is possible to list three basic assumptions for this kind of legislative measure to be implemented in practice:

- precise definition of business assets, their calculation and systematic monitoring,
- criminal law liability of responsible entities,
- asset law liability of obligatory persons.

If the legislator accedes to this form of regulation in the future, it will make sense only if these assumptions are fulfilled. This naturally cannot prevent excesses and cases where responsible entities knowingly opt for criminal behaviour; nevertheless, in the long term perspective it would lead to pushing through regulation for accepting liabilities in connection with the debtor's assets and thus to a range of positive effects resulting from such measures.

Among these, we could mention improved relations between creditors and debtors insofar as limiting creditors' risks would lead to a reduction in the cost of money. Debtors would practically be forced to pay closer attention to the prudence of their enterprise from the angle of the capital structure of the business, leading to a higher measure of caution in their decision-making processes.

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