The possibilities of reforming Czech insolvency law

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Abstract: - This study concerns the possibilities of reforming Czech insolvency law on the basis of experiences during the first four years of the efficacy of the new legislation in the country. After evaluating changes in expenses outlaid by creditors on an insolvency proceeding, the length of an insolvency proceeding and in yields from insolvency proceedings for creditors, the thesis is formulated that further improvement of creditors' situations and further improvements in the functioning of the insolvency system as a whole is possible only if more comprehensive changes are made in the legislation. An analysis of the functioning of the new law and connected regulations from 2008 to 2012 (the first quarter) shows that a fundamental problem in the processes of solving bankruptcies among Czech business subjects is the fact that insolvency proceedings are commenced very late, at a time when these business subjects possess very few assets which are dramatically insufficient for satisfying the debtor's creditors, especially non-secured creditors. For this reason, new measures of a legislative and systematic type which could lead to a rectification of this unacceptable state are proposed.

Key-Words: - Bankruptcy, debtor, insolvency, insolvency law, reorganisation, creditor.

1 Legislative promise

With the implementation of the new *Insolvency Act* (Act No. 182/2006 Coll. on *Bankruptcy and Ways Towards its Solution*, legally abbreviated InsA) and its coming into effect in 2008, significant hopes, among other things, were placed on the strengthening of the so-called financial rehabilitation principle in insolvency practice. In the given context of business bankruptcy, we understand that this concept entails a more frequent utilisation of reorganisation as opposed to compensation, which was the case with the previous act (Act No. 328/1991 Coll. *on Bankruptcy and Compensation*). After more than four years of the new legal amendment's being in effect, however, the time has come to assert that these hopes have not been fulfilled and in reality, we are unable to show that, in comparison to the total amount of bankruptcies, the financial rehabilitation principle has become a more significant aspect of insolvency practice than was the case with compensation.

At the same time, it would be somewhat naive to thereby deduce that it is merely the fault of the diction of the act and its particular provisions. On the contrary, the problem is apparently deeper and arises from crucial economic relationships and habits set in the Czech economic environment.

2 Problems of insolvency proceedings in the CR

Although there was a marked improvement in the results of the insolvency system after 2008, after the new insolvency legislation took effect, the situation in the Czech Republic is still far behind that of the state in OECD countries. This assertion can be substantiated by numerous facts.

Tab. 1: Duration of insolvency proceedings, costs for proceedings and yields from proceedings (2011)

Country	Duration (years)	Costs (% of yield)	Yield (%of 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
GB	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 [1]

As we can see, the duration of insolvency proceedings in the Czech Republic is almost twice the average of OECD countries. If we were to use the country's largest commercial partner, i.e. Germany, as a comparison, the duration of insolvency proceedings would be practically three times as long. The situation is practically the same with costs of proceedings. Yields from investments are also considerably higher on average for creditors in OECD countries; it is true that, in comparison to Germany, the Czech economic environment is successful in this regard, but if we look at Finland, Great Britain, or the USA, then the difference in this category of comparison is literally enormous.

It is an indisputable fact that the length of time for insolvency or similar proceedings in the Czech Republic has significantly decreased in recent years, clearly as a result of the new insolvency act. This is, moreover, shown by Table No.2. We can observe similarly noteworthy progress where yields for debtors are concerned – the increase is truly rapid; however, as Table No. 1 shows, in comparison to the OECD average and, most importantly, in comparison to certain economies which can boast the highest quality environment in this sense, the improvement must still be deemed totally insufficient.

Tab. 2: Duration of proceedings and yield for creditors from proceedings following declaration of a debtor's bankruptcy (in the CR)

Year	Duration of an insolvency proceeding (in years)	Creditor's yield from debtor's bankruptcy (% of receivable)
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

Source: Doing Business 2012, http://www.doingbusiness.org/custom-query [2]

Because Czech commercial law can (after the coming into effect of the insolvency act) be termed a legal system on the level of significant foreign regulations which also served as an important model for the Czech legislation, the fact that the insolvency system as a whole is still relatively weak in efficacy should be probably be searched for in areas other than the diction of the insolvency act itself.

We can to a high degree of probability define two loci of reasons as to why the efficacy of the Czech system is lower than that of systems in developed economies. The first reason is probably the fact that we have to deem the entire system of commercial judicature and settlement of lawsuits arising from entrepreneurial activities in the Czech Republic slower than similar systems in the most developed countries. Secondly, there is also the issue that Czech businesses and other business subjects enter the insolvency process later than what is appropriate, especially in times when the business's problems are not merely defaults to creditors, but over-indebtedness to a much more fundamental degree, i.e. when the business's liabilities are significantly higher than the value of its property.

2.1 The problem with the length of commercial lawsuits

According to World Bank statistics (*Doing Business* 2012), the usual length of a commercial lawsuit in the Czech Republic is 611 days (In OECD countries the average is 518 days).

Tab. 3: Duration of a commercial lawsuit (amount of days from filing to court ruling)

Year	CR	Netherlands	New Zealand	Germany
2002	663	534	232	403
2003	663	534	232	403
2004	653	534	220	394
2005	653	514	220	394
2006	653	514	220	394
2007	653	514	216	394
2008	653	514	216	394
2009	611	514	216	394
2010	611	514	216	394
2011	611	514	216	394

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

This serves to prove the relatively poor quality of the whole system of commercial judicature. Although some improvement can be observed here, we can by no means deem this sufficient or corresponding to the needs of the economy.

It thus seems that within a relatively short time it will be necessary to considerably change the situation in this regard and that the court system will generally need to become significantly more effective. This could probably be achieved through a further simplification of the court system, reducing time limits and, most importantly, excluding less important cases from this relatively complicated mechanism

The problem with the length of commercial lawsuits has one important effect which has not been fully appreciated in the Czech environment. Conducting a lawsuit which leads to seizure of a debtor's property is a means of individual enforcement of the creditor's receivables from the debtor. Given that this type of enforcement is still neither fast nor effective enough, numerous subjects do not resort to it and rather allow space to negotiate with the debtor instead. Individual enforcement entails expenses and, given the length of commercial lawsuits, does not allow much space for a creditor to truly succeed should he choose to consistently defend his rights in this manner. While his lawsuit proceeds, the debtor's situation is likely to deteriorate, meaning that at the end of the lawsuit, the debtor will either not have any property at his disposal anymore with which to satisfy the creditor, or his situation develops in such a way that he has to enter into an insolvency proceeding. In such cases, however, any further possibilities of collective enforcement of receivables are curtailed and creditors are relegated to a collective approach. A responsible creditor thus outlays expenses, but his prospects for success are extremely low as it is impossible to assume that, given the significant length of a lawsuit, it is possible to achieve appropriate satisfaction by means of individual approaches.

2.2 The problem of insufficient property

Another circumstance, however, manifests itself as more important aspect of the situation insofar as businesses entering into insolvency proceedings do not have sufficient property to appropriately satisfy creditors. This state of affairs is shown by Table 4, from which we can read the proportion between the entire amount of declared bankruptcies and those cases where further court adjudication is cancelled (when it becomes evident that the bankrupt business subject has no property which would enable effective conducting of insolvency procedures which could achieve its aims, i.e. satisfaction of creditors).

Tab. 4: Proposals rejected on the grounds of insufficient debtor property in comparison with other cases

Year	Proposals rejected on the grounds of insufficient property	Declared bankruptcies	Approved reorganisations (compensation)
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/ [3]

In Table No. 4 we can see that the proportion between petitions filed which were subsequently rejected by the court on the grounds of insufficient debtor property and those which culminated in declaration of bankruptcy has changed in a significant way over the past ten years. In certain periods, the amount of petitions which the court

refused to hear was actually higher than the amount of declared bankruptcies. This is an extremely disquieting fact, considering that in 2007, practically twice as many petitions were rejected owing to the fact that the businesses had ceased to exist by the time they had been accepted for proceedings. In fact, it is fascinating: Let us imagine an economy where two out of three businesses try to remain in operation so long that they expend the last remnants of their assets, at least those that are not pledged in favour of creditors and that are thus accessible to the debtor. Such an economy is evidently full of managers who consider maintaining a business in operation to be their mission in life.

It could also be an economic system where certain legal regulations have been poorly set, so the legal system is unable to intervene against the kinds of managers and business proprietors who keep their bankruptcies secret – whatever their intentions may be. This explanation is arguably more probable, as it corresponds to the models we are familiar with. Bankruptcy and insolvency proceedings are a sort of period in the history of a business's existence when, from the proprietor's point of view, assets are destroyed with final effect – whether by becoming worthless or because they are monetised and the yield is used to remit the creditors' receivables. Also from the perspective of the management, the future is generally closed, at least within the scope of the given business insofar as the end of its existence is mostly clear, and if it is not, it is improbable that the future proprietors will take over the company with the management. As far as the impact in terms of reputation is concerned, it is often serious for the management. It is therefore not surprising that both the proprietors and the management exert effort to influence events before bankruptcy to such an extent in order to open avenues for uses of assets other than those which are a natural part of an insolvency proceeding.

Thus, if we were to search for reasons as to why so many companies enter into the insolvency phase of their existence in a state where they are truly devoid of property, we could name several motives besides the classical economic ones (such as inability to compete).

Primarily, it seems that the insolvency act was unable to effectively oblige responsible persons to petition for insolvency for their own companies. The new amendment prescribes this to a group of responsible persons not only in cases of evident bankruptcy; that is, in cases of inability to remit the company's liabilities within the agreed time or at least thirty days after their due date (inability to pay or default), but also in cases of latent, or hidden bankruptcy, i.e. if the business's liabilities are greater than its property (over-indebtedness). The lawgivers' intentions, however, clearly remained unfulfilled in practice.

Evidently, the fact that over-indebtedness can occur relatively long before actual insolvency takes place was not fully appreciated. In practice, we can find many businesses which are truly over-indebted, but which continue in their existence; and in reality it cannot be ruled out that some of these businesses are later saved or that prolonging their activity eventually leads to real solution of their bankruptcy – for instance, through a merger or other procedure outside the area of insolvency law. In reality, however, the number of these "happy endings" which entail one hundred percent or almost one hundred percent satisfaction for creditors is not likely to be high. A far more common consequence of prolonging the operation of an over-indebted business is usually that the business enters into insolvency proceedings with property that is insufficient in proportion to its liabilities, or even low enough to render the effective course of insolvency proceedings impossible.

This means that emphasis on property or criminal liability of business managers or proprietors should lead to a reduced number of businesses entering insolvency in a state of extreme over-indebtedness. But apparently, although we cannot take it as a proven fact, the opposite is the case, and the actual codification of criminal and property liability of managers has resulted in no substantial change in this state of affairs.

It should, moreover, be taken into account that the efficacy of pertinent provisions of the *Insolvency Act* (itself effective from 1 Jan. 2008) was already stopped once during 2009 and renewed on 1 Jan. 2012. [4] It is therefore difficult to examine their true functionality; at least we cannot do so from the perspective of a longer period, which is certainly necessary for a critical assessment of the situation. However, Table No. 4 shows that in all probability, this amendment is insufficient at present and does not meet the aims of the legislation. The first of these was to create an environment in which there would be fewer businesses whose entry into an insolvency proceeding would culminate in the court discovering that the property of the business does not suffice to conduct the insolvency proceeding, that is, that the property of the business is practically null and void. The second intention was to create a state where, in the majority of cases, not only secured creditors would gain higher remittance for their receivables, but non-secured creditors too would reclaim at least some of their finances. At

present, however, this occurs only in very exceptional cases.

3 Possibilities of reforming the insolvency system

This discovery opens the need for discussion regarding further reforms of the insolvency system in the Czech Republic, including reforms in commercial judicature.

As regards the field of insolvency law, there is room for a quite radical, but arguably effective solution to the discussion which relates to the problem of over-indebtedness of businesses. In the given context, over-indebtedness is defined as follows in § 3 Para. 3 of the *Insolvency Act*: "Over-indebtedness occurs when a debtor has several creditors and the sum of his liabilities exceed the value of his property. When fixing the value of the debtor's property, further administration of his property, or further operation of his business is also taken into consideration if, in view of all circumstances, it can reasonably be assumed that the debtor can continue in the administration of his property or the operation of his business." [5]

Logically, a provision thus defined is completely ineffective owing to the fact that it always enables authorised parties to claim that they had expected further administration of property and subsequently a significant improvement in the business's financial situation which would lead to its bankruptcy being brought under control. This diction of the act could largely be dismissed as an example of passing the buck from the perspective of legislative activity: On the one hand, the lawgivers make it clear that an over-indebted business should not partake in future economic relationships, and that it should be prevented from transferring its financial situation to other subjects – most importantly, its suppliers (creditors from commercial contact, mostly non-secured creditors from the logic of things). On the other hand, however, the lawgivers define such "gentle" criteria for assessing over-indebtedness (i.e. hidden bankruptcy), against which the creditors have no effective defence that, with the exception of completely unambiguous cases, we basically cannot assert that responsible persons could not, "in view of all circumstances", assume future successes for the business enabling an improvement in its financial situation.

However, the issue of an appropriately defined obligation to propose that one's own business file for bankruptcy is decisive for increasing the yields taken from insolvency proceedings for creditors – both secured and non-secured (who face a far more fundamental problem). The present solution thus needs to undergo critical analysis of its functionality – both on the basis of real, known cases and with the aid of modelled situations.

For the time being, however, it can be asserted that one possible solution would be to define "over-indebtedness" differently than is presently the case. There can be no doubt that this would entail a fundamental intervention into the very concept of insolvency law and even into the philosophy of this law.

This can be conceived on two levels. The first would involve the removal of relative conditions from the formulation of § 3 Para. 3 of the *Insolvency Act*. This means that bankruptcy would be defined as a state when the liabilities of a business exceed its property, without further circumstances, i.e. strictly. Naturally, the question remains as to how to define property from the aspect of its true value, that is, as security that creditors will receive adequate fulfilment in the event of its monetisation. This accounting problem is fundamental; nevertheless it can largely be considered technical in the sense that a difficulty with correct definition is in question. However, it is obvious that the real amount of monetisation is detectable after its realisation; any estimate of value carried out even with the best of intentions is clearly a merely theoretical concept. [6]

Even this intervention would clearly evoke a significant reaction in the behaviour of debtors, as it would involve a restriction on their approaches and would force the debtors to be far more cautious if we now simplify the issue of debtors to the locus of responsible persons from the legal perspective.

It is also possible to go still further and define over-indebtedness more strictly than as liabilities exceeding 100% of the property of the business. This thought may immediately seem absurd for several reasons – for instance, in view of the volatility of asset value and other influences [7] which businesses are subjected to. Still, even these are in fact merely technical complications and are no different from those which we are presently dealing with in similar regards. In any event, similar measures would entail a meaningful strengthening of creditor security.

Such a solution would use a logical concept as a departure point insofar as the property of a business is an unknown value given as we do not know its potential during the monetisation process. The rules of caution in such cases dictate that it is not possible to accept a debt to the amount of 100% of the potential security; on the contrary, it is necessary to index the value of the security downwards to also cover risks. This would, however entail defining

over-indebtedness not as a state in which liabilities reach over one hundred percent of the business's property value, but rather when they reach eighty, ninety or perhaps even seventy percent of the business property value.

4 Advantages and risks of reform

The aim of similar reforms of law and the insolvency system should not be the creation of a situation in which creditors receive one hundred percent of their receivables. Such a state would evoke inappropriate reactions on the side of creditors: it would lead to their laxity and the growth of risks taken on their part in a way that would be unwise economically. However, increasing safety for investors and for creditors can bring about an improved situation on the money market, increase trust in the whole economic system and it could also create an environment for reducing prices – both of money and supplies. Insofar as participants in economic matters would not be forced to calculate risks in volumes as they have had to until now, new avenues would be opened for a general reduction of risk margins.

From the economic point of view, the matters described above have been clearly proven and it is thus unnecessary to prove this potential. The volume, or the extent of changes to which these measures could lead to in the long term perspective cannot be estimated.

A highly probable result of this would be that, if numerous businesses entered into an insolvency proceeding in a state when they were still capable of further operation, strengthening them using the financial rehabilitation principle (reorganisation) would be a solution. In view of the fact that debtors would be forced to entrust further decisions regarding their company to their creditors substantially sooner than is the case at present, there would be a better chance to save the business subject in the sense of its continued existence. This would have the effect of fulfilling one of the goals which the new legislation accepted in 2008 intended to achieve. At the time, the new act aimed towards fewer businesses ending their existence during an insolvency proceeding in liquidation and bankruptcy. On the contrary, the number of businesses which would undergo reorganisation and be preserved as independent units and, most importantly, as employers, was meant to increase.

The Czech business environment is no oddity in this sense, given that political pressure in developed aims primarily to prevent insolvency from becoming a cause of further unemployment. In several developed countries, the perception of settling insolvency has evolved to the extent that the courts themselves are legally obliged to seek possibilities for preserving employment positions when a debtor is declared bankrupt, which forces them into an insoluble dilemma with a further obligation – taking maximum profits for the creditor. [8] A solution which would involve a reform of the insolvency system and changes in the definition of over-indebtedness, would probably move in the direction of achieving this goal in an economically cleaner fashion which could not be dismissed as an invasion into the nature of economy.

Naturally, changing the definition of over-indebtedness would carry considerable risks which cannot be taken lightly. One of these is the danger that hasty implementation of similar regulations (especially in the sense of implementing a new definition of over-indebtedness) would evoke a certain reaction in the business field, where the legal definition of bankruptcy would be applicable to too many businesses. Prior to the implementation of this measure, it would therefore be necessary to define a transitional period during which businesses would receive a certain period of time to adapt to the new legislation – an appropriate period would probably be three years in the event that the boundary for bankruptcy would be liabilities at an amount of 90% of the business's property, or five years if this boundary were to be 80 percent. In the first phase, it would also be appropriate to remove the passage following the actual definition of bankruptcy from the effective law which relates to circumstances for assessing a business' property in relation to its further existence and annual trading income. Any future amendment would have to be stricter than the present variant – it would have to cease considering exceptions and strictly fix a level of liabilities against property to make it impossible to manoeuvre within the legal prescription and thereby destroy the entire provision.

Of course, it is highly possible that new regulations, especially the removal of manoeuvring space making it possible to rely on a business's future results, would result in bankruptcies even in the cases of companies which were not dead economically and which were really only experiencing temporary difficulty. A situation can conceived in which, in a completely exceptional case, a sustainable project could disappear from the economy. This, however, is more a question of the capabilities of the proprietors of such a business and their negotiations with their creditors – if they are able to prove that the future management of the company would be more effective, they would quite probably be capable of implementing reorganisation

as a means of solving bankruptcy problems. This is despite the fact that the current insolvency act gives the debtor substantial room to propose reorganisation as a means of solving bankruptcy problems, propose a reorganisation plan and, if he cooperates with the court in an appropriate manner, to receive approval for the plan. Such approval could be gained although certain groups of creditors may disapprove and (if the plan is compiled in a certain way) even despite the disapproval of the majority of creditors.

5 Conclusion

If such a reform of insolvency law and its related regulations proceeded powerfully enough, it could bring about a general reduction in time in commercial lawsuits on the one hand. Furthermore, it could lead to strengthening individual enforcement of receivables given a reduction in time needed to conduct commercial lawsuits in court. This would benefit the economic environment in general – debtors would lose manoeuvring space when facing creditors, who would thus be in a stronger position. At the same time, if the change mentioned in the insolvency act and stricter definitions for over-indebtedness were implemented, businesses would not enter bankruptcy proceedings without the necessary property and creditors would be satisfied to a much higher degree than is presently the case.

All these movements of the economic environment would primarily have the effect of lowering the general extent of risks and strengthening the mutual trust of economic subjects. This in turn would lead to significantly decreased creditor expenses, both on a general level, and during actual insolvency proceedings.

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