35026

REPORT ON OBSERVANCE OF STANDARDS & CODES
INSOLVENCY AND CREDITOR RIGHTS SYSTEMS
CZECH REPUBLIC

DATE: APRIL 2001

PREPARED BY: GORDON W. JOHNSON

TABLE OF CONTENTS

I. INTRODUCTION

1. This report assesses the Czech Republic's insolvency and creditor rights systems pursuant to a joint International Monetary Fund-World Bank program to observe compliance with international standards and codes ("ROSC") in areas pivotal to a country's financial sector stability and market integrity.[1] This particular assessment is based on the World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* ("Principles"),[2] and reviews compliance in four key areas: (i) creditor rights (including secured transactions) and enforcement procedures; (ii) the legal framework for corporate insolvency; (iii) the regulatory framework to implement the insolvency system, and (iv) the enabling framework for credit risk management and informal corporate workouts. These systems constitute an essential cornerstone of commercial confidence and the bedrock for sound credit management and resolution.

2. The conclusions in this assessment are based on a review of the Bankruptcy and Composition Act, the laws dealing with the creation, registration and enforcement of pledges and security interests (e.g., Commercial Code, Civil Code, Civil Procedure Code, Public Auctions Law, and the Execution Law), and other relevant pieces of legislation.[3] In addition to the review of legislation, regulations, and related information, the conclusions in this assessment are based on a wide range of meetings with institutions and professionals in the public and private sectors.

STRUCTURE AND PERFORMANCE OF THE CORPORATE SECTOR

3. **By the mid-1990s the Czech privatization program had been substantially implemented, with the conclusion of the privatization of small enterprises and the completion of the mass privatization program, which involved the privatization of about 1,800 large and medium enterprises through voucher methods**. However, the efficiency gains that were expected to follow the privatization program fell well below expectations. As shown in **Table 1**, Czech enterprises seemed to be restructuring in the first half of the 1990s, as indicated by the decrease in gross losses and the increase in net profits. However, this positive trend was interrupted in 1996, without a clear indication of improvements in performance in the second half of the 1990s. In the case of manufacturing a net deterioration occurred.

4. **The poor performance of the corporate sector during this period was also reflected in the low price-earnings (P/E) ratios for the 1,800 publicly traded enterprises privatized**

---

[1] The assessment took place in connection with a joint International Monetary Fund-World Bank mission to assess the Czech Republic's financial system (FSAP) from November 28 through December 12, 2000 and from February 13 through February 22, 2001. The assessment was subsequently conformed to the final set of World Bank principles used for assessing insolvency and creditor rights systems. This report was prepared by Gordon Johnson (World Bank, Senior Counsel) with contributions by Roberto Rocha (World Bank, Senior Economist) and Luc Laeven (World Bank, Financial Economist) to the "structure and performance of the corporate sector."

[2] World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001) <http://wbln0018.worldbank.org/Legal/GILD/csadmin.nsf/wblaunchtext?readform&Best+Practices>.

[3] Primary legislation reviewed in relevant part includes: Act No. 99/1963 Coll., as amended ("Civil Procedure Code"); Act No. 40/1964 Coll., as amended ("Civil Code"); Act No. 328/1991 Coll. on Bankruptcy and Composition, as amended, including, among others, by Act No. 105/2000, Coll. ("BCA"); Act No. 513/1991 Coll., as amended ("Commercial Code"); Act on Securities, No. 591/1992 Coll., as amended ("Securities Act"); Act No. 26/2000 Coll. ("Public Auction Law"); Law on the Tax Treatment of Reserves and Provisions; Income Tax Law, and the Law on Tax Administration; Proposed Act. No. 725/2000 ("Private Execution Act," second reading, not passed).

through the mass voucher program. During the second half of the 1990's P/E ratios averaged only 10 for the 100 largest publicly-traded enterprises and were dismally low (close to 1) for the other publicly traded enterprises. In contrast, average P/E ratios in both emerging markets and developed countries are usually between 12 and 25, but direct comparison is complicated by different accounting norms in measuring earnings.

5. **The financial performance of the corporate sector was disappointing during the second half of the 1990s, especially in the case of the manufacturing sector.** Gross profits generated by enterprises in manufacturing declined while gross losses increased, resulting in a significant deterioration of the overall result in manufacturing (**Table 1**). The results for the whole industrial sector were not significantly better. The disappointing financial performance of the corporate sector in this period is to some extent related to the slowdown in economic activity, but more important structural causes included the poor governance structures resulting from the voucher privatization program, and the lack of creditor discipline.

Table 1. Czech Republic: Enterprise Profits and Losses, 1993-1999

(In percentage of GDP)

	Average sample size	1993	1994	1995	1996	1997	1998	1999
Gross Profits								
Industry	2,080	8.5	7.7	7.5	5.3	4.8	5.8	6.2
Manufacturing	1,308	4.1	4.0	4.2	3.0	3.3	2.0	2.2
Gross Losses								
Industry	1,133	4.1	2.6	2.0	2.5	2.2	2.6	3.2
Manufacturing	720	3.7	2.3	1.8	2.3	1.9	1.6	2.2
Net Profits								
Industry	3,213	4.4	5.1	5.5	2.8	2.6	3.2	3.0
Manufacturing	2,028	0.3	1.7	2.4	0.7	1.5	0.4	0.0
Memo: GDP growth		0.6	2.7	6.4	4.8	-1.0	-2.2	-0.8

Source: CSO (author's calculations). Data are for non-financial enterprises with 100 or more employees.

6. **There are preliminary indications that financial performance began improving in 2000.** The ratios of asset utilization (revenues/assets) and the return on assets (profits/assets) increased significantly in the first two quarters of 2000, while the leverage ratios declined. The improvement in performance in the first half of 2000 is partly explained by the recovery of economic activity, but there may also be structural factors underlying this improvement. FDI inflows are probably having an impact on the overall levels of efficiency and profitability. The tightening of credit in the recent years may have also forced several enterprises to restructure. Finally, there has been an overall effort to improve capital market regulations and enforcement which may also be having a positive impact on managerial behavior.

7. **Despite the signs of improvement in 2000, there is a large segment of the corporate sector which continues to generate losses and is highly leveraged.** The average debt-equity ratios in the corporate sector are not excessive—roughly 100 percent for industry and 135 percent for manufacturing (Table 2). In comparison, the average debt-equity ratios in Korea and Thailand before crisis were 450 and 200 percent, respectively. However, the debt-equity ratios for the group of loss-making enterprises are twice as high, and the debt-equity ratios for enterprises classified as doubtful or loss (the two lowest categories) are extremely high, exceeding 700 percent for a sample of manufacturing enterprises. Moreover, the debt-equity

ratios for the weak performers probably underestimate their true leverage, since the market values of their equity tends to be a fraction of book values.[4]

Table 2. Czech Republic: Debt-Equity Ratios in Different Segments of the Corporate Sector, 1999
(In percent)

All Enterprises		Profit Makers		Loss Makers		Classified as Standard		Classified as Doubtful/Loss	
Industry	Manuf.	Industry	Manuf.	Industry	Manuf.	Industry	Manuf.	Industry	Manuf.
(5,019)	(1,711)	(3,517)	(1,178)	(1,502)	(533)	(1,434)	(486)	(63)	(25)
94.4	135.5	80.7	101.3	147.7	227.2	69.6	116.2	660.8	764.8

Sources: CSO, CNB
Note: Number of sampled enterprises in parentheses.

8. **Most of the enterprises that have been performing poorly and are highly leveraged are assumed as classified debtors that have been or are in the process of being transferred to the workout institutions**. As mentioned earlier, the completion of the bank restructuring program will result in a stock of classified loans on the books of the KOB group of around 20 percent of GDP, involving roughly 10,000 debtors. KOB's workout strategy will be based on sales of pools of loans to private investors at a deep discount. The investors are expected to lead the restructuring of these distressed borrowers, either through out-of-court settlements (involving buy-backs or voluntary debt-equity swaps) or by pursuing their claims under the bankruptcy law. However, the quality and speed of enterprise restructuring will depend in good part on the government's success to improve creditor rights and overall efficiency of the bankruptcy regime. This will not only improve recoveries under bankruptcy, but also enhance the incentives for debtors to negotiate out-of-court to avoid bankruptcy.

9. **The enterprise loans that will stay in the books of commercial banks are mostly to enterprises classified as standard or watch, which tend to be better performing and less leveraged.** As mentioned before, the residual credit risk in the loan portfolio of commercial banks after the completion of the bank restructuring program seems moderate. However, the residual portfolio risk is again dependent on the quality of the collateral and insolvency regimes, and the extent to which creditor rights are improved.

10. **There may be a segment of medium and small enterprises which are profit-making and not excessively leveraged, but are being deprived from credits due to the weak legal framework.** Although medium and small enterprises tend in general to have higher debt-equity ratios, the average ratio of medium-sized, profit-making enterprises does not seem excessive—100 percent for industry. However, the traumatic experience with non-performing loans and the difficulties that banks have experienced in the past to foreclose on collateral and pursue their claims under bankruptcy has contributed the contraction in lending activities. Medium enterprises which would be acceptable risks under well functioning collateral and bankruptcy regimes have also been deprived from credits. The new Law on Public Auctions has been, in this regard, a very positive step in the right direction, but it has not been tested in practice. The

[4] The average debt-equity ratios for groups of enterprises classified as standard and loss were obtained by cross-checking information from the Central Statistical Office with data from commercial banks.

authorities should monitor closely the implementation of this law, and take steps to improve the collateral regime further.

II. DESCRIPTION OF COUNTRY PRACTICE

A. CREDITOR RIGHTS AND ENFORCEMENT PROCEDURES

11. The legal environment in the Czech Republic to support creditor rights and debt enforcement has been widely regarded as unsatisfactory. The deficiencies in the legal system have contributed to a deterioration in the quality of bank loan portfolios and, more recently, to a stifling of credit growth. In principle, creditors have had access to three primary avenues for enforcement and debt collection: (1) a court action on unsecured debt; (2) actions by secured creditors to seize and sell collateral; and (3) the filing of bankruptcy. However, none of these procedures has resulted in an efficient or predictable outcome for creditors.

12. Court actions against a debtor to obtain a judgment typically take from 1-3 years due to procedural delays. Obtaining an execution order to sell the debtor's property can take another year. During this lengthy period, a creditor has no practical means to ensure the preservation of the debtor's assets, which may be dissipated or lose value.

13. Secured creditors have not enjoyed a significantly stronger position than unsecured creditors, though it has been common for banks to take security over real estate. While loan contracts typically allow the lender to directly sell the collateralized real estate in the event of default, in practice lenders have been unable to exercise self-enforcement powers over the objection of the debtor. The alternative of conducting a sale of real estate under court supervision requires exact compliance with strict procedures and is subject to delays of up to two years.

14. Secured creditors have experienced even greater difficulties seeking to enforce collateral rights in movables (plant equipment, inventory, or receivables). In practice, movables essential to the operation of the business (plant equipment) have been exempted from foreclosure proceedings. Receivables are not effective collateral either, because under Czech law, receivables must be specifically identified at the time the pledge is created and because some regional courts have required that the principal debtors must acknowledge the assignment. Although the law requires agreement of the original party, the accepted practice has been that a debtor has no say in who receives an assignment of a receivable. Finally, the effectiveness of equipment, inventory and receivables financing is also hindered by the absence of a public registration system for security interests.

15. The narrow range of collateral options is particularly felt as a deterrent to banks from lending to second and third tier enterprises or start up businesses. The process for recovery of collateral should be made easier by the new Public Auction Law. The new Law on Public Auctions was a significant step in the right direction, as it broadens the range of property subject to non-judicial auction procedures and potentially streamlines the foreclosure process, even for collateral rights created before May 2000. If the Law is actually enforced consistent with the terms intended by policy-makers, it will likely improve financial discipline among lenders and borrowers in the future, and also allow creditors to deal more effectively with the distressed debt already on their books. The effectiveness of the new Law remains to be tested, however,

particularly its application to collateral rights created before May 2000, and which apply to most of the large stock of distressed debt within the banks and transformation institutions.

16. Bankruptcy, has presented perhaps the worst of the three choices for a creditor. Unsecured creditors typically realize little or nothing on their claims in bankruptcy. Since May 2000, the prospects for recovery by unsecured creditors may be slightly improved, but only at the expense of secured creditors who are statutorily obliged to give up as much as 30% of the proceeds of their collateral for the benefit of unsecured creditors. Secured creditors have done only marginally better, as collateral rights have been severely curtailed in bankruptcy. After declaration of bankruptcy, secured creditors are prevented from exercising their right to foreclose on and sell their collateral, and have received no compensation for the delays in realizing on their assets. In most cases, the collateral has been sold at values substantially below the face amount of the secured creditors claims. Although secured creditors have had priority for the balance of sales proceeds payable on final distribution, they have little control over the timing of these distributions, which have taken years.

17. The process of bankruptcy has been slow and inefficient, and creditors generally have not viewed it as a viable option for debt recovery. Creditors have had few if any rights in bankruptcy, other than intermittent consultations with the administrator through the Creditors Committee. They have not been entitled to propose names for administrators, to veto decisions made by administrators, or to influence the actions of the administrators. In effect, creditors have been relegated to a passive role, and consider the whole process as a debtor's haven.

18. The weak legal framework has had two adverse consequences for the performance of the Czech economy. First, it has contributed to the deterioration of the problem of non-performing loans in the banks and the insufficient pace of enterprise restructuring. Second, it has increased the risk to creditors and affected negatively the new flows of lending by the banking system. The reduced value of collateral in the Czech Republic has led the Czech National Bank (CNB) to introduce strict provisioning rules. These rules require banks to disregard the value of collateral and fully cash-provision the loans in default for more than 360 days (the loans in the worst category—loss loans). This policy has been criticized for having contributed decisively to the reduction of credit, and the persistence of the economic slowdown. Although the policy of full cash provisions looks overly restrictive by international comparison, it is actually consistent with the absence of creditor rights and the low value of bank collateral in the Czech Republic.

19. Notably, recent amendments were introduced to the Bankruptcy Law as of May 1, 2000. Although the amendments introduced several improvements, it failed to address important weaknesses in the bankruptcy framework, and in some specific areas weakened the framework further. For example, creditors still report that they still do not have effective control over the choice of the liquidator. Moreover, a system to rescue viable enterprises is still lacking. Finally, rights of secured creditors under liquidation remain curtailed regarding the distribution of proceeds from the sale of the collateral. Reportedly, creditors, lawyers, and practitioners remain generally dissatisfied with the law and have urged more comprehensive reforms.

B. Legal Framework for Corporate Insolvency

20. **The Czech bankruptcy framework remained ineffective and dysfunctional throughout the 1990s.** As indicated in **Table 3**, although the number of bankruptcy filings and

declarations increased during the decade, they remained small relative to the number of troubled enterprises. Moreover, there were still 10,416 cases pending in 2000, the equivalent of 42 percent of all cases (24,830) filed over the past nine years. One third of cases pending were undeclared, of which the majority had been pending for 1-3 years already. Meanwhile, in the remaining cases still open where the court has declared bankruptcy, 45 percent have been pending for 1-3 years, 23 percent for 3-5 years, and 12 percent for more than 5 years.

21. The very long time that it has taken to conclude a bankruptcy case, and the other deficiencies in the bankruptcy process, have resulted in very little or no return to creditors, with banks reporting collection rates of 5 percent and lower. More importantly, during this period there were very few reorganizations, as participants lacked the tools and the skills necessary for the financial restructuring of viable enterprises. This left liquidation as the only viable option, which proved frequently ineffective for creditors and debtors alike.

Table 3. Czech Republic: Number of Bankruptcy Filings and Declarations, 1992-2000

No. of cases	1992	1993	1994	1995	1996	1997	1998	1999	2000
Filings	353	1,105	1,828	2,400	2,996	3,311	4,306	4,339	4,192
Declarations	1	66	294	727	808	1,251	2,022	2,000	2,290
Closed	123	418	921	1,117	1,716	2,047	2,418	2,964	3,745
Pending	234	929	1,864	3,179	4,575	6,027	8,087	9,706	10,416

Source: MOJ

22. **The reasons for the low of number of declared bankruptcies and the inefficient outcomes are to be found in the weaknesses of the law itself and the deficient institutional and regulatory framework which prevailed throughout the 1990s, despite several amendments to the Bankruptcy Law**. Among other problems, creditor rights under bankruptcy remained limited during this period, the procedures were long and not subject to any time-bound rules, the process of bankruptcy was subject to asset-stripping by debtors and other insiders, there was no mechanism to secure financing during reorganizations, the resolution of debts remained inflexible, with excessive emphasis on cash payments, and the scope for debt forgiveness and debt-equity swaps remained limited. The lack of an efficient infrastructure of judges, liquidators, administrators, and other related professionals (accountants, restructuring experts, asset valuators) reduced the level of efficiency further.[5]

23. **The government is aware of the severe deficiencies of the Bankruptcy Law and submitted a number of amendments to the Law in early 2000**. The original bill was discussed and revised during Parliamentary debate and became finally effective on May 1, 2000. The amendments introduced a number of positive changes to the bankruptcy regime but, unfortunately, also introduced some questionable changes, and also failed to address some critical deficiencies. The positive changes that have been introduced include: (1) allowing for preservation of debtor's property and appointment of interim trustees prior to bankruptcy declaration; (2) permitting professional firms (in addition to individual persons) to act as administrators; (3) allowing creditors some control over the selection of the liquidator (through

[5] The World Bank (2000), *Completing the Transformation of Banks and Enterprises,* provides a more detailed analysis of the bankruptcy regime and the ongoing reform efforts.

some veto power), and also some control over some of the actions of the liquidator (e.g., service contracts); and (4) introducing more realistic and flexible fee structure for administrators.

24. **At the same time, some of the amendments were questionable and have the potential to decrease the efficiency of the bankruptcy system further**. The most problematic of these include: (1) an amended definition for insolvency that is vague and confusing and will likely discourage rather than promote timely filings (the enterprise is defined as insolvent if it fails to pays its obligations "for a long period of time"); (2) further erosion in the rights of secured creditors, by requiring that 30 percent of net recoveries from enforcement of collateral lose priority and fall into the general creditor pool (this is contrary both to best international practice and to the incentives and goals of stimulating bank lending); and (3) the possibility for the courts to dismiss the creditors' committee without well defined criteria (effectively threatening the creditors and weakening their control over the choice and the actions of the liquidator).

25. **In addition to this combination of positive and negative changes, the recent amendments to the Bankruptcy Law failed to address some important weaknesses of the bankruptcy framework**. The amendments focused on changing the liquidation part of the law, and did not deal sufficiently with the reorganization of potentially viable enterprises. The Bankruptcy Law contains an entire section on composition or reorganization, but this section remains virtually unused. This means that a functional and efficient scheme for rescuing potentially viable enterprises is still missing in the Czech Republic. The recent amendments also failed to improve the institutional and regulatory framework for insolvency, that is, the organization of the courts, court procedures, and the regulation of the activities of all the professionals working in the system.

26. **There is a clear need for further improvements in bankruptcy rules and procedures, especially now, that the government is completing bank privatization, transferring large volumes of bad assets to the KOB group, and instructing the group to resolve these assets in the next few years**. As shown in the banking section, the restructuring of IPB and KB in preparation for their privatization is expected to result in a massive increase in KOB's bad asset portfolio, to around CZK 430 billion, or the equivalent of 21 percent of GDP.

27. **During the 1990s, KOB was not proactive in dealing with its problem assets, as suggested by the low number of loans sold and written-off** (**Table 4**). During this period the quality of its loan portfolio deteriorated further, as indicated by the increasing number of clients and value of loans under bankruptcy. However, in 2000 the KOB group (including KOB, Ceska Financni and Konpo) developed a more pro-active strategy that focuses on transferring the loans to the private sector (basically through sales), and has started implementing it. The first step has been a pilot tender of a loan pool of CZK 20 billion to private investors, involving 300 borrowers, for CZK 1.3 billion. The low price received by KOB (7 percent of face value of the loans, and 11 percent of their value in KOB's books),[6] but also reflects the weaknesses in the legal framework, particularly the weak creditor rights under bankruptcy.

28. **The pilot sale has paved the way for an acceleration of the workout strategy through further and larger loan sales in the future, but has also indicated the need to strengthen the**

[6] The value of these loans in KOB's books is lower than face value, because KOB typically purchases the loans from commercial banks at a discount.

insolvency regime. Strengthening the insolvency regime would not only expedite enterprise restructuring (by improving the rights and legal tools of the investors buying the bad assets), but would also increase the price received by KOB in the auctions and reduce the net fiscal costs of bank restructuring. The improvements that must introduced include a better definition of insolvency, time bound rules for the declaration of bankruptcy, and, especially, greater control by creditors on the selection and actions of the liquidator. A fast reorganization track must also be introduced, improving the prospects for the rescue of financially viable enterprises.[7]

Table 4. Czech Republic: Classified Loan Portfolio of KOB, 1996-2000

(In millions of korunas)

	1996	1997	1998	1999	2000
Classified	64,400	69,200	90,200	125,500	120,300
Watch	3,900	4,800	700	600	168
Substandard	4,300	3,800	18,600	200	315
Doubtful	12,000	6,400	4,700	19,600	17,800
Loss	44,200	54,200	66,200	105,100	102,000
Gross Loans Written-off	200	830	74	1,660	470
Gross Loans Sold to Private Investors	-	-	-	-	1,760
Gross Loans in Bankruptcy	10,400	17,000	28,400	53,400	62,700
Total Number of Clients	4,044	3,950	4,045	4,748	3,745
Total Number of Clients in Bankruptcy	193	319	511	720	912

Source: KOB

C. Regulatory Framework for Insolvency

Institutional Framework and Capacity

29. Bankruptcy judges in the Czech system are part of the Regional Courts, which deal with commercial matters. Within the regional courts, although not required, the practice adopted has been to designate certain judges in some regions of the country (e.g., Prague) as special bankruptcy judges, handling only bankruptcy cases. In areas where the number of cases are insufficient to justify a full time bankruptcy judge, judges handling bankruptcy matters also handle other commercial matters.

30. Judges are selected from among those judges in the Regional Courts. There may be an initial attempt to designate as bankruptcy judges those judges who have expressed a preference to handle bankruptcy cases, but they could just as easily be judges who have been asked to serve in this capacity. They do not generally have any background or specific training in bankruptcy prior to office. The "Institute for the Education of Judges" attached to the Ministry of Justice provides training in e.g. bankruptcy proceedings for trustees, bankruptcy judges and other officers of the court. Bankruptcy judges were said to be among the most trained group of judges in the Czech Republic, and even bankruptcy personnel received training. There are no apparent standards to measure competence and performance of the judges.

[7] The World Bank (2000) *Completing the Transformation of Banks and Enterprises* provides a more detailed analysis of the insolvency regime and recommendations for improvements.

31. Most judges are overloaded with cases and there appears to be an increasing backlog in cases, as judges are unable to close cases as quickly as they are opened. In Prague, the bankruptcy judges appear to be fairly well resourced with computers and relevant staff. There is no centrally managed file system for all judges, and each judge maintains their own orders, decisions and other relevant information as they determine. Similarly, each judge operates his or her docket of cases according to their own procedures. Some have developed a standardized approach to handling cases in their courts, including various forms, while others have developed a completely different set of procedures and forms, and still others have no procedures or forms. Judges also complain of having to spend too much time monitoring and supervising trustees, a task that some acknowledge should be left to the Creditors Committee.

32. The process for administering cases is unusually slow and inefficient in the Czech Republic, taking on average about 5.5 to 6 years, by some estimates. Some cases are disposed of more quickly. Most rules of dispute are resolved under the rules adopted in the Civil Procedure Code, which are not conducive to rapid resolution of bankruptcy issues. Creditors complain of a proliferation of appeals, which again are governed by rules pertaining to general commercial disputes and are not conducive to insolvency proceedings. Case files and decisions are not necessarily made public or available for review by creditors.

33. As typical of civil law systems, apart from decisions of the Supreme Court and Constitutional Courts, decisions of courts are generally binding only for parties in dispute (with few exceptions when everyone is bound by the decision). In practice, decisions by the Constitutional Court, the Supreme Court and often High Courts are carefully studied and followed by judges of lower instances as well as other lawyers because it is presumed that these courts would decide the same or similar matters in the same way as the precedent one if the case comes before them on appeal.

34. The Procedural Code of the Supreme Court of Dec 13,1995, amended on Dec 14, 2000 (and Selected Articles of the Law 335/1991 Col. on the Supreme Court) address the established practice of publication of decisions in the Czech Republic. The Procedural Code describes, among others, the levels of decision making within the Supreme Court (judges, chairmen of senates, 3-member senates, chairmen of collegia, collegia (criminal, civil, commercial), grand senates of collegia, plenary, President and Vice President). Collegia are responsible to follow effective decisions by courts within their area of responsibility (criminal, civil, commercial) and to "generalize the lessons learnt" (Para. 13). This refers to decisions by all courts, not just the Supreme Court. Based on that they submit to the President, Supreme Court, proposals of a fair and consistent interpretation of the Law or other legal documents. Judges are encouraged to request opinions of "chairmen of higher courts, public administration, other institutions, and legal bodies." They are also responsible to select cases (from all levels of courts) for the Collection of Court Decisions, which is published regularly. See articles 13-21 and 23-30 of Procedure Code of Supreme Court.

35. Currently the Supreme Court has two case law senates, one jointly for civil and commercial cases, the other for criminal cases. Based on the implementation policy of 1997 all courts are encouraged to save their decisions in an electronic form right after the decision, to code based on a simple coding system and to pass them to the appropriate case law senate. In practice, we are informed that this is fully respected in cases by the Supreme Court (so the case law senates indeed review almost all cases), and increasingly also by lower-level courts.

36. The cases selected by the case law senates for publication are subject to a very broad-based external review including not just courts, but also Law Schools, Bar Associations, Ministry of Justice, prosecutors, and if relevant, also the line ministries, Securities Exchange Commission, etc. Based on this review and a separate review by judges of the Supreme Court, the collegia decide on the publication of the legal decision. They do so almost as a rule in cases of inconsistency of decisions by lower-level courts, i.e. when the collegium receives information (from anybody) that there are at least two contradictory decisions on an analogous case by two or more different courts. Since May 1, 2000, the Col. of Court Decisions has been available on-line, in addition to its printed version.

Regulatory Framework for Insolvency

37. The main shortcoming is the absence of a regulatory framework to monitor and supervise the actions of trustees and other participants. The expansion of rights and involvement by Creditors and the role of the Creditors' Committee should promote stronger checks and balances on the system, however, in many cases creditors have insufficient funds and incentive to take on this role, especially where there is no established and reliable framework for correcting abuses.

38. Aside from the general qualifications for trustees identified in the statute, and courts decision about which trustees to use or not use, there is no effective regulatory framework for qualifying participants, such as administrators, liquidators, and insolvency practitioners. Until recently, only individuals could serve as administrators, and were selected from a list of administrators held by court. There were approximately 1,600 names on the list, which included a number of individuals with no legal, accounting or business training. In some cases, those on the list had lost their jobs elsewhere and had applied to be an administrator as a way of having some employment. Administrators are still not licensed or required to meet criteria for registration, nor are they supervised, except by the court in individual cases. Although there is a Czech chamber of insolvency practitioners, membership is voluntary and comprises only half of all administrators. The chamber operates on a code of conduct, but has no disciplinary powers. The chamber has been recognized by and associated with INSOL International, the largest association of insolvency practitioners world wide. Nevertheless, the chamber does not appear to have strong influence in the process and has not developed criteria nor a system for regulating the practitioners.

39. These principles have not been followed substantially in the BCA or in practice. Some practitioners and office holders have performed quite well and substantially meet the above criteria, while many others do not. The principal problem is the inadequacy of the system to regulate and monitor the system to assure that all office holders are held to the same standards of conduct.

40. BCA section 8 governs, qualifications, appointment, duties and remuneration of the trustee. The trustee is to be selected from a list of trustees kept by the court, appropriate to the bankruptcy. Qualification include unimpeachable character, full legal capacity, and appropriate professional qualifications. Trustees can include natural persons or a public business company that must nominate members to serve in this capacity. Refusal of appointment only where there are significant grounds for refusal of appointment. BCA 8(3) indicates that the trustee is to be reimbursed from the estate, or if proceeds are inadequate from the initial deposit against the estate deposited by the petitioner. The court can approve beforehand advances to the trustee and

may increase or decrease as appropriate the amount of remuneration set by statute. A recent amendment to the law provides for a graduated commission based on the aggregate value recovered from the disposition of the estate. BCA 8(3) allows the trustee to delegate obligatory tasks to third persons at the expense of the estate, subject to consent of the creditors' committee.

D. Credit Risk Management/Informal Corporate Workouts

Environment for managing credit risk

41. Czech banks have attempted to reach negotiated settlements out of court. However, the successes have been limited for a number of reasons. For one, the lack of a credible bankruptcy threat, and of creditor rights more generally, reduces the incentives for voluntary workouts. The debtor can protract negotiations and speculate with the knowledge that the creditors have little to gain in a formal bankruptcy process.

42. Secondly, there has been a lack of tradition and experience in conducting out-of-court negotiations, and no established framework for bank coordination. In particular, local banks have little prior experience with working collectively to maximize recoveries, with the establishment of committees of bank creditors and the negotiation of "standstill" agreements. Also, banks have operated in an uncertain environment where they are unsure of their ability to exchange information on customers when negotiating workouts because of the confidentiality of customer accounts. In the past year, improvements have been made with respect to bank practices related to risk management of distressed or non-performing loans. These improvements coincide with efforts by the government to address the enormous problems in this area, although by virtue of the more centralized approach adopted, the concentration of experience has been in KOB and the Revitalization Agency.

43. Thirdly, efforts to reach a settlement out of court have been undermined by minority and dissenting creditors. Where a minority creditor chooses to pursue separate proceedings to enforce its claim, such actions deprive the enterprise of vital assets or force the debtor into bankruptcy. Similarly, if the holdout creditor files for bankruptcy, this action divests the negotiating parties of any power to orchestrate a consensual arrangement, as the debtor is no longer entitled to make decisions for the enterprise. Because the courts do not consult the creditor body in making its determination on bankruptcy, negotiating creditors are powerless to alter the outcome, unless holdout creditors are paid in full. The end result is that minority junior creditors have enormous leverage over senior secured creditors in the out-of-court context, frequently coercing the senior creditors to satisfy their claims to avoid harsh consequences.

44. Progress in debt workouts has also been undermined by difficulties in conducting debt-equity swaps. These arrangements are particularly challenging in the current legal environment, as prior agreement is required with a sufficient majority of the shareholders of the debtor company to vote for a capital increase and approving the swap of debt for new equity of the issuing company. In other words, shareholders are entitled to vote on the dilution of their interests. The Commercial Code requires an affirmative vote of two thirds of shares presented at the general meeting, a target that will often be difficult to achieve where there are large numbers of shareholders. This rule is desirable in normal conditions, as it protects minority shareholders, but may become an obstacle to restructuring in situations of financial distress. Most developed legal systems limit the voting rights of shareholders at the start of bankruptcy, but the Czech

Commercial Code upholds shareholders' rights and imposes obstacles to debt-equity conversions even when the enterprise is clearly insolvent and subject to formal insolvency procedures.

45. Finally, the tax system has also imposed obstacles to restructuring. Under the Act on the Tax Treatment of Reserves and Provisions, banks cannot easily deduct the required provisions on their bad loans from taxable income. For example, a loan classified as loss needs to be fully provisioned, but the use of these provisions for tax purposes can only be accomplished over a period of five years (20 percent every year). Moreover, the insufficient recognition of provisions for tax purposes is not compensated by the Income Tax at the time of a loan write-down. If the bank decides to write down the loan or convert it into equity, it may lose part or even most of its tax deduction rights. Therefore, there may be situations where it is more advantageous for the bank to let the loan "rot" in the books than to reach a settlement with the debtor. At present, a loan cancellation is recognized as a loss for tax purposes if the cancellation occurs as a result of the bankruptcy of the debtor. A write-off of a receivable is also recognized as a loss for tax purposes up to the amount covered by using provisions created in accordance with Act on the Tax Treatment of reserves and Provisions (Income Tax Act, section 24, par. 2, letter y). The failure of these two laws to ensure tax neutrality (essentially by allowing the recognition of actual losses by creditors on the value of their claims) may continue hindering efficient workout activity outside the court system.

46. A further problem caused by the current tax system is the position of the tax authorities as major creditors of firms. Tax arrears comprising unpaid taxes and social security contributions (and including penalties and accumulated interest) amounted to Kc 120 billion in September 1999, an amount equivalent to nearly 30 percent of the total stock of non-performing loans (or the equivalent of 6.5 percent of GDP). The tax authorities have the power, under the Tax Administration Act, to impose a lien on any property of the taxpayer as a security for payment, and may enforce the lien by forced sale or by seizure of funds held on deposit with banks. The Law on Tax Administration allows creation of a tax lien by decision of the tax administrator. Indirect amendment of this law (Act No. 367/2000 Coll.) introduced a new method for obtaining liens, which arguably discriminates in favor of the tax administrator in securing and enforcement of tax liens. As a practical matter, it is worth noting that penalties and interest on tax claims amount to 40 percent of the total sum of registered tax arrears. Approximately, one third of tax arrears is registered by entities that became bankrupt, 70 percent of which had insufficient assets to allow full settlement of the tax claims. In practice, not more than 5 percent of the total sum of registered tax liens is paid, which is roughly equivalent to that of other creditors (e.g., banks) in the context of bankruptcy. Likewise, in 1999, tax offices managed to collect through court enforcement procedures only about 0.5 percent of tax arrears (23.7 million CZK).

47. The tax authorities have the power to write-off penalties and interest, which amount to about one third of the total stock of arrears, but there are no clear guidelines for the approval of waivers and write-offs in the course of a financial restructuring. Tax arrears may be waived if exacting them would cause the liquidation of the debtor, and the likely collection under liquidation may be less than potential tax revenue. However, these provisions do not provide clear guidelines to the authorities, making the review of requests for waivers difficult and lengthy, and the results uncertain. Moreover, this review is not coordinated with the negotiations between the debtor and the other creditors, adding uncertainty to the final outcome.

48. Efforts are underway to amend the Law on Tax Administration, including a proposal that tax arrears may be cancelled in exceptional cases (such as where an enterprise is insolvent and in bankruptcy). Cancellation depends on certification by the tax administrator that the tax arrear is uncollectible and that the period of limitation for enforcement has expired. In addition to cancellation of interest and penalties, the current proposals would preclude the accrual of penalties after the declaration of bankruptcy and would enable the tax authority to cancel principal as well interest, in exceptional cases. A decision by the 29th Chamber meeting (8.12.2000) attempts to prescribe precise criteria for write-off and enables the Ministry of Finance to authorize on a case-by-case basis the write-off of loans that are uncollectible. Although this provision may improve the potential for successful workouts, it could remain largely unused, due the lack of clear guidelines, experience and skills of tax administrators. As mentioned in the previous section, it would be useful to consider the creation of a unit in the Ministry of Finance, focused on workout issues and empowered to participate in negotiations with other creditors. Clear rules for the treatment of tax arrears could also be introduced under a new fast rehabilitation track under the Bankruptcy Law, as elaborated below.

Environment for informal corporate workouts

49. There is no specific legislation governing the process of informal workouts. Most of the bad loans have been carved-out of the banks and placed in KOB or its subsidiaries, and KOB will probably sell most of this distressed debt to third private parties. The bad loans are estimated to amount to approximately 25 percent of GDP and include approximately 12,000 debtors. In addition to the carve out of bad loans to facilitate the privatization of banks, the Government has created the Revitalization Agency.

50. The scheme proposed is an appropriate strategy for the Czech Republic, as it facilitates bank privatization and insulates workout activities from political pressure. At the same time, it also implies an increase in the number of creditors (the strategic and financial investors that are expected to buy the distressed debt) and their objectives and incentives. Special out-of-court schemes designed primarily to reduce the debt burden of viable enterprises in a short period of time are simply not relevant and appropriate in these situations. At the same time, it is important to note that the realization of value and the speed at which the process of recovery or workout can occur is entirely dependent on the existing infrastructure for enforcement and insolvency, which as noted above is inadequate, inefficient, and riddled with obstacles that make enforcement and workout extremely difficult.

51. There is a high risk that Konsolidacni Banka will be overwhelmed by the magnitude of the problem, that large numbers of bad debts will remain parked on its balance sheet without prompt resolution, and that enterprise restructuring will be delayed further. Even in the most extreme cases, where the debtor is already inactive and most of the assets have been stripped away, there are still some assets left (e.g., real estate) that could have better alternative uses and contribute more effectively to the performance of the Czech economy.

52. The Revitalization Agency is a reasonable solution to deal with large and complex cases, but these cases amount to only a fraction of the total value of bad assets, and involve only a handful of large borrowers. At present, the Revitalization Agency is only dealing with four large cases. Sometime next year, the RA is to be folded into the KOB, which will itself be restructured into an agency for debt resolution. This process has the potential to transfer vital skills to the

KOB expanded over a broader portfolio of assets. However, the strategy for KOB has not been clearly articulated as yet and needs to be clearly defined and supported by enabling legislation, possibly including certain superpowers related to recovery.

53. In addition, the process must be supported by a reliable procedure for achieving restructurings for viable companies. We have previously made recommendations for adoption of amendments to the BCA that would facilitate workouts through a fast restructuring track under the Bankruptcy Law and urge that these be given prompt consideration to assure that the comprehensive strategy adopted for KOB can be implemented effectively.

III. AUTHORITIES RESPONSES AND NEXT STEPS

54. **Response to the assessment .** The authorities provided comments to the draft during discussions in Prague, and in general welcomed the assessment. The authorities stressed that some of the recommendations given in the assessment would require substantial increases in the resources allocated to the bankruptcy court system to be efficient. Without such changes implementing time limits for court procedures would not be practically possible.

55. **Recommended plan of action** . The reform of the Czech system with respect to insolvency and creditor rights would need to contain three major elements that require strengthening: (i) the general debt recovery and enforcement mechanisms, including *inter alia*, introducing more efficient and summary judicial procedures for obtaining judgments and executions/sale for collateral and by ensuring that the new Law on Public Auctions produces the intended effects for non-judicially supervised procedures; (ii) the bankruptcy law, by improving further the liquidation track, and introducing a new, streamlined reorganization track; and (iii) the institutional and regulatory framework for bankruptcy.

56. The new Law on Public Auctions is expected to improve debt enforcement outside bankruptcy, and is important to ensure that the Law produces the intended effects. In this regard, it is essential to avoid changes in related pieces of legislation, such as the Law on Executions, that could reintroduce obstacles to foreclosures and undermine the objectives of the new Law on Public Auctions. In fact, the authorities should make efforts to expand the range of collaterals further, to include receivables and inventory used in an operating business. That will require modifying the concept of possessory pledge, so that the delivery of possession by the debtor to the creditor is not mandatory, thus allowing the debtor to continue using the movable assets for its normal business operations. Also necessary is a system of public notice, normally through a public register, in which the existence of the collateral can be recorded, substituting for the current requirement that movables be specifically identified.

57. Another major task in the area of legal reforms involves improving the bankruptcy framework further. The liquidation track could be improved further by clarifying the definition of insolvency and other commencement rules, strengthening and clarifying further creditor rights, particularly the rights of secured creditors, and by introducing time bound rules in the various stages of the liquidation process. The improvements in the liquidation should include granting creditors greater control over the selection and the actions of the liquidator, and removing any ceilings on the distribution of proceeds from collateral sales to secured creditors.

58. A new and streamlined reorganization (or composition) track could be introduced through a series of new provisions in the Bankruptcy and Composition Act. These new provisions would include strict time bound rules for specific steps in reorganization, and the introduction of a cramdown feature, designed to bind minority (typically commercial) creditors to the restructuring plan agreed by the majority of creditors. The introduction of a fast reorganization track could be achieved through a pilot program, involving initially restricted entry criteria, and a pre-selected number of courts and judges. The pilot program would be extended over time to cover a larger number of courts, and would be eventually extended so as to cover the whole court system.

59. Developing the bankruptcy framework also involves developing further the organization of the court system and regulating the professionals working in the bankruptcy system, such as judges, trustees, liquidators, accountants, restructuring specialists, and asset valuators. This will include improving and standardizing court procedures, training judges and liquidators in modern restructuring techniques through formal courses and the elaboration and dissemination of handbooks and manuals, and introducing stricter certification/educational requirements for all the professionals working in the bankruptcy system.