NATO Democratic Institutions Fellowship Programme 1995 - 1997

Bankruptcy in the Czech Republic

by Ladislav Venyš , Ph.D.

Abstract

This report looks at the basis and development of bankruptcy law in the Czech Republic and the impact of bankruptcy on various sections of Czech society.

The current legal framework is founded on the Bankruptcy and Settlement Act of 1991and has been amended seven times, the most recent and significant of these being the 1996 amendment. As a consequence of these changes, the law now represents a reasonably functional mechanism for bringing about bankruptcy and settlement.

The number of bankruptcy cases coming to court grew rapidly in the period 1992 - 1996. However, because of the shortcomings of bankruptcy legislation, the vast majority of these cases became stuck in the courts, while settlement of such cases was almost non-existent. The 1996 amendment sought to address the loopholes in the law which allowed indebted businesses to prolong or avoid bankruptcy declaration, principally by restricting the availability of the so-called „protection period“.

The lack of expertise within the Czech legal fraternity has contributed to the slow processing of bankruptcy cases. In particular, the low level of training of bankruptcy administrators and the low financial rewards such work offers has limited the number of competent officials able to deal with bankruptcy cases.

There are a number of factors within the Czech economy which have also had a significant impact on the nature and development of bankruptcy. The continued existence of loss-making industries which have been propped up by the state, and the inordinately high level of cross-ownership between banks, investment funds and the state-run national property board have meant extremely slow progress in bankrupting those insolvent industries. The privatisation process contributed to this heavy "bank-company-state" interdependence, while this institutional reluctance to remove such burdensome enterprises led to a continual growth in the budget deficit. There has also been evidence of a lack of political will among many Czech politicians to undertake the steps necessary for implementing bankruptcy legislation and reforming the banking sector. This is mainly because of the perceived social and political damage such steps would cause, as well as the government’s aversion to yielding up its control of the major banks.

There have been some recent bankruptcy cases that have illustrated the complexity of bankrupting large firms. The case of Poldi Kladno is a good example of how cross-ownership negatively impacts on the behaviour of indebted enterprises, as well as demonstrating the political impact of bankrupting a big firm.

There still exist a number of areas which require attention if the law on bankruptcy and settlement is to be truly effective. There needs to be closer control over the allocation of costs during bankruptcy proceedings, particularly regarding the remuneration of the administrator. Tied into this is the need to raise the professional standing of those involved in overseeing bankruptcy cases. Other priorities include the breaking of the „insider’s market“ and resolving the contradictory relationship between the state, the banking sector and the private sector regarding indebted enterprises. The harsher new economic climate in the Czech Republic may now force the government to consider taking these important steps.

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Research Fellowship

"BANKRUPTCY IN THE CZECH REPUBLIC"

Presented by:

Ladislav Venyš, Ph.D.

June 1997

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Introduction

Transforming former Czechoslovakia's centrally planned economy to a market economy has necessitated a variety of sweeping systemic changes in policies, procedures, and behaviour. Developing a dynamic, healthy private sector has been one of the most important objectives of the transformation process in the years since 1989. Solid policies for privatisation and bankruptcy are fundamental to the success of this process, as privatisation moves property and enterprises into citizens' hands, and bankruptcy provides a viable and proven method of leaving strong companies in the market while allowing weak ones to leave it in a way that does the least possible financial damage to all parties involved. The Czech Republic's relative economic success since 1989 has been recognised around the world, yet its policies for dealing with insolvent companies and debt have lagged behind developments in other areas of the economy. Nevertheless, recent legislative changes instigated by the Czech Parliament promise to improve the situation.

During the Communist era, financial resources were transferred from profitable businesses to less productive and unprofitable concerns by means of the state budget. With the re-introduction of a market economy in the Czech Republic, the need for a functional bankruptcy policy became an economic necessity, if not a political priority. Creating and implementing an effective and comprehensive law has thus proven to be difficult. During the transition to a market economy, the untested and relatively unknown nature of the mass privatisation scheme in Czechoslovakia led to a hesitancy among economists, politicians and business managers regarding bankruptcy. Now, with privatisation almost complete, this fear of the unknown is no longer a factor. In spite of this, several other considerations have continued to discourage bankruptcy as an option for Czech businesses. The weak financial position of many businesses, worries among politicians of the social consequences of widespread business failures, a banking system in the midst of a crisis, and an untrained court system unable to process a large number of bankruptcy cases have all contributed to procrastination in many quarters on the thorny issue of bankruptcy.

In spite of these obstacles, the Czech Parliament has approved a number of acts aimed at addressing this issue. The cornerstone of current legislation is the Act on Bankruptcy and Settlement (no. 328), passed by parliament on October 1, 1991. This Act, like most bankruptcy acts found in market economies, has both a legal and an economic aspect. The legal aspect

“divides the loss” among the creditors while at the same time temporarily safeguarding the assets of the debtor. The economic function removes unproductive businesses from the market, thereby releasing their economic resources to developing businesses.

Although the Act on Bankruptcy and Settlement was an important move towards realising these two main functions, gaps and oversights in the original act became apparent as court cases began to be processed. The Act was thus revised (no. 122) and approved on April 22 1993, while between 1993 and 1995 six further amendments were passed in an attempt to improve the law. These changes had only a minor impact on the Czech economy and thus necessitated a further alteration to the legal framework, which happened in March 1996. This most recent amendment corrected some of the major flaws in Czech bankruptcy legislation. It addressed many of the shortcomings of the existing law and sought to improve the financial restructuring process in the country. These provisions will be examined in this paper.

To better understand the issues facing the Czech Republic in 1996 and beyond, this report will analyse the original Czech Bankruptcy Act of 1991 and amendments to it over the last five years. It will also examine the effects that the Bankruptcy Act has had on the Czech economy by looking at changes in the court system, government, banking sector, and private sector. Finally, the report will use recent court bankruptcy and settlement cases to illuminate the situation and concretely illustrate the Act and amendments in practice.

I. Recent Legal Provisions for Dealing with Insolvency, Bankruptcy and Settlement

1. The current legal framework

The relevant legal provisions for bankruptcy proceedings are laid down in Act No. 328/1991 on Bankruptcy and Settlement, which is currently valid in the writ of Act No. 122/1993, Act No. 42/1992, Act No. 74/1994, Act No. 117/1994, Act No. 156 /1994, Act No. 224/1994, Act No. 84/1995, and Act No. 94/1996. The Ministry of Justice of the Czech Republic has also issued Edict No. 476/1991, valid under Edict No. 37/1992 and Edict No. 583/1992, regarding the Implementation of the Act on Bankruptcy and Settlement.

2. The development of current legal provisions for bankruptcy and settlement

The Act on Bankruptcy and Settlement (hereafter **ABS**), adopted in 1991, has its roots in the bankruptcy provisions that had been in place up until 1950 (in particular, Act No. 64/ 1931 on Bankruptcy, Settlement and Competition). After 1950, bankruptcy and settlement legislation and its application were essentially disregarded. There were certain partial provisions concerning the liquidation of property introduced into legal statutes of the Czechoslovak Socialist Republic (in the civil judicial code of 1950, and then in the civil judicial code of 1963), and the notarial code even made reference to the liquidation of inheritance. All of this, however, was little more than a formal anchoring of the law and had little practical impact. Following the demise of the communist regime in 1989, a number of significant pieces of legislation appeared which addressed the apparent shortfall in bankruptcy law. The first of these was the Bankruptcy and Settlement Act of 1991, the details of which are set out below.

3. The Act on Bankruptcy and Settlement of 1991 [1]

The Czechoslovak Federal Republic's Bankruptcy and Settlement Act of 1991 (#328) was fashioned after the Czechoslovak Republic's bankruptcy law of the 1930's. Before the act was actually implemented, the Act was revised (#122) and approved on April 22, 1993. The Act contains four parts: introductory provisions, bankruptcy proceedings, settlement proceedings, and final provisions.

Czech Bankruptcy legislation applies to individual entrepreneurs and legal entities, including commercial companies, state enterprises, and co-operatives.

1. Introductory Provisions

The purpose of the introductory provisions was to settle the proprietary relationships of a debtor who is insolvent. The provision defines insolvency as a state where a legal entity is "unable to meet his financial obligations which have been due to several creditors for a protracted period of time." In addition, an entrepreneur or a legal entity is considered to be insolvent if he is overburdened with debt. In this regard, the introductory provisions began to address the claims of the creditor against the debtor's assets.

Lastly, the introductory provisions determined which court (regional or municipal) had jurisdiction for a particular case. Bankruptcy hearings are ordered by the court only if required by law or if considered necessary. The court's decision takes the form of a court order.

2. Bankruptcy Proceedings

Bankruptcy proceedings may be proposed by the debtor, the creditors, or a company's liquidator. Bankruptcy proceedings are declared by the commercial court. The Act stipulates that bankruptcy proceedings will not be ordered if assets of the bankrupt party would not at least cover the costs of the proceedings.

After the court declares that bankruptcy proceedings can take place, it appoints an administrator to manage the assets of the bankrupt party. Once this happens, any claims by

[1] Legal information for this section was taken from Trade Links--Czech Republic, Slovak Republic-Bankruptcy

creditors are filed against the administrator, who is then fully liable for the damages of the insolvent party.

Creditors can participate in bankruptcy proceedings by filing their claims with the bankruptcy court. Creditors' claims are divided into several classes, to be addressed in the order specified by the act. Receipts from the realisation of the bankrupt party's assets are then used to satisfy the creditors' claims. If it is impossible to fully satisfy all the claims listed in the same class, the claims will be satisfied on a proportionate basis.

3. Settlement Proceedings

The Act also includes provisions on settlement proceedings which can only be proposed by the debtor and may or may not be approved by his creditors. Settlement proceedings make it possible to grant creditors at least some settlement of their loss in the shortest possible time, while at the same time allowing the debtor to survive beyond the proceedings.

4. Final Proceedings

Should the court establish that all the conditions have been met for a declaration of bankruptcy, it will issue a bankruptcy order. The bankruptcy order lists the claims of creditors against the assets of the debtor. The order also restricts the actions of the bankrupt party from depleting the assets of the business. The final provisions also address the problems associated with businesses that have international elements; either assets abroad or foreign ownership of assets within the Czech Republic. (See Appendix B for more detail regarding the bankruptcy order.)

5. Bankruptcy or Settlement?

The 1991 Bankruptcy Act specifies two distinct procedures for resolving disputes. The first procedure involves a ***bankruptcy proper (liquidation),*** with a subsequent sale of the assets of the debtor. There is a settlement phase allowing the debtor to reach an agreement with the creditors, while remaining in limited control of the company. If the court determines that the conditions for declaring bankruptcy have been met, it will make a formal declaration which has the following effects:

- the control and the right to dispose of assets is transferred to the Administrator
- all claims and obligations to the bankrupt's assets become due

- preferential rights to assets acquired by creditors within two months preceding the declaration are made void (Modified in 1996 Amendment)
- legal proceedings related to claims on the assets of the bankrupt party are either halted or, if the claims are secured by partial assets, continued against the Administrator
- ongoing privatisation procedures are halted.

All creditors must submit their claims within 30 days of the public announcement of bankruptcy. The claims are reviewed by the Administrator and the court. In order to satisfy the approved debts, the debtor's assets are sold through court-approved procedures, including non-auction sales administered by the Administrator. The court will then issue a distribution order.

The second procedure in the bankruptcy legislation, the *settlement procedure*, is an alternative to liquidation which allows the debtor to petition the court to undertake settlement procedures and also gives the debtor protection against liquidation proceedings. During these proceedings, subject to a number of restrictions, the debtor remains in control of the business' assets. This procedure is comparable to Chapter 11 bankruptcy proceedings of the United States of America. Except for a few small businesses that have been liquidated, every Czech bankruptcy case has utilised this procedure.

4. A Critique of the Bankruptcy Code in Application

Compared to the West, particularly the United States, Czech bankruptcy law tends to over-protect creditors and under-protect debtors. The United States bankruptcy law leans towards the interest of the debtors as this reflects the free-market, populist orientation of the state, with public opinion favouring employees of a business, rather than a bank with outstanding debts. Although Czech bankruptcy law should not necessarily go as far as to emulate the bankruptcy law of the United States, the 1991 bankruptcy law seemed to unjustly favour creditors. There were also other problems with the law which rendered it inefficient.

Cross-ownership

A problem that exists within the Czech economy and which has great significance for bankruptcy legislation is the unprecedented level of cross-ownership within the Czech financial sector between banks and management investment companies. Firstly, a handful very large domestic banks in the Czech Republic have inherited the portfolios of most large Czech companies. In addition to this, several management investment funds that were formed in the course of the voucher privatisation scheme in 1992-95 (and were established with backing from major banks) acquired a controlling share in a number of large companies. One example was Harvard Capital, which gained a large stake in companies supported principally by bank financing. This bank - management investment fund interrelationship has lead to a clear inter-dependence, with banks de-facto owning substantial shares in large companies while at the same time being these same companies' major creditors. They are thus well aware that it is in their best interests to keep indebted and inefficient companies in which they have sizeable shareholdings from going bankrupt. This situation not only poses a threat to the entire hierarchical structure of the Czech economy, but also acts as a major disincentive to forcing through the bankruptcy of insolvent businesses.

Skills Shortage

Another criticism levelled at the Czech bankruptcy law is that it gives too much power to judges. Although very specialised finance skills are needed in this area, judges rarely are financial experts or have even a basic knowledge in corporate finance. A judge appoints a court administrator, (rather than giving power to company managers, as is done in the US) to manage the debtor's property once bankruptcy proceedings begin. Administrators are offered a very small salary, and

thus the job of an administrator tends not to attract financial experts. Thus the critical powers to decide the fate of a company often rest in the hands of someone who is not fully competent to discharge such an important task. Instead, the final decision could perhaps best be made by those managers or creditors who have everything at stake.

Excessive Conditions for Settlement

Another problem slowing the bankruptcy process relates to the law's overly stringent requirements for agreeing settlements of cases. Czech bankruptcy law states that 75% of all creditors must agree on the act of settling a bankruptcy case. This usually proves to be very inefficient since it is difficult logistically to bring all of the participants together. It also prevents any rights to claims before proceedings start.

US AID--Deloitte and Touche Study

According to a 1995 US AID-funded Deloitte & Touche study on bankruptcy proceedings and business restructuring, legislative and practical disincentives are the main reason so few bankruptcy cases get processed by the courts. The biggest problem they identified lay with the bankruptcy procedure itself. According to the report, there is a lack of incentive, and even some disincentive, for companies to go through with bankruptcy (as either debtors or creditors) due to long court delays and lack of a court infrastructure to handle bankruptcies. The Deloitte & Touche study further states that banks who are large creditors have accumulated sufficient funds to clear high-risk credits, and bankruptcies do not render any guarantee of their return on investment. They only file for bankruptcy in hopeless cases, usually when it is too late for them to be restructured. The largest banks, mostly state-owned, have a negative attitude toward bankruptcy.

A contributing factor to the above-mentioned criticisms is that Czech accounting law does not require businesses to produce consolidated financial statements. The transparency of financial flows between the parent business and its subsidiaries is often low. By looking only at the businesses' balance sheet, the creditor does not get an accurate picture of the financial health of a business and may conclude that forgiveness of debt or depreciation are unnecessary.

5. 1993-1995 Amendments to the Bankruptcy Code

In the period 1993- 1995, there were five amendments made to the 1991 Act. The basic features of these amendments are laid out below:

42/1994

This was an amendment to the code relating to pensions and benefits. It established an insurance fund to serve as a supplementary source of pension income in those instances when businesses are unable to provide pensions. It stipulates that payments to this insurance fund are to made in the instance of bankruptcy and are to treated as a preferential claim in the course of settlement proceedings. It indirectly relates to bankruptcy in that it recognises the fact that employees may be left without compensation as a result of bankruptcy.

74/1994

This was an amendment to the labour code and provided no significant changes to the bankruptcy code other than giving some rights to employees enabling them to claim against an employer who has filed for bankruptcy. These claims are classified against the debtor as a preferential claim.

117/1994

This amendment states that in the case of a political party's insolvency, bankruptcy proceedings cannot begin against it in a period from the start of elections to 10 days after their end.

156/1994

This amendment stipulates that in the instance when a bank has more that one creditor and is unable to pay its creditors for an extended period of time, the creditors cannot apply for the initiation of bankruptcy proceedings while the bank is under the compulsory administration of the government.

224/1994

A special status was established for state businesses, state organisations and firms in which the state had some level of involvement (normally firms in which the state has a percentage shareholding). Under this amendment, the protection period given to firms following the initiation of bankruptcy proceedings could be extended according to individual circumstances that may have arisen in the course of privatisation.

6. The 1996 Amendment to the Bankruptcy Law (Amendment No. 94/1996)

This amendment was a significant addition to bankruptcy and settlement legislation, in that it addressed a number of shortcomings in the 1991 Act and its subsequent amendments. It also introduced some new provisions that made the process of filing and settling a bankruptcy case not only more straightforward, but just as importantly, made it a practical and applicable legal instrument. Its aims were to reduce the time taken to process bankruptcy cases, limit the abuse of certain legal provisions contained within the existing legislation (such as the protection period and the use of bankruptcy as a punitive measure to force repayment of debt) and also to clarify the legal concept of indebtedness and bankruptcy.

The principle features of the amendment were as follows:

1. It added to the existing act a legal definition of insolvency which had previously been missing. Prior to the amendment's introduction, insolvency could be defined on the basis of a temporary negative deficiency in capital, which failed to take into account any possibilities of obtaining further means of keeping the business in operation. According to the new amendment, indebtedness should be considered from the viewpoint of the balance of property and assets to debts repayable. The debtor henceforth can be considered bankrupt only when those debts repayable are higher than the total value of property, assets and any expected profit from business transactions.[2]

2. The amendment placed the responsibility of filing for bankruptcy on the debtor, thus removing the "needless stalling" that was prevalent under the previous act. In the event that the debtor fails to discharge this obligation, he will be solely responsible to the creditors for any liabilities arising from his inaction (until then, this was the sole responsibility of the company's administrator.)

3. Another aspect of the new amendment was an attempt to remove the practice of creditors filing bankruptcy proceedings against indebted subjects to force repayment of debts to them. Previously, banks would file bankruptcy petitions as a punitive measure against a business, so as to remind it to pay its debts to the bank. To counteract this practice the

[2] This concept of "expected profit from business transactions" is not specifically defined by the new legislation, nor is there a clarification of the time period when a legal entity is no longer considered to be experiencing a temporary negative deficiency of capital and has become insolvent. *See Pajas, P. & O'Connor, S. pp. 26-27*

new legislation increased the fee required to file for bankruptcy so as to make it a financially meaningful act and to stop banks from misusing this provision. This fee of 10,000 Czech crowns was also designed to help cover court costs associated with bankruptcy filings and to reduce the filing time for courts. Part of the fee also covered the costs and remuneration of the Administrator.

4. The method used for summoning bankruptcy participants was changed by the amendment. Previously, the court had to enter into correspondence with each participant individually, whereas following the amendment's adoption, all relevant parties were summoned by way of an announcement on the official bulletin board of the court.

5. In the past, the pace of bankruptcy proceedings was exceedingly slow because every debtor filing for bankruptcy was given a three- or six-month protection period. The previous amendment did not fully preclude the misuse of this provision because, as long as all the legal conditions were met, the court had no choice but to allow the debtor to enter a protection period. In addition, the court did not have the authority to investigate the reasoning behind, and usefulness of putting off bankruptcy hearings. On the other hand, if the debtor could not meet even one of the legal conditions necessary for the declaration of a protection period, he would then be excluded from the possibility of filing for one. In order to address such anomalies, the new amendment left room for the settlement of cases. The protection period was preserved, albeit with a different approach, which corresponded to other recent amendments of foreign laws. Following the introduction of the amendment, this protection period came to be understood as the first phase of the bankruptcy proceedings, and would be granted only in what were considered by the courts to be justified cases. Therefore, it no longer became such a widely-used instrument.

   The new provision also removed old legislation that was vulnerable to abuse by debtors. Previously, when the debtor filed for settlement while under a protection period, the protection period was prolonged until a ruling on this application was passed. Furthermore, the new amendment limited the protection period to businesses employing more than 50 employees. Smaller businesses thus lost the privilege to obtain a protection period in the hope of speeding up the process of bankruptcy proceedings.

6. In the six-month period prior to filing bankruptcy, all actions of the debtor would thereafter be considered null and void. This prevented the debtor from:

- founding a new business out of the old businesses' assets
- extending his business activities to different businesses
- transferring company assets at less than market value
- accepting unreasonably high obligations, and
- refusing inheritance.

This provision was designed to protect creditors from loss or damage caused by the debtor by barring him from transforming his property and assets into, for example, sister companies or by investing it into other business ventures outside the legal entity of the indebted subject.

7. In the past, an Administrator was chosen by selecting the first name on a list of possible administrators. As already mentioned, it was also difficult to find qualified administrators because the pay was insufficient to attract people with the necessary financial skills to execute the function. Following the 1996 Amendment, an Administrator would be chosen by specialisation and his salary determined by the amount of money gained from selling off the bankrupt business' assets.

Implications

There have been several positive developments as a result of this latest bankruptcy amendment which passed Parliament on 13th March 1996, and was implemented on 1st June 1996. It represented the seventh amendment and the second significant overhaul of the law. The former Minister of Trade and Industry, Mr. Vladimí r Dlouhý, admitted that the bankruptcy law is not quite "Western" yet, but showed significant progress. The main thrust of the new amendment is to render the bankruptcy process faster and simpler. The focus is to provide creditors as well as debtors incentives to file, while being tougher on those debtors who are dishonest. In addition, changes have been made in the civil and commercial codes which overlap the bankruptcy act and have in the past complicated the process further. Changes to these codes should reduce the length of time involved in going through the filing process.

Concerning settlement, the new law stipulates that creditors can now negotiate with debtors before and during the bankruptcy process without fear of losing what is owed to them. The act says that all creditors should be repaid their debts even if they do not present in full the official papers in advance, as was required under the earlier legislation.

The law also clearly names the order in which debt is to be repaid. This aspect is important in that it addresses mainly the large banks. Up to now, banks have tended to keep bankrupt businesses afloat in the hopes of eventually recovering some of their loans. The 1996 act stipulates that any credit given after the filing process has begun, is last to be compensated. This discourages from giving out "debt to cover debt" and thus slow down the bankruptcy process.

Another important change is that businesses are permitted to remain open as long as possible during the bankruptcy process. This is beneficial to businesses which are able to continue as a going concern while under protection from creditors. This was not allowed in the past, thus making it virtually impossible for a business to restructure and turn itself around.

The 1996 bankruptcy law clearly addressed fraudulent behaviour by debtors, and with good cause. Before the new amendment to the bankruptcy act, the owner of a business could file for bankruptcy, liquidate, start a new business promptly and repeat this cycle indefinitely (in the U.S., a bankrupt entity would have to wait seven years before being allowed to get credit). The new act stipulates that records will be kept and time limitations given. Furthermore, small businesses of 50 employees or less are not allowed to file for protection.

In addition, the law addresses those managers who behave fraudulently just prior to filing. The debtor is now prohibited from filing for bankruptcy if he has, in the previous six months, created a new company, transferred funds, refused an inheritance, joined another company, or accepted above-average commitments. This thus prevents activities whereby a potential bankrupt could strip his insolvent business of its assets, move them to another location and deprive his creditors of any chance of seeing the money owed to them.

As far as the administration of the filing process, the new act stipulates that the creditor must pay an advance of 10,000 Kè to cover future court costs at the time of filing. This is a significant change, since the previous act dictated that the debtor pay for court costs. This provision was passed to stop creditors from misusing the system. In the past, creditors would file bankruptcy papers against a debtor as a way of reminding the debtor to pay his bills. This practice created additional paperwork for the courts, and slowed down the whole bankruptcy process. Rather than seriously pursuing bankruptcy against the debtor, the creditor was merely reminding him to pay his bills. Even though the bankruptcy fee is still a relatively small one for large creditors, it was hoped that it would be large enough to discourage this practice in the future.

The court-appointed administrator is no longer chosen randomly from a list of inexperienced or unqualified trustees. Administrators are becoming specialised and are being chosen according to their area of expertise. Administrators are being compensated financially by the creditor at the end of the process depending on how competent they are and how quickly they perform their tasks. Also, a portion of the increased bankruptcy filing fee will be used to compensate the Administrator for the initial work necessary in each bankruptcy filing.

The changes contained in the 1996 amendment are thus aimed at increasing the number of bankruptcies in the Czech Republic, which had hitherto been at a pitifully low level. The Ministry of Trade and Industry, aware of the need to induce the bankruptcy of burdensome and inefficient enterprises, has been hoping that once the process starts and businesses begin to file for bankruptcy, others will follow.

II. Statistical Analysis of Data on Bankruptcy Proceedings[3]

During the last few years, the number of bankruptcy filings has markedly risen. The chart below illustrates that there was a 32% increase in the number of bankruptcy filings from 1994 to 1995. Also, the number of bankruptcy filings in the first quarter of 1996 (701) show a substantial increase when compared to the first quarter of 1995 (547). Bankruptcy cases in process have also increased during the last few years. There was a 40% increase in 1995 compared to 1994. The first quarter of 1996 had 405 cases compared to only 228 cases in the first quarter of 1995.

Table 1

Development of Bankruptcy-Related Cases in the Czech Republic, 1992 - 1996

Stage of Bankruptcy	*Total 1992*	*Total 1993*	*Total 1994*	*Total 1995*	*Total 1996*	*Total 1992 - 1996*
Bankruptcy Filings	353	1105	1826	2400	2996	8680
Ongoing Proceedings	234	688	937	1312	1716	4887
Other Methods of Settlement	111	349	585	599	516	2160
Legally Bankrupt	1	66	294	727	808	1896
Settlements Proposed	0	1	6	2	0	9

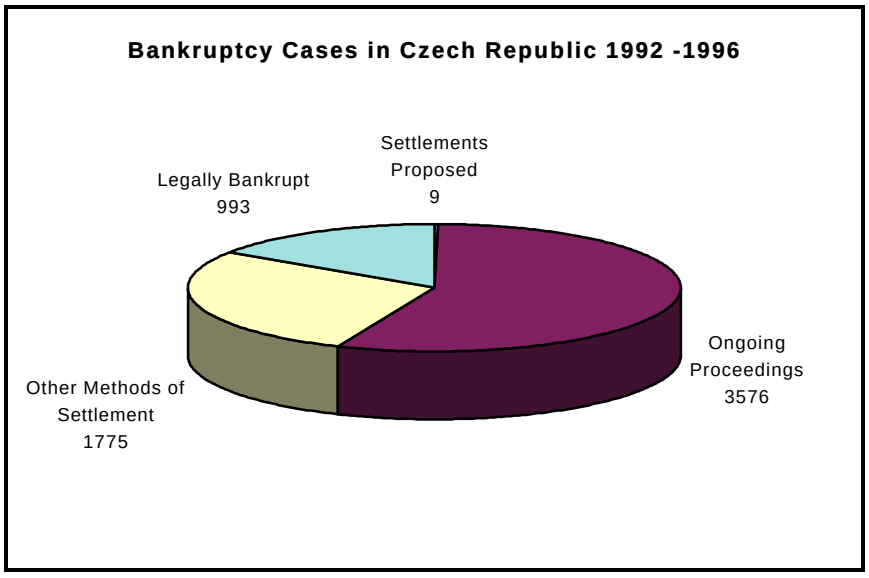
Source: Ministry of Trade and Industry, Ministry of Justice of the Czech Republic, 1997

An analyst from the Ministry of Industry and Trade believes that in addition to restructuring and privatisation, another factor that had prevented the number of bankruptcies from growing is that newly privatised companies usually obtained two and three year loans in 1993. The payment due on these loans during the last 6 months to a year could be a factor in the large increase in the number of bankruptcy filings occurring at this time. The analyst also believes that a larger number of bankruptcies can be expected after new owners assume their ownership rights in businesses privatised during the second wave of coupon privatisation. Businesses listed in the second wave of privatisation are more problematic than those from the first wave. The second wave of privatisation began in 1995. However, large businesses can be expected to stay afloat through debt restructuring and capitalisation.

[3] Data provided by Ministry of Trade and Industry and the Ministry of Justice of the Czech Republic.

Of the total 6358 bankruptcy filings since 1992, more than 56% are still in process. Almost 28% (1775) have been resolved utilising other methods of settlement. Of a total 6358 bankruptcy filings, 993 businesses have been declared bankrupt, representing 16% of the total. However, only nine businesses in the last four years have proposed settlement to creditors that were accepted and registered as such by the courts. (See Graph 1 below)

Graph 1:



Source: Ministry of Trade and Industryof the Czech Republic

Table 2 compares the most recent figures available to show the growth in the number of firms filing for bankruptcy, or who have been declared bankrupt in the first quarter of the years 1995-1997. Graph 2 illustrates the increase in the number of firms declared bankrupt in the same period.

Table 2

First Quarter Comparison of Bankruptcy Proceedings, 1995 - 1997

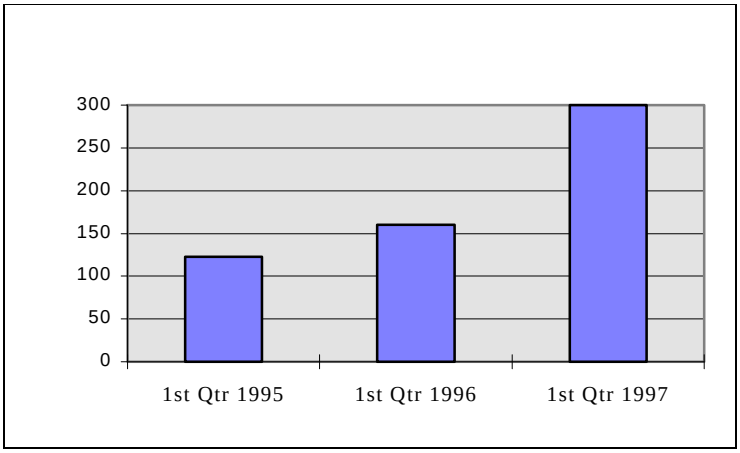
Type of Proceeding	*1st Qtr 1995*	*1st Qtr 1996*	*1st Qtr 1997*
Bankruptcy Filings	547	701	678
Ongoing Proceedings	228	405	n/a
Other Methods of Settlement	188	131	n/a
Legally Bankrupt	123	160	300
Settlements Proposed	1	0	n/a

Source: Ministry of Trade and Industry, Ministry of Justice of the Czech Republic, 1997

Graph 2:

Number of Enterprises Declared Legally Bankrupt

First Quarter Comparison 1995 - 1997



Source: Ministry of Trade and Industry, Ministry of Justice of the Czech Republic, 1997

As can be seen from the figures, the number of legally bankrupt firms has grown rapidly in the course of the three year period (from 123 cases in January to March 1995, to 300 in the same quarter of 1997). This can be attributed to increased effectiveness of amended bankruptcy legislation in speeding-up cases, as well as improving experience and understanding of court officials in dealing with insolvency cases.

Conversely, the moderate fall in the number of bankruptcies filed can be interpreted as being caused by the 1996 amendment, which aimed specifically at preventing bankruptcy proceedings as a punitive measure to shock firms into paying debts. It can also be seen as a consequence of firms being initially reluctant to file their own bankruptcy, as stipulated by the amended ABS.[4]

Bankrupt businesses are usually either incorporated companies (48%) or entrepreneurs (28%), with state-owned businesses making up only 9%. The remaining 15% are joint stock companies, farmers' co-operatives, and production, construction and public commercial companies (see appendix B2). Whereas small businesses made up 77% of total businesses undergoing bankruptcy proceedings in 1995 as compared to 55% in 1994, the share of large joint-stock or state-owned companies declaring bankruptcy fell by nearly half in the same period. In the past, bankrupt businesses have typically been incorporated companies as opposed to individuals.

In summary, it can be said that although there are some positive trends demonstrated by the figures, the woefully low number of settlements and the consistently high number of cases

[4] See Mladá Fronta Dnes, 25/2/97, *"Konkurs vrátí vìøitelùm vìtšinou jen èást jejích penìz"*, p.4

that are stuck in the courts suggest that the effectiveness of bankruptcy legislation has been extremely limited. However, the impact of the June 1996 amendment is likely to show itself in figures for 1997. It will then become clear whether this new attempt at shaking the bankruptcy tree has been successful.

III. The Political Impact of Bankruptcy and Settlement in the Czech Republic

A major side-effect of economic transformation not only in the Czech Republic, but in the region of central and eastern Europe as a whole has been the widespread insolvency of enterprises. This can be largely attributed to the highly inefficient business practices of the previous state socialist regimes. Therefore, the economic context in which legislative measures and political decisions are made is of great significance when considering the importance of bankruptcy legislation and its development. Insolvent and heavily-indebted enterprises pose a huge problem for post-communist governments not because they are a drain on financial resources, but also because their position within society as large employers in often politically important regions makes them a highly sensitive political issue. In this regard the Czech Republic is no exception.

The following table illustrates the level of insolvency within the major sectors of the Czech economy at the end of 1995.

Table 3

Insolvency of Business Enterprises in the Czech Republic by Selected Sector, 1995

Sector	**% of firms with insolvency problems**		**% of production influenced by insolvency**		**No. of firms in sector**
	Yes	***No***	***Yes***	***No***	
Industry	55	45	35	65	881
Construction	39	61	25	75	445
Retail	39	61	30	70	308
Average	44	56	30	70	-

Source: Statistical Bulletin of the Czech Statistical Bureau, No. 12/1995, cited in Zemanovièová, D. and it ñanská, L., p.6

At the end of 1995, of those Czech firms not operating in financial services (8716), some 32% were trading while insolvent, while over 6,000 firms had outstanding debts on their books.[5] Such a situation had clear ramifications on political decision-making, particularly in light of the fact that a large number of these enterprises were (and still are) at least partly state-owned. The political

[5] cited in Zemanovièová, D. and Žitñanská, L. *Comparative Report of Bankruptcy Regulation: "The Czech Republic & Slovakia" pp. 6-7*

cost of introducing legislation that would bring about the closure of large factories, along with the accompanying negative social consequences, goes a long way to explaining the hesitancy of the government in issuing an effective legal instrument for bringing about the bankruptcy of insolvent business entities. It is interesting to note that the first major example of the bankruptcy of a large industrial concern, Poldi Kladno, one of the principal employers in the town of Kladno, did not happen until the early part of 1997 and was accompanied by widespread public dismay, accusations of corruption among management and top officials, and of course bitter political recriminations.

Parliament

In the past, the Czech Parliament avoided enacting aggressive bankruptcy legislation because it considered bankruptcy to be harmful to the economy. In an interview for the Central European Economic Review, former Economics Minister Karel Dyba said, "We are a normal economy, a normal society. Why should we encourage bankruptcies?" He further stated that the lag in enacting the bankruptcy legislation encouraged businesses to restructure more quickly without the threat of liquidation. However, Dyba's comments reflected an outdated view among parliament officials and this was made evident with the 1996 amendment to the act on bankruptcy and settlements (see implications above). In fact, the sweeping changes of the March 1996 amendment to the bankruptcy legislation passed with very little opposition.

The changing attitude in Parliament was represented by Vladimí r Dlouhý, former Minister of Trade and Industry, who in 1996 said the time was right, now that the economy was stable and the free market sufficiently developed, to pass a new bankruptcy law without the threat of the "domino effect." i.e. if a large business went bankrupt, many other smaller businesses would follow because of their dependency on the large business to buy their products. In an underdeveloped free market system, small businesses have no other outlets to sell their products. Therefore, the bankruptcy of the big business also leads to the bankruptcy of the smaller businesses. Obviously, people in Parliament have realised that the free market is more developed now and the threat of the domino effect is no longer a driving force in decision making. However, there is still a great reluctance in Parliament to encourage big businesses with large outstanding debt to file for bankruptcy (see government section below).

Government

The Czech government's main concern has been to provide stable macro-economic policies. The economic policies it has chosen have been based on maintaining low unemployment and controlling inflation. The government has had some success in achieving both of these policy goals with an average 4.5% unemployment rate and 8% rate of inflation for 1996. In order to maintain the goal of keeping unemployment low, the government has avoided the difficult responsibility of allowing large unproductive businesses with many employees to go bankrupt.

It has been clear that large unproductive businesses have still not left the market and are consuming limited resources that could be flowing to more productive enterprises. Using limited resources to keep large unproductive businesses solvent is a contributing factor in the Czech Republic's burgeoning trade deficit and perceptible slowing of economic growth, which by mid-1996 had begun to arouse concern in many quarters. In May 1996, the Czech business daily, Hospodáøské noviny, noted that

> *"The nation's trade deficit for the year 1996 (as of 30th May) stands at 54.9 billion Kè. This is the largest one month deficit on record. The Czech National Bank (CNB) forecasts the trade deficit for the year to be 150 billion Kè. In May, one billion crowns were pulled out of the Czech economy to help pay for the trade deficit."*[6]

The growth of the deficit has by-and-large been due to poor performance in Czech exports. Small to medium-sized businesses that are productive and export-oriented are not receiving bank credit to expand because most credit goes to the larger, and usually less profitable firms.

The Czech government also uses its monetary policy to try to manage the economy. In order to conduct monetary policy, the Czech National Bank was instituted in 1991. The CNB performs similar functions to the Federal Reserve Bank in the United States. Among other things it issues bank licenses, sets the discount rate and the minimum deposit requirements for banks and supervises the course of the Czech crown on the money markets.

Due to scandals involving some smaller banks during the 1992 privatisation process, the CNB took a more active role in enforcing reasonable behaviour within the Czech banking industry. The scandals involved unscrupulous bank owners offering loans to their own limited-liability companies, shipping the money elsewhere, and then defaulting, leaving the

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[6] Hospodaøské noviny 29/5/96

bank with the unpaid debt.[7] Banking laws were changed in an attempt to curtail such activities.

The steps the CNB has taken to assert its authority over the banking industry and maintain control over the money supply have included:

- Enacting a deposit insurance scheme
- Raising capital adequacy provisions
- Refusing to grant licenses to foreign banks
- Placing limitations on big banks issuing Global Depository Receipts (GDR)
- Maintaining a permanent 10% stake in the big four banks through the National Property Fund.

"Mladá Fronta Dnes [the Czech daily newspaper] says the CNB has nearly managed to clean up the banking sector since it announced a consolidation plan. Six small banks have essentially been eliminated. Bankers agree that the advantages of the costly plan far outweigh the disadvantages."[8] Nevertheless, the collapse of Kredntní banka in 1996 and the forced administration of Agrobanka in early 1997 at the behest of the CNB indicate that the banking system is still far from perfect and needs both close supervision from the Government and CNB, as well as a tightening up of the legal framework in which banks operate.

Since the beginning of 1996, there have been some slight but fundamental changes in the banking industry due to the CNB easing some of the above mentioned restrictions. For instance, "The CNB ended its 2.5 year moratorium on new banking licensing by issuing authorisation to West LB of Germany and Midland Bank of the U.K. to operate in the Czech Republic."[9] Also, recently the CNB has granted permission to a few of the state's big banks to issue GDR's. One example has been "Komerèní banka, accompanied by CS First Boston Bank, began a two week road show in western Europe and the U.S. in support of its planned GDR issue."[10]

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[7] Transitions. Unstable Banks. pp. 18-21 May 17, 1996
[8] Mladá Fronta Dnes 27/6/96
[9] Hospodaøské noviny 24/5/96
[10] Hospodaøské noviny 22/4/96

The state, however, will continue to exert tremendous influence over the banking industry. According to an article in the Mladá Fronta Dnes newspaper (MFD), "if the state is to sell off its stakes in the banks, it is a question of years and not months before it will happen."[11]

Court System

According to many senior judges dealing with commercial cases, bankruptcy legislation reflects the view that bankruptcy is a criminal act and does not take into account the possibility of it acting as a catalyst for revitalising bankrupt companies. This leads to the practice of entrepreneurs trying to avoid co-operating with courts in insolvency cases and attempting to cover up the true state of their business' finances. The weekly journal "Ekonom" believes that a bigger problem than the heavy caseload of those commercial courts dealing with bankruptcies lies with the law itself, and claims that the bankruptcy law needs to be improved before the process can work effectively.[12] Whether the latest bankruptcy amendment will have a positive effect on the court system will only be seen in the course of time.

The current bankruptcy law requires that many tasks be completed before a bankruptcy order can be issued. When an order is finally filed, there is a long period of time allotted to each step of the bankruptcy process, with every step taking many months to complete. The amount of time is at the discretion of the judges, although they tend to favour long waiting periods. It may well be that the provisions of the 1996 amendment will speed up this process (See implications above).

Banking Sector

There is an unprecedented cross-ownership within the Czech banking community. There are only a few (four) very large domestic banks that inherited the portfolios of large businesses during the privatisation process. Since banks own major shares in large businesses, it is in their best interest to keep the companies from going bankrupt. One factor is the potential conflict of interest that results from bank ownership of the Czech voucher investment funds. For example, one of the Czech Republic's largest banks, Komerèní Banka, bought 5.5% of all shares from the first privatisation wave and now controls seats on approximately 120 management and supervisory boards. Since the bank acts as both creditor and owner, this

[11] Mladá Fronta Dnes 6/6/96
[12] Ekonom 15/03/96

potential conflict of interest prevents bankruptcy filings. It is easy to see how a bank might be afraid to push for a debtor's bankruptcy when it will simultaneously diminish their fund's value. Other reasons banks are reluctant to enter the bankruptcy process are:

- highly leveraged businesses
- lack of experience with the new law
- the ambiguous stance of the government towards intervention
- many capital assets of big businesses with outstanding debt are worthless[13]

Despite these problems associated with bankruptcy, banks are trying to cope with the transition to a market economy. Specifically, at the order of the CNB, they have created reserves to cover potential losses from bankruptcies. Also, the banks are in the process of training their managers on loan appraisals to businesses. The results are beginning to be seen in increased capital ratios and increased reserves to cover bad loans. The big four banks reported that classified (i.e. problem) loans represented 35% of all loans in 1995, down from 38.6% in 1994.[14] The financial status of the four major banks has been improving in recent years. Moody's Investors Service announced credit ratings for the nation's four largest banks. Komerèní, ÈSOB, Èeská Spoøitelna, and IPB all received a Baa2 long-term investment grading (one grade below the Czech Republic's rating) and a Prime-2 short-term rating.[15]

Unfortunately, the collapse of Kreditní banka in 1996, and the forced administration and eventual bankrupting of one of the country's larger banks, Agrobanka, has shown that the banking sector in the Czech Republic is by no means on the same level as western banks. The case of Kreditní banka, where the role of the state insurance company and major shareholder, Èeská Pojiš ovna and that of the investment fund, Motoinvest, led to criminal investigations and the arrest of financiers involved in running the bank's affairs on a domestic level highlighted the lack of adequate supervision exercised by the CNB, legislative shortcomings and the incompetence of many senior officials responsible for overseeing banking activities (see below for further details). From an international standpoint it was another embarrassing episode for the Czech financial sector which further damaged international confidence in the Czech economy.

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[13] Jiøí Huebner of the EBRD said that, "many Czech companies need to undergo restructuring because their machines and other capital assets are outmoded and under productive." Hospodaøské Noviny (HN/1) 20/3/96

[14] Hospodaøské noviny 11/4/96

Private Sector

In 1992, the Czech government, using various methods (see Appendix B1), took action to privatise state-owned businesses. Approximately 34% of state owned businesses were privatised in the voucher privatisation process of 1992. The voucher privatisation method had many benefits and it led to very few political pressures. It helped speed up the creation of the institutional infrastructure for a market economy by creating of financial intermediaries such as investment banks and funds, brokerage firms, a stock exchange and financial consultants. The voucher privatisation method also provided an opportunity for commercial banks to offer new financial instruments. The value of the property privatised amounted to almost 60% of the total value of all the properties in the market (see Appendix B1).

The Czech government's original intention was that voucher privatisation would generate mostly individual investor interest. However, large management investment fund companies were formed which bought the privatisation coupons from the individual investors. Now, the investment fund companies, along with the four big banks, control the ownership of many large companies. According to an article in the June 1995 edition of the Central European Economic Review, more than 60% of the privatisation voucher points ended up in investment funds and over one-third is owned by banks and the Czech insurance company. An article in the daily Czech Mladá Fronta Dnes newspaper notes that despite the government's ambitious privatisation plans, a full three-fourths of the nation's 20 largest industrial companies are still controlled by the state.[16] In addition, the Statistical Office reports that companies controlled by the National Property Fund (a state-owned investment fund) account for 40% of the nation's economic output.

The main criticism coming from the financial community is that management insiders, banks and investment fund companies are all too dependent on each other and they are not operating within a free-flowing system typical of a healthy open economy. Analysts in the finance industry also believe that the Finance Ministry's supervision of the capital market is poor and that inspections are ineffective and inspectors are too inexperienced to uncover any instances of fraud.[17] A recent example of the misuse of funds occured at the insurance company, Èeská Pojiš ovna. An article in MFD says that, "heads must simply roll at Èeská

[15] Hospodaøské noviny 15/3/96
[16] Mladá Fronta Dnes 27/5/96
[17] Mladá Fronta Dnes 15/3/96

Pojiš ovna for the way the insurer allowed itself to nearly go bankrupt through its handling of the situation at Kreditní banka. The public is used to the fact that someone would found a bank merely to steal from it (as in the case of other bank failures), but it is hard to swallow a multi-billion crown loss at an institution that supposedly has some of the country's best financiers on its governing board."[18]

There are many calls for reform in the capital markets. Prague Stock Exchange (PX 50) Chairman, Tomáš Je ek, says that a fundamental need of the Czech capital markets is the quick establishment of an independent supervisory institution, similar to the U.S. Security and Exchange Commission. Such an organ would be vested with extensive powers to regulate and supervise the activities of the financial community, and would at the same time allow Parliament and the Ministry of Finance to deal with broader issues regarding the sector, rather than every minute detail.[19]

The Prague stock market operates in the Czech Republic with two indexes: the PX 50 and the HN-Wood Index. Despite the problems with regulation and reform, 1995 was a good year for the PX 50 and the HN-Wood. Aside from domestic investors, there is a substantial foreign presence on the Prague stock exchange. For example, the U.K. accounts for 39% of portfolio investment, followed by at U.S. 27% and Germany at 7%."[20] What this means for bankruptcy is that with this availability of foreign capital on the home market, there is considerably less of a creditor incentive for pursuing better bankruptcy laws as a means of protecting investments.

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[18] Mladá Fronta Dnes 17/6/96
[19] Hospodaøské noviny 3/5/96
[20] Hospodaøské noviny 10/6/96

IV. The Law on Bankruptcy and Settlement in Practice

1. A Recent Settlement Case - Let Kunovice

A recent bankruptcy court settlement involving Let Kunovice, an aircraft manufacturing company, has been hailed by the Ministry of Trade and Industry as a model for future bankruptcy cases. The court settlement reached with the creditors will leave the company out of involuntary bankruptcy. The settlement was legal since creditors representing more than 75% of the debt agreed to the terms proposed by the debtor. The settlement is comparable to a Chapter 11 style bankruptcy where the company is forced to reorganise rather than liquidate to pay off its debts (see chapter 3, section 5).

This settlement allows Let Kunovice to continue operating in the hope that it will turn itself around and start making a profit, so it can begin to pay back some of its debts. The bankruptcy order included the provisions that: creditors owed less than 5 million Kè will receive 45 hellers cash on the crown. Komerèní banka guarantees this operation up to 850 million Kè. Those creditors owed more than 5 million Kè will receive shares in the company, also representing 45 hellers on the crown.[21] Let Kunovice has agreed that within two years, they will repay 45% of the claims greater than 5 million Kè. Presently, Let Kunovice has 5.4 billion Kè in outstanding debt.

[21] MFD Newspaper 31/5/96

2. A Recent Bankruptcy Case - *Poldi Kladno*

The case of Poldi Kladno demonstrates the complexity of the issue of bankruptcy in the Czech Republic. The purchase, running down and eventual bankruptcy of one of the biggest steel companies in the country illustrates that, in practice, bankruptcy is not merely a legal and economic mechanism for redistributing the resources of bankrupt entities, but a highly sensitive social and political issue as well. It also highlights the problem of bankrupting a large business when billions of crowns, thousands of jobs and major political reputations are at stake.

In March of 1997, one of the largest and what was expected to be one of the most profitable Czech steel companies, Poldi Kladno, was officially declared bankrupt. It now seems likely that the giant company will be sold off in bits and pieces, while its director, Vladimí r Stehlí k, has been under criminal investigation. The scandal has shaken the faith of many Czech and foreign investors alike, and once again called into question the policies, competence and ethics of Czech banks, investment funds, and the National Property Fund.

On February 28th 1997, Marko Stehlí k, Vladimí r's son and acting director while his father was in jail and under investigation, unexpectedly sold their family business, Bohemia Art, to a firm by the name of ProWin. Bohemia Art is the majority holder in Poldi Kladno after it purchased a 54.8% share in the company under a special privatisation tender granted by the National Property Fund, for 1 billion crowns, in 1994. A week later, ProWin was revealed to be a debt collection firm. The Stehlí ks sold their company to ProWin for just 15 million crowns. Marko Stehlí k took this action without notifying the company's creditors. In April, The Prague Commercial Court began bankruptcy proceedings against Poldi Kladno.

Although Poldi's exact debt has yet to be determined, it is known to owe at least 8 billion crowns ($276 million). It owes 4 billion crowns to Komerèní Banka (the largest Czech bank with a considerable percentage still in state hands), and over 130 million crowns in unpaid wages to its workers. It is very likely that both Komerèní Banka and Poldi's second largest creditor, Konsolidaèní Banka, will lose billions of crowns in the bankruptcy proceedings. The National Property Fund still retains a minority share in the company through one of its holding companies, Holding Kladno.

ProWin stated that it was shocked when it learnt of the grave nature of Poldi's situation, and it has filed motions to block the bankruptcy proceedings. It has announced that it will take measures to save the failing company and eventually sell it after restructuring, even though this could necessitate the selling of portions of the firm to creditors and laying off a large part of the work force.

Where does the blame lay for this crisis? Of course a large part of the blame can be laid squarely at the feet of the Stehlí ks who, according to a parliamentary commission, transferred 1.6 billion crowns from Poldi to Bohemia Art during their ownership. After their sale of Bohemia Art, they then created a new company, Poldi Steel and transferred most of the Poldi Kladno property and the trademark - thought not the debt - to it. In the interim since the bankruptcy proceedings, Marko Stehlí k has been stripped of his position as Poldi Kladno's executive director and all of the company's accounts have been frozen.

Part of the blame for the fall of Poldi must also lie with the Czech government's financial policies, especially regarding holding companies, privatisation and its attitude to bankruptcy. From 1993 to 1996, the Czech government intervened in the market repeatedly, often to forestall bankruptcies and layoffs. While keeping inflation and unemployment low, it retained a large ownership (from 30-60 %) in the four largest banks, one of which, IPB, is now in a serious financial crisis of its own.

The government also permitted these banks to remain interconnected through mutually owned investment funds. In turn, the banks' lending and investment policy was driven not so much by considerations of efficiency and profit, but rather by their inclination to assist those companies whose stocks were held in the portfolios of investment funds, and with whom the banks had a close financial relationship. The case of Poldi is indeed a classic example of this. Komerèní Banka (a bank with a large state share-holding) and Poldi Holding (a company run by the National Property Fund) were both closely involved in the privatisation and collapse of Poldi Kladno, with both bearing the brunt of the resulting 4 billion crown loss.

The trap does not end here. The National Property Fund (NPF) often represents the state in the ownership of private enterprise, such as the minority holding it retained in Poldi through the holding company Holding Kladno. Though the NPF should be interested in the long-term viability of its investments, it often focuses on receiving instalment payments from owners (like the Stehlí ks), at the expense of poor management, production, etc. The state's effort to stave

off bankruptcy at Kladno went even further, in allowing Poldi Kladno to suspend paying both privatisation and social security instalments, resulting in a 5.6 billion ($200 million) crown debt.

Under the 1996 amendment, the transfer of the assets and trademark of Poldi Kladno to the new company founded by the Stehlí ks, Poldi Steel, should be declared invalid, if it took place six months prior to the firm filing for bankruptcy. Although the sale of the asset-stripped company to ProWin will undoubtedly be scrutinised in the course of the bankruptcy proceedings, the real focus of interest will be the role and activities of the chief officers of Poldi, the Stehlí ks. Attention will also focused on other issues such as the extent to which the government and the NPF were aware of the chicanery taking place within the company.

The political and economic fallout from Poldi's collapse is still unfolding, as the resulting crisis has thrown several banks into disarray, and has arguably contributed to the political demise of the Minister for Trade and industry, Vladimí r Dlouhý, who engineered a large portion of Poldi's privatisation scheme.

There could be some positive aspects to Poldi's bankruptcy, though. The court appointed administrator for Poldi has told the company's trade unions that he is more interested in bringing Poldi back to life than liquidating it. He has also expressed openness to contract with interested partners in running the company.

V. Conclusions

In the Czech Republic, the law on bankruptcy and settlement, especially after its most recent amendment, represents a reasonably functional mechanism for the regulation of restructuring and bankrupting of businesses. Nevertheless, there still exist some areas which require further development in order to make the legal framework complete and effective for this task as, on its own, it is insufficient.

Bankruptcy proceedings can be a truly effective instrument when underpinned by the necessary stimuli. As is shown from the economic experiences of the most developed nations, there is still a need for a more intensive implementation of measures such as tightening-up expenditure connected with bankruptcy proceedings (court costs, payment of administrators, the financing of bankruptcy procedures) without damaging the security of creditors. Likewise, protecting secured creditors and ensuring the protection of preferential creditors (such as claims of employees and the state budget), issues addressed by the Czech law are fundamental to ensuring confidence in the process within the business community.

There are a number of factors that still prevent the Czech bankruptcy law from functioning properly. One factor is a court system that is ill-equipped to process bankruptcy cases. The law still contains many requirements that are ultimately very time consuming one a case gets to court. Thus, nearly 2000 bankruptcy cases are still being processed by the courts, with quite a few of those have been going on for years. The Czech government recognised this problem and the 1996 amendment to the bankruptcy act contained a provision that speeded up the court process by limiting the protection period in bankruptcy cases only to businesses that employ more than 50 people.

Another area which influences the success of the bankruptcy law is the skills level of those people administering its application. Up until recently, there has been a lack of suitably qualified and experienced judges and in particular bankruptcy administrators to deal with the ever-growing number of bankruptcy cases in the Czech Republic. Similarly, judges and court appointed administrators are not trained in the intricacies of corporate finance and banking procedures. The 1996 bankruptcy amendment attempted to address the problem of unskilled administrators by allowing the selection of administrators according to their area of specialisation, thereby improving the expertise in each specific bankruptcy case. Not

surprisingly, the lack of financial reward in the profession has also contributed to a lack of quality among administrators, a problem the 1996 amendment also sought to resolve. Suffice to say, however, that time will be needed in order for these measures to have a tangible effect.

As a model for further improving the current situation among administrators, Czechs can draw inspiration from sources close to home. For example, in an effort to improve the situation within the profession, the Hungarian Ministry of Finance laid down a number of conditions for those individuals or firms wishing to become administrators of bankruptcy assets, which have had a significant and positive impact. These measures included requiring potential bankruptcy administrators to employ at least one lawyer and one financial expert, to have proven professional experience in dealing with bankruptcy cases, and to have at their disposition the sum of at least 150,000 US dollars (or an insured guarantee to the value thereof). In addition to these measures, there are now two professional associations for bankruptcy administrators and a federation of bankruptcy lawyers has also been established. As a consequence of this there are now in Hungary over 100 officially registered administrators of bankruptcy assets, providing a professional service to the business community.[22] This approach shows that establishing a functional framework for implementing and administering bankruptcy law is not impossible, nor is it restricted to the more developed economies.

It would be fair to say that the behaviour of most of the major actors in the Czech privatisation process, and the relationships that these actors developed following privatisation has contributed in no small part to the sluggish pace of bankruptcies in the Czech Republic. Furthermore, there have been several examples of what at best could be called „financial irresponsibility“, and at worst gross negligence on the part of the banks, the state bodies and their officials, and some private companies which have had an impact not just on bankruptcy law implementation, but which has damaged the economy as a whole, by weakening overall business confidence.

One example of this has been the formation of an insider’s market in the Czech economy, which has as a consequence limited the proper implementation of the bankruptcy law. Banks, large investment fund companies, and the government (through ownership of banks and through the National Property Fund) are the main creditors in many businesses and own large voting shares of the stock. In the privatisation process, the banks inherited portfolios of many companies and the investment funds bought large controlling interests in many of the

same firms. Since these creditors own large portions of the businesses, it is in their best interest to keep the businesses viable. Financial analysts believe that many insolvent businesses would be liquidated if the Czech economy was a truly operating market economy. There are no provisions in the 1996 amendment that address this specific area.

Due to poor management of businesses, unavailability of credit, loans payable becoming due now and increasing competition, the number of businesses filing for bankruptcy protection is growing each year. Since 1992, 6358 businesses filed for bankruptcy, but only 9 businesses have received bankruptcy relief. Over 56% of the bankruptcy filings are still in process while hardly any major company has been forced into liquidation. The trend of not forcing through liquidations will continue into the future, since recent bankruptcy cases which involved restructuring, rather than liquidating, heavily indebted businesses has been hailed by the Ministry of Trade and Industry as a model for future bankruptcy cases. The government must realise that, "A credible threat of bankruptcy serves as a means of forcing debtors and creditors to reach agreement in cases of financial distress and avoids opportunistic behaviour."[23] One provision in the 1996 amendment does seek further protection of creditor's rights by limiting the debtor's activities 6 months prior to filing for bankruptcy. [24]

Until the financial markets break the hold of the insider's control of the bankruptcy will not perform the function of removing unproductive businesses from the market and releasing the economic resources to developing businesses and the Czech Republic will not operate as a fully functioning market economy. While the current legal framework goes quite some way towards resolving many of the problems connected with the complex issue of bankruptcy, it is widely accepted that the Czech Republic still has quite a way to go. As the current Minister of Justice, Mrs. Vlasta Parkanová observed recently;

„The Czech Republic would, in the foreseeable future, need a completely new law on bankruptcy and settlement, but it is impossible to bring about overnight, especially when [one considers that] the equivalent law in Germany took ten years to prepare."[25]

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[22] See O'Connor, S. and Pajas, P. "Financial Restructuring of Czech Companies" pp. 54-55

[23] Institute for East-West Studies, Policy Recommendations on Banks, Capital Markets and Enterprise Restructuring. Kalman Mizei

[24] At the time of writing this report, the Czech Government were discussing an amendment that would further tighten up the law regarding debtors' activities prior to the commencement of bankruptcy proceedings. Included in this new amendment is a provision that would make it compulsory for a debtor to file for his own bankruptcy as soon as he finds himself insolvent, and should this not occur he would then be liable for criminal prosecution. See Lidové noviny, 05/06/1997, p.16.

[25] Lidové noviny, 05/06/97, p.16.

VI. Observations on the issue of bankruptcy in the Czech Republic, June 1997

In the course of this paper's preparation (from mid-1996 to early 1997), the Czech Republic had been seen as the model transitional economy. Solid economic growth, a prudent fiscal policy and a stable political order gave the impression that the Czech economy would be one of the first to move from the half-world of struggling post-communist basket-case to something approaching the mature free-market economies of western Europe, with EU membership the ultimate prize. The full convertibility of the Czech crown was seen as a further sign of this economic success story, being as it was the first former communist currency to be traded on the open currency markets.

Recent events have put all these perceived achievements into sharp perspective. The slowdown in economic growth that began to evidence itself in the first part of 1997 and the government's uncertainty of how to deal with this problem coincided with a series of banking and investment fund scandals and a loss of public confidence in the government. The most recent and heaviest blow dealt to the Czech economy has been the alarming tumble in the value of the Czech crown, thus putting a massive question mark over the whole so-called Czech economic miracle. For the first time, politicians and economists alike are talking openly about the painful steps that are necessary to streamline the economy and cut away the inefficiencies that have undoubtedly contributed to the current economic problems. It is clear that in this regard the Law on Bankruptcy and Settlement will play a large part in clearing out those inefficient businesses that have been able to survive in the hitherto relaxed economic climate.

It is worth noting that the premises upon which the law was established, particularly the 1996 amendment no longer bear relevance to economic reality. Indeed it can be argued that the government's belief in its own success in no small part has contributed to the current economic problems. When the recently sacked Trade & Industry Minister, Vladimí r Dlouhý, observed last year that the economy was stable and the free market developed enough to pass a new bankruptcy law without the threat of the “domino effect”, he had clearly concluded that the economic transformation of the country was complete and an economic crisis highly unlikely. Nor had he, nor his governmental colleagues fully taken into account the burden placed on economic growth by inefficient businesses, whose continued existence relied

largely on a lax bankruptcy law, a banking sector happy to prop up such firms to serve their own ends and a government happy to turn a blind eye to the politically sensitive but economically necessary issue of bankruptcy. Unfortunately, it now appears that these economic chickens are now coming home to roost.

It seems certain that these companies will bear the brunt of this harsh new economic reality and in all probability be the first ones to experience bankruptcy. The domino effect feared by Mr Dlouhý may or may not occur, but it is indeed ironic that a law recently amended thanks to perceived domestic economic stability, may only see its true effectiveness in a period of economic difficulty. One can only wonder at how the courts may have dealt with the potential explosion in the number of bankruptcy cases without the changes introduced by the 1996 amendment. Nevertheless, it is clear that the courts will need further legislative instruments to deal with bankruptcy if they are not to be overwhelmed by a new wave of insolvency cases.

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Appendix A

Resource Articles for Bankruptcy not specified in bibliography

Date	Source	Author	Language	Title	Notes
01.08. 1992	The Economist	not mentioned	English	Bankruptcy. When firms go bust.	Corporate bankruptcy involves balance between creditors and shareholders. America's Chapter 11, giving equal weight to debt and equity is a disaster: slow, unfair, expensive. Lawyers are beneficiaries. Biggest ever bankruptcies. How to reform Chapter 11.
01.08. 1992	The Economist	not mentioned	English	French shareholders British creditors	Comparison of how countries treat their bankrupt firms: Japan by informal rescues or legal liquidation. Germany: coaxing back to health by bankers or brutal liquidation. France: declare bankruptcy, court official. Britain: creditors interests first.
31.12. 1992	Economy 51/1992	František Bernát	Czech	Bankruptcy or Reconciliation	Result of the application of law #328/1991: financial opportunities given by law, responsibilities of debtor for outstanding debts after bankruptcy, tracking unresolved debts.
31.08. 1993	Obchodu a podnikání	Stanislav Kalný, Jiøí Kodat	Czech	Bankruptcy wave did not arrive	Bankruptcy law in practice. Proposal of Economics Ministry of the Czech Republic for enabling the state to resolve bankruptcies out of court. Number of claims and obligations, turning claims and credit into assets, purchasing claims writing claims.
01.03. 1995	CDFE	Karel Lacina	Czech	Bankruptcy law in developed nations	Experiences of the USA, UK, France, Germany. Comparison with the law in CZ.
01.03. 1995	CDFE	Karel Lacina	Czech	What the bankruptcy law means for the development of the Czech economy	Analysing the consequences of declaring bankruptcy under the new amendment. Description of phases in bankruptcy proceedings.
01.03. 1995	CDFE	Karel Lacina	Czech	Bankruptcy legislation in the Czech Republic	What laws affect the proceedings. Dissection of the law #328/1991.
01.03. 1995	CDFE	Karel Lacina	Czech	Problems with the application of the bankruptcy law in the Czech Republic	The weak points of the current law: Delays and lengthy discussions, unpredictability, the role of trustees of the subject of bankruptcy, initiating legal action, publicising the declaration of bankruptcy, steps regulating financial settlement.
01.03. 1995	CDFE	Karel Lacina	Czech	The course of bankruptcy proceedings in the Czech Republic	The role of the courts and the trustee.

Date	Source	Author	Language	Title	Notes
01.03. 1995	CDFE	Karel Lacina	Czech	Survey of the number of bankruptcies in the first half of the nineties	Analysis of the years 1991-1995.
01.03. 1995	CDFE	Karel Lacina	Czech	Preparation phase of bankruptcy in the Czech Republic	Breakdown of phases of bankruptcy proceedings.
01.04. 1995	Ekonom 11/1995	Alena Adámková	Czech	Firms who fell in the pit, or the ghost of bankruptcy	Analysing the materials of the Ministry of Economy and Trade in 1994. Citing businesses in bankruptcy proceedings, mostly old state companies. Declaration of bankruptcy is rather a threat of the creditor.
30.05. 1995	DHK - sešit 10	Miroslav Jansa	Czech	Settling bankruptcy through legal action	The definition of terms, steps, consequences. Satisfaction of the creditors that have come forth, dividing them into classes, exclusion of claims for sanctions outside of the contract. Withdrawing of bankruptcy and the consequences.
11.06. 1995	CDFE	Gary Traynor	English	Summary of the Czech Bankruptcy Code 328/1991	13 Bankruptcy Order, 34 Involuntary Dissolution, 46 Composition. When available, initiated by Requirements of Proposal, Approval Required, Preference of Claims, Corporate survival conditions.
16.06. 1995	CDFE	Gary Traynor	English	Central European Economic Review	Overview of several articles cited: Cracks in the Facade by Neil King, Jr. & Shallagh Murray, The development and Reform of Financial Systems in Central and Eastern Europe by Kálmán Mizsei.
22.06. 1995	CDFE	Gary Traynor	English	American Bankruptcy Code	Purposes of the Code. Chapters 7 (Liquidation), 11 (Reorganisation), 13 (individual). Jurisdiction. Judges. The Trustee. Deptor-in-Possesion. Creditor's commitments. Summary of parties involved.
27.06. 1995	CDFE	Laura Bergman	English	Update: Bankruptcy in the Czech Republic	Data on bankruptcy proceedings. Summary of present bankruptcy legislation. General views. Critique of the Bankruptcy Code in Application. Amendments to the bankruptcy Code. Anticipation Legislation.
03.07. 1995	CDFE	Laura Bergman	English	Summary of the Bankruptcy Conference in Bratislava	Overview of the conference proceedings. Talks of Schmolerova, former Vice Premier Minister.
19.07. 1995	CDFE	Gary Traynor	English	The Bankruptcy and Composition Act - 328/1991	The first outline of the code translation.
19.07. 1995	CDFE	Gary Traynor	English	The Bankruptcy and Composition Act - 328/1991	Full translation of the Czech Bankruptcy Code with an introduction.

Date	Source	Author	Language	Title	Notes
31.07. 1995	not mentioned	Brigita Schmögnerová	Slovak	The speech of an MP from the Slovak Republic, conference on bankruptcy in Bratislava	The situation of financial management of companies in the first quarter of 1995. Claims and obligations of companies reach 253 and 334 billion SLK. 200 companies are being liquidated by the state.
12.09. 1995	Lidové noviny	Milan Hulík	Czech	Czech courts and judges	The state of business judiciary is trustful.
18.10. 1995	Právo	not mentioned	Czech	The dictionary of bankruptcy and reconciliation	The Bankruptcy procedure and its participants, the Trustee, the Estate. The Committee of Creditors. Claim and it Registration. Reconciliation and Settlement.
01.12. 1995	Národní hospodáøství 2	František Zoulík	Czech	Amendment to the bankruptcy law	The arrangement has to do primarily with bankruptcy. The conception is not changing. It is limited by the use of civil courts. The standing of trustees of the estate is being adjusted.. The institution of bankruptcy is being established.
31.12. 1995	CDFE	not mentioned	English	The state of financial restructuring in the Czech Republic	Evaluation of the transformation of the banking system in the CZ. Changes since 1990. Share of Financial entities in restructuring. The Act on Bankruptcy and settlements and Financial Management. Presumed further development.
19.01. 1996	Hospodáøské noviny	not mentioned	Czech	Economic committee agrees with the quickening bankruptcy processes and out of court settlements	Proposals in the state's amendments: Protection period only for companies with more than 50 employees. Out of court auctions for buildings. Giving responsibility to the debtor to file for bankruptcy during insolvency.
01.02. 1996	Hospodáøské noviny. 2	Martin Jašminský, Zdenìk Zuntych	Czech	Number of bankruptcies is growing even though laws don't effectively enforce payment of debts	Banks are wary but allow for bankruptcy proceedings more often. Slow courts prolong bankruptcy. Fewer possibilities for creditors. It is not possible to dispose of affairs ended in bank's favour.
15.02. 1996	Ministerstvo hospodáøství ÈR, odbor hospodáøské a sociální politiky	not mentioned	Czech	News of bankruptcy from January to December 1995	Summary, analysis, graphs for the year 1995.
01.03. 1996	Právní rádce 2/1996	Rozhovor: Rudolf Chalupa - Hana Kratochvílová	Czech	Amendment to the bankruptcy law	Substantiating the necessity for change is its basis. Rewarding trustees. Adjustments of the liquidation’s position and of the rights of the detached creditors. Clearing up of claims on the estate.

Date	Source	Author	Language	Title	Notes
15.03. 1996	Peníze 36	István Lékó	Czech	Does bankruptcy threaten? Be calm... Why can Mr. Èekan Komanický, or Stìhlík smile?	Filing for bankruptcy is like a broom or ram for competition. To steal what has not yet been taken away. The small creditor falls by the wayside.
15.03. 1996	Ekonom è. 3	Jiøí Nesnídal	Czech	Business courts are overwhelmed	Claims have to be forced and the filing of bankruptcy plays into the hands of the debtor. It is possible to appeal the payment order within 15 days. The procedure judge has little effect.
26.03. 1996	MF Dnes	Jan Raška, Lukáš Havlas	Czech	To resist bankruptcy does not make sense	A critique of the Ministry of Industry and Trade's proposal.
26.03. 1996	CDFE	Karel Lacina	Czech	Czech and European experience in applying the bankruptcy law	An overview of bankruptcy development. The European view of the meaning of forced bankruptcy. Insufficient addressing of the post-bankruptcy business revitalisation question.
09.04. 1996	Hospodáøské noviny	Karel Lacina	Czech	What bankruptcy means for the economic development	Bankruptcy law is a tool to put an end to the activities of unhealthy businesses. After the amendment is passed filing for bankruptcy process will be done automatically.
26.04. 1996	MF Dnes	(ÈTK)	Czech	The court accepted Let Kunovice proposed settlement	Let Kunovice owes five billion and has a financial loss of 700 million. Nevertheless, a court in Brno accepted its proposed settlement.
01.05. 1996	Ekonom 16/1996 - pøíloha	Jiøí Nesnídal	Czech	The bankruptcy law (in its entirety) including explanations	All amendments through March 13, 1996.
01.05. 1996	S'96, è. 21	Karel Lacina	Czech	The smaller the city, the fewer the bankruptcies	The amendment to the law makes protection period more difficult to gain. It protects against speculation on debtor property before bankruptcy is declared. Makes declaring leveraging mandatory. Regions may help smaller businesses by leasing businesses.
26.05. 1996	Ministerstvo hospodáøství ÈR, Odbor hospodáøské a sociální politiky	not mentioned	Czech	Overview of bankruptcies from 10/8/92-3/31/96	Bankruptcies are increasing yearly by 25%, 6358 cases in total, 993 bankruptcies declared, only 9 settlements proposed, 5 are in protection period, 3576 are still in process. Divided regions and kinds of business
31.05. 1996	Hospodáøské noviny	not mentioned	Czech	Creditors of Let Kunovice decided to settle in court	The result of this singular case apparently means the preservation of the Let manufacturer. The sum owed 5,387 billion Kè will be settled according to the debtor's proposal. A written expression of the appeals court is expected.
31.12. 1996	Ministerstvo spravedlnosti	not mentioned	Czech	Report on development and status of commercial courts	The commercial courts are not doing their job sufficiently well, which has a negative effect on the business sector, community, as well as the courts themselves.

Appendix B

Additional Tables

B1: Privatised Property and Utilised Methods of Privatisation[26]

Method of Privatisation	Business units		Value of Property	
	Number	Share in %	Mil. Kè.	in %
Public Auction and tender	365	13.06%	8602.8	2.22%
Direct Sale	701	25.08%	140803.8	36.29%
Voucher Privatisation	943	33.74%	229364.2	59.11%
Unpaid Transfers	786	28.12%	7395.3	1.91%
Restitutions	n/a		650.4	0.17%
Small Privatisation			1177.1	0.30%

[26] Table taken from report written by Jiøí Hlavacek and Zdenìk Tùma, May 1993. Bankruptcy in the Czech Economy

B2: Bankruptcies According to Types of Companies[27]

Comparing the first quarter totals for the last three years.

	I./IV.	I./IV.	I./IV.	Total
Type of Company	1994	1995	1996	1992-1996
Limited	31	54	82	490
Private	11	37	38	273
Joint-Stock	6	10	10	67
State Owned	6	6	12	75
Agricultural Assn.	2	8	12	51
Manufacturing Assn.	2	3	3	19
Trade Co-operative	0	0	0	1
Public Traded	0	2	3	13
Command	0	2	0	3
Trade Association	0	1	0	1
Total	58	123	160	993

[27] Data Provided by Ministry of Trade and Industry

Appendix C

Sample Bankruptcy Order

Bankruptcy Order			
Initiated By:	**Bankruptcy Order** The Debtor, any creditor or another person if law allows	**Involuntary Composition** The Bankrupt	**Composition** The Debtor
When Available:	Anytime, except the order cannot be given for an agricultural company between April 1 and September 30 Also, the order may be delayed by 3-6 month protection period	Before the distribution schedule has been released but after the review hearings.	Before the bankruptcy order
Requirements of Proposal	The debtor must provide a detailed balance sheet with appraisal of assets The claims of creditors are reviewed at special hearings	Must satisfy all but 2/3 of the 3rd. Class creditor claims	The preferred claims must be completely paid or ensured 45% of the preferred claims must be scheduled to be paid within 2 years. All other claims must be satisfied to "an equal extent"
Preference of Claims	1. Administration of Estate 2. 1st. Class: Employment Related 3. 2nd. Class: Taxes, fees, SS, etc. 4. 3rd. Class: All others	1. Administration of Estate 2. 1st. Class: Employment Related 3. 2nd. Class: Taxes, fees, SS, etc. 4. 3rd. Class: All others	Preferential Claims: taxes Administration, employment Non-preferential: All others
Corporate Survival	No	Yes	Yes