Notes on

History and Development of Bankruptcy Procedures

in the Czech Republic

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Abstract

This article deals with the historical evolution of the bankruptcy code in the Czech Republic, published as the Bankruptcy and Composition Act of 1991 Coll. The main focus is on the fourteen amendments from the period from 1992 to 2000. We describe the major changes in the law that significantly changed the status of the bankrupt, trustee, debtor, or bankruptcy procedure as such, as well as the remaining weaknesses that prevent or hamper the bankruptcy proceedings. The final part of the paper deals with the Highest Court rulings that are used to unify the interpretation of the Act across the regional courts and we conclude with the major practical problems of the current usage of the bankruptcy laws.

Notes on History and Development of Bankruptcy Procedures

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Content:

1. History of Bankruptcy Law (BL) in the Czech Lands till 1989

The codification of bankruptcy law as separate and serried law went on from the thirties of 18th century and peaked by edition of a general bankruptcy code of Joseph II in 1781. The formal condition to start the procedure was to file a petition (note: form of action, prosecution) if the debtor was the initiator of the process. All claims were filled as actions. Since all prosecutions (including the bankruptcy law cases) went through three hearings, the procedure was costly and lengthy. An interesting point from today view is that the bankruptcy was not ended with actual conversion (realization) of all available assets but with the full satisfaction (repay) of all claims that were eligible and filed in time. The claims were classified into two groups while the second group consisted of six classes. Because of its costs and length the bankruptcy procedure has been subject to effort of replacement with a new bankruptcy law in 19th century. After several unsuccessful attempts a new bankruptcy act No. 1/1869 was accepted and the bankruptcy was adjudicated as a more modern code.

The principles of bankruptcy rules - especially the principle of universality - when all assets of the debtor were subject to the procedure that should serve to satisfy all creditors, shifts the bankruptcy procedure as such in the right direction. Property was conversed from the debtor and entrusted to the trustee, a compulsory creditors' committee was introduced. During the end of 19th and beginning of 20th century this BL became criticized as well, especially because of the insufficient legal protection of creditors in out-of court composition settlements. The problematic issue was the existence of a large amount of preferred creditors and separate creditors that caused that practically no ordinary creditors were ever satisfied.

Such a critique culminated into an issue of emperor's decree No. 337/1914 that introduced, among others, separate settlement rules for out-of-bankruptcy (voluntary) settlements and new punitive provisions with respect to bankruptcy procedure.

This bankruptcy law was introduced into the Czechoslovak law by act No. 11/1918 together with the Hungarian bankruptcy law XVII/1881 and with both Austrian and Hungarian settlement rules. All these thus became a part of the Czechoslovak legal system. There were

only minor changes in the law and these norms were in effect till 1931. Act 64/1931 Sb., together with supplementary decrees (vyhláška) unified bankruptcy law on the whole territory of Czechoslovakia.

After the year 1948 the bankruptcy law was abolished by the communist regime and replaced with a part of a Civil Code 142/1950 Sb. (in '' 570-605) introducing institute of seizure liquidation. Even this part of the Civil Code was replaced in 1963 and further on stayed in the law system only as a formal name on a reciprocal basis. Because of the exclusive state ownership of all production means (except labor), the bankruptcy was inapplicable in the communist environment.

2. Bankruptcy and Composition Act, of 1991

The Bankruptcy and Composition Act (BCA, "Zákon o konkursu a vyrovnání") No. 328/1991 Sb., in effect from Oct. 1, 1991, stemmed from the Act 64/1931 Sb. as well as from legal norms of other countries, especially Austrian, German, Italian and French influences are notable, but we can also find British and American elements. The new law was intended to facilitate the transition nature of the Czechoslovak economy. Unlike the pre-war legislation, this Act did not separately cover appeal rights as well as it did not introduce so-called bankruptcy commissioner (trustees). The whole bankruptcy was in hands of the court.

BCA was divided in four major parts:

1 Definition of the purpose and aim of the law - protection of creditors and settlement of debtors' assets ('' 1-3)

2 Bankruptcy procedure including involuntary settlement ('' 4-33, '' 34-45)

3 Settlement rules ('' 46-66)

4 Joint, transitory and closing provisions ('' 67-73).

According to ' 67 BCA, it was possible to declare bankruptcy of state enterprise (e.g., SOE in literature) or exclusively state owned company only because of overdebtness but not because of its insolvency within one year from the date the BCA came in effect. The government (in a

broad sense) was afraid of a possible chain-reaction where one bankruptcy would initiate a wave of subsequent ones. The mass privatization has just started at that time and chained bankruptcies could completely undermine its goals.

Such limiting regime for SOEs ended on Oct 1,1992, however the causes of the limiting regime were still in place and further on the wave of bankruptcies could meet in time with the division of Czechoslovakia. Therefore, the limiting regime was prolonged by 6 months with Act No. 472/1992 Sb., these limits on the declaration of bankruptcy of SOEs vanished by April 22,1993, according this act.

3. Amendment No. 122/1993 Sb.

In 1993 a new, extensive, amendment of BCA was accepted as Act. 122/1993 Sb., taking effect on April 22, 1993. This amendment brought in several important changes.

A protection period between the filling for a bankruptcy and declaration of bankruptcy is introduced. The debtor has a chance to consolidate himself (note: it/he/she) and overcome the insolvency stage. The protection period lasts for three months and a prolongation is rather exceptional.

Another limitation of declaration of bankruptcy concerns self-employed farmers, till Dec 31, 1994, it is possible to declare the bankruptcy only with the approval of the possible bankrupt. The firms with more than 50 % shares dedicated to the voucher privatization scheme did receive a reprieve until the shares are transferred to the new owners.

The protection period also serves as a device of coordination. Its publication allows other creditors to file their claims as well as warns the potential business partners of the debtor. During the protection period the creditors cannot separately collect their claims and the debtor has to detain form any actions damaging or discriminating (directly or indirectly) the creditors.

Exceptional handling was allowed for a certain group of legal subjects in order to have a smooth privatization process - these exceptions covered state enterprises, other state organizations, and legal entities with a significant state ownership. These legal entities were listed in the Commercial Bulletin (Obchodní vestník) and a special regime within the frame of BCA with respect to particular phases of the privatization was governing bankruptcies for them. Basically, this special approach allowed finishing already started privatization.

The amendment also introduces the creditors' committee, which leads to better procedural arrangements since there is no need for the plenary session of all creditors for every decision. This was a problem especially when there were a lot of small creditors.

The management of the bankrupt is restricted and cannot buy assets of the bankrupt even in the auction and cannot buy them from third persons within three years after the end of bankruptcy procedure.

4. Amendments in 1994-1995

There have been seven amendments of BCA passed in 1994 and 1995, mostly within amendments of other laws in order to facilitate consistency between the particular new law and BCA. For the completeness, the summary follows:

- 42/1994 Sb., Act on additional pension insurance, effective from March 21, 1994
- 74/1994 Sb., Labor Act amendment, effective from June 1, 1994
- 117/1994 Sb., effective from July 1, 1994
- 156/1994 Sb., effective from September 29, 1994
- 224/1994 Sb., effective from December 6, 1994
- 84/1995 Sb., effective from July 1,1995, this amendment reacts on the fact that the bankrupt could be a bank entity and the holders of mortgage-bond holders should be treated as preferential creditors.

5. Amendment No. 94/1996 Sb.

Act 94/1996 Sb. effective from June 1,1996, amends the BCA in the way that it more precisely formulates certain aspects and alters the law according the needs of the court revealed in the practice. This amendment is therefore quite substantial and contained these new features:

a) more precise definition of the overburdenedness with debts (overdebtness) of the debtor
b) more precisely formulated the formal necessities of the bankruptcy filling and the consequences of the declaration of the bankruptcy procedures (legal, fiscal, etc.)
c) the obligation to pay the deposit for the bankruptcy costs was made a necessary condition to declare it
d) new definition of the protection period
e) the law prohibits transfers of assets when the bankruptcy may be declared, voids such acts of the bankrupt and allows to appeal the legality of all acts of the bankrupt
f) declaration of bankruptcy does not cause the cease of production or ordinary activities
g) there has been set forth a time limit for the filling of claims that prevents prolongation of the bankruptcy with overdue fillings
h) reasonable means of delivery were introduced as these apply in other parts of the legal system (i.e., post in the official noticeboard is sufficient for certain steps)
i) the debtor has to fill in himself for the bankruptcy if he is overdebted

In general, the amendment 94/1996 Sb. aimed, and quite successfully, to speed up the bankruptcy process, to make it more transparent and also to protect the creditors against debtors actions causing the diminishment of the remaining assets of the bankrupt. Typically, the debtors were previously transferring the assets for a negligible price to allied legal subjects.

6. Amendment No. 12/1998 Sb.

Similarly, the amendment of BCA No.12/1998 Sb., effective from April 1,1998, stemmed out from the judicatory needs and court experience. The hardness towards the bankrupt of the suggested amendment was subject to a broad discussion and affected the final reading of the amendment. The most important notions of this amendment are:

a) more precise formulation of the term bankruptcy (úpadek).
b) the obligation of the debtor and management of the debtor to fill in for the bankruptcy and punitive consequences of not doing so.
c) modifications of the possibility to sell assets from the list of assets of the bankrupt not in the auction.
d) possibilities to hire third persons to levy receivables of the bankrupt.

The amendment contains also so-called "Ms. Parkanova's amendment" (Parkanova was a Minister of Justice at that time) that obliges the trustee to present the final report within 18 months from the declaration of bankruptcy. According to my opinion, the legislator erroneously assumed that the lengthiness of the bankruptcy process is caused by the lax approach of trustees that intentionally prolong the process.

7. Year 2000 and "Legal Cyclone"

In year 2000 the ruling Social Democrats propose a fast speed of introduction of new laws necessary to harmonize the Czech legal system with the one of the EU and the approach is nicknamed "legal cyclone". Such unseen amount of new laws passed included also the BCA. Unfortunately, the speed highly influenced the quality of the new laws. After two minor amendments 27/2000 Sb. and 30/2000 Sb., a new major amendment 105/2000 Sb. was passed. In the final reading can be seen that this (by pure occasion, thirteenth) amendment was created out of two, sometimes contradictory, basic concepts. In addition, unqualified, and mostly dilettante, amendments of legislators caused an immediate need for another new amendment 214/2000 that would result in usable law. The accepted suggestion of the senate eliminated procedural parts of the act. Consequently, this completely blocked the BCA usage. Evan after

this correction the BCA contained many flaws and another correction was made within the Commercial Code No. 370/2000 Sb.

The major points of the problematic 105/2000 Sb. amendment of BCA are:

a) Transfer of a part of the competence from the court to the trustee.
b) Introduction of public interest to the bankruptcy procedure (ecology, preservation of employment).
c) It allows to use third-party assets to cover the claims (' 27 sec. 5 BCA includes pledges and mortgages of third persons that the debtor posses).
d) Makes the distribution among creditors fairer by reducing the amount that can be used for preferred creditors.
e) Introduces punitive (penalty) clauses for the bankrupt that does not obey his/her duties.
f) Simplifies the formal necessities of the bankruptcy filing.
g) Restricts the debtor in his actions affecting the assets prior the declaration of bankruptcy.
h) Introduces the preliminary trustee.
i) The rights of the trustee are widened, he/she has more power, e.g., he/she has the right to end any leasing or rent agreement, he/she has the right to enter the bankrupt facility and the state and other agencies and institutions are obliged to cooperate with him/her upon his/her request.
j) The creditors' committee role is strengthened (or creditors' representative role).

8. Decrees (provádecí vyhláška)

In concurrence with the BCA the Ministry of Justice issued a decree No. 476/1991 Sb., which also significantly affects the bankruptcy procedure in the Czech Republic. The decree arranges the terms of the entry to the list of trustees maintained at the regional courts (Krajské soudy), conditions that determine the reward of the trustee and contains other stipulations. The decree, like the BCA, underwent several modifications. The major one was amendment No. 277/1996 Sb., which increased the trustees' reward and caused an increase of interest of people in this profession. The other major change is represented by amendment No. 229/2000 Sb. that set terms for the public business companies (verejné obchodní spolecnosti, all natural persons are

fully liable as citizens, i.e., there are no liability limits) to be included in the list of trustees. It also modifies the trustees' reward in such a way that the reward depends on the realization of assets and the number of the creditors while in the past the reward depended on the realization and the level of satisfaction of the claims. This brings more justice into the calculation of the trustees' reward since there were bankruptcies with many creditors but limited small assets left. In such a case the trustee would receive inappropriately small reward although the amount of work could be quite enormous. In general, in most cases the average trustee's reward was increased.

9. Rulings of the Highest Court (Nejvyšší soud CR)

Since there exist different procedures among different courts and among state administration (the major differences are among regional tax offices and among cadastral offices), the rulings of the highest court provide a guide among these inconsistencies. With connection to the BCA, the highest court issued a ruling on June 17,1998, that should eliminate certain discrepancies. Between the date of the issue of the ruling and effect of the amendment 105/2000 Sb. the ruling served as a guide both for the trustees and courts in the limiting cases where no clear interpretation of the BCA existed. The major issues the ruling governed were:

a) Formal aspects of the filling, certification of bankruptcy, the role of all parties of the process of bankruptcy.
b) The list of all assets of the bankrupt and properties of third persons that served as a collateral of the bankrupt.
c) The rights of the trustee after the declaration of the bankruptcy, the consequences of the declaration of the bankruptcy on other pending legal actions (including cadastral entries).
d) The role of undivided co-ownership of spouses.
e) The order of the exercise the right of the lien of tax offices vs. other liens.
f) The rights of the trustee regarding bank accounts of the bankrupt.

The ruling of the Highest Court of June 17,1998, significantly improved the bankruptcy procedures during the 1998-2000, especially by means of unification of interpretation of the BCA across regional courts. It also strengthened the power of the trustees in disputes with the bankrupts and state institutions.

10. Practical Problematic Issues of the Usage of the Bankruptcy Laws

The current, although imperfect, reading of BCA can help to improve the current bankruptcy proceedings when fully utilized. Unfortunately, the trustees and creditors do not commonly use several powerful instruments. Certain provisions, on the contrary, slow down the speed of the bankruptcy process and limit its continuity. There are also regions where the courts are inadequately furnished with manpower.

Bankruptcy Declaration

The court has to declare the bankruptcy within 10 days. Such time limit is quite unrealistic if we take into account that the court should invite the petitioner to pay the deposit, which is not fixed but varies from 10,000 CZK - 50,000 CZK. This legally set time limit is not obeyed frequently. Another consequence is that the debtors' suggestions are processed faster than the creditors' ones.

Criminal and financial sanctions (liability) for negligence in respect of the breach of the obligation (managerial duties of statutory bodies) to fill in for the bankruptcy, when required to do so by the BCA, are not yet fully known and obeyed. As a consequence, overwhelmingly overdebted firms continue to operate until they are not able to pay wages and energy bills and there is no other option than to hand over the unsolvable problems to trustee. In these cases it is extremely difficult for the trustee to revive the enterprise and continue their operation even under crisis management and the bankruptcy procedure can continue only with successive sell of all assets if the enterprise is not dissolved immediately for insufficient assets left to cover at least the costs of bankruptcy procedure itself. The solution is to really start prosecute the legally responsible management for criminal behavior.

Determination and Securement of the Bankrupt's Estate

The amendment 105/2000 Sb. contains series of provisions that improve the trustees' legal status in their effort to determine the bankrupt's estate and, consequently, secure it for the creditors. It as well limits the possible bankrupt's actions that could lead to the reduction of the estate.

The institute of a preliminary trustee is established and is gradually more often used in all large bankruptcies. The potential bankrupt is no longer allowed to reduce the estate from the moment when the bankruptcy petition is filed and this fact is delivered to the potential bankrupt by the court. Public administration bodies and banks are obliged to cooperate with the trustee and the trustee can get a search warrant in order to be able to secure the estate and relevant documents.

Event this approach is not enough to deal with certain bankrupts, but the threat of imprisonment usually helps the trustee in his/her effort. The possibilities given to the trustee, when used appropriately and completely, lead to successful securing of the estate.

Creditors' Committee

The creditors' committee (or creditors' representative) gained additional power in the bankruptcy procedure. They can even initiate the replacement of the trustee. It is explicitly stated that the creditors' committee is responsible to other creditors and has to defend their common interests. The trustee has to report not only to the court but also to the creditors committee. The new rules for the division of the proceedings towards the claims caused that even all classes of creditors are likely to benefit. Therefore, they are all well motivated to take more active part in the procedure and to be interested in the matter at all.

Realization of the Estate

The estate can be realized in auction or out of auction now. New momentum was introduced with the Act No. 26/2000 Sb. on Public Auctions. The trustee can utilize, instead of the lengthy labored judicial sale (auction), licensed private auctioneers. The law explicitly requires to auction in the case of realization of collateral of secured (separated) debts. No approval of the creditors' committee or the court is required whet the estate is auctioned.

The trustee has to, in addition to maximization of the realization of the estate, to protect employment and natural environment.

Review and Satisfaction of Claims

The claims are newly classified in two groups only. The first group consists of employees' claims and restitution claims; all other claims belong to the second group. The employees' claims from unpaid wages for the last three years preceding the bankruptcy have an extraordinary status: They are considered as claims against the estate and have a priority against all other claims. I.e., they are satisfied in full, if possible. On the contrary, the claims of separate (secured) creditors are satisfied up to 70% from the realization of the estate in the first step. This mechanism eliminated the former unwanted situation when (in 90% of all bankruptcies) the claims of employees, of separated creditors and of the state (taxes, social security, health insurance) were (partially) satisfied while the ordinary (third) creditors received no share on the proceedings. As a consequence, no ordinary creditors were interested in the bankruptcy process or to file for the bankruptcy.

Closure of the bankruptcy

The last stage after the presentation of final report by the trustee at court is, according to me, uselessly protracted and hampers the successfully finished fast bankruptcy. It takes 6 months at minimum (when the courts work fast and no appeals are filed) till the trustee is allowed to distribute the proceedings. This phase could be easily shortened by modification of the procedural rules with no effect on the rights any of the parties involved in the bankruptcy.

The remaining problematic factor is the inconsistency of BCA with other existing laws and stipulations. In certain cases, severe contradictions even exist. The most prevalent conflicts are with the act governing the administration levies and fees together with other tax laws. Revenue authority bureaus, supported by the Ministry of Finance, act according the fiscal laws during the bankruptcy procedures and try to satisfy their claims on the account of other creditors, i.e., in higher portion that the appropriate share would be according the BCA. The trustees are always primarily bond by the BCA and the disputes lead to lengthy litigation to be settled by another court. For example, the tax authorities hold-back the VAT refunds that

originated after the bankruptcy was declared to satisfy their prior-bankruptcy originated filed claims.

The last Income Act amendment even levied the proceeding of the estate and the obligation to file in tax return every year during the bankruptcy. The procedural decrees were not issued yet so it is hard to judge what and how big complications would arise but he most likely conflicts would occur at the final stage of the bankruptcy.

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