Czech Bankruptcy Reform: A Light at the End of the Tunnel?

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Only three countries of the 141 in the World Bank's Closing Business 2004 database — India, Brazil and Chad — have bankruptcy procedures that take longer than those in the Czech Republic. The average bankruptcy in the Republic takes more than nine years to complete, compared to an average of 21 months for the 'old' EU. Such lengthy procedures, combined with weak protection for creditors, allow managers to tunnel out the value from insolvent firms.

The effects of inefficient legislation on the Czech capital market are such that banks — already risk averse and facing harder budget constraints after privatization — are doubly reluctant to lend to firms.

In the summer of 2001, the government took a first step by proposing to draft new bankruptcy legislation, which would replace the inefficient Bankruptcy and Composition Act of 1991 (amended 20 times since). The core concepts of the reform include a more debtor-friendly approach thanks to a reorganization chapter, which allows the debtor to retain control over the firm, the re-introduction of the principle that secured debtors are entitled to the full proceeds of the security sale, as well as better protection for creditors, by enabling them to dismiss a court-appointed bankruptcy trustee and appoint a new one.

The urgent need to reform the bankruptcy legislation was highlighted by the corruption scandal surrounding the bankruptcy of Union Banka, a medium-sized bank, in spring 2003. The bank's managers made a deal with a "bankruptcy mafia" involving a bankruptcy judge, to keep full control over the bank. To ensure that the case would be brought to the preselected judge, the managers moved the headquarters to another city, where they filed for bankruptcy. The judge immediately declared the bankruptcy and appointed a trustee, who would act quickly in the interest of the incumbent management at the expense of the bank's depositors. Serious accusations were raised regarding the bank's managers, the bankruptcy judge, and the bankruptcy trustee, as well as highly positioned members of the state administration.

The case proved to be the tip of an iceberg, as similar practices were uncovered at large industrial enterprises. The events intensified the pressure from the media and the public for faster measures. However, the government's pace in preparing the reform remained unsatisfactory, and progress was impeded by the fact that the legislative work was in the hands of the same people who had been in charge of previous amendments.

To circumvent the government's sluggishness, several large Czech banks drafted an extensive amendment to the 1991 Act. The amendment, which significantly reduces space for corruption by increasing creditors' rights, limiting judges' discretion, and enhancing debtors' and trustees' accountability, is currently under discussion in the parliament. While the amendment would improve the situation, it does not address some other problems, such as a bias towards liquidating a bankrupt firm due to excessively strict conditions for the non-liquidation solution, late initiation, and the duration of bankruptcy procedures.

The first draft of the law presented in the spring of 2004 was heavily criticized from various sides. First, as in the current law, bankruptcy was again viewed mainly as a legal issue, and not one of management of an insolvent company. Second, drawing on U.S. legislation, the chapter on reorganization significantly increased the authority and discretion of judges, who were given the sole power to prevent the debtor from harming creditors. The case of Union Banka has shown, however, that, unlike in the U.S., the Czech system cannot rely on judges' integrity and competence in sophisticated commercial decisions, such as whether an insolvent firm should continue operation.

The government reshuffle in July 2004 provided a strong impulse for addressing the key problems in bankruptcy legislation. The government invited a broader panel of legal and economic experts to re-write the law and make it compatible with the existing institutional framework and the needs of the Czech economy. The resulting draft strengthens the rights of creditors, while giving them incentives to keep the firm operating whenever reasonable. The application of the bankruptcy chapter does not have to lead to a liquidation of the insolvent firm, as has usually been the case under the current law. The reorganization chapter is designed to minimize the risk that the debtor will abuse the system. What's more, the law sets time limits for some court decisions, gives managers incentives to initiate timely bankruptcy proceedings, and contains specific provisions for the insolvency of financial institutions. The new draft appears to have broad support across the political spectrum. Provided the parliament adopts the law in the beginning of 2005, it can take force in 2006.

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Bankruptcy proceedings in the Czech Republic, 2000 and 2002

	Number of bankruptcy proceedings 2000	2002
Total bankruptcy proceedings, of which:	14604	14646
Unresolved from the previous period	9694	10387
Resolved cases, of which:	4067	4429
Stopped proceedings	1955	1735

Source: www.ejustice.cz