CZECH REPUBLIC
POLICY NOTE: INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

Prepared by a staff team of the World Bank
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I. INTRODUCTION

1. As part of an ongoing effort to modernize its laws in preparation for accession to the European Union, the authorities of the Czech Republic recently expressed a renewed commitment to developing a new, modern insolvency law. To assist the authorities in their efforts, this policy note reviews some of the key issues and contrasts the current environment on insolvency and creditor rights with other accession economies and EU member countries.

2. The World Bank’s assistance to the government of the Czech Republic in the area of insolvency and creditor rights began in 1999 in the context of a technical assistance program to assist the authorities in the final stages of transforming the banking and enterprise sectors in the Czech economy, culminating in a report that focused on the status of bank restructuring and privatization, the workout of the large stock of classified assets in the banking system, and the legal framework for enterprise restructuring. The bank restructuring report complemented a prior report by the Bank on the Czech capital market that was published in May 1999. These reports were also complemented by a report by the Bank reviewing the country’s preparedness toward EU accession. The Czech ROSC report on insolvency and creditor rights systems was finalized in April 2001.

3. In 2000, the Czech authorities expressed an interest in participating in a joint World Bank-International Monetary Fund financial sector assessment program (FSAP) that assessed the strength of Czech financial system in core areas benchmarked against relevant standards and codes. The assessment included a review of the Czech commercial insolvency and creditor rights systems, based on the World Bank’s Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (“Principles”), which reviewed compliance in four key areas: (i) creditor rights (including secured transactions) and enforcement procedures; (ii) the legal framework for corporate insolvency; (iii) the enabling features pertaining to corporate rehabilitation, addressing the formal reorganization proceeding as well as the informal corporate workouts; and (iv) the regulatory framework to implement the insolvency system. The Czech ROSC report on insolvency and creditor rights systems was finalized in April 2001. Since undertaking the Czech assessment, the World Bank has undertaken similar assessments in other countries that provides a strong comparative base for examining the performance of systems across other countries in the region.

2 World Bank, Czech Republic: Completing the Transformation of Banks and Enterprises (October 2000).
4. Since the enactment of Act No. 328/1991 Coll. of July 11, 1991, which came into force on October 1, 1991 (the “Bankruptcy Law”), the law has been amended approximately seventeen times to date. Many of these changes have addressed varying issues and problems in the system, but have not materially altered the essential framework of the law since it was first adopted, which has been acknowledged to be deficient and ineffective for a modern commercial market. The Czech government is now undertaking further comprehensive insolvency reforms. It is hoped that this policy note will help in providing a comparative background against which some of the problems and shortcoming in the system can be examined more closely. In the context of doing so, however, it is important to bear in mind that many countries around the world are undertaking similar reforms and that the experience of any one country should not be viewed as an indication that another system is or is not sufficiently effective. Ultimately, the real litmus test for whether these systems are most effective is how the markets assess lending or investment risk based on their functioning. Less effective systems result in a higher risk of non-recovery and thereby pose greater constraints on credit access and market activity.

5. In order to better illustrate the current standing of the Czech Republic insolvency and creditor rights systems, this note includes some graphs containing relevant statistics and two annexes have been added to this paper. The graphs may be classified as: (i) those which depict historic developments in the Czech Republic, and (ii) those which present a comparative picture of the Czech system as compared to those of other countries, particularly EU accession and current EU member countries. Results from assessments conducted on the basis of the World Bank Principles are compared; while those from five non-EU European countries, as well as those from the Czech Republic, are from the ROSC program; ratings of the EU countries and the US are based on a study undertaken by a European Commission working group aimed at promoting corporate restructuring and a fresh start policy to revitalize viable but distressed businesses within the EU. The study, completed in May 2002, was prepared by Deloitte & Touche Corporate Finance and Philippe & Partners. Annex 1 contains a brief synthesis of the ROSC findings and updated recommendations. Annex 2 underscores the key components of a functional environment for informal workouts.

II. LEGAL FRAMEWORK FOR ENTERPRISE INSOLVENCY

Description of Country Practice

6. The Czech framework for enterprise insolvency remained ineffective and dysfunctional throughout the 1990s, with a relatively small number of troubled enterprises being entangled in insolvency proceedings. The number of cases in the

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6 Intensive activity has been registered in the field of insolvency law reforms throughout the world. Though reforms vary in scope, many countries from both inside and outside of the region have engaged in extensive reforms; from within the region, the following may be mentioned: Hungary (1992), Romania (1995), Georgia (1996), Lithuania (2001), Montenegro and Poland (2002) and Macedonia.

7 For the full conclusions of Assessing Compliance within the European Union against The World’s Bank Principles and Guidelines for Effective Insolvency and Creditor Rights Systems, see http://www4.worldbank.org/legal/legps/Papers/PhilippeCompliance.pdf
system has declined in recent years, but continues to be quite numerous. Likewise, the
time that it takes to declare the bankruptcy, following an application, and to conclude
proceedings continues to be excessive.\(^8\) This sluggishness and inefficiency results in
little return to creditors, with banks reporting collection rates of 5 percent or lower.
Reorganizations are relatively rare, due largely to shortcoming in the law and inadequate
skills. This leaves liquidation as the only feasible option, which frequently proves
ineffective for creditors and debtors alike. The reasons for the low number of declared
bankruptcies and the inefficient outcomes were found to lie in the weaknesses of the legal
framework itself, as well as in the deficient institutional and regulatory framework that
prevailed throughout the 1990s, despite numerous amendments to the Bankruptcy Law.

Table 2: Historic Development:
Czech Trends in Insolvency Proceedings

<table>
<thead>
<tr>
<th>Date: March 2003</th>
</tr>
</thead>
</table>

7. Aware of Bankruptcy Law’s severe deficiencies, the government put forward
a number of amendments to the Law in early 2000. The amendments introduced a
number of positive changes, but coupled these with other amendments that were
detrimental. Positive changes introduced included, among others: (1) allowing for
preservation of debtor’s property and appointment of interim administrators prior to
bankruptcy declaration; (2) permitting professional firms (in addition to individual
persons) to serve as administrators; (3) granting creditors some control over the selection
of the liquidator and the liquidator’s actions (e.g., service contracts); and (4) introducing
a more realistic and flexible fee structure for administrators.

8. In hindsight, some amendments intended to have a salutary effect actually
exacerbated some of the problems and contributed to less efficient outcomes. The
most problematic of these are: (1) an amended definition for insolvency that is vague,
confusing, and likely to discourage – rather than promote – timely filings; (2) further
increasing lending risk by requiring that 30 percent of net recoveries from enforcement of
collateral lose priority and fall into the general creditor pool (a measure contrary to both
best international practice and the incentives and goals of stimulating bank lending); and,
(3) an inadequate balance (lack of well-defined criteria) for the possibility of courts
dismissing the creditors’ committee (weakening creditors’ rights and control over the
liquidator’s selection and actions).

\(^8\) See Table 2 for historic development of Czech trends in insolvency proceedings.
9. The amendments also failed to address a number of gaps and weaknesses in the legislation that continue to persist. The amendments focused on modifying the liquidation section of the law, but did not sufficiently address the reorganization of potentially viable enterprises. Although the Bankruptcy Law contains an entire section on composition or reorganization, this section has only received modest use. Consequently, it may well be said that a functional and efficient scheme for rescuing potentially viable enterprises has been left out in the Czech Republic, even after the referenced reform. Moreover, the aforementioned amendments also failed to improve the institutional and regulatory frameworks for insolvency – that is, court organization and procedures, and the regulation of the activities of all the professionals engaged in the system.

Comparison with other countries

10. While the Czech insolvency law does not rank significantly better (or worse) than other transition countries in the region, it is significantly less efficient than the average rating for more modern systems in the EU and the US. Notably, when comparing the Bank’s assessment ratings of the Czech insolvency law, based on the World Bank Principles, against other countries in the region and those in the EU and US, it is apparent that the Czech law is not significantly worse (or better) than the insolvency laws of other transition countries in the region measured under the ROSC assessment program. The results are considerably worse, however, when compared against the average among EU countries and the US.

Table 3: Comparative Study: Comparing Czech corporate insolvency law to other countries (Transition/EU/US)

<table>
<thead>
<tr>
<th>Category</th>
<th>Czech R.</th>
<th>Transition</th>
<th>EU</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall objectives</td>
<td>3.00</td>
<td>3.00</td>
<td>2.00</td>
<td>1.00</td>
</tr>
<tr>
<td>Director and officer liability</td>
<td>2.00</td>
<td>2.40</td>
<td>1.53</td>
<td>1.00</td>
</tr>
<tr>
<td>Balance between liquidation &amp; rehabilitation</td>
<td>3.00</td>
<td>2.40</td>
<td>1.93</td>
<td>1.00</td>
</tr>
<tr>
<td>Scope and application</td>
<td>1.00</td>
<td>1.80</td>
<td>1.80</td>
<td>1.00</td>
</tr>
<tr>
<td>Ease of access (Insolvency Test)</td>
<td>3.00</td>
<td>2.60</td>
<td>1.50</td>
<td>1.00</td>
</tr>
<tr>
<td>Moratorium and suspensions of rights</td>
<td>3.00</td>
<td>1.80</td>
<td>1.60</td>
<td>1.00</td>
</tr>
<tr>
<td>Governance and management</td>
<td>2.00</td>
<td>1.80</td>
<td>1.64</td>
<td>2.00</td>
</tr>
<tr>
<td>Creditor safeguards &amp; committees</td>
<td>2.00</td>
<td>2.80</td>
<td>2.20</td>
<td>2.00</td>
</tr>
<tr>
<td>Collection, preservation, disposition of assets</td>
<td>2.00</td>
<td>2.80</td>
<td>1.80</td>
<td>1.00</td>
</tr>
<tr>
<td>Treatment of contractual obligations</td>
<td>3.00</td>
<td>2.20</td>
<td>1.87</td>
<td>1.00</td>
</tr>
<tr>
<td>Recovery of avoidable transactions</td>
<td>3.00</td>
<td>3.00</td>
<td>1.40</td>
<td>1.00</td>
</tr>
<tr>
<td>Treatment of stakeholders rights</td>
<td>3.00</td>
<td>3.00</td>
<td>1.75</td>
<td>1.00</td>
</tr>
</tbody>
</table>

1 = Fully Observed  2 = Largely Observed  3 = Materially Non-Observed  4 = Not Observed

11. On balance, Table 3 reveals that the Czech system (at least as of April 2001), received materially non-observed ratings in over half of the categories, and only a largely observed ratings in others. Only in one category did the law receive a fully observed rating.

9 Countries in the sampling include: Lithuania, Russia, Slovak Republic, Turkey, and Ukraine. The figures reflect an average. Some countries performed higher than others in particular categories.

10 EU results are based on a study commissioned by the EU in all 15 member countries (and the US) using the World Bank’s Principles.
rating, having to do with the application of the law broadly to all enterprises. This illustrates the need for continued reform across many areas. There is a clear need to modernize insolvency law in line with international best practice. In particular, laws and procedures need to (i) improve efficient access to the system, based on rules that are designed to balance incentives and disincentives for being subjected to the system; (ii) introduce greater efficiency in administration through time-bound rules for all stages of the proceeding, (iii) strengthen creditors’ rights by increasing their participation in the process and by aligning priorities so as to increase commercial certainty and promote greater access to credit and lending (see creditor rights discussion below); and (iv) modernizing the rehabilitation procedures to provide flexible options for salvaging viable enterprises, while providing for efficient liquidations of non-viable ones.

12. **Next steps.** Following the description of the legal framework for insolvency, a comprehensive reform is still much needed in order to provide for an efficient and effective system that would maximize the value of a firm’s assets by providing an option to reorganize, strike a careful balance between liquidation and reorganization, provide for a timely, efficient and impartial resolution of insolvencies, recognize existing creditor rights and respect the priority of claims through a predictable and established proceeding.

### III. FRAMEWORK FOR ENTERPRISE REHABILITATION

**Description of Country Practice**

13. **The legal environment related to corporate rehabilitation has not provided a suitable, efficient scheme for resolving the insolvencies of viable businesses.** In fact, notwithstanding the large number of insolvent enterprises over the last years, the composition proceedings have scarcely enjoyed success, partly due to the onerous requirements for payments to creditors and the strict burdens imposed on debtors who wish to commence these proceedings. Fundamental problems marred the design of the composition track.\(^\text{11}\) Although the 30% minimum cash payments for certain non-preferred creditors (within two years of petition filing) have been relaxed by allowing for payment in kind or by issuing new shares, the absence of appropriate incentives and disincentives is still evident. Additionally, there are still fundamental problems in the design of the composition track, which needs to be overhauled and replaced with a procedure that promotes streamlined, accelerated restructurings.

14. **Czech banks have had limited success in negotiating settlements out of court.** Successes have been limited for a number of reasons: (1) the absence of a credible bankruptcy threat and – more generally – of a reliable creditor rights framework that reduce the incentives for voluntary workouts; (2) the debtor can protract negotiations and speculate with the knowledge that creditors have little to gain in a formal insolvency process; (3) there is a lack of tradition and experience in conducting out-of-court negotiations; (4) banks operate in an uncertain environment, where they feel unsure of their ability to exchange information on customers when negotiating workouts because of the confidentiality of customer accounts; (5) efforts to reach an out-of-court settlement have been undermined by minority and dissenting creditors, who enjoy enormous

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leverage over senior secured creditors in the out-of-court context; (6) debt workouts have also been undermined by difficulties in conducting debt-equity swaps, such arrangements being particularly challenging in the Czech legal environment since shareholders are entitled to vote on the dilution of their interests; (7) the tax system has not created an enabling environment; and (8) no informal workout framework exists.

15. **The pace of resolution of non-performing loans has increased, but recovery rates continue to be extremely low due to weak resolution mechanisms for debt recovery and restructuring.** Table 4 illustrates that improvements have coincided with efforts by the government to address the significant problems in this area. Since 2001, the Czech Consolidation Agency (CKA) has accelerated the disposal of its assets by using effective methods, such as block sales, individual sales, sales of collateral, sales of ownership interests, as well as a search for strategic investors and use of executions and bankruptcy and liquidation law. The CKA’s workouts have been recognized as expedited, transparent and efficient, awarding credibility to the CKA’s transformation, restructuring process and non-performing assets resolutions. Yet, while the pace of disposition of distressed bank assets has accelerated in recent years, the overall returns and recoveries through various resolution measures has been very low, largely due to ongoing weaknesses in the legal frameworks that support restructuring and recovery procedures. Many potential investors have been put off these shortcomings and have concluded that acquiring distressed assets from CKA are not worth the effort.

Table 4: Historic Development:
Asset Quality in the Czech Republic

| Date: March 2003 |

16. **Enterprise rehabilitations in the Czech Republic have occurred but only rarely.** As a complement to the bank privatization activities, and in the context of the ROSC assessment, a number of impediments to enterprise restructuring were identified, such as: (i) ineffective incentives and disincentives for restructuring; (ii) dysfunctional systems that generally serve as the backdrop to negotiations; (iii) unfriendly tax treatment on bad debts; and (iv) inefficient court procedures and a lack of adequate expertise and skills by those responsible for administering cases. Nearly all of these problems persist today. An examination of Table 5 below indicates that the Czech Rehabilitation procedure was ranked as the least effective when compared with 5 other transition countries assessed under the ROSC program, and in comparison with the average ratings for the EU countries and the US.
Table 5: Comparative Study: Comparing Czech corporate rehabilitation laws to other countries (Transition/EU/US)

<table>
<thead>
<tr>
<th>Corporate Rehabilitation</th>
<th>Czech R.</th>
<th>5 Transition</th>
<th>15 EU</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>17. Design features of rehabilitation statutes</td>
<td>3.00</td>
<td>2.80</td>
<td>1.87</td>
<td>1.00</td>
</tr>
<tr>
<td>18. Stabilizing and sustaining business operations</td>
<td>3.00</td>
<td>2.60</td>
<td>2.20</td>
<td>1.00</td>
</tr>
<tr>
<td>19. Information access and disclosure</td>
<td>3.00</td>
<td>2.00</td>
<td>2.40</td>
<td>1.00</td>
</tr>
<tr>
<td>20. Formulation, consideration and voting</td>
<td>3.00</td>
<td>2.20</td>
<td>1.93</td>
<td>1.00</td>
</tr>
<tr>
<td>21. Approval of plan</td>
<td>3.00</td>
<td>2.20</td>
<td>2.13</td>
<td>1.00</td>
</tr>
<tr>
<td>22. Implementation and amendment</td>
<td>3.00</td>
<td>2.60</td>
<td>2.07</td>
<td>1.00</td>
</tr>
<tr>
<td>23. Discharge and binding effects</td>
<td>3.00</td>
<td>1.80</td>
<td>1.93</td>
<td>1.00</td>
</tr>
<tr>
<td>24. International considerations</td>
<td>2.00</td>
<td>3.00</td>
<td>2.87</td>
<td>1.00</td>
</tr>
</tbody>
</table>

1 = Fully Observed    2 = Largely Observed    3 = Materially Non-Observed    4 = Not Observed

17. There remains a strong need to develop an effective “fast track” restructuring procedure to establish a level playing field on which parties can reach agreements to support enterprise rehabilitation. This proposal was initially considered and recommended in the context of the bank restructuring and privatization initiative to help salvage viable enterprises and reduce the overall cost to the state of underwriting the bank restructuring and privatization. The proposal aimed at reducing political interference by establishing an environment for corporate workout that would produce a restructuring agreement that, if necessary, could be submitted to and approved by the courts on an abbreviated schedule with minimal court intervention. As discussed in section V below, such a “fast track” procedure continues to be strongly needed.

18. A number of countries have gained substantial experience in working with hybrid workout systems in S.E. Asia and elsewhere. Notably, several countries with similar insolvency systems are now moving to adopt “fast track” restructuring solutions similar to the one proposed in the Czech Republic. In Turkey, the Ministry of Justice has recently completed a new law, under a World Bank project, that is substantially similar to the “fast track” solution, and which would operate in tandem the Istanbul Approach (modeled after the London Approach). In addition, it is notable that a directorate of the EU for small and medium enterprise growth has recognized the need for such systems within the European Union to promote the idea of a fresh start policy and informal workout approaches. Likewise, in Brazil, a country with a very similar economic history to the Czech Republic, has been working on comprehensive, modern insolvency reforms that incorporate similar procedures to promote informal workouts and allow for accelerated approval mechanisms.

Recommendations and Next Steps

19. Given the need to reform corporate rehabilitation procedures, amendments should concentrate on solutions that encourage informal out-of-court workouts, while providing for fast-track reorganization where possible, and full-fledged formal proceedings where needed. As regards formal reorganizations, the government should

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12 The new procedure is entitled “IV. RESTRUCTURING OF CORPORATIONS AND COOPERATIVES VIA RECONCILIATION,” new articles 309/m to 309/v, Turkish Execution and Bankruptcy Act.
13 See discussion under V. Informal Corporate Workout Framework.
consider designing a functional, commercially and economically effective rehabilitation proceeding. Access should be easy and cost-effective. Sufficient protection should be awarded to all parties involved, enhancing the creditor rights framework. Inter-creditor relationships (secured-unsecured, majorities-minorities) should be clearly defined, along with the creditor’s powers and their appropriate protections, thus encouraging parties to engage in fair negotiations and responsible risk management. Among others, features of the new law should include the following:

- **Time-bound rules for the different steps in the reorganization.** Such rules should be subject to limited, narrowly tailored possibilities for extensions. Timeliness is currently a major deficiency that requires immediate action for insolvency cases to be efficiently and expeditiously resolved.

- **Binding-in of minority or dissenting creditors to the reorganization agreement.** This binding effect should be the outcome of approval of a plan by adequate majorities that complies with rules of fairness and offers opposing creditors equal or better treatment than what they would receive under a liquidation proceeding.

- **A fast-track reorganization scheme to provide for accelerated approvals of pre-negotiated agreements.** These procedures would reduce the current burden on the courts by minimizing the amount of time that a court usually takes to administer an insolvency case. This solution offers certain additional advantages: (i) an accelerated, bankruptcy-oriented solution for corporate rescues, and (ii) institutional capacity building and long-term development within the court system for handling corporate rescues. A predictable, reliable and simplified restructuring track also creates the backdrop against which out-of-court negotiations can take place, which should encourage more out-of-court workouts. In addition, it may be easier to bind dissenting creditors under a court-led proceeding, which may prove to be a strong advantage when there are many commercial creditors. The fast track may be introduced either by an independent set of provisions that build on the composition statute, or by carefully amending and supplementing the existing provisions of the composition proceeding with effective procedures and timeframes once the process is initiated.

- **New reorganization procedures, including a fast track approval scheme, would need to be supported by amendments in other laws, designed to generate an enabling environment and appropriate incentives to restructurings and workouts.** The following complementary reforms should also be considered: (i) amendments to the Commercial Code in order to limit shareholders’ voting rights in insolvency cases and provide a friendly environment for debt swaps; (ii) tax law reforms in order to design – at a minimum – a tax-neutral framework, allowing for recognition of actual losses by creditors on the value of their claims; and (iii) amendments to the Law on Tax Administration, in order to streamline precise criteria for tax arrears and write-offs of penalties and interest.
IV. INSTITUTIONAL AND REGULATORY FRAMEWORKS

Description of Country Practice

20. Institutional Framework. The institutional framework for insolvency is still widely considered to be lacking adequate expertise and resources. Insolvency judges in the Czech system are part of the Regional Courts, which deal with commercial matters, with some regions having special judges handling only insolvency cases, and others, with fewer insolvency cases, having judges in charge of insolvency matters also handle other commercial matters. Judges are selected from among those judges serving in the Regional Courts, without a legal requirement to have experience or intention to serve as insolvency judges. They generally do not have a background or specific training in insolvency prior to taking office. Insolvency judges are said to be among the better trained group of judges in the Czech Republic, however, and even insolvency personnel receive training. Nevertheless, no apparent standards exist to measure competence and performance of the judges. Moreover, most judges are overloaded with an increasingly heavy backlog of cases. Judges also complain of having to spend excessive time in monitoring and supervising administrators.

21. The process for administering insolvency cases is perceived to be unusually slow, inefficient and costly in the Czech Republic. As illustrated in Tables 6-9, the court system sluggishness exceeds the customary levels as measured in other countries. We recognize that generalities are hard to apply across a range of different kinds of proceedings, and that at best the figures below are illustrative of relative levels of efficiency. We also hasten to point out that some of the figures for actual insolvency have declined in recent years based on amendments shortening time period for administering cases, and that the average time of early cases tended to be between 3-5 years (less where no assets were involved). The other interesting comparative note about the figures in Table 6 are that the costs of administering an insolvency case in the Czech Republic is considerably higher relative to the costs in the other transition sampling group and when compared with the more developed systems in the EU and the US. Tables 7-8 compare the Czech experience on time and costs with that of EU countries. Again, although there are reports that the timeframe has come down considerably, the levels are still considered to be on average higher than in the EU.

Table 6: Comparative Study: Comparing Czech corporate insolvency practice to other countries (Transition/EU/US)

<table>
<thead>
<tr>
<th>General Insolvency Law</th>
<th>Czech R.</th>
<th>5 Transition</th>
<th>15 EU</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Actual time (in years)</td>
<td>9.20</td>
<td>2.46</td>
<td>1.75</td>
<td>3.00</td>
</tr>
<tr>
<td>Actual cost (% of estate)</td>
<td>38</td>
<td>13</td>
<td>9</td>
<td>4</td>
</tr>
<tr>
<td>Absolute priority preserved</td>
<td>0.67</td>
<td>0.80</td>
<td>0.80</td>
<td>1.00</td>
</tr>
<tr>
<td>Efficient outcome achieved</td>
<td>0</td>
<td>0.20</td>
<td>0.71</td>
<td>1</td>
</tr>
<tr>
<td>Goals-of-Insolvency Index</td>
<td>22</td>
<td>55</td>
<td>73</td>
<td>88</td>
</tr>
</tbody>
</table>

Date: January 2003
Table 7-8: Comparative Study:
Comparing time and cost to go through insolvency in CR to EU/EU accession countries

<table>
<thead>
<tr>
<th></th>
<th>EU</th>
<th>EU &amp; EU accession</th>
<th>Czech Republic</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Time of insolvency proceedings</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Time in years</td>
<td>1.75</td>
<td>2.26</td>
<td>9.2</td>
</tr>
<tr>
<td><strong>Cost of insolvency proceedings</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>% of estate</td>
<td>9</td>
<td>13</td>
<td>38</td>
</tr>
</tbody>
</table>

Date: January 2003
* Cyprus, Estonia, Luxemburg and Malta have not been considered for purposes of elaborating the chart due to data unavailability

22. **Case efficiency should be promoted by standardizing practices and making available a body of jurisprudence with published decisions on key issues.** The Procedural Code of the Supreme Court of December 13, 1995 was amended on December 14, 2000 (and Selected Articles of the Law 335/1991 Col. on the Supreme Court), addressing the established practice of publication of decisions in the Czech Republic. The Procedural Code describes, *inter alia*, the levels of decision-making within the Supreme Court, encourages all courts to save their decisions in electronic format, code them and pass them on to the appropriate case law senate. The cases selected by the case law senates for publication are subject to a very broad based external review including not just courts, but also law schools, Bar Associations, Ministry of Justice, prosecutors, and if relevant, also the line ministries, Securities Exchange Commission, etc. Since May 1, 2000, the Col. of Court Decisions has been available online as well as in print.

Table 9: Comparative Study:
Fast Facts about the Czech insolvency system compared to EU/EU accession countries

<table>
<thead>
<tr>
<th>Comparing Czech Republic to EU and EU accession countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Longest average actual time for insolvency proceedings.</td>
</tr>
<tr>
<td>✓ Time for insolvency proceedings is more than four times the average in EU and EU accession countries.</td>
</tr>
<tr>
<td>✓ Highest average actual cost (% of estate) – shared with Hungary – for insolvency proceedings.</td>
</tr>
<tr>
<td>✓ Cost (% of estate) is almost three times the average cost in EU and EU accession countries.</td>
</tr>
<tr>
<td>✓ Lowest goals-of-insolvency index.</td>
</tr>
</tbody>
</table>

Date: January 2003
* Cyprus, Estonia, Luxemburg and Malta have not been considered for purposes of elaborating the chart due to data unavailability

23. **Regulatory Framework.** As regards this framework, the main shortcoming is the absence of a regulatory system to monitor and supervise the actions of administrators and other participants. The expansion of rights and involvement by creditors and the role of
the creditors’ committee should promote stronger checks and balances on the system. However, in many cases, creditors lack sufficient funds and incentive to take on this role, particularly where there is no established and reliable framework for correcting abuses.

24. Apart from the statutory general qualifications for administrators, and the court’s decision about which administrators to use or not to use, there is no effective regulatory framework for qualifying participants, such as administrators, liquidators, and insolvency practitioners. Originally, only individuals could serve as administrators, and were selected from a list held by the court; hence, there were approximately 1,600 names on the list, including a number of individuals with no legal, accounting or business training. Until the present, administrators are still not licensed or required to meet criteria for registration, nor are they supervised, except by the court in individual cases. Although there is a Czech Chamber of Insolvency Practitioners, membership is voluntary and comprises only half of all administrators. The Chamber, which enjoys international recognition, operates on a code of conduct, but has no disciplinary powers. Nevertheless, the Chamber does not appear to have commanding influence in the process and has developed neither criteria nor a system for regulating the practitioners. The principal problem remains, that is, the inadequacy of the system to regulate and monitor itself to assure that all office holders are held to the same standards of conduct.

25. BCA section 8 governs qualifications, appointment, duties and remuneration of the administrator. The administrator is to be selected from a list kept by the court. Qualifications include unimpeachable character, full legal capacity, and appropriate professional qualifications. Administrators may now be natural persons as well as unlimited partnerships, but the latter must nominate members to serve in this capacity. BCA 8(3) indicates that the administrator is to be reimbursed from the estate, or if proceeds are inadequate, from the initial deposit. The court can approve advances to the administrator beforehand and may increase or decrease the amount of remuneration set by statute. A recent amendment to the law provides for a graduated commission, based on the aggregate value recovered from the disposition of the estate. BCA 8(3) allows the administrator to delegate obligatory tasks to third persons at the expense of the estate, subject to creditors’ committee’s consent.

Recommendations and Next Steps

26. Following the description of the institutional framework for insolvency, it is clear that courts could greatly profit from capacity building and greater standardization of court procedures, as well as improved material resources, such as modern equipment and information technology. The training of judges and insolvency liquidators in modern restructuring techniques should be upheld, particularly if legislation is going to be amended to modernize composition proceedings and introduce fast-track reorganization agreements and an out-of-court workout-friendly environment.

27. There is a clear need to introduce an effective regulatory framework, the absence of which has long been recognized. In addition, professional qualifications for practitioners working in the insolvency field should be streamlined, including stricter, more clearly defined certification / educational requirements.
V. INFORMAL CORPORATE WORKOUT FRAMEWORK

28. **An expedited procedure for reaching voluntary out-of-court agreements, with minimal court involvement, is crucial to avoid saturation of the courts.** Faced with a heavy overload that overwhelms the processing capacity of the courts, some crisis countries have resorted to voluntary out-of-court procedures – building upon their idiosyncratic strengths – to resolve corporate debt problems. A collection of out-of-court actions has been assembled together in statutory frameworks to facilitate consensual corporate reorganizations. Sometimes these procedures incorporate features of formal corporate rehabilitation or reorganization procedures, such as a supervisor or facilitator to oversee negotiations, temporary legal protection to reorganize in the form of a stay on selected default or bankruptcy actions, legal validation by a judge of the agreement reached, and its opposition in the case of bankruptcy. There exists a growing body of evidence that lends support to these mechanisms.

29. **Corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability.** An enabling environment includes laws and procedures that require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise; encourage lending to, investment in or recapitalization of viable financially distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, reschedulings, restructurings and debt-equity conversions; and provide favorable or neutral tax treatment for restructurings. Because informal workouts take place in the “shadow of the law,” consensual resolution requires reliable fallback options through existing legal mechanisms for individual enforcement and debt collection or through collective insolvency procedures. As such, the most conducive environment for informal workouts is having effective insolvency and enforcement regimes, as reflected in the foregoing sections.

30. **In addition, the ability to implement a restructuring relies on having a legal framework that can accommodate the restructuring plan at a fundamental level, such as allowing debt-equity swaps, forgiveness of bank debt and taking of collateral. The legal framework must also provide incentives for the parties to accept treatment that will render the restructured business viable (for example, favorable offsetting tax treatment for debt forgiveness).** Participants must be provided with sufficient information on a borrower’s operations and related financial criteria as well as the ultimate judicial or nonjudicial enforcement process. Concerns and issues relevant to informal workouts are often addressed in the context of formal frameworks for rehabilitation procedures, but are often overlooked or ignored in the context of informal arrangements. While there are a variety of different policy choices on the substantive and procedural nature of laws and the allocation of risk among participants, these rules must be clearly specified and consistently applied to encourage consensual workouts.

31. **The informal process may produce a formal rescue, which should be able to quickly process a pre-negotiated or “prepackaged” plan agreement produced by the**
informal process. The formal process may work better if it enables creditors and debtors to use informal techniques. While informal workouts have been used for many years, most recent procedures trace their lineage to the so-called London Approach, pioneered by the Bank of England in a largely unofficial capacity and further developed by leading English commercial banks. A similar approach has emerged in the United States and possibly become more developed among the banking, financial and insurance sectors. The reasons for the development of this process are important because they suggest that more formal “modern” rescue regimes may not always be suitable for rescue. In October 2000, INSOL International released a “Statement of Principles for A Global Approach to Multi-Creditor Workouts,” which espouses eight best practices for multi-creditor workouts. The principles are fundamental to informal multi-creditor workouts and is a useful guide for developing effective practices and procedures in this area.

32. There are a variety of explanations for the popularity of informal workouts. There is a need for something more flexible and less rigid than the process available under formal rescue regimes. Many cases of corporate financial difficulty require an earlier and more active response from key bank and financial institution creditors, which is normally not possible under formal rescue regimes. It is a much more private process and, possibly, less prone to unwanted publicity and speculation. It is less confrontational and so provides a better environment for market negotiations, both between creditors and the debtor and among creditors themselves. It is perceived to carry less stigma than the formal process.

33. An informal workout probably would not be attempted unless a number of well-defined conditions were present, including:

- A significant amount of debt owed to a number of main bank or financial institution creditors.
- The inability of the debtor to service that debt.
- The attitude that it may be preferable to negotiate an arrangement for the financial difficulties of the debtor—not only between the debtor and the creditors but also between the creditors.
- The availability of relatively sophisticated refinancing, security and other commercial techniques that might be used to alter, rearrange or restructure the debts of the debtor or the debtor itself.
- The sanction that if the negotiation process cannot be started or breaks down there can be swift and effective resort to the insolvency law.
- The prospect that there may be more benefit for all through the negotiation process than through direct and immediate resort to the insolvency law (in part because the outcome is subject to the control of the negotiating parties and the process is less expensive and can be accomplished more quickly without disrupting the business).
- The debtor does not need relief from trade debt, or the benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome contracts.
Favorable or neutral tax treatment for restructuring both in the debtor’s jurisdiction and the jurisdictions of foreign creditors.

34. **Workouts typically involve relevant stakeholders who are essential to reaching a consensual solution.** Relevant stakeholders typically include banks, bondholders, and other major creditors. Less often, other stakeholders may need to be included, such as workers, the tax authorities, and holders of legal claims on the firm. Workout systems should flexibly accommodate a range of solutions and stakeholders, as befits the needs of each enterprise and restructuring. At the same time, workout framework that allows narrow groups of stakeholders (e.g., stockholders plus related creditors) to capture the process would be fraught with moral hazard. Such groups would have incentives to strip value from the firm to the detriment of other stakeholders. The onus therefore should be on designing a creditor-friendly environment and procedure that encourages their much-needed support.

35. **A voluntary out-of-court workout scheme with exceptional legal measures has to be comprehensive in all respects to grant fair treatment to creditors, and dispel uncertainty about the future of firms.** A workout framework may include some of the judicial features of court-supervised reorganization: e.g., standstill, judicial validation, and opposition in bankruptcy. Such strong measures should be adequately balanced with appropriate controls that correspond to the safeguards proper to formal proceedings.

36. **Workouts will be successful if they strike a balance between being effective and expedient, and awarding equitable protection to stakeholders’ rights.** It is especially important that a workout process not be captured by a reduced group of stakeholders, who may obtain judicial protection for an agreement that disadvantages excluded creditors. Workouts are about simultaneously adjusting the value of all claims on distressed firms, and distributing the resulting loss and additional burden among stakeholders in a manner deemed fair by laws and business customs. It is difficult to envisage a successful workout that proceeds in a sequence of limited agreements with different classes of creditors, because at every step it would be subject to the incentive problems mentioned above. In short, workout expediency should not be reached at the expense of excluded creditors’ rights.

37. **A reliable mechanism for resolving inter-creditor differences is an essential component of workouts.** Discrepancies among creditors may be more difficult to resolve than debtor-creditor differences. An authoritative arbiter should be appointed, and arbitration procedures established. It is important, however, to resist the temptation of involving a governmental authority as a direct participant in corporate workouts in a way that would create a natural conflict of interest with its basic supervision functions. In this respect, it is important for the banking supervisor to resist calls for regulatory forbearance to facilitate corporate workouts, which in a crisis become widespread even among orthodox analysts. Judicial validation of a workout agreement with majority creditor support (51%-75%) also remains an effective manner of dealing with holdout creditors or stockholders.
VI. CREDITOR RIGHTS AND ENFORCEMENT SYSTEMS

Description of Country Practice

38. The legal environment in the Czech Republic to support creditor rights and debt enforcement is widely regarded as unsatisfactory, with its deficiencies having contributed to a deterioration in the quality of bank loan portfolios and to a stifling of credit growth. Creditor rights have remained weak, and a decisive focus on improving the business environment is demanded of the authorities, including strengthening the legal framework and facilitating access to finance. As Table 10 illustrates, the shrinking access to domestic credit by private sector enterprises has pulled Czech figures down to the lower levels of other EU accession countries.

Table 10: Comparative Study: Comparing Czech Trends in Domestic Credit with other EU Accession Countries

<table>
<thead>
<tr>
<th>Year</th>
<th>Czech Rep</th>
<th>Hungary</th>
<th>Poland</th>
<th>Slovak R.</th>
<th>Slovenia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1994</td>
<td>100</td>
<td>90</td>
<td>80</td>
<td>70</td>
<td>60</td>
</tr>
<tr>
<td>1997</td>
<td>90</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>50</td>
</tr>
<tr>
<td>2000</td>
<td>80</td>
<td>70</td>
<td>60</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>2002</td>
<td>70</td>
<td>60</td>
<td>50</td>
<td>40</td>
<td>30</td>
</tr>
</tbody>
</table>

Source: Standard & Poor's, Bank Industry Risk Analysis: Czech Republic.
Date: March 2003

39. In the current Czech system, none of the three primary avenues for enforcement and debt collection – court action on unsecured debt, actions by secured creditors to seize and sell collateral, and filing of bankruptcy – has provided an efficient or predictable outcome for creditors. The need for a reduction of length and cost of court proceedings has been detrimental to collection by unsecured creditors, with improved court training being unable to compensate for legislative deficiencies. Court actions against a debtor by unsecured creditors are reported to suffer significant procedural delays obtaining judgments or execution orders, with little practical means for the creditor to ensure the preservation of the debtor’s assets from dissipation or value loss. As Table 11 below suggests, contract enforcing figures in the Czech Republic compare negatively to those of other transition and EU countries, both in time and cost. Figures that are particularly reinforced as regards cost, when contrasted to the average figures of EU and EU accession countries (Tables 12 and 13) as well as to the individual figures of those countries (Table 14).

Table 11: Comparative Study:
Comparing Czech contract enforcing to other countries (Transition/EU/US)

<table>
<thead>
<tr>
<th>Contract Enforcing</th>
<th>Czech R.</th>
<th>5 Transition</th>
<th>15 EU</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time to enforce a contract (in days)</td>
<td>270</td>
<td>196</td>
<td>252</td>
<td>365</td>
</tr>
<tr>
<td>Cost to enforce a contract (% of income per capita)</td>
<td>18.5</td>
<td>12.6</td>
<td>5.9</td>
<td>0.4</td>
</tr>
</tbody>
</table>

Date: January 2003

Tables 12-13: Comparative Study:
Comparing Time and Cost of Contract Enforcement in CR to EU/EU Accession Countries

<table>
<thead>
<tr>
<th>Time to enforce a contract</th>
<th>Cost to enforce a contract</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU</td>
<td>EU &amp; EU accession</td>
</tr>
<tr>
<td>252</td>
<td>326</td>
</tr>
<tr>
<td>EU</td>
<td>EU &amp; EU accession</td>
</tr>
<tr>
<td>5.9</td>
<td>7.4</td>
</tr>
</tbody>
</table>

Date: January 2003

*Cyprus, Estonia, Luxemburg and Malta have not been considered for purposes of elaborating the chart due to data unavailability

Table 14: Comparative Study:
Fast Facts about the Czech Contract Enforcement compared to EU/EU Accession countries

<table>
<thead>
<tr>
<th>Comparing Czech Republic to EU and EU accession countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>✓ Highest average actual cost to enforce a contract in the region.</td>
</tr>
<tr>
<td>✓ Cost (% GNI per capita) more than doubles the average cost in EU and EU accession countries.</td>
</tr>
</tbody>
</table>

Date: January 2003

*Cyprus, Estonia, Luxemburg and Malta have not been considered for purposes of elaborating the chart due to data unavailability

40. The process for recovery of collateral has been made easier by the Public Auction Law (effective May 1, 2000), which has broadened the range of property subject to non-judicial auction procedures and potentially streamlined the foreclosure process. If consistently enforced, the Law is likely to improve financial discipline among lenders and borrowers, and allow creditors to deal more effectively with the distressed debt already on their books. There have been some reports of abuses of the new public auction law. Moreover, increased prospects for recovery by unsecured creditors in bankruptcy have been at the expense of secured creditors who are at present statutorily obliged to surrender as much as 30% of their collateral’s proceeds for the benefit of unsecured creditors.

41. Secured creditors do not enjoy a significantly stronger standing, despite banks commonly taking security over real estate. Contractually agreed direct sales of secured real estate in events of default face practical difficulties; while the court
supervised real estate sales are affected by delays. Difficulties are reported to be even greater when seeking to enforce secured rights over movables for various reasons, among them: (i) procedural delays, (ii) exempting movables essential to the operation of the business from foreclosure proceedings in practice, and (iii) requiring object identification at the time of pledge under Czech law (Civil Code art. 156.2). In addition, and despite the efforts made in the Civil Code reform (effective January 1, 2002), the effectiveness of equipment, inventory and receivables financing is also hampered by the difficulties for public registration of secured interests. The range of collateral options is perceived to be a deterrent to banks from lending to second- and -tier enterprises or start-up businesses, and small- and medium-sized enterprises that require a focus on facilitating their access to finance.\(^{15} \)

42. **Filing for bankruptcy is presented as the worst of the three alternatives for the creditor, with unsecured creditors typically realizing little or nothing on their claims.** After declaration of bankruptcy, secured creditors are prevented from exercising their right to foreclose on and sell their collateral, and receive no compensation for the delays in realizing on their assets. Frequently, the collateral is sold at values substantially below the face amount of the secured creditors’ claims. Furthermore, in spite of the fact that secured creditors enjoy priority over the balance of sales proceeds payable on final distribution, they enjoy scant control over the timing of those distributions, which often take long periods. With the liquidation proceeding being perceived as slow and inefficient, creditors are frequently of the view that it is not a viable option for debt recovery, with them enjoying little - if any - powers in bankruptcy. Having been relegated to a passive role, creditors consider the whole process as a debtor’s haven. The amendments introduced to the Bankruptcy Law (as of May 1, 2000) incorporated certain improvements, but have resulted in only modest improvements.\(^{16} \) The amendments have somewhat strengthened creditor rights in insolvency proceedings, but failed to address the essential weaknesses in the bankruptcy framework, and, in some specific areas, further weakened the framework, particularly as regards the rights of secured creditors under liquidation to the distribution of proceeds from the sale of the collateral.

43. **Such a weak legal framework had adverse consequences for the performance of the Czech economy.** First, it leads to further deterioration of the problem of non-performing bank loans and the insufficient pace of enterprise restructuring. Second, it increases the risk to creditors and negatively affects new flows of lending by the banking system. Both factors have been criticized for contributing to the reduction of accessible credit.

**Examples of reform efforts in other countries.**

44. **The process of reform in the creditor rights and secured transactions field has been particularly active in recent years, especially in the Eastern European region, where most of the countries have engaged in reforms.** Examples of reforms

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include the Russian Federation (1992), Ukraine (1992), Belarus and Estonia (1993), Bulgaria, Estonia, Hungary, Montenegro and Poland (1996), Bulgaria, Georgia and Ukraine (1997), Armenia, Azerbaijan, Latvia, Lithuania, Macedonia (1998), Albania, Azerbaijan and Romania (1999), Moldova (2001) and Slovak Republic (2002). Reforms in this are also taking place in many other countries around the world (e.g. Chile, China, Finland, Indonesia, New Zealand, Sweden, and Vietnam), underscoring the perception that modern security and enforcement systems attract investment and help fuel sustainable growth. One of the most significant laws recently passed with great success has been the new Slovak security law, which was developed in connection with a World Bank structural adjustment operation and with assistance from the World Bank and the EBRD.

45. The different approaches vary in range, and may be divided into: (1) a comprehensive system creating a unified concept of secured interest; (2) laws governing possessory as well as non-possessory pledges; (3) laws concentrating in only non-possessory security interests; (4) laws addressing more global security devices, such as enterprise mortgage; (5) laws on purchase money security devices; and (6) laws governing assignment of receivables. Romania, as well as the Canadian Province of Quebec, the US and Norway adhere to the first approach, providing for a broad range of assets and security interests and for registration of non-possessory security interests. The second approach has been preferred by countries enacting new civil codes or comprehensive laws on property as well as secured rights – including possessory and non-possessory pledges – among these the Civil Code of Georgia (1997), and the Law on Pledges of Ukraine and Russia (1992). The countries concentrating in approach (3) have either followed the pledge tactic (e.g., Bulgaria and Poland (1996), Lithuania (1997), and Latvia (1998)) or concentrated on the fiduciary transfer of title, like Montenegro (1996). Enterprise mortgages (4) have been adopted in Sweden and Finland (1984), and more recently in Belarus (1993) and Estonia (1996). Some countries, notably Belgium (1998), have amended their legislation to meet the modern demands for business financing as regards assignments of receivables.

46. Furthermore, creation or reform of security right registries has also been awarded priority treatment in several countries. In the region, at least Albania, Kosovo, Poland, Romania, and the Ukraine have engaged in registry reform, including adoption of electronic registries by Albania, Romania and the Ukraine, evidence of a trend that has been in place for some time now in Norway and the US.

47. In addition to efforts at the national level, significant efforts have been made on multilateral level. In addition to the World Bank Principles, the European Bank for Reconstruction and Development (EBRD)\(^\text{17}\) and the Organization of American States (OAS)\(^\text{18}\) have each engaged in developing a model law on secured transactions to be considered – and eventually adopted – by their constituencies. The Asian Development

\(^{17}\) For access to the full text of the EBRD Model Law, part of the EBRD Project on Secured Transactions, see \url{http://www.ebrd.com}

\(^{18}\) The Sixth Inter-American Specialized Conference on Private International Law has finalized its work putting together the Model Inter-American Law on Secured Transactions (February 2002); for the Model Law full text see \url{http://www.brownwelsh.com/Archive/cidip_secured.htm}. 

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Bank has likewise been highly active in defining principles of good practice in this field within the Asian markets. In addition, the United Nations Commission on International Trade Law (UNCITRAL) has more recently begun efforts to assemble a legislative guide on secured transactions to assist legislators by providing legislative recommendations for the writing of national legislation.¹⁹

**Recommendations and Next Steps**

48. The Czech creditor rights and enforcement framework is generally as effective as other transition countries, but less efficient than more developed markets in the EU and the US. As Table 15 illustrates, the level of compliance in Czech systems for creditor rights was materially non-observed, which was only slightly worse than other transition countries, some of which have made notable gains in recent years (e.g., Romania, Slovakia). When one examines those countries in the EU that will serve as potential competitor for investment, however, the contrast is much more severe, with most of those countries demonstrating on average largely compliance, modern and functional systems. Accordingly, the Czech Republic needs to continue to make gains in this area as well to better position itself for competition following accession into the EU.

**Table 15: Comparative Study**

**Comparison Czech collateral/enforcement systems to other countries (Transition/EU/US)**

<table>
<thead>
<tr>
<th>Creditor Rights Framework</th>
<th>Czech R.</th>
<th>5 Transition</th>
<th>15 EU</th>
<th>US</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Well-Integrated Commercial Laws</td>
<td>3.00</td>
<td>3.00</td>
<td>1.80</td>
<td>1.00</td>
</tr>
<tr>
<td>2. Enforcement of Unsecured Claims</td>
<td>2.00</td>
<td>2.40</td>
<td>1.73</td>
<td>1.00</td>
</tr>
<tr>
<td>3. Security and Collateral Systems</td>
<td>3.00</td>
<td>2.20</td>
<td>1.53</td>
<td>1.00</td>
</tr>
<tr>
<td>4. Registry Systems</td>
<td>3.00</td>
<td>2.20</td>
<td>1.73</td>
<td>1.00</td>
</tr>
<tr>
<td>5. Enforcement of Security</td>
<td>3.00</td>
<td>3.00</td>
<td>2.13</td>
<td>1.00</td>
</tr>
</tbody>
</table>

1 = Fully Observed 2 = Largely Observed 3 = Materially Non-Observed 4 = Not Observed

49. Prior recommendations to strengthen the creditor rights framework include reforms to promote: (1) a stronger, more expedited debt recovery and enforcement mechanism, allowing for easier and less costly recovery and controlling the possibility of prolonged delays; and (2) the enactment of modern collateral legislation with wider scope of assets eligible to serve as collateral, enhanced enforcement rights for secured creditors, and an improved system for public notice, through efficient – and preferably electronic – public registers. It should be underscored that, among the several amendments required to modernize insolvency law, secured creditors should be better empowered during liquidation proceedings. The following aspects should be singled out: (i) they should see their right to foreclose on and sell their collateral limited only for a specified duration and complemented with the ability to obtain relief from that stay by petitioning the court, (ii) their priority over their collateral should be fully respected and the current cap should be abrogated, and (iii) distributions from proceeds should promptly be made accessible to them.

¹⁹ For the draft of UNCITRAL’s *Legislative Guide on Secured Transactions*, see [http://www.uncitral.org/en-index.htm](http://www.uncitral.org/en-index.htm), Working Group VI.
VII. CONCLUSIONS

50. The reform of the Czech system with respect to insolvency and creditor rights would need to address, as pointed out by the ROSC – and also signaled out by other studies – three major elements that require strengthening: (1) the general debt recovery and enforcement mechanisms, (2) the legal framework for insolvency cases, (3) the institutional and regulatory framework for insolvency.

51. The debt recovery and enforcement mechanisms require strengthening to allow for a more expedited and cost-efficient recovery. Execution law should be amended to provide streamlined foreclosure and stronger rights to secured creditors. The legal framework for security rights needs to be modernized and expanded, with the system of public registries requiring enhancement.

52. The legal framework for corporate insolvency should be streamlined according to international best practice. Both liquidation and composition proceedings should be modernized, provided with time-bound rules and stronger participation of creditors and creditors’ committees. Speedier liquidations of non-viable companies should be allowed for, and a more flexible and enabling environment should be provided for the speedier formal reorganization proceedings. In addition, actions should be taken to adopt a voluntary out-of-court workout scheme. It will be important that all stakeholders be given equitable treatment in line with international best practices. The Commercial and Civil Codes, as well as tax legislation, should be amended to provide for a friendly climate for reorganizations in general, and debt-equity swaps and debt forgiveness in particular.

53. The institutional and regulatory frameworks for insolvency should also be strengthened. Capacity building for courts and insolvency professionals should be continued, with particular emphasis on modern restructuring techniques. Court procedures should be streamlined, standardized, and designed to significantly reduce the length and cost-efficiency of court proceedings, in line with international best practice. An effective regulatory framework should be introduced, including stricter, narrowly tailored certification/educational requirements for administrators.
ANNEX I

Insolvency and Creditor Rights Legal and Institutional Frameworks

Findings

Creditor Rights and Enforcement Systems
- Procedural delays for enforcement proceedings, including for seizing collateral.
- Elevated court costs for enforcement.
- Low recovery rates for creditors.
- Uncertainty of security rights over movable property (e.g., equipment, inventory and receivables).
- Difficulties with the public registry for movables.

Legal Framework for Corporate Insolvency
- Slow and inefficient system.
- Few rights for creditors, including limited direct influence over administrator.
- Vague definition of insolvency.
- Erosion of secured creditors’ rights.
- Court discretion to dismiss creditors’ committee.

Features Pertaining to Corporate Rehabilitation
- Onerous requirements for payments to creditors hinders reliance in composition.
- Lack of a functioning, predictable reorganization scheme.
- Absence and disincentive for out-of-court negotiations.

Institutional or Regulatory Framework
- Absence of appropriate standards for competence and performance.
- Heavy caseload and administrative inefficiency.
- Slow and inefficient court system.
- Absence of effective regulatory framework to qualify, license and monitor professional behavior.

Recommendations

Creditor Rights and Enforcement
- Adopt stronger and more expedited debt recovery and enforcement mechanisms.
- Enact modern collateral legislation.
- Strengthen the system for public notice/public registers.
- Strengthen registration of movables.
- Further expand the range of collateral.

Legal Framework for Corporate Insolvency
- Modernize insolvency law in line with international best practice.

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• Provide time-bound rules in different stages of the proceeding.
• Clarify the definition of insolvency.
• Strengthen creditors’ rights.
• Strengthen secured creditors’ rights.

Features Pertaining to Corporate Rehabilitation

• Design a functional rehabilitation proceeding.
• Introduce strict time-bound rules for specific steps in reorganization.
• Introduce the possibility of a majority decision to bind minority creditors to the restructuring plan.
• Introduce a fast-track reorganization scheme.

Institutional of Regulatory Frameworks

• Strengthen court capacity.
• Improve and standardize court procedures.
• Train judges and liquidators in modern restructuring techniques.
• Introduce effective regulatory framework.
• Introduce stricter certification/educational requirements for professionals working in the insolvency system.
Components of a Functional Corporate Workout Environment

- **Level playing field:** Significant tax, legal, and regulatory impediments to corporate restructuring must be addressed. A functioning restructuring environment depends on a legal framework that facilitates the restructuring plan, such as allowing debt-equity swaps, forgiveness of bank debt, the taking of collateral, and authorizing priority financing for new money. The legal framework must also provide proper incentives for the parties to accept treatment that will render the restructured business viable. Stakeholders should receive fair treatment according to the priorities of their rights.

- **Information sharing and due diligence:** Access to reliable and accurate information on the business, including business activities, trading position, and general financial statements, is essential to reaching a consensual agreement. This is comparable to the statutory requirement for similar disclosure found in formal rescue regimes. Facilitators ought to emphasize the dissemination of information to all creditors. At a minimum, all participants ought to have access to accounting statements in a format consistent with international standards and certified by independent and qualified expert opinion as to their reliability. The facilitator could also hire auditors or financial experts to perform a due diligence of projections and proposals put forth by the debtor or other workout participants. In addition, a framework for participants’ share of information is also needed.

- **Participants:** A functional corporate workout environment has to effectively create the conditions for broad creditor participation, which should be open to most claim holders, leaving the decision to join in their hands. Initiation of the workout should be conditional on at least half of all liabilities –both current and long term– being represented in the proceedings or at least explicitly not objecting to them.

- **Coordination:** A ‘lead’ creditor should be appointed to coordinate negotiations, and provide leadership, organization, and administration. The lead creditor typically reports to a steering committee of creditors.

- **Stabilization:** To stabilize the business operations and provide for a negotiation period, a ‘standstill’ agreement should be used, which suspends adverse actions by both the debtor and the main creditors, and endures for short period. It is similar to the ‘moratorium’ or stay of actions under the formal rescue process in bankruptcy. It should only be granted if a majority of all creditors participate in, or do not object to, the negotiations and explicitly request it. In addition, as a prerequisite for the judge to grant the standstill, a qualified independent expert ought to certify the feasibility of the debtor’s proposal.

- **Liquidity and Access to New Money:** Liquidity is essential to stabilizing the business, and may be more difficult to provide in informal workout procedures. This is because formal insolvency laws frequently provide for a ‘super-priority’ for on-going funding of a debtor, but that law does not extend to informal arrangements. Creditors need to devise a contractual super-priority by means of an ‘inter-creditor’ agreement, which grants seniority to emergency funding.

- **Negotiation, Agreement & Voting:** Negotiating, agreeing and implementing the restructuring plan is typically based on agreement among the creditors and the debtor as to the terms and conditions for the restructuring, and acceptance by a requisite majority of creditors. The percentage of approval necessary may vary, depending on the specific acts undertaken during the restructuring. It is recommended that majority thresholds be fair, while at the same time low enough to encourage maximum potential for rehabilitation.

- **Legally Binding:** The final restructuring agreement should be offered to all creditors to decide whether they want to adhere to it terms. It should be made legally binding by an inter-creditor agreement applicable to all participants in the restructuring. Non-participating parties should not be bound by it. For the agreement to receive protection from legal reversion, a majority of all creditors (50-75%) ought to explicitly adhere to it or, at a minimum, explicitly not oppose it.