SEVERAL CONCLUSIONS FROM RESEARCH OF INSOLVENCY CASES IN THE CZECH REPUBLIC

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The survey of real outcomes of insolvency proceedings in the Czech Republic analysed by this study took place during 2012 and 2013. This is the first survey that enables (on the basis of a statistically declarative sample) the ascertainment of certain crucial data as to the actual outcome of insolvency proceedings in the Czech Republic, i.e. especially as to the yields which creditors obtain. The study analysis outcomes drawn from two waves of statistical research, compare these two waves together and place the results gained into an international context. In addition, the study also brings forward basic information on the structure of the insolvency act in the Czech Republic and possible changes in legislation that would create a more congenial environment for creditors.

JEL classification: G30, G33, K29

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Introduction

The efficiency of insolvency law and the insolvency system in individual countries are among the areas that economics traditionally overlooks. Yet it is one of the fundamental parameters of the economic environment as a whole, and it is also connected with other fundamental areas – among others, the enforceability of law generally and especially the enforceability of a contract. Economics frequently monitors with exceeding meticulousness "hard" economic data, such as the development of the gross domestic product or certain specific partially economic parameters (a typal estimate of respondents about the state of corruption in a given country); it thus devotes very little attention to such a precise telling and very important datum such as the returnability of an investment (credit) in a case of a debtor default.

The general problem with statistics

It is interesting to note that although we statistically monitor a truly large number of events, we in fact know very little about the real course of insolvency proceedings. If we wanted to describe the situation in the Czech Republic very simply, there are several types of data or outputs available. The first is the statistics of the Ministry of Justice CR. These tell us how many insolvency proposals have been filed, how many bankruptcies have been declared, how many proposals rejected, overruled and so forth. Nevertheless, they tell us absolutely nothing or only very little as to the real course of proceedings. The second type consists of data of private companies which analyse information from the ministry and also from the Insolvency Register (in which proposals as well as documents concerning all proceedings are made public). The outputs of these companies bring forth certain interesting findings, provided their data is based on a faithful representation of economic reality (see e.g. Bonaci et al., 2013). Nevertheless, these are in fact mostly finalizations of available statistical outputs to a more analytical level than a mere publication of numbers. From these sources, we ascertain only peripherally more than we do from the official statistics of government institutions. International statistics are the third type of data on insolvency proceedings; these, however, in fact provide neither a precise nor distorted reference as to reality in the Czech Republic. This is due to the fact that a comparison of countries together is achieved by settling model cases; therefore, it may be possible to compare systems and their theoretical effectiveness in individual states, but not reality as such. And finally, the fourth type of output consists of attempts to evaluate certain samples of insolvency cases, summarize their real outcomes,

and then calculate the success of the system from the perspective of a given sample and then to generalize the figures gained. The results of these surveys are of course limited in relation to reality by the quality of the sample and quality of workmanship and, in view of the significant complexity of insolvency proceedings, also by the quality of the compiled questionnaires; nevertheless, if these pitfalls are overcome, the results can be considered to be relatively authoritative.

If we observed individual data sources, then as far as the Ministry of Justice of the Czech Republic is concerned, the statistics of this authority are made public primarily in individual quarterlies on regularly accessible web pages (MSp, 2013). Companies that focus on analysing outputs from the area of insolvency proceedings include, for instance, Creditreform (Creditreform 2013), or CRIF (CRIF, 2013), as the case may be. International statistics are primarily analyses which the renowned institutions, The World Bank and International Finance Corporation (WB and IFC, 2013) publish under the title *Doing Business.* The problem with these comparative studies is their methodology, which uses the following assignment as their departure point: Respondents in individual countries are presented with a model example of insolvency proceedings and they are to assess how long its settlement would take in the given country, what the costs would be, what the yield would be for creditors, whether the case would be solved rather by the liquidation method, the financial rehabilitation method and so forth. The method itself is also problematic in the principle of questionnaire ascertainment, even if among experts in the field. We can hardly be certain that specialists from individual countries will truly have the same standards in their viewpoints and the same distance from the situation. This is nevertheless not a crucial problem, as in terms of the numbers of respondents, it is probable that the majority of individual fluctuations are eliminated in a natural way. However, a far greater danger of a distortive view on reality lies in the problem of the model case. This concerns a company that has clearly defined, easily sought-out property and a relatively simple structure of creditors; in other respects also, this is rather an academic case and does not correspond with reality. However, the main problem of insolvency proceedings in the Czech Republic, as we shall later show, is not even the inefficiency of the system or poor quality of the insolvency act, but rather the fact that the vast majority of businesses enter into proceedings only at a time when their assets have been depleted or removed from the reach of their creditors. As a result, however, the data from the survey serves no other purpose than a comparison of the quality of systems as they are viewed by respondents in individual countries.

We thereby arrive at the problem of the last source of data – various studies based on a greater or smaller sample of concrete and real insolvency cases, on the evaluation of their outcomes and courses and a generalization of the entire group of insolvency cases.

From the perspective of reality, we observe that only such studies can give a certain concept of real outcomes of bankruptcies, at least in the sense that only they can provide a real image as to real yields for creditors and other important aspects of the situation.

The work of authors Davydenko and Franks (Davydenko and Franks, 2008) is a very well-known study. They based their unusually inspiring work on a sample of 2,600 small businesses. They were able to do this primarily thanks to the fact that ten large banks representing significant market shares in markets of researched states provided a range of specific data. This method is not even remotely customary; for instance, another indisputably significant study (Lee et al, 2011) uses results from the publication *Doing Business* for comparative purposes as to how insolvency law influences growth in individual countries.

In Czech conditions, it is especially the *Výzkum insolvence* (translation: *Insolvency survey*) team that has commenced research of real outcomes of insolvency proceedings. (This team was assembled to handle a project supported by the Technological Agency of the Czech Republic). The results of the investigation are available primarily on the team's web pages (Výzkum insolvence, 2013) and in numerous professional studies (Schönfeld, Smrčka and Malý, 2013; Smrčka, Arltová and Schönfeld, 2013; Smrčka and Malý, 2013).

The real situation in insolvency proceedings in the Czech Republic

In 2012 and especially in 2013, two statistical investigations were conducted of a comprehensive sample of insolvency proceedings that were commenced after 1 January 2008, i.e. after the coming into force of the Insolvency Act (182/2006 Coll., which replaced the preceding Act on Bankruptcy and Settlement, 328/1991 Coll.). Both surveys included only such cases of insolvency proceedings with entrepreneurial subjects that were commenced after January 2006 and were likewise actually closed by October 2012. There were about 8.5 thousand of such cases at the time when the first survey was being conducted. In this regard, it should be mentioned that a part of these cases are actually from the group that is

Table 1 Results of the statistical investigation of the *Insolvency survey I* team

Parameter	First wave (2012)		Second wave (2012/13)	
	Abs.	In %	Abs.	In %
Number of proceedings (total)	**615**	**100.0**	**962**	**100.0**
Number of proceedings closed prior to declaration of the debtor's bankruptcy	**428**	**69.6**	**593**	**61.6**
Of which: rejected for faults (§128)	93	15.1	229	23.8
lack of property (§144)	153	24.9	216	22.5
failure to pay deposit for costs of proceedings	43	7.0	58	6.0
retraction	13	2.1	58	6.0
other reasons	126	20.5	32	3.3
Declared bankruptcy	**187**	**30.4**	**369**	**38.4**
Of which: bankruptcy	179	29.1	310	32.3
minor bankruptcy	8	1.3	57	5.9
reorganization	0	0.0	2	0.2

Source: Insolvency Register, www.vyzkuminsolvence.cz

gradually erased from the Insolvency Register (records on cases are deleted from the public database five years after a binding closure of proceedings); on the other hand, many of the cases commenced even during the first years of the Insolvency Act's being in force do not fall into this group as these proceedings have not really been closed. Distinguishing between a binding and real closure is logical – many cases are in fact closed in reality, the insolvency administrator's closing report and the schedule for creditor satisfaction have been approved, but the case is formally still proceeding, often over many months. This is due to administrative steps and other circumstances.

The first wave of the survey was realized in early 2012, the second in winter 2012 and in spring 2013. In basic characteristics, both waves concurred or, more precisely put, their outcomes are very similar. In this sense, primarily satisfaction of secured and non-secured creditors is at issue. As we can see in the following table, then in both survey waves, it is especially the data on satisfaction of receivables of secured creditors that converge together very closely. If we observe the information on the first wave of the survey, we find an average satisfaction amounting to 1.26 percent. This means that creditors recover 1.26 crowns from every one hundred crowns of their claimed and recognized receivables. In the second wave of the survey, this number grew slightly to 3.5 percent of non-secured receivables, but only if the sample is cleared of one significant and, in terms of claimed and recognized receivable, markedly exceptional case. If we did not clear the sample, satisfaction would reach only 2.2 percent of claimed and recognized receivables.

The situation with secured receivables is very similar. However, given the inclusion of that singular case into the sample, we would have to state that from secured receivables, only 3.1 percent of claimed and recognized receivables are satisfied. After elimination of the above-mentioned specific case, satisfaction of secured creditors reached a total of 22.9 percent in the second wave of this statistical survey. This is relatively very close to the situation of the first wave, where the measure of return on investment reached 25 percent.

It is worth mentioning the fact that both reorganizations recorded in the second wave were changed to bankruptcy in subsequent proceedings, which of course does not change the total figures in any significant way.

As we can observe from a comparison of both waves, the results are relatively similar – smaller discrepancies can be explained by a statistical deviation, which could simply be given by a still small total simple of cases against the whole. As we have already mentioned, the parameters of the survey corresponded to a total of 8,500 cases of insolvency proceedings. A total of 1,577 (i.e. 18.55 percent) of the cases were surveyed. This sample is highly representative; on the other hand, insolvency proceedings are highly complex and structured events, where several small individual cases can quite considerably deflect the whole, which is why it is not surprising that in certain specific parameters both samples show greater divergence. Minor bankruptcies are at issue; substantially more of these appeared in the second wave, as did cases that were ultimately rejected due to faults. It can be assumed that these divergences

Table 2 Results of the statistical survey of the *Insolvency survey II* team

Parameter	First wave (2012)		Second wave (2012/13)	
	Abs.	In %	Abs.	In %
Number of bankruptcies and minor bankruptcies (total)	**187**	**100.0**	**369**	**100.0**
Of which: bankruptcy	179	95.7	312	84.6
minor bankruptcy	8	4.3	57	15.4
Number of cases without satisfied creditors	93	49.7	199	53.9
Number of cases with satisfied creditors	94	50.3	170	46.1
Ratio of pay-outs to secured creditors	x	25.0	x	22.9 (3.1)
Ratio of pay-outs to secured creditors	x	1.3	x	3.5 (2.2)

Source: Insolvency Register, www.vyzkuminsolvence.cz (data in brackets include an eliminated debtor)

will also diminish with further refinement of the sample (an increased number of surveyed cases).

However, it is of course the issue of creditor satisfaction that is more substantial than the actual structure of the sample and making a distinction on individual exits of cases from the system. We have already mentioned the basic parameters above; a general overview is given by the following table.

The calculation of creditor satisfaction stems only from those cases where a bankruptcy was declared – this is the logical solution and the only one possible. Although the numbers of insolvency proceedings which do not even reach a declaration of bankruptcy are considerable and, more importantly, higher than the number of cases with bankruptcies, ascertainment of creditors' receivables does not occur in them. Likewise, an attempt to monetize the property does not occur either, nor is any property actually ascertained (which, in many cases is given by the fact that clearly no relevant debtor property exists). Moreover, it is in fact dubious whether we can even speak of debtor insolvency in these cases of insolvency proceedings – besides clear situations of zero property, hidden in this number of cases are also such cases where the debtor is not at all in bankruptcy and sometimes is not even a debtor according to the insolvency act (Kotoučová and coll., 2010), In other words, the exact opposite of when the debtor does not have any real property.

On the other hand, conditions for satisfaction of creditors are calculated from all cases where bankruptcy was declared and not only from those where at least some satisfaction is gained. In the given context, the goal is not to survey the efficiency of the system (i.e. its ability to convey property to the creditor if some is in fact discovered), but essentially to define creditor risk in a case of debtor default. (In this connection, it of course applies that it would be optimal to also have the possibility to include in this statistic those cases where bankruptcy is not even declared in view of the fact that a total lack of debtor property is discovered beforehand. As has already been mentioned, however, there would be nothing with which to compare a clear zero from the side of creditor satisfaction because no ascertainment of receivables occurs. Similarly, it would be very apposite also to be able to include into this category those cases where a deposit for costs of proceedings is not paid by some of the creditors despite being summoned to do so by the court. If it is not paid, the creditor probably expects that the debtor has no relevant property; a similar situation thus occurs as it does in a case where a proposal is overruled for lack of property. It is especially in the case of non-secured creditors that the pay-out ratio would then decline further, probably to a mere tenth of a percent.)

A look at the second table, however, primarily confirms the fact that both survey waves produced compatible results which complement one another. The only more marked divergence is in the number of cases of insolvency proceedings settled by minor bankruptcy, but this is – as we have already stated – statistically explicable. A more detailed survey result, as well as information as to methodology, is contained by certain studies of the members of the *Insolvency survey* scientific team and also the several-times mentioned presentation of the team's (www.vyzkuminsolvence.cz).

Analytical conclusions from the survey

The above-stated data certainly enable one to analyse the gained information in a relatively substantial way. The first significant impulse to conduct research directly offers itself: If we count the number of cases where a debtor's bankruptcy was in fact declared, but the bankruptcy was revoked for lack of property, or it

transpires that no fulfilment remains for the creditors from the property, and we add to them cases where the insolvency proposal is subsequently overruled for clear lack of debtor property, and also those cases where the proceedings were dismissed in view of the fact that no-one paid the deposit to cover the costs of proceedings, we then arrive at a count of 283 cases in the first wave of the survey, which is 46 percent of the entire number of surveyed cases, and then 473 cases in the second wave (49.2% of the entire number). If we related the number of cases without an outcome for creditors to the number of insolvency proceedings reduced by those where bullying proposals were filed, or where proposals were retracted or the proposals suffered faults that could not be removed, then our percentage of cases without any satisfaction for creditors whatsoever would grow sharply. In the first wave, this would be 75.5% of cases, and 73.6% of cases in the second. As we can see, the absolute majority of insolvency proposals filed against entrepreneurial subjects culminate in the creditors receiving absolutely nothing.

It would be somewhat misleading to interpret this fact as something specific to the Czech Republic. In reality, it is essentially completely normal that a certain part of insolvency proceedings are conducted with companies whose real state precludes satisfaction of creditors. It can, however, be legitimately assumed that the situation is by no means as critical as it is in the Czech Republic. In other words, we can state that lack of debtor assets in comparison to their assets is fatally frequent in the CR. In view of the fact that no internationally comparable statistics of insolvency proceedings exist, we cannot even compare how divergent this situation is in a particular given state. Nevertheless, according to available information, it seems that if a bankruptcy of a trading company or entrepreneur is declared in developed countries, it occurs only in relatively exceptional cases that creditors receive no satisfaction whatsoever.

The second conclusion that can be deduced from the presented figures concerns the frequently discussed problem of reorganization. It is a question as to the extent to which it was possible to fulfil the wishes of legislators for reorganization (as the financial rehabilitation method of settling bankruptcy) to be used more frequently than the previous settlement method. In both survey waves, a total of two cases of bankruptcy settled by reorganization appeared – both, however, were converted to bankruptcy. But this would mean that, in this direction, it was not possible to change the previous situation that very strongly preferred the liquidation method. However, the assumptions of certain authors stand against this (Richter, 2008) and so do the analyses of concrete cases (Richter, 2010; Richter, 2011, Felcman, 2011), from which it transpires that reorganization may not be a frequent solution of cases of trading companies and entrepreneurs in terms of percentages, but it is used appropriately to the situation and possibilities stemming from the general economic situation. In reality, we cannot assume that the rehabilitation method of settling bankruptcy could somehow be applied proportionally frequently at a moment when an overwhelming percentage of bankrupts have no assets and another significant part of companies generally utilize the insolvency act pointedly to terminate their activities in an at least somewhat refined manner. But as certain authors add (Kislingerová, Richter and Smrčka, 2013), and as the reasoned report to the so-called revisionary amendment to the insolvency act also states, given the number of cases where a creditor's committee is even appointed, reorganization represents a relatively substantial number of these "big insolvency cases".

Both waves brought a large amount of further information on the course of insolvency proceedings, which the *Insolvency survey's* scientific team is processing further and about which it will provide information subsequently. This concerns, for instance, information concerning the usual fees for insolvency administrators or the frequency of engaging individual administrators. On the other hand, the team is determined to keep a certain distance from the very frequently used parameter of duration of insolvency proceedings, which it considers to be rather of an orientational nature in so far as the issue of insolvency proceeding duration is less substantial than that of costs of proceedings and yields for creditors.

Results

The statistical survey of the *Insolvency survey* team proves that the yield of non-secured creditors in insolvency proceedings reaches very low values, but values in an order which is generally expected, i.e. between one and four percent of receivables. But the yield of secured creditors, which is far less than what is expected – at a level of approximately 25 percent of receivables – was a great surprise.

Managerial Implications

Of course, the results described above may to some extent be a confirmation of the assumptions of the academic community and are, on the other hand, very surprising to some degree; there is nevertheless no doubt that some market participants know these data or it is at least highly probable that they assume them – we are referring primarily to financial businesses,

especially banks, but also leasing companies and similar entrepreneurial subjects. The larger the number of defaults among business partners which one or the other business has encountered or encounters, the more precise and true is its notion as to the impact of their failure. But it is very likely that many companies are not particularly aware of the fact that it is highly probable that the default of their business partner essentially entails such a dramatic loss of the value of a receivable that it becomes equal to zero. This is because it is essentially certain that if a non-secured creditor actively endeavours towards the enforcement of its receivable or at least actively participates in insolvency proceedings, then its costs exceed the sum that it will collect from regular insolvency proceedings. This state of affairs is demotivating, and if market participants are aware of it, then this risk becomes an aspect of the price level.

In other words, the traditional rule on transaction costs applies. Those entrepreneurial subjects that have a greater need to be fully informed about client payment morale (i.e. banks, for instance, in relation to clients, and especially debtors or wholesale firms, for instance, towards their clients) will always have a better overview of the insolvency situation as a whole than will a small firm which operates locally or regionally. Furthermore, it applies that the receivables of those subjects are mostly greater in absolute values than are receivables arising from commercial activity, so the costs of monitoring them, keeping records and enforcement are not as significant with respect to the entire volume as is the case with relatively small receivables.

The demotivating aspect of the real course of insolvency proceedings has yet other contexts that are interesting – one of them being a certain powerlessness of the majority of creditors in the face of a certain significant favouring of other creditors. Some of the creditors, whose receivables stem from regulations, i.e. insurance premiums or tax, have an easier possibility to obtain a court ruling in the context of individual enforcement and, for instance, attain property forfeiture or exercise judicial right of lien. On the other hand, employees with their receivables enter the group of receivables placed on the level of receivables beyond property, which makes them a markedly privileged group of creditors (the economic reasons of this rationale are problematic; it is in fact the political and social arrangement of the whole system that is at issue) and this is not a Czech curiosity (Blazy et al., 2011).

From the perspective of the management of trading companies, the question of reducing risks stemming from the danger of default is naturally a traumatising decision between increasing costs and a potential profit or, more precisely, limiting some losses. For the most part, however – without doubt also due to the low probability of some yield from insolvency proceedings – the expenditure of further costs is considered ineffective.

In reality, at least a partial solution could lie in a change of the insolvency act and certain other regulations. It would essentially be possible to consider three substantial reforms.

Very briefly, these are the possibilities: intervention into the issue of creditor order in the direction of favouring those creditors who would make significant progress by individually enforcing receivables still prior to commencement of insolvency proceedings; furthermore, enabling full write-off of receivables as early as the moment a debtor's bankruptcy is declared, while taxing an incidental yield from insolvency proceedings after it is collected; and thirdly, a change in the way over-indebtedness is defined in the insolvency act (Kotoučová and coll., 2010) so that this definition is clearer and therefore usable also in the normal economic environment. Especially this third change would entail significant intervention into the current economic environment in the country, but it would nevertheless probably lead especially towards its cultivation.

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