



A WORLD BANK COUNTRY STUDY

21440
November 2000

Czech Republic

*Completing the Transformation
of Banks and Enterprises*

Czech Republic

Completing the Transformation of Banks and Enterprises

*The World Bank
Washington, D.C.*

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First printing November 2000
1 2 3 4 04 03 02 01 00

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ISBN: 0-8213-4880-9
ISSN: 0253-2123

Library of Congress Cataloging-in-Publication Data has been applied for.

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ABSTRACT

This report on bank and enterprise reforms in the Czech Republic is based on the findings of a mission that visited Prague in October 1999. The report was requested by the Czech authorities in the Spring of 1999, and is a complement to a previous report on the Czech capital market that was published in May 1999. Whereas the Capital Market Report focused on the reform of capital market institutions and securities markets, this report focuses 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 team that visited Prague between October 4 and October 15, 1999, was led by Mr. Roberto Rocha (lead economist, regional office in Budapest, and task manager), and included Messrs. Hormoz Aghdaey (co-task manager in Washington DC), Andrew Lovegrove (consultant, bank restructuring and debt workout); William Mako (enterprise restructuring); Douglas Webb (legal framework), and Gordon Johnson (legal framework and insolvency specialist). Mr. Lajos Bokros also joined the mission and contributed to the discussions.

The team benefited from discussions with several officials in the Ministry of Finance, the Ministry of Economy, the Czech National Bank, the National Property Fund, the Consolidation Bank, and the Revitalization Agency, as well as bankruptcy judges, liquidators and practitioners, senior managers of numerous commercial banks, accountants, lawyers, and tax specialists. The team benefited in particular from discussions with Mrs. Jana Matesova (assistant ED at the World Bank), and Messrs. Jan Mladek (State Secretary, Ministry of Finance), Ladislav Zelinka (State Secretary, Ministry of Finance), Jiri Havel (Chairman, National Property Fund), Pavel Racocho (Vice-Governor, Czech National Bank), Miroslav Zamecnik (Director, Revitalization Agency), Kamil Ziegler (Chairman, Consolidation Bank), and Ladislav Reznicek (Director, Consolidation Bank). The team is also grateful to Mr. Ales Satanek (Director, Ministry of Finance), Mr. Dimitrij Loula (Ministry of Finance), and Mrs. Veronika Znamenackova (Ministry of Finance) for fruitful discussions and continuous support to the mission members during their stay in Prague.

The final document reviews the status of bank restructuring and privatization, examines the ongoing efforts to design and implement a coherent strategy to workout the large stock of classified loans, and assesses the efficiency of the legal framework for debt enforcement and enterprise restructuring. The legal analysis involves a review of the Bankruptcy and Composition Act, the laws dealing with foreclosure (the Law on Public Auctions and the Execution Law), and other relevant pieces of legislation. The report provides numerous recommendations for the design of a diversified and balanced workout strategy, as well as recommendations for improvements in the bankruptcy and foreclosure laws and the institutional framework for bankruptcy.

The report was discussed with the Czech Government in February 2000 in Prague, updated in September 2000, and cleared by Roger Grawe (Country Director, World Bank) in October 2000. The report was processed by Andrea Toth.

CURRENCY AND EQUIVALENT UNITS

Currency Unit = Czech Crowns

US\$ 1 = 41.6887 CZK

CZK 1 = 0.0240 USD

ACRONYMS AND ABBREVIATIONS

AMC	Asset Management Company
BIS	Bank for International Settlements
CF	Ceska Financni
CI	Ceska Inkasni
CNB	Czech National Bank
CS	Ceska Sportelna
CSOB	Ceskolovenska Obchodni Banka
EBITDA	Earnings Before Income Tax and Dividends
EU	European Union
FED	Federal Reserve
FRA	Financial Sector Restructuring Agency
FSA	Financial Supervision Authority
GDP	Gross Domestic Product
IPB	Investicni a Postovna Banka
KAMCO	Korean Asset Management Company
KB	Komercni Banka
KONPO	Konsolidace Pohledavek
CZK	Czech Koruna
KOB	Konsolidacni Banka
MOF	Ministry of Finance
NPF	National Property Fund
OCC	Comptroller of the Currency
RA	Revitalization Agency
RTC	Resolution Trust Corporation
UNIDROIT	United Nations
UNCITRAL	United Nations Commission for International Trade Law

Fiscal Year
January 1-December 31

EXECUTIVE SUMMARY

The Unfinished Restructuring Task in the Bank and Enterprise Sectors

The Czech Republic arrived at the end of the 1990s with an unfinished transformation agenda, as indicated by the lingering problems in the major banks and in large segments of the corporate sector. The stock of non-performing loans in the balance sheets of banks and transformation institutions amounted to more than one third of total bank loans or to 26 percent of GDP at the end of 1999. The stock of tax and social security arrears was also large, amounting to about 6.5 percent of GDP at the end of the decade. The accumulation of these large bank and tax arrears was essentially due to the poor financial performance of large numbers of enterprises during most of the decade. The weak microeconomic underpinnings of the Czech economy were ultimately reflected in a poor growth performance during the second half of the decade—in the 1996-1999 period GDP grew by less than 0.6 percent p.a., despite a relatively high investment ratio (around 30 percent of GDP). The economy seems to be initiating a recovery in 2000, but the extent and depth of this recovery will depend on the extent to which the structural problems that led to this poor past performance are properly addressed.

The reasons for this unsatisfactory economic performance lies in good part in the weak internal and external mechanisms of corporate governance. The weak internal mechanisms of corporate governance have their roots in the mass coupon privatization scheme implemented in the first half of the decade, and the absence of strong capital market regulation during most of the decade. These factors allowed controlling insiders to tunnel or strip the assets of many enterprises to their own benefit, to the detriment of minority shareholders (the population at large) and the other stakeholders. The tunneling activity could have been reduced through the imposition of strong external mechanisms of corporate governance (creditor discipline). However, these mechanisms also remained weak during most of the decade due to delays in privatizing the large commercial banks, the absence of a comprehensive strategy for the workout of bad loans, and severe problems in the bankruptcy and debt enforcement frameworks.

Recent Efforts at Structural Reforms

The Czech Government has made recent efforts to improve the situation in these two broad areas. Since 1998, there has been a concerted effort to improve capital market regulation and the internal mechanisms of corporate governance. These efforts are reflected in the creation of an independent securities exchange commission, the mandatory opening of investment funds created for the mass coupon privatization scheme, and the drafting of several amendments to the Commercial Code, the Securities Act and the Accounting Act, designed to improve transparency of corporate decisions, accountability of boards, shareholder rights, and quality of reported information.

There has also been an effort to improve the external mechanisms of governance in the last two years. First, bank privatization has been accelerated, as indicated by the concluded privatization of two large banks (CSOB in May 1998 and Ceska Sporitelna in January 2000), the takeover and re-privatization of another large ailing bank (IPB in June 2000), and the expected privatization of Komerční Banka in the next few months (which will complete the bank privatization program). The institutional framework for the workout of bad loans is also being strengthened, as indicated by the imminent merger of the two most important transformation institutions, Konsolidacní Banka and Ceska Financni, and the creation of a privately-managed Revitalization Agency (a subsidiary of Konsolidacní Banka), tasked with the restructuring and privatization of large companies. Finally, there is also an effort to strengthen creditor rights, as indicated by the implementation of a new Law on Public Auctions and amendments to the Bankruptcy Law, both in May 2000.

Remaining Policy Challenges

Despite the genuine progress at structural reforms in the recent years there are still elements of the restructuring agenda that remain largely absent. This report focuses on two broad areas where further progress is needed. The first is the workout of the large stock of bad assets. The second is the legal framework for bankruptcy and debt enforcement, which still needs to be improved, despite the recent legislative improvements. The focus on these key elements of external corporate governance is justified, because the Government has been improving the other mechanisms of governance for a longer period, and also because this problem was extensively analyzed in a previous World Bank report.¹

A comprehensive strategy to deal with the large stock of bad loans is still lacking, despite the merger of Konsolidacni Banka and Ceska Financni, and the creation of the privately-managed Revitalization Agency. The preparation of the banks for privatization has already resulted in substantial transfers of bad assets to Konsolidacni Banka, and the prospects of further carve-outs from Komerční Banka (and possibly IPB) could result in a very large amount of bad assets in Konsolidacni Banka, possibly the equivalent of 15 percent of GDP, and involving more than 12,000 borrowers. The creation of the Revitalization Agency is a reasonable solution to deal with large and complex cases, but these cases amount to only a fraction of the total value of bad assets, and involve only a handful of large borrowers. There is a high risk that Konsolidacni Banka will be overwhelmed by the magnitude of the problem, that large numbers of bad debts will remain parked on its balance sheet without prompt resolution, and that enterprise restructuring will be delayed further. Even in the most extreme cases, where the debtor is already inactive and most of the assets have been stripped away, there are still some assets left (e.g., real estate) that could have better alternative uses and contribute more effectively to the performance of the Czech economy. Of course, it is even more important to act promptly in the less extreme cases where the debtor is still active and could be preserved as a going concern.

Despite the recent adoption of the new Law on Public Auctions and amendments to the Bankruptcy Law, the legal framework continues to impose obstacles to restructuring. The new Law on Public Auctions was a significant step in the right direction, as it broadens the range of property subject to non-judicial auction procedures and potentially streamlines the foreclosure process, even for collateral rights created before May 2000. If the Law is actually enforced consistent with the terms intended by policy-makers, it will likely improve financial discipline among lenders and borrowers in the future, and also allow creditors to deal more effectively with the distressed debt already on their books. The effectiveness of the new Law remains to be tested, however, particularly its application to collateral rights created before May 2000, and which apply to most of the large stock of distressed debt within the banks and transformation institutions. The applicability of the Law to the large existing stock of bad assets is particularly uncertain, given recent attempts to introduce amendments to another related law—the Law on Executions—which in the version initially submitted would have weakened substantially the Law on Public Auctions. These proposed amendments were recently rejected by Parliament, but it is possible that a revised version of the bill will be resubmitted, which could reintroduce the same or other problems again.

The recent amendments to the Bankruptcy Law raise even greater questions and concerns. The amendments have introduced some apparent improvements to liquidation procedures, such as providing for appointment of an interim trustee at the start of the procedures, strengthening creditor influence over the choice of trustees/liquidators and some of their actions, expanding the list of trustees/liquidators to include firms (as opposed merely to individuals), and introducing time bound rules in a number of specific areas. At the same time, the amendments also introduced some negative changes to the bankruptcy framework, such as vague wording in the definition of insolvency that may throw confusion

¹ World Bank (1999). *Czech Capital Market Review*. Washington DC.

in the process and reduce the incentives by debtors and creditors to resort timely to use of the process. In addition, the amendments further undermine commercial expectations in the taking of security by capping recoveries of secured creditors from the proceeds of their collateral at 70 percent of the net revenues realized. And while creditors are on the one hand, offered the opportunity for stronger voice in the process, that voice can be silenced if the courts in their subjective determination decide to replace the committee.

In addition to this combination of positive and negative changes, the amendments to the Bankruptcy Law failed to address some important weaknesses of the bankruptcy framework. The amendments focused on changing the liquidation part of the law, and did not deal sufficiently with the reorganization of potentially viable enterprises. The Bankruptcy Law contains an entire section on composition or reorganization, but this section remains virtually unused and unusable. This means that a functional and efficient scheme for rescuing potentially viable enterprises is still missing in the Czech Republic. The recent amendments also failed to improve the institutional and regulatory framework for insolvency, that is, the organization of the courts, court procedures, and the regulation of the activities of all the professionals working in the system. These are essential components of an efficient bankruptcy system, and the lack of more progress in this area may continue hindering the overall progress at restructuring.

Completing the Transformation of Banks and Enterprises

The successful completion of the restructuring task in the Czech Republic will require progress in two broad areas. The first is the design and implementation of a strategy to transfer the classified claims to the agents with the best incentives and skills for working them out. The second is the implementation of further legal reforms designed to promote restructuring of viable enterprises through informal and formal channels, to transfer the assets of unviable enterprises to alternative users, and to promote new lending by reducing the uncertainty to banks and other creditors.

Regarding the workout challenge, the best option for the Czech Republic is to follow a diversified, multi-track approach, under which the heavy burden of debt workout is distributed among many players in the economy. As in the case of other countries that have faced a similar problem, the optimal workout solution will probably include a centralized component to deal with large and complex workout cases, and several decentralized components to deal with the very large number of medium and small enterprises. It is important to maintain the centralized component limited in size, in order to ensure effective progress in workout, and to shield it from political interference. In this regard, the model adopted by the Revitalization Agency is a reasonable one, because it limits the scope of the agency to a reasonable number of enterprises, and also because it outsources management to the private sector. This model could be expanded to an additional group of large enterprises.

The centralized component would involve the workout of a limited number of large debtors, whereas the remaining part of the stock of bad loans (involving nearly 12,000 enterprises holding smaller debts) would be dealt with in a decentralized way. The design of the decentralized components would depend primarily on the size of the claims and the economic and legal status of the debtor. The best solution probably involves the auctioning of these claims after proper bundling and pooling. The claims could be bundled either at the company level or at a more aggregate, sectoral level, depending on the interests of potential investors. The claims that do not find buyers would be dealt with by outsourcing management and collection to the private sector. The claims on enterprises that are already under bankruptcy procedures probably do not require any hard financial or operational restructuring, just liquidation of collateral. These claims would be pooled on a regional basis (classified according to court districts) and managed by law firms. Konsolidacni Banka would retain a very important role during the

whole workout process, by organizing tenders and auctions, writing the management contracts, and supervising them.

The second major component of the reform agenda is the design of a coherent package of legal reforms, designed to remove legal obstacles to the restructuring of viable enterprises, as well as the prompt liquidation of non-viable enterprises. The implementation of a coherent package of legal reforms would also increase investor interest in classified claims and should be seen as a pre-condition for developing a secondary market for these claims. This package should contain three major elements: (i) improving further debt enforcement mechanisms outside bankruptcy, including *inter alia*, more efficient and summary judicial procedures for obtaining judgments and executions/sale for collateral and by ensuring that the new Law on Public Auctions produces the intended effects for non-judicially supervised procedures; (ii) strengthening further the bankruptcy framework, by introducing further improvements in the liquidation track, a faster, streamlined reorganization track, and by improving the institutional and regulatory framework for bankruptcy; and (iii) introducing other complementary changes in other legislation to remove remaining obstacles to workouts and enterprise restructuring.

As mentioned before, the new Law on Public Auctions is expected to improve debt enforcement outside bankruptcy, and is important to ensure that the Law produces the intended effects. In this regard, it is essential to avoid changes in related pieces of legislation, such as the Law on Executions, that could reintroduce obstacles to foreclosures and undermine the objectives of the new Law on Public Auctions. In fact, the authorities should make efforts to expand the range of collateral further, to include receivables and inventory used in an operating business. That will require modifying the concept of possessory pledge, so that the delivery of possession by the debtor to the creditor is not mandatory, thus allowing the debtor to continue using the movable assets for its normal business operations. Also necessary is a system of public notice, normally through a public register, in which the existence of the collateral can be recorded, substituting for the current requirement that movables be specifically identified.

Another major task in the area of legal reforms involves improving the bankruptcy framework further. The liquidation track could be improved further by clarifying the definition of insolvency and other commencement rules, strengthening and clarifying further creditor rights, particularly the rights of secured creditors, and by introducing time bound rules in the various stages of the liquidation process. Balancing better the rights of secured and unsecured creditors in bankruptcy (in favor of secured creditors) will prove essential to reduce the risks in lending and contribute to lower interest rates and a greater access of enterprises to credit. This will require adopting solutions that allows unsecured creditors to maximize the collection of their claims, but always preserving the full value of the claims on secured creditors.

One of the greatest challenges faced by Czech policy-makers is the development of a functional reorganization scheme for rescuing potentially viable enterprises. Nearly all countries facing situations of generalized corporate distress also had to face this challenge. In most cases, the reorganization activity was conducted through three main avenues or tracks. First, debtors and creditors were encouraged to engage in purely informal, voluntary, non-binding, out-of-court negotiations. This informal and non-binding environment did not work well in many cases, however, leading the authorities to introduce a second, more formalized reorganization scheme, but still outside the court system. Finally, in all countries there was also a parallel effort to improve court-led reorganization procedures.

The Czech authorities might also consider introducing a formal, but streamlined restructuring mechanism, designed to handle many workouts in a relatively short period of time. One attractive option that may be considered involves the introduction of a fast restructuring track, operating with very streamlined procedures, but relying on a final approval by the court. This option formalizes what are in essence consensual out-of-court negotiations, and may prove the most attractive option for the Czech

Republic, for many reasons. First, it may prove more effective in coordinating the actions of many creditors, including State creditors and commercial creditors. Second, it will contribute more effectively to the needed development of the court system in the long-run. Third, it may also prove more effective in preventing perverse signals and misperceptions of a bailout by debtors (a common problem faced when introducing out of court schemes). The introduction of a fast reorganization track could be achieved through a pilot program, involving initially restricted entry criteria, and a pre-selected number of courts and judges. The pilot program would be extended over time to cover a larger number of courts, and would be eventually extended so as to cover the whole court system.

Developing the bankruptcy framework also involves developing further the organization of the court system and regulating the professionals working in the bankruptcy system, such as judges, trustees, liquidators, accountants, restructuring specialists, and asset valuers. This will include improving and standardizing court procedures, training judges and liquidators in modern restructuring techniques through formal courses and the elaboration and dissemination of handbooks and manuals, and introducing stricter certification/educational requirements for all the professionals working in the bankruptcy system.

Finally, the introduction of a coherent package of legal reforms may also require changes in other pieces of legislation, such as the Commercial Code, the Civil Code, and several Tax Laws, such as the Law on the Tax Treatment of Reserves and Provisions, the Income Tax Law, and the Law on Tax Administration. The purpose of these changes is to ensure that there are no conflicts between different pieces of legislation, and that all the obstacles to workout activity and restructuring are removed, whether this activity is conducted inside or outside the court system. For example, changes in the Commercial Code may be needed to facilitate debt-equity swaps in bankruptcy (the Commercial Code requires the consent of shareholders for debt-equity swaps, even in situations where the value of equity is effectively zero or negative). Changes in tax laws may also be needed to allow for the recognition of actual credit losses for tax purposes, and encourage agreements between creditors and debtors. This is particularly true for agreements conducted outside the court system, as loan write-offs and debt-equity swaps may be severely taxed when conducted out-of-court.

1. INTRODUCTION

1.1. The Unfinished Restructuring Task in the Bank and Enterprise Sectors

The Czech Republic arrived at the end of the 1990s with an unfinished transformation agenda, as indicated by the clear signs of distress in the major banks and in large segments of the corporate sector. The stock of non-performing loans in the balance sheets of commercial banks and special transformation institutions amounted to more than one third of total loans or to 26 percent of GDP at the end of 1999, one of the highest ratios in the region. The stock of tax and social security arrears was also large, amounting to about 6.5 percent of GDP. There is no reliable information on inter-enterprise arrears, but these are also perceived to be large. These large bank, tax and commercial arrears were essentially due to a poor average financial performance of the corporate sector and involved many enterprises—the number of problem borrowers in the banks and transformation institutions amounted to around 12,000 at the end of 1999.

The weak microeconomic underpinnings of the Czech economy were ultimately reflected in a poor growth performance during the second half of the decade—in the 1996-1999 period GDP grew by less than 0.6 percent p.a., despite a relatively high investment ratio (around 30 percent of GDP). The slowdown in economic activity became even more pronounced at the end of the decade, when the economy experienced negative growth rates (–2.3 percent in 1998 and –0.2 percent in 1999). The economy seems to be initiating a recovery in 2000, but the extent and depth of this recovery will depend on the extent to which the structural problems that led to this poor past performance are properly addressed.

The reasons for this unsatisfactory past economic performance lies in good part in the weak internal and external mechanisms of corporate governance. The weak internal mechanisms of corporate governance have their roots in the mass coupon privatization scheme implemented in the first half of the decade, and the absence of strong capital market regulation during most of the decade. These factors allowed controlling insiders to tunnel or strip the assets of many enterprises to their own benefit, to the detriment of minority shareholders, workers and creditors. It must be noted that minority shareholders comprised large numbers of small investors (the population at large), which had bought the coupons and had invested, directly and indirectly (though privatization funds created during the mass coupon privatization program) in the enterprises.

The tunneling activity could have been reduced through the imposition of strong external mechanisms of corporate governance, or strong creditor discipline. However, the external mechanisms of governance also remained weak during the decade. For one, bank privatization was surprisingly assigned a very low priority in the Government's reform agenda. These banks remained subject to political influence and poor governance, and did not exert any significant pressure on their delinquent debtors. Also, although relatively large amounts of bad loans were carved out of the banks and transferred to special transformation institutions, these actions were ad hoc, fragmented, and non-transparent, and were not accompanied by the implementation of a coherent workout strategy. Finally, the lack of creditor discipline was also due to severe problems in the bankruptcy and debt enforcement frameworks. Creditor rights remained weak during the decade, leading to creditor passivity, and to a relaxed payments culture.

1.2. Recent Efforts at Structural Reforms

The Government has made recent efforts to improve the situation in these two broad areas. Since 1998, there has been a concerted effort to improve capital market regulation and the internal mechanisms of corporate governance. These efforts are reflected in the creation of an independent securities exchange

commission, the mandatory opening of investment funds created for the mass coupon privatization scheme, and several amendments to the Commercial Code, the Securities Act and the Accounting Act, designed to improve transparency of corporate decisions, accountability of boards, shareholder rights, and quality of reported information.

More recently, there has also been an effort to improve the external mechanisms of governance. First, bank privatization has been accelerated, as indicated by the concluded privatization of the Foreign Trade Bank (CSOB) in May 1999, the privatization of the Savings Bank (Ceska Sporitelna—CS) in February 2000, and the expected privatization of the Commercial Bank (Komerční Banka—KB) in the next few months (which will conclude the privatization program). Moreover, the Government also took over and re-privatized the Investment Bank (IPB) in June 2000. IPB is a large ailing bank that had been sold in 1997 without proper restructuring to a financial investor without experience in banking.

The institutional framework for the workout of bad loans is also being strengthened, as indicated by the creation of the Revitalization Agency (a subsidiary of Konsolidacní Banka) in late 1999 and the merger of the two most important transformation institutions, Konsolidacní Banka and Ceska Financni, in June 2000. The Revitalization Agency was tasked with the restructuring and privatization of a small number of large and complex companies, and was legally structured so as to insulate it from political pressure (among other features, management of the Agency has been outsourced to a reputable international investment firm). The creation of the Revitalization Agency was the first step towards the implementation of a coherent workout strategy. The merger of the two most important transformation institutions was a second positive step, as this merger will reduce unnecessary fragmentation, enable a more efficient use of scarce resources in workout activities, and also the design of more efficient solutions.

Finally, there is also an effort to strengthen creditor rights, as indicated by the implementation of a new Law on Public Auctions and several amendments to the Bankruptcy Law, both in May 2000. The Law on Public Auctions is expected to broaden the range of collateral and streamline enforcement procedures, while the amendments to the Bankruptcy Law have strengthened creditor rights in some important areas, such as greater control of creditor over the selection and the actions of the liquidator. These measures may be considered as important steps towards more efficient debt enforcement and insolvency systems.

1.3. Identifying Unfinished Reforms

Although the recent progress at structural reforms is commendable and should generate efficiency gains for the Czech economy, there are still important elements of the restructuring agenda that remain largely absent. This report focuses on two areas where further progress is needed. These comprise the workout of the large stock of bad assets and the legal framework for bankruptcy and debt enforcement, which still needs further improvements. The focus of the report is justified, because the Government has been improving the internal mechanisms of governance for a longer period (the first important reforms in this area were initiated in the first half of 1998), and also because this problem was extensively analyzed in a previous World Bank report.²

Although the merger of Konsolidacní Banka and Ceska Financni, and the creation of the privately-managed Revitalization Agency are to be commended, a comprehensive strategy to deal with the large stock of bad loans is still missing. Creating the Revitalization Agency was a reasonable solution to deal with large and complex cases, but these cases amount to only about 10 percent of the total value of bad assets, and involve only 9 large borrowers. Konsolidacní Banka and its subsidiaries still face the

² World Bank (1999). *Czech Capital Market Review*. Washington DC.

challenge of working out a large volume of bad debt (around 15 percent of GDP) involving around 12,000 borrowers.

There is also a risk that the legal framework will remain hostile to restructuring and lending activities, even after the recent adoption of the new Law on Public Auctions and the amendments to the Bankruptcy Law. The effectiveness of the new Law on Public Auctions remains to be tested, particularly its application to collateral rights created before May 2000, and which apply to most of the large stock of distressed debt in the banks and transformation institutions. Moreover, the range of enforceable collateral remains restricted, hindering the access of enterprises to credit. The recent amendments to the Bankruptcy Law raise even greater questions and concerns. The amendments did improve creditor rights in some important areas, but also introduced some questionable changes and also failed to address important weaknesses, such as the lack of a functional scheme for rescuing viable enterprises.

1.4. Objective and Structure of the Report

The objective of this report is to assist the Czech authorities in their ongoing efforts to improve the overall institutional and legal framework for the restructuring of distressed enterprises and for new lending as well. With this main objective in mind, the report was divided into two main sections. Section 2 examines the workout challenge. It reviews the progress at bank privatization, examines the size of the bad debt problem and the status of the workout institutions, and proposes a workout strategy for the Czech Republic that combines centralized and decentralized elements. Section 3 examines the legal framework for restructuring and lending. It starts by reviewing debt enforcement mechanisms outside bankruptcy. This is followed by a detailed analysis of the main problems in the bankruptcy framework and the changes introduced by the recent amendments. Finally, it provides a number of recommendations for improvements in the bankruptcy framework, including further improvements to the liquidation track, the introduction of a streamlined reorganization track designed to rescue viable enterprises, and improvements in the institutional and regulatory framework for bankruptcy.

The report also contains three annexes that address in detail specific issues related to the restructuring challenge. Annex 1 provides an analysis of seller financing schemes that could be used in implementing a workout strategy. Annex 2 provides an analysis of the changes in banking regulation that would facilitate restructuring and strengthen the lending environment. Finally, Annex 3 provides a more detailed analysis of the institutional and regulatory elements of a bankruptcy system, and also provides a number of recommendations for improvements in this area.

2. THE INSTITUTIONAL FRAMEWORK FOR WORKOUT AND RESTRUCTURING

2.1. Introduction

The delays in privatizing the major State banks, the lack of political resolve to deal with enterprise restructuring, the absence of sufficient technical capacity in State banks and workout institutions, and the failure to improve the legal framework for debt enforcement and restructuring, contributed together to the persistence of the bad loan problem in the Czech Republic. By the end of 1999 total classified assets amounted to around 26 percent of GDP, excluding tax arrears, indicating clearly that the bad loan problem had not been properly addressed during the decade.

Whereas there has been more progress in privatizing the banks since 1998, it was only during 1999 that the authorities stepped up their efforts to deal with the bad loan problem. The purpose of this section is to contribute to this effort by reviewing the current situation and proposing viable solutions. As elaborated below, the design of a workout strategy for the Czech Republic needs to consider five major factors: (i) the need to finalize bank privatization; (ii) the very large volumes of bad assets to be worked out; (iii) the wide distribution of the bad assets by size, number and underlying borrower; (iv) the lack of capacity of any single institution to deal directly with a large number of cases and assets; and (v) the obstacles that have been created by the existing legal and tax framework for workout and restructuring activity.

This section proposes a workout strategy for the Czech Republic that takes into consideration this constrained initial environment. The section starts by reviewing the current status of bank privatization. This is followed by a discussion of the current situation in the three State workout institutions. The most common workout and bank privatization strategies are then reviewed, highlighting the strong and weak aspects of each of these strategies. Finally, the section outlines a proposal for a workout strategy designed to address the problems now faced in the Czech Republic.

2.2. The Status of Bank Privatization and the Problem of Classified Assets

Progress in Bank Privatization³

Progress in bank privatization proceeded at a very slow pace until end-1997. Although the share of the private sector in the largest banks amounted formally to 30-50 percent of equity, this partial privatization was achieved primarily by mass coupon methods, and did not generate any improvements in corporate governance. By that date, the State still had effective control over the four largest banks accounting for nearly 60 percent of total bank assets. This group of large banks included the Commercial Bank (Komerční Banka—KB), the Savings Bank (Česká spořitelna—CS), the Investment Bank (Investiční a Poštovní Banka—IPB), and the Foreign Trade Bank (Československá Obchodní Banka—CSOB). In March 1998, the first major bank privatization was concluded, with the sale of IPB to Nomura, but the bank had not been properly restructured, and the transaction proved to be controversial, especially for the absence of a strong strategic investor (Nomura was a financial investor with no track record in banking). By the end of that year, progress in bank privatization remained unsatisfactory, with three banks accounting for half of bank assets still under State control, and growing disappointment over the results of IPB's privatization.

³ This section does not provide extensive background information on the Czech banking sector and the problem of non-performing loans. For this purpose, see the Country Economic Memorandum for the Czech Republic: *Czech Republic: Toward EU Accession*. The World Bank (1999).

The failure to restructure the State banks and sell them to strong strategic investors was probably driven by the initial reluctance of the Government to accept explicitly the large fiscal costs of restructuring, its initial aversion to foreign strategic investors in the large banks, and also its reluctance to recognize the failure of coupon privatization to improve the governance of enterprises and banks. The Social Democratic Government elected in mid-1998 had been very critical of mass coupon privatization, and implemented an economic program that assigned a much greater priority to fiscal transparency and sound bank governance. The first real evidence of the change in economic policy occurred in May 1999, when CSOB was sold to a Belgian bank (KBC). This was followed by the sale of CS to an Austrian bank (Erste Bank) in February 2000. In mid-2000 the Government and the Czech National Bank intervened in IPB, after it became clear that the bank was insolvent and illiquid, and re-sold it to CSOB-KBC. Finally, the privatization of KB was delayed by the revelation of fraudulent practices and the start of criminal investigations, but the Government still expects this bank to be privatized by end-2000 or early 2001.

The acceleration of bank privatization was only made possible by the Government's willingness to recognize explicitly the losses accumulated by the large State-controlled banks. In 1998, CSOB's balance sheet was already clean, due to the previous transfer of bad claims to Ceska Inkasni (CI—one of the three workout institutions), and the bank did not require any additional restructuring for privatization. However, as shown in Table 1, both CS and KB were still substantially loaded with classified assets, despite the transfer of many bad claims to Konsolidacni Banka (KOB—the largest workout institution) in the early 1990s. In support of the privatization of these two banks, considerable quantities of bad assets have been carved out or ring-fenced. In November of 1998 (two months before its privatization), CS's balance sheet was substantially restructured through two major operations with KOB. The first involved the transfer of CZK 21 billion (CZK 33 billion gross) of classified assets to KOB. The second involved the provision of a guarantee by KOB on CZK 75.5 billion (CZK 84.7 billion gross) of classified assets which remained on CS's balance sheet after privatization. The classified assets that remain with the privatized bank are expected to be worked out under the terms of an incentive-based management contract.⁴

The preparation of KB for privatization has so far involved two transfers of classified assets to KOB. In August 1999, CZK 13.6 billion (CZK 23.6 billion gross) of assets were transferred directly to KOB. These assets were considered to be the worst of KB's portfolio, with an estimated market value of only CZK 0.4 billion. In March 2000, KB transferred CZK 36 billion (CZK 60 billion gross including off balance sheet items) to a special purpose corporate vehicle—Konpo—which has subsequently been acquired by KOB. In the second half of 2000, KB expects to use external auditors to conduct a credit diagnostic of its remaining assets. One consequence of this exercise may be the identification of possibly large quantities of mis-classified assets which will require either carving out or ring fencing prior to privatization.

One important lesson from the CS privatization is that the attractiveness of a bank for reputable strategic investors has an inverse relationship with the quantity of classified assets which will remain on its balance sheet. In the event that KB's credit diagnostic reveals further large quantities of classified assets, the experience with bank privatization in the region suggests that the Government should consider carving out these assets in order to attract better buyers. This is particularly true in the case of KB, as the bank has already transferred most of its own workout capacity to Konpo—roughly 160 employees were transferred to Konpo, in order to enable this institution to handle the large volume and number of classified assets (involving 2,000 debtors and 5,000 credit files).

⁴ For reasons of confidentiality, Bank staff has not reviewed the terms of the CS asset management contract in detail. However, a general discussion of the incentives and put and call options involved in the contract indicated that KOB management has addressed most of the usual problems in these contracts.

Table 1: Classified Assets in All Commercial Banks, KB and CS, as of March 31, 2000 (Excluding KOB, CF, and CI, in CZK Million)

Classification	Total Banks	KB	CS	KB and CS	KB and CS (% of total)
Standard	618,190	99,660	67,602	167,262	27.1
Watch	88,600	34,885	17,941	52,826	59.6
Substandard	32,600	10,441	7,490	17,931	55.0
Doubtful	31,500	4,263	1,920	6,183	19.6
Loss	91,800	9,032	19,550	28,582	31.1
Total Loans	862,690	158,281	114,503	272,784	31.6
Total Classified	244,500	58,621	46,901	105,522	43.2
Total 3 to 5	155,900	23,736	28,960	52,696	33.8
Classified/Total (%)	28.3	37.0	41.0	38.7	
3 to 5/Total (%)	18.1	15.0	25.3	19.3	
3 to 5/Classified (%)	63.7	40.5	61.7	49.9	
Classified Loans/ GDP (%)	12.8	3.1	2.5	5.6	
3 to 5/ GDP (%)	8.2	1.2	1.5	2.7	

Note: 1/ The total volume of classified loans may be underestimated by continued recording of KOB-guaranteed classified loans at CS; and, (b) possible misclassification of standard and watch loans at KB.

Sources: CNB, KB, CS

The Status of the Three Workout Institutions

As mentioned before, three workout institutions were created in the 1990s to deal with the problem of classified assets—Konsolidacni Banka (KOB), Ceska Financni (CF), and Ceska Inkasni (CI). Created in the early 1990s, KOB is the oldest and the largest of the three workout institutions. It has continued to play a central role in financing the recapitalization of the State banks, both by direct injections of capital and by carving out assets at above-market values. As a result of these assistance transactions, KOB's stock of classified assets grew from CZK 90.2 billion at the end of 1998 to CZK 125.5 billion at the end of 1999. As indicated in Table 2, the stock of classified assets held by KOB increased further to CZK 212 billion by June 2000 (the equivalent of 12 percent of GDP) and could increase even further to between CZK 259 to 279 billion by June 2001, as a result of additional purchases of classified assets from KB and CS. It should be noted that these numbers do not include possible transfers of classified assets from IPB to KOB.

As shown in Table 2, the most recent increase in the assets held by KOB was due to the merger with CF, which had been set up in 1997 to assist in the resolution of the small bank crisis through the CNB-administered stabilization and consolidation programs.⁵ Before the merger, CF's portfolio consisted of about CZK 50 billion of assets covering 1,400 debtors. The total portfolio comprised about CZK 5 billion of claims in bankruptcy proceedings, CZK 25 billion of claims against inactive (dead)

⁵ See *Czech Republic: Toward EU Accession*, pages 110 -114 for a description of the origins and purposes of CF and CI.

companies, CZK 5 billion of claims which have been restructured with the agreement of the debtor, and a further CZK 15 billion of claims against functioning enterprises with which CF had not reached agreement on restructuring.

**Table 2: Projected Development of Konsolidacni Banka's Classified Assets
(CZK Billion)**

Item	Purpose	Date	Gross Book Value
Opening Balance		12/1999	126
Transfer from KB (Konpo)	Interim recapitalization of KB	03/2000	36
Merger with CF	Consolidation of workout capacity	06/2000	50
Transfer from KB	Privatization of KB ⁶	01/2001	40-60
Estimated CS Put		06/2001	7
Closing Balance		06/2001	259-279

Source: Management of KB, CS, and KOB.

CI has about CZK 27 billion of assets under management (these assets are effectively managed by CSOB under the supervision of the MOF). It has been proposed that CI be merged with KOB in 2001. However, unlike the case of CF, the assets held by CI may not be suitable to the workout solution described below, because they are primarily related to international trade receivables subject to either international litigation/arbitration or are the subject of State level bilateral negotiations. Therefore, continuing the present management arrangement between the MOF/CI and CSOB (or continuing the contract with CSOB if title to the CI assets is transferred to KOB) may be the most appropriate solution for the resolution of these assets.

The Revitalization Agency

In 1999, KOB created a special subsidiary, the Revitalization Agency (RA), to deal with a limited number of large and complex cases. The RA's mandate includes selecting companies for its portfolio; purchasing their debt and/or equity at fair market value; managing and restructuring these assets to minimize fiscal costs; and maximizing revenues from asset sales.

To insulate the RA from political interference, its management was outsourced to the private sector and an independent Investment Committee was also created. In October 1999, a consortium led by Lazard Brothers was selected by competitive tender to manage the RA, and has been encouraged to base much of its compensation on success fees or equity participation.⁷ The Board of Directors consists of 2 members appointed by KOB and 3 members appointed by the Manager, including the CEO and Chairman. The Board submits restructuring plans and proposes divestiture/sale transactions for portfolio companies to the Investment Committee for approval. Approved plans and transactions are overseen by the Board. The Supervisory Board, which consists of Government appointees chaired by a Ministry of Industry representative, is responsible for monitoring RA's activities. However, the Supervisory Board is barred from involvement in specific portfolio companies and transactions. The Investment Committee for the RA consist of the 5 Board members plus 4 independent workout or financial specialists and/or

⁶ Staff estimates of misclassified assets based on estimated portfolio cash-flow.

⁷ The management services agreement is confidential. However, general information that has been disclosed states that the RA will provide 90 days worth of fees for the Manager to conduct due diligence on companies that might be accepted into the RA portfolio. After its provisional selection, the Manager would agree with the Investment Committee on a starting valuation for selected companies and on the formula(e) for success fees to be paid from eventual sale/disposition.

shareholders of RA. The Committee reviews/approves restructuring plans and proposed divestiture/sale transactions.

The selection of assets purchased by the RA has been based on the following criteria:

- A forward-looking assessment that the debtor company is viable;
- The willingness of the debtor company's management to cooperate with the RA;
- Consent by existing shareholders to substantial dilution of their equity position;
- Likelihood that other creditors will agree on a restructuring plan;
- More than 2000 employees;
- Local procurement in excess of CZK 1 billion;
- Total classified loans at KOB, KB, and CS in excess of CZK 3 billion; and
- Positive EBITDA

Based on these criteria, 8 companies have been included in the RA's portfolio, as indicated in Table 3. The RA seems to be operating fairly well, in the sense that it has been fulfilling its mandate apparently insulated from political pressure. However, this initial success was to a large extent due to a drastic limitation of the number of companies in its portfolio. It would be possible to replicate the RA model to restructure an additional number of large companies. However, the total number of enterprises restructured along these lines would still need to be moderate, as this type of restructuring is relatively costly and time consuming, only being justified for large and complex cases.

Table 3. Revitalization Agency Companies
(Financial data in CZK millions)

<u>Company</u>	<u>Staff</u>	<u>KOB NPLs</u>	<u>Total Debt</u>	<u>EBITDA</u>	<u>Largest Shareholder</u>	<u>%</u>	<u>Second Shareholder</u>	<u>%</u>
Aliachem	9,000	2,365	4,971	n.a	Chempol	23	Aliachem	17
CKD Praha	12,200	>3,000	n.a	n.a	Inpro	39	Deutsche Bourse	26
Hutni montaze								
Spolana	3,275	1,430	3,566	670	FNM	37	Chemapol Group	29
Skoda Plzen	14,042	>3,000	n.a	n.a	NERo s.r.o.	23	Deutsche Bourse	19
Tatra	3,800	3,600	n.a	n.a	Skoda	43	-	-
Vitkovice(1)	3,131	n.a	5,297	2,098	FNM	67	-	-
Zetor	2,241	2,120	2,590	95	KOB	50	Motokov	48
ZPS Zlin	3,400	n.a	n.a	n.a	SIS fund	21	Ceska Pojistovna	19

(1) Figures exclude CZK 500 million loan from KOB and conversion of CZK 1.7 billion debt into equity to give KOB a 12% holding.

The problem of classified loans constitutes a very important challenge for policy-makers, and the RA solution can only be realistically expected to cover a relatively small fraction of the total. Indeed, in March 31, 2000 the total size of classified loans in the banks and workout institutions amounted to approximately to CZK 483 billion, or the equivalent of 26 percent of GDP, involving more than 12,000 cases.⁸ The RA is currently handling 8 large cases, amounting to less than 10 percent of the total volume of classified loans. Even if the RA model were applied to an additional number of large enterprises, there would still remain a large volume of classified assets in need of restructuring and resolution.

⁸ Approximately CZK 244 billion at the banks, CZK 212 at KOB, and CZK 27 at CI.

It must be noted that the total volume of classified loans could be increased by a further CZK 40-60 billion, if KB management's assessment of the potential misclassification of that bank's portfolio proves to be accurate. Excluding loans in the second category (watch) the number is still impressive: about CZK 395 billion or 21 percent of GDP. The overall debt problem in the corporate sector is even greater considering the large stock of tax, social security and health contribution arrears, which reached roughly CZK 120 billion at end-1999, or the equivalent of 6.5 percent of GDP. There is no reliable information on the size of inter-enterprise arrears, but these are also perceived to be large. The large value of total non-performing assets and the large number of enterprises involved indicate the need for a more diversified solution, of which the RA model is just one (although important) component. The sections below examine the most common options and outline a solution for the Czech Republic.

2.3. Institutional Arrangements for Workout Operations - Common Options

Introduction

A large part of the assets requiring work out in transition economies originate in the balance sheets of banks.⁹ This sub-section discusses: (a) the three major models for sterilizing classified assets on banks' balance sheets in the context of bank privatization; and, (b) the main strategies employed in workout programs. This discussion of common options is useful, not only because of its general relevance to other countries in Central and Eastern Europe, but also because it helps clarify the particular strategy that is proposed for the Czech case.

Bank Privatization and the Sterilization of Classified Bank Assets

Privatization transactions can be structured in three main ways, each of which has an impact on the ultimate net cost of the transaction to the State. This sub-section discusses the three options commonly used for the sterilization of classified asset and the impact on the costs of the privatization transaction of each.

The "Write Off and Sell" Transaction. The privatization transaction is structured as an "as is and where is" no-recourse sale:¹⁰

- The purchaser performs very extensive due diligence and seeks to identify all assets which it believes (or can convince the seller to believe) have a risk of loss. If more than one bidder is competing, it is usually possible to structure a set of rules for asset valuation. If only one bidder is present, then every valuation may become a subject for negotiation.
- The bank then writes off its capital through provisions against these potential losses.
- If capital is negative after the provisions have been taken, the State contributes sufficient capital to bring it to at least zero net worth, and the purchaser takes control by means of a new capital subscription.
- Post-privatization, the new owner of the bank is free to maximize value from the provisioned assets. In the event that he is able to extract value from these assets above their purchase price, the gains are a windfall profit from the transaction.
-

⁹ The other main sources (often involving the same debtors) are tax and social security arrears.

¹⁰ This type of privatization is also sometimes referred to as a whole bank transaction. Note that the first privatization of IPB was a variant of this method.

The transaction structure has positive features from the perspective of the State:

- If undertaken under conditions of competitive bidding, the purchaser is likely to incorporate some portion of its estimate of the liquidation value of the classified assets in the price paid for the bank. The State can influence the valuation of classified assets by improving the legal environment for work out operations.
- The State faces no post-privatization administrative demands to administer or oversee the liquidation of the classified assets.
- The purchaser may move ahead as rapidly as possible with working out assets (if some classified asset risk is retained), providing impetus to the process of enterprise restructuring.

On the negative side, the risks of this type of structure are well understood:

- Significant opportunities may arise for a technically skilled purchaser to secure classified assets at valuations far below realizable economic value (windfall profits).
- Post-privatization events such as a change in the legal environment may occur, again providing potential windfall profits to the purchaser.
- For assets which are retained at zero net book value, the purchaser has no incentive to incur the administrative costs of work out. With some exceptions (where the purchaser sees potential for significant capital gains), the bulk of the portfolio may be left to rot.
- Purchasers require very extensive due diligence (as risks are to be retained on balance sheet), slowing down the privatization process and increasing the risk of a single bidder negotiation as potential purchasers decide that the costs of due diligence are not acceptable without the certainty that a transaction will result.

The “Carve In” or “Ring Fence” Transaction. The bank privatization is structured so that the classified assets of the bank remain on the balance sheet of the bank but under a state guarantee - the “carve in” or “ring fence” method. Under this strategy, the purchaser may also receive the right to “put” additional assets which become classified during a defined time period to the seller. The transaction may also be structured with a “call” provision which allows the purchaser to buy back assets from the classified asset pool according to previously agreed pricing rules. The bank receives a contract to manage the classified asset pool post-privatization, and is paid a management fee plus incentive fees to administer and work out the assets.

This transaction structure can be attractive to acquirers in that it allows the purchase of the bank on a “clean” balance sheet basis (because the classified asset risk is sterilized by a State guarantee), and the fees arising from management of the classified assets may provide a substantial source of income to enhance the profitability of the post-privatization bank. However, some purchasers may find the structure unattractive because they desire to make a clean start for the bank without the negative publicity which inevitably results from involvement in work out activities.

From the perspective of the State, the carve in transaction structure has some attractive features:

- The potential use of a State guarantee allows initial cash outlay to be restricted.

- The State retains beneficial ownership of the classified assets and so captures the benefit (net of costs and incentive payments) of any value realized from them. The bank purchaser cannot capture windfall profits from these assets if the management contracts are well structured.
- If the incentives in the asset management contract are structured correctly, the State will receive the benefit of private sector asset management skills and significantly higher net proceeds from liquidation than if it attempted to carry out this activity itself (particularly if the state lacks a pre-existing skills and resource base for this purpose).

On the negative side, the transaction poses significant risks to the state:

- The incentive structures incorporated in an asset management contract are extremely complex. If incentives are incorrectly structured, the State may find itself paying substantial fees to an asset manager pursuing a “do nothing” strategy.¹¹
- The incorporation of asset put and call features requires the State to maintain the technical ability to challenge puts and correctly value calls. In the event that errors are made in the structuring of either of these features the bank purchaser may be able to either (a) engage in risk-free speculation; or, (b) capture the economic benefit of improvements in external circumstances at the State’s expense.
- Asset management contracts normally require the state to maintain an institutional oversight structure capable of defending its interests during the life of the asset management contract.
- Where the classified assets are retained under guarantee on the bank’s balance sheet substantial tax benefits may accrue to the purchaser, a problem which may need to be addressed via an administratively complex synthetic tax estimation agreement.

The “Carve Out” Transaction. The “carve out” transaction has been the most commonly used pre-privatization technique for cleaning up a bank balance sheets in transition economies. In this transaction, the classified assets of the bank are transferred from the bank to a State institution in exchange for either cash or government securities, or a combination of both. The new owner of the bank has no further connection with the assets involved, although in some instances the bank continues managing the assets for a period of time. This structure can also incorporate asset “put” provisions which allow the bank to transfer additional assets to the State over time according to agreed rules.¹²

The structure has several advantages from the State’s perspective:

- Most bank acquirers view this as an attractive structure. They are able to acquire the bank on a clean basis and the skilled personnel and management time required for work out activities can be re-focussed on developing the “new” bank.
- The costs of the privatization transaction are very transparent.

¹¹ The Federal Savings and Loan Insurance Corporation’s Southwest Plan of the early 1980’s had precisely this result, despite that institution’s extensive resources.

¹² The privatization of CS involved a combination of the carve-out and the ring-fence methods.

- If rights to put additional assets to the State are well structured,¹³ the bank will have stronger incentives to work on questionable assets¹⁴ to avoid the costs of putting them to the State.
- The structure allows the State to resolve the issue of how to work out the carved out assets outside the context of the bank's privatization. It can therefore attempt to optimize its workout strategy without the constraints imposed by incorporating workout arrangements in the privatization transaction.

The negative aspects of the transaction from the State's perspective are:

- The transparency of the structure requires that the costs of the privatization transaction must be recognized and covered "up front" (although the use of government securities can be used to reduce the budgetary impact).
- The State must have a well thought out strategy for working out the carved out assets. These assets will deteriorate rapidly if they are not worked out, increasing the net cost of the transaction.
- If asset puts are incorporated into the structure, the State must maintain the technical ability to challenge them. In the event that errors are made in the structuring of put rights, or the State lacks the technical ability to challenge puts successfully, then the bank may be able to engage in risk-free speculation at the State's expense.

Workout Strategies

The discussion of workout strategies in Central Europe and elsewhere usually centers in three main models: (i) a centralized, usually State-sponsored, institution is employed as the primary workout entity, following a thorough carve-out of bad loans from the banks undergoing privatization; (ii) a bank-led solution, where banks are either privatized using the "write-off and sell" approach discussed above, or the banks manage the assets sterilized under a carve-in method; or, (iii) a mixed approach is used where some assets are managed directly by a State workout unit after their carve-out, some are actually acquired by the new owner as part of the privatization transaction (write-off and sell), and handled by the new owner, some are also handled by the bank, but under a contract using "carve in" privatization, some are sold directly to private sector investors, and some are managed in a quasi-private fashion by private sector firms working under contract to the State.

Centralized Strategy. The use of centralized State-sponsored institutions to implement large scale workout programs using their own resources has been attempted without success in the transition economies (see also Box 1). The major problems with this approach are:

- *Human resource constraints.* Workout is a highly skilled activity requiring the use of experienced management and staff. For historical reasons, these types of human resources are scarce in transition economies and, if available, tend to be employed in lucrative positions in the private sector. Recruiting adequate numbers of qualified staff is often impossible due to the limitations placed on compensation packages by State employment rules. Where

¹³ One method (used successfully in the United States) of providing appropriate incentives is to impose an increasing discount to the transfer value of assets over time. This imposes substantial costs on the bank if it attempts to speculate with marginal assets rather than attempt to restore them to health.

¹⁴ This group of assets would normally include those in a gray area composed of the best of substandard and worst of watch classification loans.

intensive training is provided in order to give staff the necessary technical skills (experience cannot be taught), the institutions experience delays due to the time required to train staff, and may also experience high attrition rates as the best staff are actively recruited by the private sector.

- *Incentives.* Due to State employment rules, State workout units are normally unable to provide incentives such as performance bonuses which encourage staff to undertake the more difficult aspects of the workout process (such as forcing the lay off of debtor employees). Staff tend to become administrators rather than being actively involved in the work out process.
- *Decision making process.* Due to laws and regulations governing the disposal of State property the work out institution may be unable to conduct effective negotiations (where private sector investors/creditors require fast and flexible decision making) or to accept prices which reflect the market rather than legally established minimums.
- *Political interference.* State workout units are subjected to political pressures which make the rational restructuring of enterprises extremely difficult. Considerations such as social and employment impacts may be given greater weight than debt recovery by the political supervisors of a State institution.
- *Creditor/debtor attitudes.* The State is viewed by other creditors and by debtors as an inferior creditor. Foreign creditors may (successfully) argue that any enterprise controlled by the workout institution is a "sovereign risk" and use threats of adverse sovereign credit impacts to secure preferential treatment. Debtors use political tools to weaken the ability of the work out institution to force needed remedial action.
- *Finance.* If the State workout institution has access to funds debtors will often use political tools to secure additional finance from it (funding for payroll costs, supplier payments, etc.) without compensating remedial action or contributions from other creditors. The result may be that size of the problem increases rather than decreases.

Pure Bank-Led Approach. A pure bank-led approach to workouts would normally only be applied if the dimensions of the problem are small or restricted to a single institution. Commonly, the technique employed is the "as is and where is" structure described above for whole bank transactions. Alternatively, in developed markets, structures such as liquidating trusts and liquidating banks have been used to dispose of large quantities of bad assets from a privately-owned financial institution.

The major constraints on using a pure bank-led strategy in a transition economy are:

- *Political constraints.* In transitional economies, banks may be reluctant to lead large and complex workout cases, especially when the debtor enterprises involved are large employers (and sometimes the single employer in a depressed region). Unlike mature economies, where banks and other creditors drive the workout of large and complex firms, and decide frequently to take an enterprise into the liquidation phase, banks in transitional countries may fear the political ramifications of these cases. Moreover, potential strategic investors may be reluctant to buy a bank loaded with a large number of these cases on its loan portfolio, irrespective of the status of loan provisions.

- *Lack of capacity.* Although most State banks have made efforts to build workout departments, their workout capacity remains limited, and the staff tends to concentrate on a handful of important clients, leaving large number of assets poorly managed.
- *Lack of finance.* There is frequently a perception that financing may be provided by the banks themselves, either under a write-off-and-sell, or a “carve in” transaction, but this may be unacceptable to bank strategic investors. In practice, the banks provide finance to a fraction of the debtors. It may also prove difficult to secure the debt and equity financing required for the creation of privately owned and managed special purpose vehicles.¹⁵

Box 1: Public Asset Management Companies

The good performance of central asset management companies in some developed countries is sometimes cited in arguments supporting a centralized approach to debt workouts. However, comparisons between the KOB and such other central asset management operations – e.g., the USA’s RTC (1989), Sweden’s Securum (1992) – are inappropriate for two reasons. First, the proportion of financial system assets transferred was much smaller than will be the case with KOB – in both Sweden and the U.S., assets transferred to centralized asset management units represented about 8 percent of total financial system assets. The share is much higher in the Czech case. Second, a large share of KOB’s assets is tied to operating companies, which are much more difficult to restructure and sell than the assets held by RTC and Securum. For the RTC, 84 percent of its assets were mortgage loans, real estate, or cash and securities. For Securum, 80 percent of its assets were real estate-related.

Additional factors, not present in the Czech Republic, contributed to the success of the RTC and Securum. These included the following:

- A large part of the RTC’s assets were performing;
- Local capital markets were deep, liquid, and sophisticated; providing many potential buyers for RTC assets and;
- The legal framework, governance mechanisms, and private management capacity were strong.

The RTC’s asset base (mostly performing real estate and commercial loans) and the availability of private contractors facilitated wholesale asset dispositions. The RTC relied on a detailed set of directives and guidelines to its staff and contractors covering asset management and disposition, contracting, bidding procedures, marketing, and other operations. This approach reduced the RTC’s flexibility in handling individual cases, but it minimized the possibility of fraud, made policy and cost evaluation more transparent, and expedited the resolution process.

Most of Securum’s assets were real estate-related, and shareholdings were concentrated in construction companies. These assets raised fewer political issues (e.g., plant closures, layoffs) and were easier to restructure. According to one assessment, Securum may have helped expedite restructuring in the real estate and construction industry by enhancing coordination among debtors, but its impact on restructuring in other sectors of the economy appears limited.

Source: Klingebiel, Daniela (1999), *The Use of Asset Management Companies in the Resolution of Banking Crisis: Cross-Country Experiences*, Unpublished Manuscript, The World Bank.

Mixed Private Sector/State Strategy. A mixed private sector/State strategy has been used in transition countries which have successfully addressed their work out problems (e.g. Hungary and Poland), and is also being applied in other regions (e.g. Thailand and Korea). This strategy calls for the use of a centralized State work out institution to manage some large and complex cases (generally heavy industrial enterprises). The same State institution may also manage additional assets through contracts

¹⁵ This is true even the most advanced capital markets. Instances of the use of these structures are rare even in the US, except when the assets concerned are primarily commercial real estate (itself a liquid market).

with private sector asset managers. A certain proportion of bad assets are worked out by banks using whole bank carve in structures, and an additional quantity of assets is sold to the private sector on an individual asset or pool basis.

The mixed strategy is considered the most attractive option for transition countries for the following reasons:

- *Capacity.* The mixed strategy recognizes that there is no single institution in transitional countries with sufficient workout capacity to handle the problem alone, and spreads the burden of workout over a large number of players. These include central workout agencies, the banks, workout firms, investment funds, and strategic investors (both firms and individuals).
- *Human resources.* By involving the private sector to the maximum extent, the strategy mobilizes human resources which cannot be accessed or retained by the State due to employment rules. Specialist foreign expertise is drawn in as workout firms are drawn in by the opportunity both to manage assets under contract to the State or for their own account.
- *Capital.* If the bankruptcy and debt enforcement frameworks are reformed to create a creditor friendly environment, it becomes much easier to develop a secondary market for distressed assets, and to draw in capital in various forms, including foreign capital. The creation of large assets (by consolidation of relationships or by assembling asset pools) for sale is important, as minimum deal thresholds must be crossed in order to attract larger investment institutions.
- *Political interference.* The ability of political pressure to influence the workout process is restricted to a few large debtors (for which the consideration of the social and employment impacts of restructuring may be appropriate). The vast majority of debtors are worked out by private sector managers.

2.4. Outline Proposal for Workout Activities in the Czech Republic

Introduction

This section proposes the adoption of a mixed private sector/State strategy for workout in the Czech Republic, and provides an outline of how such a strategy could be implemented. It also provides recommendations for improvements in the event that additional RA-type vehicles are to be used as part of the workout solution. The mixed strategy relies in substantial sales of assets to third parties, as well as substantial outsourcing of asset management. Although the workout agencies and the banks have experienced great difficulties trying to sell their classified claims in the recent years, this difficulty has been due essentially to the very hostile legal framework that has prevailed in the recent years, more specifically the lack of creditor rights. The improvements in the legal framework that have been recently introduced should facilitate the development of a secondary market for classified debt, and such a secondary market could be promoted further by additional improvements in the legal framework, along the lines suggested below (section 4). It must be stressed that sales of assets to third party investors have been an essential component of restructuring in successful Central European cases, such as Poland and Hungary and, more recently, in East Asian countries as well (see Box 2 for a description of the cases of Thailand and Korea).

Box 2: Rapid Sale of Business Loans: The Case of Thailand

The Financial Sector Restructuring Agency (FRA) moved quickly to auction assets with a combined book value of \$21.3 billion from 56 failed finance companies taken over by the FRA in June and August 1997. The assets were catalogued by February 1998 and the first auction was held in June 1998. One international accounting firm and an investment bank helped bundle and market these assets.

The first two auctions in June and August 1998 sold \$1.5 billion in auto loans and \$700 million in home mortgages. Recovery rates were 47-48%.

Since then, the FRA has held four auctions for business loans – typically unsecured working capital loans – with a cumulative face value of \$13.5 billion. These auctions disposed of 49,000 loan contracts organized into 127 bundles. Overall proceeds averaged 22% of face value. Purchase prices as a percentage of face value averaged 28% for foreign buyers, 22% for private-sector Thai buyers, and 17% for purchases by a public Asset Management Company (AMC). The public AMC acquired \$5.2 billion of these assets.

Outsourcing of Asset Management: The Case of Korea

By 31 May 1999, the Korean Asset Management Company (KAMCO) had sold less than 2% of the \$35 billion in assets acquired, mostly from Korean banks, at an average of 42% of face value. KAMCO plans to sell \$13 billion of these assets by mid-2000. To expedite this effort, KAMCO is looking to establish 7 or so joint ventures. Possible partners include Goldman Sachs, Lone Star, Deutsche Bank, Cerberus Capital, AMRESKO, GE Capital, and Morgan Stanley. In each case, KAMCO is proposing to place assets with a face value of \$250 million in a special purpose corporation. An independent third party would assess the market value of these assets. Each joint venture would be owned 50/50 between KAMCO and the partner, with the partner paying KAMCO 50% of the assessed value of the venture's assets. A separate management company, to be owned 65/35 by the joint venture partner and KAMCO, would be established for each joint venture receive a management fee.

Key Issues for the Selection of a Strategy

Selection of an appropriate and successful strategy is dependent on a number of issues, such as the capacity of workout institutions, the quality of legal framework, and the characteristics and legal status of the assets to be worked out. Tables 3 summarizes the main issues and the current situation in the Czech Republic.

Table 4: Main Issues in Designing Workout Strategies and the Czech Situation

Variable	General Comments	Situation in Czech Republic
What work out institutions (private sector and State) already exist? What are their capacities?	If large numbers of assets have to be worked out in a short period of time, the institution(s) designated to work them out must have the administrative capacity to handle them. In the event that capacity constraints and/or shortages of qualified staff result in assets being unmanaged or given insufficient attention, significant reductions in potential recoveries may occur.	<ul style="list-style-type: none">• Three State workout units established (KOB, CF, CI).• State workout units have limited capacity. Ring fence arrangements and establishment of Konpo only partly address this problem.• Some local investment banks and accounting firms are active in the restructuring of enterprises, but as yet only on a limited basis. Both groups indicate a strong interest in expanding these activities.
Is the legal framework	The benefits of the environment will	<ul style="list-style-type: none">• The legal environment has been

<p>conducive to work out operations (creditor friendly), is it a hostile environment (debtor friendly). Are improvements in the framework likely to occur in the near future?</p>	<p>be reflected in pricing. In a hostile environment, pricing will be very low as recoveries are also expected to be low. If significant improvements in the framework are expected, then work out arrangements need to be structured to capture some of the improved recoveries which would occur as the framework is improved.</p>	<p>recently improved due to Bankruptcy Law amendments and the new law on Public Actions, but the new laws remain to be tested and are still considered to have important weaknesses. For example, recent amendments to the Execution Law have weakened considerably the new Law on Public Auctions, and creditor rights in bankruptcy remain weak in some areas, even after the recent amendments.</p> <ul style="list-style-type: none"> • Introduction of a completely new Bankruptcy Law is being discussed. However, it is very unlikely that the reform process can be completed before the bulk of workout activity is underway. • Tax treatment of loan write-offs and treatment of tax arrears remain obstacles to workout activity.
<p>Is there a market for distressed assets? Of what types?</p>	<p>The existence of a market for distressed assets creates a positive environment in which to pursue the rapid sale of assets by means of individual asset auctions or selling pools of assets.</p>	<ul style="list-style-type: none"> • A small market for individual loans exists. The main buyers are debtors buying their own debts, customers of debtors seeking to offset payables to debtors, or investors seeking to acquire either the debtor or property owned by the debtor. However, development of the market has so far been constrained by the inadequate legal framework and tax disadvantages for sellers. • Major foreign investors are expressing interest in entering the Czech market. These investors would have access to the skills and capital required for large transactions.
<p>Do multiple State institutions and State banks have claims on individual debtors?</p>	<p>If many debtors have multiple claims on them, packaging (consolidation) of these claims may be necessary.</p>	<ul style="list-style-type: none"> • Multiple claims exist on many debtors. Tax and social security arrears are also an issue for many debtors. Unfortunately, there is no reliable data on inter-enterprise arrears. • KOB has performed some consolidation but has yet to complete consolidation across its entire portfolio (including Konpo, CS and CF). Consolidation of tax and social security arrears with classified debt is not yet contemplated, although it could potentially enhance revenues for all the creditors.

What are the characteristics of the assets to be worked out? In particular, what is the legal status of the classified assets?	Efficient resolution of assets frequently requires their segregation according to their status. For example, assets already under liquidation may not require conventional workout, but rather legal management to ensure that appropriate court filings are made on time.	<ul style="list-style-type: none"> • Significant numbers of classified assets held by both KOB and CF are already in bankruptcy. • Assets have not yet been segregated by type, size, obligor, location and status (in/out of bankruptcy). Mapping of claims will be a major exercise. • Large scale legal management will be an issue to be addressed.
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Outline of a Workout Strategy for the Czech Republic

The objectives of the workout strategy should be to:

1. Move the management and ownership of classified claims to the private sector to the maximum extent;
2. Support the privatization of KB;
3. Solve operational problems which threaten to increase the cost of the workout process to the State;
4. Encourage the transformation of the enterprise sector by providing incentives for restructuring and working out of debts rather than liquidating potentially viable enterprises;
5. Bring a halt to off budget financing of the enterprise sector by KOB; and
6. Create work out arrangements which allow the State to capture some of the benefit of proposed changes in the legal and institutional framework.

Implementation of the Strategy

The strategy should have the following main operational elements:

1. A consolidated database of classified claims held by KOB, Konpo, CF, CS (ring fence), and KB should be developed to allow consolidation of claims by debtor. If possible, tax and social security claims should be added to this database.
2. Assets already in KOB, Konpo, CS's ring fence (where KOB, Konpo or CF also have a claim), and assets identified for carve out from KB (grades 3 to 5) should be segregated by size and status. This should define five main groups of assets, as indicated below and in Diagram 1:¹⁶
 - **Group A.** Very large and important enterprise debtors. This should be a small group of debtors (less than 50). The majority of these enterprises will have multiple creditors, including both KOB and the originating bank (CS or KB), and the tax authorities.

¹⁶ The staff did not have access to the data required to quantify these asset groups.

- **Group B.** Medium debtors not in bankruptcy. This should be a large group of debtors, some of which will have multiple bank creditors, and many will have tax arrears.
 - **Group C.** Small debtors not in bankruptcy. Most will have only two main creditors - a bank and the tax authorities.
 - **Group D.** Medium debtors already in bankruptcy. This should be a large group of debtors, some of which will have multiple bank creditors, and many will have tax arrears.
 - **Group E.** Small debtors already in bankruptcy. This should be a very large group of debtors most of whom will have only two main creditors - a bank and the tax authorities.
3. If Konpo's operational capacity proves insufficient to immediately commence servicing the transferred KB assets, then prior to privatization of KB, KOB and the bank would sign an interim management agreement. This agreement would incorporate provisions which would:
- Require the bank to continue servicing the classified asset portfolios for a period of six months after they are purchased/transferred to KOB as part of the privatization of the bank. KOB would have the option, on 60 days notice, to renew these agreements for a single additional period of four months.
 - Compensate the bank for this service by payment of a management fee equal to the average of their six previous months' direct operating costs associated with the classified assets.
 - Provide for payment of an additional incentive fee of 10 percent of all cash collections made by the banks from the classified portfolio during the six month management period.
 - Give KOB the right to withdraw assets from each bank's management on 60 days notice.
4. During the period from adoption of the strategy to the completion of the banks' asset servicing agreement, KOB would:
- Establish a number of subsidiaries using the Revitalization Agency (RA) model and conduct tenders to secure qualified asset managers to operate these subsidiaries. Group A assets would be consolidated and transferred to these subsidiaries.
 - Conduct tenders for the management of Group D and E assets. Management contracts would be offered for each Group by district court region. Qualified bidders for these contracts would be: in the case of Group E, law firms with appropriate bankruptcy experience; and, for Group D, consortia of consulting/investment firms with restructuring experience and law firms with bankruptcy experience.
 - Conduct a tender for a qualified firm or firms (most likely a consortium of an investment bank and an accounting firm) to prepare a cash flow projection model of the Group B assets. The consortium would be required to prepare recommendations for segregating the Group B assets into pools which could be either: (a) sold using seller financing;¹⁷ or, (b) become the subject of the asset management contracts.

¹⁷ See Annex 1 for a discussion of options for the sale process.

- Conduct a tender for a qualified firm or firms (most likely an accounting firm) to prepare recommendations for segregating the Group C assets into pools which could be either: (a) sold outright; (b) sold using seller financing; or (c) become the subject of management contracts.
- Segregate Group B and C assets into pools according to the recommendations of the advisers. Pools would first be offered for sale (using seller financing if required). For any pool which could not be sold, KOB would tender for asset managers to take over management of the pools from the banks (although the banks would be permitted to bid for these contracts).

Diagram 1

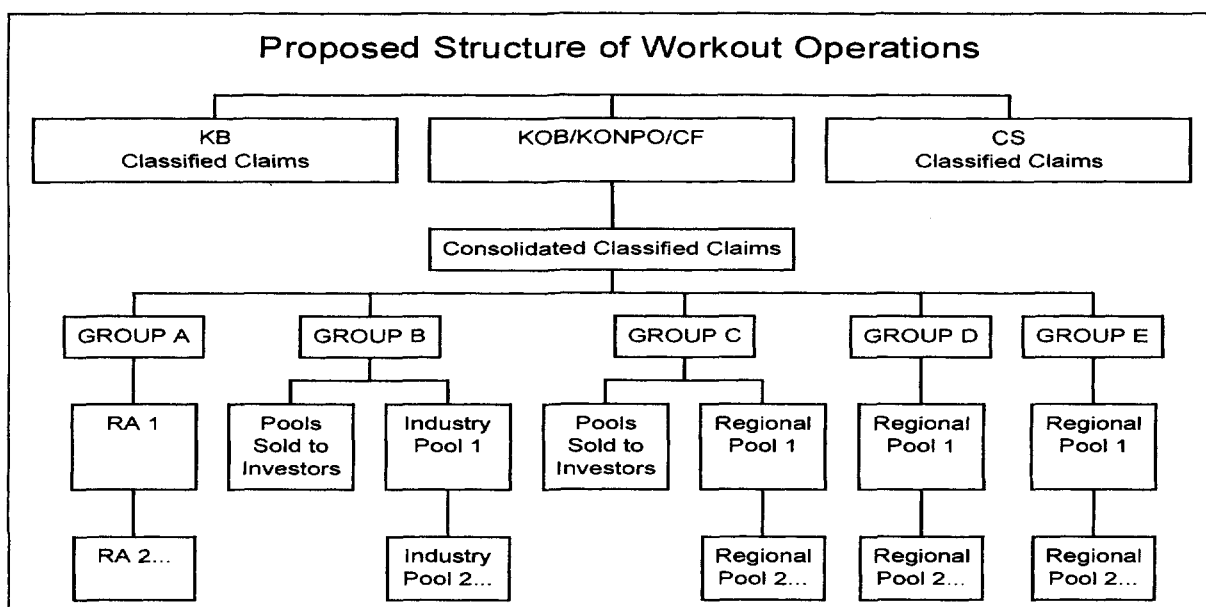
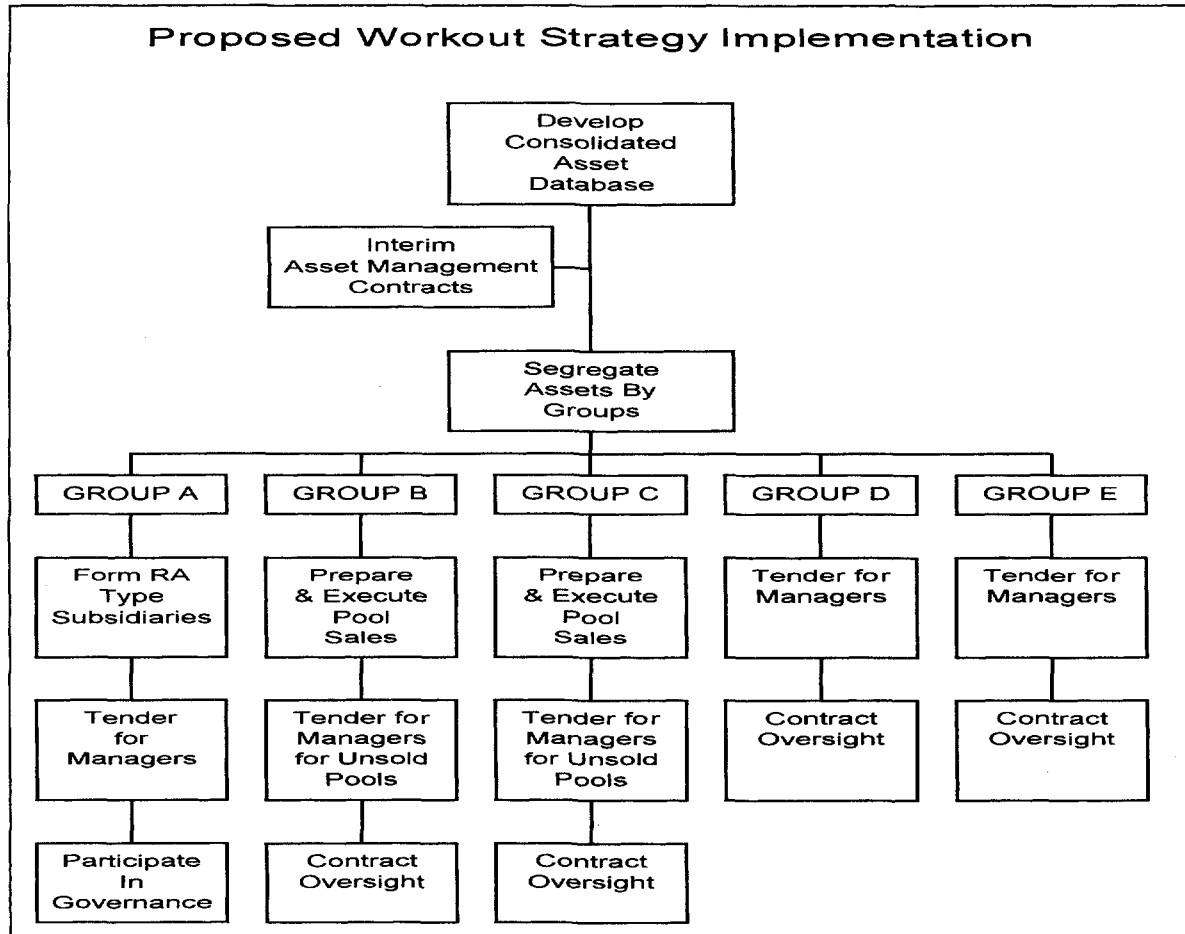


Diagram 2



Transformation of KOB

By implementing the strategy above, KOB would be transformed from an asset manager into an organization charged with the administration and oversight of the workout process, but with much reduced involvement in the process itself.

The restructuring of KOB would result in an institution focussed exclusively on the success of the workout strategy, with a life restricted to the date on which the last asset management contract expires. Given that KOB's staff would be focussed on contract administration, the problems posed by the lack of incentives for KOB's staff to function as active workout professionals should diminish. The need for these incentives would shift to the asset management contracts in the hands of the private sector, where they can be easily provided.

KOB's main functions would be to manage and supervise the implementation of the workout strategy by:

1. Supervising the operation of the interim management contract with KB (if applicable);
2. Conducting tenders and supervising the implementation of contracts to consolidate debtor/asset information;
3. Conducting tenders to prepare assets for pool sale or placement in pools managed by the private sector;
4. Conducting tenders for financial advisers to prepare, and then supervising the implementation of the pool sales;
5. Supervising the operation of pool asset management contracts;
6. Representing the interests of the State in the operations of the Group 1 pools using the governance structure developed for RA.

The following complimentary actions would be taken in order to ensure that the workout process remains transparent and efficient, that KOB focus on its new role, and to enhance the position of KOB as a creditor:

1. The Government should adopt a general strategy (along the lines recommended above) guiding the actions of all State institutions concerned with the workout and bank restructuring process;
2. The Government should also instruct the NPF (as controlling shareholder of KB) and KOB to proceed immediately with developing and implementing an operational plan to implement the strategy, and authorize the procurement of all necessary technical and advisory assistance.
3. KOB's development banking functions and associated staff should be transferred to Bank of Bohemia no later than December 2000;
4. KOB should give up its banking license no later than December 2000. In the interim period, KOB's supervisory board should restrict direct borrowing and lending by KOB. Any financing to problem debtors should be ideally provided in a transparent manner through explicit budget transfers (irrespective of whether this financing comes from general revenues or privatization revenues originated at the NPF); and,
5. The MOF should establish a unit within tax administration to take over responsibility for handling the resolution of tax claims against all companies in the consolidated debtors of KOB, CS, KB, and CF. Internal operating procedures should be established requiring this unit to work out claims: (a) utilizing existing powers to forgive interest and penalties; (b) taking an active and constructive role in the workout process; and, (c) establishing levels of delegated authority which permit efficient decision making by the unit. The MOF should be authorized by the government to expend funds necessary to develop and train the professionals assigned to this unit.
6. The Government should monitor closely the efficiency of the new pieces of legislation, and stand ready to introduce further amendments, as needed. As elaborated in section 4, further improvements in the liquidation track will probably be needed, and the authorities must also make an effort to introduce a fast reorganization track, a mechanism designed to reorganize viable enterprises in a short period of time.

Recommendations for Structuring Future RA-Type Vehicles

As mentioned above, the RA model could be used for the restructuring of an additional set of large and complex enterprises. However, the authorities should consider introducing a number of improvements to this model before applying it to an additional group of enterprises. The areas that would deserve careful consideration are listed below:

Criteria for Selection. Acceptance for active restructuring prior to sale should be strictly limited to a very few companies meeting the aforementioned criteria. In particular, each company accepted should have some viable operations. A super-majority of shareholders and other major creditors should be prepared to cooperate with the Manager; and the company should be important in terms of employment and local procurement. Scarce and expensive restructuring skills should not be wasted on lesser companies or more problematic cases.

Timing. The Manager should be encouraged to conclude the sale/disposition of portfolio companies within 12-24 months. Early acquisition by a qualified strategic investor offers the best prospect for turning around large industrial companies.

Political Interference. To be effective, the RA must be free to restructure and sell/dispose of companies on purely commercial terms. Development of realistic expectations and goals for portfolio companies and strong appointments to the Investment Committee are essential.

Investment Committee Appointments. The Investment Committee has two broad functions: (i) to control the Manager in a constructive manner and (ii) to justify the Manager's actions to KOB and the Government. For instance, the four independent appointees to the Committee must be able to identify any under-valuations of prospective portfolio additions and raise credible challenges to such claims by the Manager. The appointment of individuals with experience in Czech turnarounds, *Securum*, the *Treuhandanstalt*, and merchant banking, which the RA is considering, seems appropriate.

Manager Compensation. If prospective investors insist on minimizing up-front cash payments for the purchase of portfolio companies, but are willing to provide other consideration, it will be necessary to adopt a flexible approach to compensating the Manager. For instance, the Manager could be compensated on a lower scale for future capital investment or the RA/Manager could retain some post-sale equity interest in the company. To encourage a timely disposition of portfolio companies, the RA might also seek to adjust the Manager's compensation for the cost of carrying the debt of portfolio companies beyond a specified time, e.g., 12 months.

Multiple RA-Type Vehicles. It might be more efficient to organize KOB's Group A portfolio into several sectors (e.g., steel, heavy engineering, chemicals) and assign each to a different RA-type sector vehicle with a specialized Manager.

Finalizing the Portfolio(s). To guard against the possibility of Managers "cherry picking" KOB's portfolios, future RA-type vehicles should (i) designate companies that will be definitely be included in one or more portfolios; and, (ii) tender for managers on the basis of this fixed portfolio.

3. THE NEED TO REFORM THE LEGAL FRAMEWORK

3.1. An Overview of the Current Situation

The Czech Legal Framework on Creditor Rights and Insolvency

The legal environment in the Czech Republic to support creditor rights and debt enforcement has been widely regarded as unsatisfactory. The deficiencies in the legal system have contributed to a deterioration in the quality of bank loan portfolios and, more recently, to a stifling of credit growth. Comprehensive reforms are required to virtually all elements of the debt enforcement and credit systems to promote normalized relationships between debtors and creditors predicated on recognition and enforcement of reasonable commercial expectations.

In principle, creditors have had access to three primary avenues for enforcement and debt collection: (1) a court action on unsecured debt; (2) actions by secured creditors to seize and sell collateral; and (3) the filing of bankruptcy. However, none of these procedures has resulted in an efficient or predictable outcome for creditors.

Court actions against a debtor to obtain a judgment typically take from 1-3 years due to procedural delays. Obtaining an execution order to sell the debtor's property can take another year. During this lengthy period, a creditor has no practical means to ensure the preservation of the debtor's assets, which may be dissipated or lose value. Court costs are routinely high, amounting to 4 percent of the claim up to a maximum of CZK 1 million. Meanwhile recoveries are low. Leading banks have estimated their recoveries on unsecured debt claims through the court system to be under 5 percent of the nominal amount of the claim. This is without consideration to the time value, lost opportunity and litigation costs for amounts recovered. In other words, in real value, creditors recover nothing or negligible amounts.

Secured creditors have not enjoyed a significantly stronger position than unsecured creditors, though it has been common practice for local banks to collateralize their loans by taking security over real estate. While loan contracts typically grant the lender authority to directly sell the collateralized real estate in the event of default, in practice lenders have been unable to exercise self-enforcement powers over the objection of the debtor. The alternative of conducting a sale of real estate under court supervision has required exact compliance with strict procedural requirements and is subject to delays of up to two years.

Secured creditors have experienced even greater difficulties seeking to enforce collateral rights in movables (plant equipment, inventory, or receivables). In practice, movables essential to the operation of the business (e.g., plant equipment) have been exempted from foreclosure proceedings. Consequently, a secured creditor gains little benefit from having as collateral the more significant assets of the business, which are precisely the kind likely to give greater assurance against non-payment. Receivables have not been used as collateral either, because under Czech law, receivables must be specifically identified at the time the pledge is created and principal debtors must acknowledge the assignment. Unspecified or unacknowledged assignments can render the security interest ineffective. The process is extremely cumbersome and difficult to monitor where there is a constant turnover in receivables. Finally, the effectiveness of equipment, inventory and receivables financing is also hindered by the absence of a public registration system for security interests, with few exceptions such as cars. The result of these shortcomings in the available range of collateral options is particularly felt as a deterrent to banks from lending to second and third tier enterprises or start up businesses.

The third option, bankruptcy, has presented perhaps the worst of the three choices for a creditor. Unsecured creditors have received no recovery on their claims in bankruptcy, while secured creditors have done only marginally better, as collateral rights have been severely curtailed in bankruptcy. Secured creditors have been deprived of their right to foreclose on and sell their collateral, once bankruptcy is declared, and have received no compensation (e.g., interim interest payments) for the delays in realizing on their assets. The administrator alone has been invested with authority to sell the assets of the company, retaining 30 percent of the proceeds of the sale of collateral to cover costs of administration, including administrative costs related to efforts to sell other non-collateral assets. In most cases, the collateral in question has been sold at values substantially below the face amount of the secured creditors claims, at what often tend to be fire sale prices. Although secured creditors have had priority for the balance of sales proceeds payable on final distribution, they have little control over the timing of these distributions, which have taken years.

The process of bankruptcy has been slow and inefficient, and creditors generally have not viewed it as a viable option for debt recovery. Despite the relatively low fee for filing a bankruptcy (CZK 10,000, in contrast with the maximum cost of CZK 50,000 for proceeding on a debt claim), many lenders facing defaulting debtors have chosen not to file an application for bankruptcy, because of the inefficiency in the bankruptcy system. Creditors have had few if any rights in bankruptcy, other than intermittent consultations with the administrator through the Creditors Committee. They have not been entitled to propose names for administrators, to veto decisions made by administrators, or to influence the actions of the administrators. In effect, creditors have been relegated to a passive role, and consider the whole process as a debtor's haven. In many cases, the only advantage to the lender has been the issuance of a bankruptcy order that enables him to gain tax deductible treatment on loan write-downs.

Notably, recent amendments were introduced to the Bankruptcy law as of May 1, 2000. As noted below, the amendments introduced several improvements, but did not address all the weaknesses in the bankruptcy framework, and in some specific areas weakened the framework further. Reportedly, creditors, lawyers, and practitioners remain generally dissatisfied with the law and have urged more comprehensive reforms.

Main Consequences of the Weak Legal Framework

The weak legal framework has had two adverse consequences for the performance of the Czech economy. First, it has contributed to the deterioration of the problem of non-performing loans in the banks and the insufficient pace of enterprise restructuring. Second, it has increased the risk to creditors and affected negatively the new flows of lending by the banking system.

The volume of non-performing loans held by the banks and special workout institutions is in part a function of the weakness of the current debt recovery system. Because creditors have had limited rights against debtors, and face high levels of uncertainty and delay in using the court system to take recovery action, a relaxed credit culture has developed. Debtors do not expect that banks will be able to take quick action following non-payment, and face little downside risk in allowing the default to continue. In addition to the direct adverse effect on banks' portfolios, an even more adverse effect is the limited pressure on debtors to restructure.

Weak creditor rights also reduce the banks' incentives to make new loans. Indeed, banks seem willing to lend only to prime enterprises, and remain reluctant to lend to customers who under a functioning debt enforcement system would be an acceptable risk. The full restoration of normal credit flows requires both an effective system for the collection of debts, and a legal structure that provides for rapid enforcement of collateral. Effective debt enforcement benefits all users of credit, by allowing

creditors to reflect the reduced risk in their pricing. An ineffective debt enforcement system represents a subsidy paid by all businesses for the benefit of those who default.

The reduced value of collateral in the Czech Republic has led the Czech National Bank (CNB) to introduce strict provisioning rules. These rules require banks to disregard the value of collateral and fully cash-provision the loans in default for more than 360 days (the loans in the worst category—loss loans). This policy has been criticized for having contributed decisively to the reduction of credit, and the persistence of the economic slowdown. Although the policy of full cash provisions looks overly restrictive by international comparison, it is actually consistent with the absence of creditor rights and the low value of bank collateral in the Czech Republic. There are pressures on CNB to relax the provision policy, but any changes in this area should be preceded by a strengthening of foreclosure rules, and of creditor rights more generally.

Lack of a Secondary Market for Classified Loans

Faced with the difficulties of enforcement, large banks in many countries often sell their distressed or non-performing loans to third parties. In such cases, the buyer of the loan obtains the same legal and contractual rights as the bank, including with respect to any collateral that secures repayment of the loan. Sales of loans are a legitimate and desirable component of any large scale restructuring program, since they may trigger a wave of enterprise restructuring by third parties, which can be strategic investors, institutional investors (e.g. joint venture funds), other enterprises trying to cancel off their debts, etc. However, the secondary market for classified debt in the Czech Republic has proven very thin. So far there have been few genuine buyers, and these in most cases have demanded deep discounts on the price to compensate for the legal uncertainty and poor enforceability. This is so because those who acquire the loans gain no better rights under the contract or the law and must rely on the same enforcement systems to collect the loans.

Lack of Progress in Voluntary, Out-of-Court Workouts

Faced with three equally unappealing options for enforcement through the courts, and unable to sell these loans to third parties, most Czech banks have attempted to reach negotiated settlements out of court. However, the successes have also been limited. For one, the lack of a credible bankruptcy threat, and of creditor rights more generally, reduces the incentives for voluntary workouts. The debtor can protract negotiations and speculate with the knowledge that the creditors have little to gain in a formal bankruptcy process.

Secondly, there seems to be a lack of tradition and experience in conducting out-of-court negotiations, and no established framework for bank coordination. In particular, local banks have little prior experience with working collectively to maximize recoveries, with the establishment of committees of bank creditors and the negotiation of “standstill” agreements. Also, banks have operated in an uncertain environment where they are unsure of their ability to exchange information on customers when negotiating workouts because of the confidentiality of customer accounts.

Thirdly, efforts to reach a settlement out of court have been undermined by minority and dissenting creditors. Where a minority creditor chooses to pursue separate proceedings to enforce its claim, such actions deprive the enterprise of vital assets or force the debtor into bankruptcy. Similarly, if the holdout creditor files for bankruptcy, this action divests the negotiating parties of any power to orchestrate a consensual arrangement, as the debtor is no longer entitled to make decisions for the enterprise. Because the courts do not consult the creditor body in making its determination on bankruptcy, negotiating creditors are powerless to alter the outcome, unless holdout creditors are paid in

full.¹⁸ The end result is that minority junior creditors have enormous leverage over senior secured creditors in the out-of-court context, frequently coercing the senior creditors to satisfy their claims to avoid harsh consequences.

Progress in debt workouts has also been undermined by difficulties in conducting debt-equity swaps. These arrangements are particularly challenging in the current legal environment, as prior agreement is required with a sufficient majority of the shareholders of the debtor company to vote for a capital increase and approving the swap of debt for new equity of the issuing company. In other words, shareholders are entitled to vote on the dilution of their interests. The Commercial Code requires an affirmative vote of 60 percent of the existing shares, a target that will often be difficult to achieve where there are large numbers of shareholders. This rule is desirable in normal conditions, as it protects minority shareholders, but may become an obstacle to restructuring in situations of financial distress. Most developed legal systems limit the voting rights of shareholders at the start of bankruptcy procedures, but the Czech Commercial Code upholds shareholders' rights and imposes obstacles to debt-equity conversions even when the enterprise is clearly insolvent and subject to formal bankruptcy procedures.

Finally, the tax system has also imposed obstacles to restructuring. Under the Act on the Tax Treatment of Reserves and Provisions, banks cannot easily deduct the required provisions on their bad loans from taxable income. For example, a loan classified as loss needs to be fully provisioned, but the use of these provisions for tax purposes can only be accomplished over a period of five years (20 percent every year). Moreover, the insufficient recognition of provisions for tax purposes is not compensated by the Income Tax at the time of a loan write-down. If the bank decides to write down the loan or convert it into equity, it may lose part or even most of its tax deduction rights. Therefore, there may be situations where it is more advantageous for the bank to let the loan rot in the books rather than reach a settlement with the debtor. At present, a loan cancellation is only recognized as a loss for tax purposes if the cancellation occurs as a result of the bankruptcy of the debtor. The failure of these two laws to ensure tax neutrality (essentially by allowing the recognition of actual losses by creditors on the value of their claims) may continue hindering efficient workout activity outside the court system.

A further problem caused by the current tax system is the position of the tax authorities as major creditors of firms. Tax arrears comprising unpaid taxes and social security contributions (and including penalties and accumulated interest) amounted to CZK 120 billion in September 1999, an amount equivalent to nearly 30 percent of the total stock of non-performing loans (or the equivalent of 6.5 percent of GDP). The tax authorities have the power, under the Tax Administration Act, to impose a lien on any property of the taxpayer as a security for payment, and may enforce the lien by forced sale or by seizure of funds held on deposit with banks. Tax arrears are preferential claims in the bankruptcy of the debtor and are paid ahead of general creditor claims.

The tax authorities have the power to write off penalties and interest, which amount to about one third of the total stock of arrears, but there are no clear guidelines for the approval of waivers and write-offs in the course of a financial restructuring. Tax arrears may be waived if exacting them would cause the liquidation of the debtor, and the likely collection under liquidation may be less than potential tax revenue. However, these provisions do not provide clear guidelines to the authorities, making the review of requests for waivers difficult and lengthy, and the results uncertain. Moreover, this review is not coordinated with the negotiations between the debtor and the other creditors, adding uncertainty to the final outcome.

¹⁸ As discussed in Section 4.3 below, the recent amendments to the Bankruptcy Law on their face grant stronger rights to creditors, but it is too early to tell whether these rights will be realized in practice.

Efforts are underway to amend the Law on Tax Administration, including a proposal that tax arrears may be cancelled in exceptional cases (such as where an enterprise is insolvent and in bankruptcy). In addition to cancellation of interest and penalties, the current proposals would enable the tax authority to cancel principal as well, in exceptional cases. Although this provision may improve the potential for successful workouts, it could remain largely unused, due the lack of clear guidelines, experience and skills of tax administrators. As mentioned in the previous section, it would be useful to consider the creation of a unit in the Ministry of Finance, focused on workout issues and empowered to participate in negotiations with other creditors. Clear rules for the treatment of tax arrears could also be introduced under a new fast rehabilitation track under the Bankruptcy Law, as elaborated below.

The following sections address various aspects of the enforcement systems, some of the weaknesses identified, and recommendations for strengthening these procedures. Section 4.2 discusses the legal basis for debt enforcement in the non-bankruptcy context, while Sections 4.3 to 4.6 address aspects of the insolvency system and corporate rescue procedures.

3.2. Strengthening the Legal Basis for Debt Enforcement

An effective debt collection system will require changes to several laws and in the court procedures. Where there is no substantive dispute that a debt is payable, there should be a procedure allowing a creditor to obtain a court order for payment in a simple and quick manner without the need for a court hearing. The debtor should be required to meet clear criteria in order to delay enforcement. Those criteria could include: production of proof that the debt may not be due; and a showing that the debtor has the capacity to pay amounts owing to the creditor and has not defaulted on payment to any creditor in a previous period. The existence of such a method of enforcement would allow creditors to obtain earlier recoveries and thereby reduce the build-up of non-performing loans and inter-enterprise arrears. It would also serve as a credible threat to debtors and encourage them to participate in workout negotiations with their creditors.

Procedures for Taking Security Interests in Property

Beyond the shortcomings of the enforcement system (discussed below), the willingness of creditors to extend fresh credits is influenced by the range of collateral available as a security for payment. The broader the range of forms of collateral, the wider the access of firms to diversified forms of credit. The two principal classes of property over which collateral can be taken are immovable (real estate) and movable (plant, equipment, receivables, inventory). The taking of collateral over real estate is moderately well developed in the Czech Republic and requires no major attention beyond the simplification of enforcement. However, the taking of collateral over movables is restricted by several design features of legal regime.

Movables must be able to be identified specifically for an effective security, which means that it is difficult to take security over a fluctuating pool of movables, such as receivables and inventory used in an operating business. A number of civil law systems now allow security over classes of movable assets including future assets, which permits a firm to raise credit on an effective security over either a class of movables or over all the assets of the firm. For such a system to be fully effective, the concept of a possessory pledge should be modified so that the delivery of possession by the debtor to the creditor is not mandatory. In this way, the debtor can continue to use the movable assets for its normal business operations. Also necessary is a system of public notice, normally through a public register, in which the existence of the collateral can be recorded. This will substitute for the current requirement that movables be specifically identified (for example, by a label attached to plant noting the existence of the security interest or by separating inventory and placing it in a defined area marked with notice of the specific security interest). Registration is already feasible for assets such as cars where a separate registry

currently exists. For other types of movable, registration would be effected at the new registry of security interests, which should be electronic and allow registration and searching on-line.

The importance of a flexible legal regime for security interests, permitting security over classes of asset without individual specification and security over future property, has increasingly come to be recognised in civil law jurisdictions, which have gradually relaxed the legal restrictions on these forms of security. The Model Law on Secured Transactions prepared by the EBRD accommodates all the features mentioned above, and combines elements of civil law and common law, while avoiding the complexity and sophistication appropriate only to highly developed economies, such as the United States. Countries have also come to recognise the significance of receivables financing as a tool for increasing the liquidity of an enterprise, and the need for laws that allow global assignments of receivables. Examples are the 1988 UNIDROIT Convention on International Factoring, and the more wide-ranging UNCITRAL Draft Convention on Receivables Financing, which was due to be finalised at the end of 1999.

Enforcement of Secured Rights

There are three main avenues for a secured creditor to enforce its rights against collateral: (i) direct action; (ii) judicial sale; and (iii) public auctions. As examined in more detail below, the first two options have not been improved and lead to questionable results. The new Public Auctions Law is expected to improve the third option, by introducing more flexibility in enforcement procedures, including the sale of assets under the supervision of licensed auctioneers.

Czech law allows secured creditors to seize pledged assets and sell them directly, without resort to court proceedings.¹⁹ However, the Czech Cadastral Office refuses to register transfers of ownership of real assets where the owner of record is not a party to the transfer agreement. Since the owner must cooperate in the transfer—an event that rarely occurs—this remedy is largely illusory in practice. Similar difficulties exist for moveable assets, and both courts and creditors are reluctant to condone or pursue direct sales. The Cabinet has introduced proposed amendments to the Civil Code modeled after the Austrian or German system that would render direct sales more effective, subject to a short contestment period for the debtor and requiring a deposit of funds to protect the debtor against harm. At the time of this writing, those proposals have not been considered in Parliament.

Secured creditors may also enforce their security interest through a judicial sale or auction.²⁰ To exercise this option, creditors must file a petition with the court to seize the assets and request a court-supervised sale. The process is overly complex (e.g., inventory and valuation of debtors property) and fraught with delay, typically taking one to two years. Secured creditors have experienced even greater difficulties seeking to enforce collateral rights in movables (plant equipment, inventory, or receivables). In practice, movables essential to the operation of the business (e.g., plant equipment) have been exempted from foreclosure proceedings. Consequently, even if successful, a secured creditor may be thwarted in its effort to recover the full benefit of its bargain, as most creditors will seek as collateral the more significant assets of the business. Receivables financing is poorly developed and difficult to enforce due to potential unacknowledged or undisclosed assignments. These difficulties emphasize the need for a new more efficient public auction procedure.

¹⁹ The Commercial Code provides: “In exercising its lien, the lienee may sell at a public auction mortgaged real property or a pledged movable thing which it holds, or is entitled to dispose of, provided that it notifies the lienor and the debtor in time of its intention to exercise the lien. *If the contract so provides, the pledgee may also sell the pledge in another manner.*” Commercial Code [Act No. 513/1991 Coll.], as amended, Section 299(2) (emphasis added).

²⁰ Civil Procedure Code [Act No. 99/1963 Coll.], as amended, Section 321 *et seq.*

The new Public Auctions Law (Act No. 26/2000—the Auction Law), became effective on May 1, 2000. The new law is designed to regulate public auctions and the adjustment of the rights of parties involved in such auctions. Prior to the new law, liens on moveable property could be foreclosed through public auctions, while liens on immovable property were foreclosed only through judicially supervised proceedings. As discussed above, the judicial process was cumbersome, requiring a two-step process of first obtaining a money judgment and, failing payment of the claim by the debtor, to proceed to a court ordered execution against assets. The new law establishes a more consistent and coherent framework for all public auctions, including both movables and immovables, excepting certain categories of property.²¹ In addition, the Auction Law governs both voluntary auctions (those held at the owner's request) and involuntary auctions (those commenced by creditors). The process for voluntary auctions should be simplified and more direct, making these kinds of procedures quicker and more efficient. For involuntary auctions, the creditor must first establish its enforcement right, the process for which varies slightly depending on whether pledge arose before or after the effective date of the new law.

Pledges created before May 1, 2000, can be enforced by means of: (1) a judicial decree or arbitral award; or (2) by obtaining a notarial record. The first of these options, judicial sale or arbitration, was previously permitted and remains unaffected by the Auction Law. As previously discussed, the judicial route is slow due to congestion in the courts and can take up to three years. The second option, the notarial record, apparently improves on the current legal requirements for notarial records. Section 36(2) of the Auction Law, allows for involuntary auctions of assets subject to a lien or security interest created prior to May 1, 2000, if the proposer has made a sworn affidavit to the effect that (i) he has a due receivable (ii) that is not performing and (iii) is secured by a lien. It would appear that the sworn affidavit can be created as an ex post event in anticipation of conducting an auction under the new Auction Law. As such, it stands in the place of a court order. The primary difference between this and the procedure governing use of notarial records after May 1, 2000, is that the requirements are relaxed: there is no apparent requirement for the debtor to agree to the execution in advance, nor that the notarial document have arisen prior to May 1, 2000. In other words, it purports to provide a remedy after the fact.

If the collateral right was created after May 1, 2000, the secured creditor again has several options. It can either (1) obtain an enforceable court ruling or arbitration award or (2) rely on an enforceable notarial deed. As above, the court order or arbitration award are obtained under previously established procedures that are unaffected by the Auction Law. The notarial deed, however, must comply with the particulars of section 274(e) of the Civil Procedure Code, meaning that it must contain clear evidence of: (i) an obligation, (ii) the party entitled and party liable, (iii) a legal ground (for the obligation and performance), (iv) an object and time for performance, and (v) an agreement by the liable party to the enforcement rights contained in the record. In other words, the rights related to execution or enforcement of liens and security interests arising after May 1, 2000, are unchanged and co-extensive with the rights already in existence. Going forward, the Auction Law appears to give greater weight to the relevance and enforceability of the notarial record on the basis of the particulars required in the Civil Procedure Code, requiring debtors to agree in advance to the proposed execution and auction outcomes.

On balance, the Auction Law provides a more coherent and consistent framework for conducting public auctions. It also appears to relax the standards for enforcement on notarial records for liens and security interests arising prior to May 1, 2000. If the Auction Law is enforced on its terms, it could

²¹ Property not subject to the Public Auction law includes intellectual property rights; assets subject to state liens or preemptive rights; apartments, commercial spaces and other real property where tenants may have priority purchase rights under the law; and movable or immovable property where others may have pre-emptive rights on the property.

ameliorate the present situation for distressed secured loans arising before May 2000 (the bulk of the stock of classified loans) by providing an ex post remedy, notwithstanding the failure of debtors to agree to execution at the time the lien or security interest was created. Likewise, to the extent that the Auction Law encourages stronger credit practices going to make use of notarial records, the law may be viewed as an improvement.

At the same time, the new law is not without possible pitfalls and has not been sufficiently tested to assess whether in practice it will result in significant improvements in foreclosure procedures. First, it may be subject to challenge by debtors with respect to the pre-May 2000 treatment it affords. Second, the foreclosures and auctions under the new law could be preempted or enjoined under the more recently proposed Private Execution Act (Execution Law), which, among other things, would have cancelled the validity of Part III of the Auction Law. While Parliament recently rejected the proposed Execution Law, it could still resurface in another form. Accordingly, we are informed that the uncertainty surrounding the potential repeal or preemption of involuntary auctions has stifled reliance on and use of the new law.

3.3. Developing an Effective Insolvency System²²

The Poor Performance of the Czech Insolvency System in the 1990s

The large stock of non-performing loans (around 25 percent of GDP), and the large number of enterprises in default (around 12,000 cases) that continue to operate without major consequences and in apparent oblivion of the legal framework, underscore the extent of the weaknesses in the current system. Despite the overwhelming number of such enterprises, there have been relatively few bankruptcy cases commenced by the Czech courts. The number of cases has been increasing over time (Table 4), but is still low in relation to the size of the problem. Moreover, cases filed are almost exclusively liquidation proceedings, and take many years to be completed. In sharp contrast, reported use of the system to achieve financial restructuring of enterprises is rare.

Table 5: Bankruptcy Statistics

	1993	1994	1995	1996	1997	1998	1999
Filings	1105	1828	2400	2996	3311	4306	3258
Declarations	66	294	727	808	1251	2022	1448

Source: Czech Republic Ministry of Justice

By way of general background, insolvency laws serve to impose financial discipline on market participants by establishing:

- a mechanism for the financial restructuring of firms whose “going concern” value exceeds liquidation value (e.g., through “composition” or reorganization proceedings);
- an orderly exit mechanism for failed enterprises, terminating non-productive use of business assets and transferring them to more efficient market participants (e.g., through liquidation);

²² The terms “insolvency” and “bankruptcy” are used here to refer to both liquidation cases and rescue proceedings. The term “liquidation” refers only to the cases where the assets of the enterprise are sold, either piecemeal or collectively, and the enterprise ceases to exist as a going concern. The terms “composition,” “rescue,” “rehabilitation,” and “reorganization” all refer to the process in which a distressed enterprise is restructured and allowed to continue operating as a business. The term “insolvency system” refers to the entire framework for the process of insolvency, including the law and rules governing liquidations and compositions, the institutional and regulatory infrastructure, such as court functioning, and the qualification, training, and oversight of the judge, administrators and specialized professionals that participate in the process.

- a final debt collection mechanism for creditors; and
- greater predictability in the enforcement of creditor rights to improve credit flows.

The Czech Bankruptcy and Composition Act No. 328/1991 (referred to herein as “BCA”) has been amended thirteen times since the law was enacted in 1991. The latest amendments became effective in May 2000 and will be examined in more detail below. Prior to the most recent amendments, there was a nearly uniform consensus among politicians, judiciary, professionals (accountants, lawyers, administrators), and the commercial community that the Czech insolvency system remained dysfunctional and ineffective throughout the 1990s. The number of bankruptcy proceedings remained low by comparison with the number of troubled enterprises, and cases frequently took 5 years to complete, with little or no return to creditors. More importantly, there is still no corporate rescue culture, nor established familiarity with the process of financial restructuring of enterprises to preserve enterprises as a “going concern.” This has left liquidation as the only practical option, which is both ineffective and unattractive for financially distressed debtors and creditors alike.

To better understand the reasons for the low number of bankruptcies and inefficient outcomes, it is useful to adopt a framework of analysis that examines: (i) efficiency of the law; (ii) implementation issues; and (iii) incentives of debtors and creditors to use the bankruptcy framework. Examining the efficiency of the bankruptcy law implies evaluating the clarity and effectiveness of the rules in facilitating genuine financial restructuring and/or speeding up liquidation procedures. Assessing implementation issues calls for a review of the extent to which good rules are implemented in practice or fail to be applied due to infrastructure weaknesses or conflicts with other laws. Finally, even if a workable statutory framework and necessary infrastructure exist, the bankruptcy framework may remain little used, due to the absence of proper incentives (e.g. from tax rules).

An examination of the bankruptcy framework in the Czech Republic during the 1990s reveals problems in all three areas. First, creditor rights were limited—creditors could not propose a plan, appoint, remove or influence decisions by an administrator, or remove inefficient management and/or owners. The potential scope for re-privatization of the troubled enterprise remained largely unexplored. Second, there were no mechanisms facilitating the flows of finance during reorganization. Third, the law remained inflexible as to the mechanisms for resolution of debts, with excessive emphasis on cash payments. Fourth, the scope for genuine debt forgiveness was limited. In particular, the inability by banks to deal with large exposures and accept write-downs, or for similar conciliation with tax creditors limits severely the scope for genuine restructuring of the enterprise. Fifth, the process of bankruptcy was vulnerable to abuse by debtors intent on tunneling assets in the period preceding formal bankruptcy, leaving the enterprise with much weaker possibilities for a full sale of the business or for restructuring when it finally reached the formal bankruptcy stage. Sixth, there was a noticeable absence of time bound rules, lengthening excessively the overall duration of the procedures. As noted below, some but not all of these problems have been addressed by the most recent amendments.

In addition to problems with the law itself, there has been a number of problems with the implementation of the law. First, the infrastructure of judges, administrators, liquidators, and related professionals (accountants, restructuring experts, asset valuers) still lacks capacity and skills to deal with the volume and complexity of cases. While there is talent among professionals in the market place to handle complex corporate restructuring, the qualification and compensation procedures in bankruptcy repel many talented people. Second, there seems to be a frequent problem of enforcing the rules (e.g. the bankruptcy trigger) and court orders. Third, there are several conflicts with other laws, preventing restructuring efforts. For example, debt equity swaps are limited by provisions in the commercial code, requiring majority of shareholders votes for any changes in the firm’s social capital. Although these rules are generally good, because they protect the company’s shareholders (especially minority shareholders), they should be superseded in bankruptcy or in a quasi-bankruptcy setting. This is especially true when

the enterprise enters formal bankruptcy. When the enterprise has crossed the threshold of bankruptcy, there is a presumption that the enterprise is insolvent, and that shareholders have lost their rights. The process of restructuring (or liquidation) from this moment on should be driven by the creditors or predicated on decisions concerning the best interests of creditors, not the old shareholders and management.

Finally, the incentives for both debtors and creditors to engage in restructuring efforts were found to be weak. Creditors perceive that they have little to gain from formal procedures. Frequent efforts to take advantage of the benefits promised by these procedures were scuttled when tax creditors exercised their preferred status to seize the limited valuable assets of the enterprise. There is also a perception that the structure of the administrator fee is conducive to long and costly procedures, with limited gains for creditors. Administrators too have complained that the compensation procedures restrict their ability to operate the business to maximize value, and discourages talented, honest and hardworking administrators from continuing to play a role, because they cannot afford the costs. Finally, tax rules remain unclear in many areas, and may still penalize restructuring conducted even under formal bankruptcy.

Recent Amendments to the Bankruptcy and Composition Act

The Government is aware of several of the severe deficiencies in the bankruptcy framework, and recently adopted a number of amendment through Act No. 105/2000 (referred to herein as “Amendments” or Act No. 105/2000), which became effective on May 1, 2000. The Government has indicated that these amendments are limited in number and designed to deal with immediate problems. The Government has indicated further that it plans to undertake a comprehensive reform of the bankruptcy law over the next year or so. This more thorough revision would consider lessons from the 1995 German bankruptcy law amendment and possible application of Chapter 11-type rehabilitation mechanisms.

The Amendments introduced a number of positive changes, while also failing to address key weaknesses, and also introducing some negative changes. The positive changes that have been introduced include: (i) allowing for preservation of debtor’s property and appointment of interim trustees prior to bankruptcy declaration; (ii) permitting professional firms (in addition to individual persons) to act as administrators; (iii) allowing creditors greater control over the selection and some of the actions of the liquidator (e.g., service contracts); and (iv) introducing more realistic and flexible fee structure for administrators. Critical areas that should have been improved were completely ignored by the Amendments, such as the need to align bankruptcy treatment of secured creditors with commercial bargains and expectations, the need for a functional corporate rehabilitation process, and development of a functional regulatory system.

Finally, not all the amendments were good. In fact, some have the potential to decrease the efficiency of the bankruptcy system even further. The most problematic of these include: (i) an amended definition for insolvency that is confusing and will likely discourage rather than promote timely filings; (ii) further erosion in the rights of secured creditors’ in realizing or protecting their secured interests in the debtors property; and (iii) the possibility for the courts to dismiss the creditors’ committee without well defined criteria; and (iv) introduction of a special treatment for enterprises under the program operated by the Revitalization Agency. For the most part, the pros and cons of the amendments are discussed collectively in the context of the liquidation discussion in Section 4.4 below, while the areas overlooked are treated more comprehensively in the recommendations for further reforms to improve corporate rehabilitation and institutional capacity contained in Sections 4.5 and 4.6 below.

It is worth noting up front that the Amendments now give courts discretion to decide whether general non-payment of liabilities is of an adequately “long period of time” to justify a declaration of insolvency. The phrase “for a long period of time” introduced into Section 1(2) is highly unpredictable;

until the courts rule on this question, neither debtors nor creditors will know if legal standards for insolvency are met. The effect of this amendment will likely create confusion over when a debtor is insolvent, weakening governance incentives for recalcitrant management and providing a less effective bankruptcy trigger for creditors. The Amendments also restrict secured creditors' rights, by requiring that 30 percent of net recoveries from enforcement of collateral lose priority and fall into the general creditor pool. As discussed below, this is contrary both to best international practice and to the incentives and goals of stimulating resumption of bank lending. The Amendments also contain some provisions that may contradict and weaken the efforts to improve creditor rights. This is the case, for example, of a provision that allows the courts to dismiss creditor committees without well defined criteria.

Finally, the Amendments also contain a special mechanism to allow a firm included in the RA program to file for a protection order, once bankruptcy petition has been filed. Non-RA creditors would have minimal rights. Though designed as a pilot for wider rehabilitation mechanism, it is a carve-out from the court system for only a tiny number of cases, and will likely offer few lessons for the broader cadre of enterprises in need of rehabilitation. Moreover, there is no credible rehabilitation mechanism in sight for the vast majority of indebted firms. Sterilization of RA firms from creditor control may create opportunities and incentives for "parking" major debtors in RA for long periods without meaningful restructuring.

In sum, while the recent Amendments were designed as an interim set of improvements that would be followed by more comprehensive legal revisions, this interim solution may not strengthen creditor rights sufficiently to rectify the current problems in the banking industry, and are not well integrated with other legislative reforms. Indeed, in view of the number of critical issues not addressed, and the introduction of some questionable legal elements, the Amendments may fail to improve significantly the environment for workouts and bank lending. The time has arrived for designing and implementing a much more integrated and coherent strategy to deal with the problem of corporate distress.

Designing a Coherent Strategy for the Czech Republic

In designing a reform of the bankruptcy framework in the Czech Republic, it is useful to stress the main areas where improvements are needed: (1) liquidation procedures; (2) composition and restructuring procedures, including a scheme for accelerated corporate rehabilitation; and (3) the institutional and regulatory framework for bankruptcy. In designing a bankruptcy reform it is also assumed that debt enforcement mechanisms outside bankruptcy have been improved, as discussed in section 3.2.

Improvements in the liquidation track are essential to provide a fast transfer of the assets of nonviable enterprises to more productive uses. The purpose of improving the liquidation track is not only to enable faster and efficient liquidations. A well functioning liquidation track also enable parties to better assess their risks and outcomes through court proceedings, and provides a baseline for negotiating out-of-court workouts in the shadow of the law. A credible and efficient liquidation track can also encourage development of a secondary market for classified assets, thus contributing to restructuring activity. Finally, improvements in the liquidation track could provide greater certainty to lenders and contribute to a resumption of lending activity.²³

²³ Surveys of developing economies have shown that the ability of financial institutions to make loans can be severely restricted by the undeveloped nature of the security law, the absence of adequate credit reporting facilities and the lack of suitable debt enforcement machinery. See, for example, the series of surveys conducted by Heywood W. Fleisig and Nuria de la Peña for the Center for the Economic Analysis of Law, Washington, into the way in which problems in the framework for secured transactions limit access to credit in Latin America.

The second element of the strategy is a reorganization scheme designed to rescue potentially viable enterprises. Here the Government faces three possible options, namely: (a) encouraging informal, voluntary, out-of-court, agreements between debtors and creditors; (b) introducing a more formalized scheme, but still outside the court system; and (iii) improving court-led reorganization procedures. Every emerging country facing a situation of generalized corporate distress had also to consider these three options. Most of these countries made efforts to encourage voluntary and informal agreements, among other measures, by amending their Bankruptcy Laws and enhancing the threat of liquidation. In some cases, there was also an effort to introduce some non-binding guidelines for workouts, along the lines of the well-known London Approach to multi-bank workouts. However, these non-binding schemes only work well in countries with more sophisticated legal systems due to the higher degree of certitude in the implementation of laws for enforcement and insolvency. Experience has revealed that these non-binding procedures do not work well in countries where the legal systems are less sophisticated and integrated, and where institutional enforcement mechanisms are inefficient and ineffective. A functional workout environment requires a number of critical elements (**Box 3**), and it frequently proves difficult to ensure the presence of all these elements in a non-binding environment. The difficulty to achieve more progress in a purely informal environment proves particularly true in the larger and more complex workouts involving many financial and commercial creditors, as well as large tax arrears.

Consequently, the trend in most of the transition economies and more recently in the Asian context have all relied on a streamlined but formalized system of binding workout rules. Hungary and Poland introduced separate laws in the early 1990s, establishing simpler procedures for workouts during a limited period of time (12-18 months). More recently, in 1998/99 Thailand promoted formal and enforceable contracts between debtors and creditors to deal with its financial crisis of 1997. All these countries also made parallel efforts to improve the restructuring or composition track under the bankruptcy law, although policy-makers remained skeptical of the possibility to achieve speed in court-led reorganization procedures.

It is worth noting that one problem observed in all these special out-of-court schemes is that they usually exclude commercial creditors, precisely to limit the number of players to the largest financial creditors, and ensure speed in the resolution of bank debt. However, if enter-enterprise arrears are large, the commercial creditors have to be bought out to prevent them from disrupting the agreements. Also, although out-of-court schemes may facilitate the fast resolution of a number of cases, they may also introduce some adverse effects. These schemes may lead to expectations of bailouts and to a weakening of financial discipline among enterprises.²⁴ Also, these schemes may lead debtors and creditors to avoid the court system altogether, hindering the necessary development of the judiciary.

The Czech policy-makers have to decide whether a special and temporary out-of-court scheme for reorganizations is justified under the present situation, or whether they should focus their efforts in improving the reorganization track under the Bankruptcy Law (in addition to improving further the liquidation track). The report recommends the latter solution for the Czech case, based on three main arguments. First, although the share of non-performing loans relative to total loans and GDP is comparable or larger than other countries such as Thailand, Hungary and Poland in the peak of their

²⁴ In Slovakia, the passage of a special law in 1997 introducing a special out-of-court scheme (the Revitalization Law) apparently led to a further weakening of financial discipline and an increase in bank and tax arrears. Although it can be argued that this problem was to a large extent due to the overall populist policies of former Prime Minister Meciar, they illustrate the risks posed by special out-of-court schemes.

Box 3: Fundamental Components of a Functional Workout Environment

While the process of workouts can be complex, there are a number of fundamental principles that promote the process:

- Neutral forum: a 'forum' in which both debtor and creditors can initially come together for the purpose of exploring and negotiating an arrangement to deal with the financial difficulty or insolvency of the debtor.
- Participants: the workout process should involve all key constituencies, generally the lenders group, and sometimes other key creditors who may be affected by the restructuring or are critical to the resolution.
- Coordination: to better coordinate negotiations, a 'lead' creditor should be appointed to provide important leadership, organization, and administration. The lead creditor typically reports to a committee that is representative of creditors to assist the lead creditor and to act as a provisional sounding board toward proposals.
- Stabilization: parties need to promptly stabilize the business operations and provide for negotiation period, which is generally reflected by a 'standstill' agreement (a contractual agreement to suspend adverse actions by both the debtor and the main creditors) that endures for a relatively short period. This may be compared with the 'moratorium' or stay of actions which is a feature under the formal rescue process in bankruptcy.
- Liquidity: liquidity is essential to stabilize the business, and may be more difficult to provide in informal workout procedures. This is because formal bankruptcy laws frequently provide for a 'super-priority' for on-going funding of a debtor, but that law does not extend to informal arrangements. In these cases, creditors need to devise a contractual super-priority by means of an 'inter-creditor' agreement, which clarifies that emergency funding by one or more creditors will rank for repayment in advance of their other respective entitlements.
- Information: access to reliable and accurate information on the business is essential to reaching a consensual agreement, including its business activities, trading position, and general financial statements. This is comparable to the statutory requirement for the provision of similar disclosure found in formal rescue regimes.
- Negotiation, Agreement and Voting: negotiating, agreeing and implementing the restructure plan is generally 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 approval necessary may vary depending on the specific acts undertaken during the restructuring (for example, 75-90% for restructuring, 75% for moratoriums, 66% for capital expenditures, credit draws and asset sales, and 100% for new money). In the case of new money, obviously no lender could be forced to extend new financing against its will.
- Legally Binding: the final restructuring agreement is made legally binding on a dissenting minority, providing they are party to an inter-creditor agreement that contractually binds them to the majority decision. Parties who have not bound themselves contractually would not be bound by the decision of majority creditors, which raises a risk that the restructuring could be rendered meaningless by independent action of minority and holdout creditors. In formal proceedings, the statute creates the mechanism for binding minority creditors.
- Finally, the ability to achieve a functioning restructuring environment also depends on a legal framework that facilitates the restructuring plan, such as allowing debt-equity swaps, forgiveness of bank debt and taking of collateral. The legal framework must also provide proper incentives for the parties to accept treatment that will render the restructured business viable (e.g., favorable offsetting tax treatment for debt forgiveness and debt-equity swaps).

crisis, these countries reacted very promptly to their crisis. In particular, their special out-of-court schemes were designed to rescue the largest possible number of viable enterprises in distress before they reached the point of insolvency. The situation in the Czech Republic is different in that the bad loan problem has been lingering for the last 10 years, and during this period many enterprises have had their

assets tunneled or stripped away. Therefore, the share of distressed enterprises that are candidates for liquidation in the Czech Republic today is probably larger than it was in these other countries when they introduced their special schemes. A special out-of-court scheme would therefore generate smaller benefits, while still introducing the risks and problems typical of these schemes.

Second, most of the bad loans have been carved-out of the banks and placed in KOB or its subsidiaries, and KOB will probably sell most of this distressed debt to third private parties. As argued in section 3, this is an appropriate strategy for the Czech Republic, as it facilitates bank privatization and insulates workout activities from political pressure. At the same time, it also implies an increase in the number of creditors (the strategic and financial investors that are expected to buy the distressed debt) and their objectives and incentives. Special out-of-court schemes designed primarily to reduce the debt burden of viable enterprises in a short period of time are simply not relevant and appropriate in these situations.

Third, a well designed fast restructuring track under the Bankruptcy Law could also be able to handle a relatively large number of enterprises that remain potentially viable in a reasonable period of time, without producing misleading signals, and while contributing to the long-run development of the court system. The main strategy followed in the design of these fast tracks is to minimize court involvement during the elaboration of the workout solution by the debtor and the major creditors, in order to maximize speed. The court is more involved in the very final stages, in order to ensure that minority creditors are bound to the agreement, that burdensome contracts are dealt with, and also that tax issues are more easily addressed. If the rules for court involvement are clear and streamlined, the overall procedure can be concluded in a reasonable period of time.

The sections below provide a number of specific recommendations for the design of an integrated strategy for the reform of the Czech insolvency system. These include recommendations for: (i) a further set of improvements in the liquidation track; (ii) the introduction of a fast restructuring or reorganization track; and (iii) the development of a medium-term institutional development program.

3.4. Reforming the Liquidation Track

Role and Significance of Liquidation Procedures

Liquidation procedures serve a number of important functions. They provide an important exit mechanism for inefficient enterprises, and enterprises can voluntarily leave the market place through company wind-up and dissolution procedures. These procedures are generally available only for solvent enterprises.

Insolvent enterprises raise more complex issues. When a company is insolvent, generally there is no remaining equity in the company. Such an event renders the creditors as the real financial stakeholders in the enterprise. This being so, shareholders should not make decisions on liquidation and dissolution of assets, when the proceeds of those assets will be used to repay only the creditors. For this reason, the formal court-supervised proceedings provide a more equitable and efficient forum for redistributing the value of an insolvent enterprise among the creditors, who themselves may have competing interests. As an exit mechanism for insolvent enterprises, the liquidation system should strive for efficiency in returning assets to new more efficient owners in the market place, while striving to satisfy the claims of creditors as quickly as possible, so that their economic stake can likewise be re-deployed into the market through other channels.

When properly functioning, liquidation laws also serve as a disciplinary mechanism posing a constant threat to inefficient management, who may be displaced through bankruptcy and have their

interests in the enterprise extinguished. In cases of financial distress, the liquidation statute serves as backdrop for informal negotiations and workouts between debtors and their creditors. If the rules of the liquidation process are clear, predictable and applied in a transparent manner, then parties to the negotiation have a clear understanding of the downside of bankruptcy and presumably will negotiate on more reasonable grounds to avoid this outcome.

There are other societal interests that play an important role in shaping the liquidation procedures. Such laws can serve as a safeguard to protect creditors against mismanagement and other abuses by an enterprise or its owners. Once an enterprise has reached a state of insolvency, former owners and equity holders generally have a marginal or non-existent role in the liquidation process, and the creditors become the principal decision makers.

The relative rights of creditors should be respected to the extent possible in accordance with their pre-bankruptcy contractual positions. Creditors who bargained for senior rights or the right to take collateral, had an expectation of being paid from their collateral or ahead of other creditors. On the basis of that expectation, they entered into financial arrangements with the enterprise that were perhaps more favorable to the enterprise (e.g., lower interest rates, larger credit exposures), because the risk of non-payment in the case of a default or an insolvency was reduced by these higher rights. To encourage lending on more favorable financial terms, market expectations of creditors in the rights for which they bargained should be upheld in bankruptcy. This means that secured creditors should be entitled to realize on their collateral and should not have their secured rights altered at the point of or after the commencement of proceedings. In order for this policy to have effect, it must generally be supported by a moratorium on payments to creditors for pre-bankruptcy claims, and combined with a prohibition on creditors from engaging in acts to recover on their claims through execution or other means. This latter avoids the self preservationist tendency of creditors to “grab” what they can as quickly as possible, at the expense and often in disregard for the rights of other creditors, including those holding more senior rights.

Finally, an overarching objective of liquidation should be an emphasis on administering the estate in a manner that is in the best interest of creditors. What is typically considered to be in the creditors’ best interest is realizing maximum value for the enterprise or the assets. Maximum value is rarely subject to precise calculations, formulas or determinations, and the time value of money must be taken into account. For example, receiving a lesser payment today would be worth more than receiving a moderately larger payment in five years. Creditors, who have an economic interest at stake, should have a strong influence on determinations and decisions regarding the disposition of assets. In other words, they should be allowed to decide for themselves whether they prefer less now or more later. To promote confidence and provide necessary checks and balances, the process of selling assets should be transparent, giving creditors full access to information that affects their interests. If a sale is to take place, creditors should be informed about the terms and have an opportunity to oppose sales that they consider not to be in their interests. Indeed, creditors may even have the right by appropriate vote to disapprove sales or remove and replace liquidators.

Major Problem Areas in the Czech Liquidation Process

The current legal and business environment in the Czech Republic precludes creditors, including banks holding security interests, from realizing optimal recovery on their bad credits for a variety of reasons. Many of the bad credits relate to enterprises that are already the subject of administration proceedings. Most of these proceedings have been ongoing for years. Given the diminished rights of creditors in bankruptcy, including those of secured creditors, the value of these credits is highly questionable. The system seems to be vulnerable to abuses, which materialize in the form of tunneling, fraudulent dispositions of assets, artificial purchase of services from related parties, and fabrication of artificial companies and claims to provide a mechanism for execution in defeat of the rights of other

creditors. Likewise, creditors having small claims have been successful in placing otherwise viable enterprises in bankruptcy with no prospect thereafter for rehabilitation, and to the demise of the negotiations that were ongoing between the major creditors and the enterprise in an effort to reach a meaningful out-of-court settlement.

While there are a number of problems in the liquidation procedure, there are three key areas that were previously identified as in need of immediate improvements: (1) commencement rules and effects; (2) the role and rights of creditors in the bankruptcy process; and (3) the regulation of time-bound procedures to assure swift resolutions. The recommendations for improvements in each of these areas are elaborated below in light of the recent Amendments.

Recommendations for Improvements in Liquidation (1): Commencement Issues

Test for Insolvency. In the recent amendments to section 1(2), the definition of “insolvency” has been changed by inserting the phrase “for a long period of time” to modify the language regarding the debtor’s inability to pay its obligations as they come due. This change dilutes the former definition by adding a less precise and more ambiguous phrase. The rationale for this change is the perception that the current definition is too harsh and results in too many filings, although the contrary is probably true. The effect of relaxing the commencement trigger could enable distressed enterprises, desperately in need of restructuring, to avoid their obligations by hiding behind an impotent definition of insolvency. The amendment will also make it more difficult for creditors to urge bankruptcy against debtors that fail to pay their debts and likely will perpetuate undisciplined conduct in the corporate sector, as creditors have a less credible threat against management to commence proceedings.

There are two common tests applied for insolvency—the “balance sheet” test and the “illiquidity” test. Under the balance sheet test, an enterprise is insolvent if its total liabilities exceed the fair market value of its assets, whereas illiquidity is based on cash flow criteria and relates to a debtor’s inability to service its debts as they come due. The balance sheet approach can be an inaccurate measure of insolvency, as domestic accounting standards and valuation techniques may give rise to distorted values that do not reflect fair market values, and where markets are not sufficiently developed and unstable. Where domestic practices and rules do not follow internationally accepted accounting principles, and are not uniformly applied by qualified valuation experts, the balance sheet test as the sole measure of insolvency may invite arbitrariness, uncertainty, and possibly even corruption. The balance sheet approach is also likely to be more costly and difficult to prove, as it generally requires an expert evaluator to review all books, records and financial data to reach a determination of the enterprise’s value.²⁵

The more common standard and the increasing trend for commencing proceedings is the use of the illiquidity test. As previously indicated, under this standard a debtor is considered insolvent if it has ceased making payments or cannot pay its debts as they come due. In other words, the company’s cash flow is insufficient to service its current obligations that come due in the ordinary course of business. When debts are due is determined by the terms of the contracts that govern the relationship. The current definition, coupled with Section 3(1) and 3(2) requirement for debtors to commence procedures when they are bankrupt, places more responsibility on debtors and their management and directors to act responsibly, but still leaves uncertainty as to when the enterprise is bankrupt, which may be open to

²⁵ Fair market value is generally considered to be the value that can be reasonably expected to be obtained in an arm’s length sale between a buyer and a seller, where neither party is under a compulsion to buy or sell. A difficulty in establishing accurate valuations is that there may be different values based on the assumptions made for the sale of the assets in question. The only real test of a fair market value is what is achieved through the sale, although some techniques have been developed to approximate value on the basis of sales of comparable businesses and assets, or on the basis of a multiple of the enterprise’s earnings potential.

subjective interpretation of phrases like “a long period of time” and “overburdened with debts.” The former is tied to an illiquidity concept and the later to a balance sheet concept of insolvency.

When deciding on the requisite trigger for commencing proceedings, consideration should be given to potential abuses by debtors or creditors. Accordingly, where a debtor is improperly using bankruptcy as a shield against a single creditor, creditors should have the ability to seek a dismissal of the proceeding or a conversion to a composition or fast track arrangement, which might be in the best interest of creditors. The system should also be protected from abuses by creditors intent on using bankruptcy to unfairly force viable businesses out of the market place—that is, using the bankruptcy system as an extortion mechanism.

Changes to Section 12a(1) now require the court to make a decision on debtor filed petitions within 10 days, which will correct some of the problems associated with lengthy delays. Pending a decision and entry of a declaration order, the debtor should be presumed to be insolvent and the court allowed to take all steps required in the event of such insolvency. The shorter period is also bolstered by the Amendments to Section 4a(1), which would prevent the debtor from disposing of assets, except in the ordinary course of business. The shorter timeframe for debtor initiated petitions will also assure greater protection to creditors resulting from the injunction on disposition of assets that is invoked at the point of commencement of proceedings. For creditor filed petitions, the court still has no clear timeframe, other than to declare the bankruptcy “without undue delay.” Clearly, some reasonable time limits should be established for deciding creditor filed petitions (e.g. 60 days) with summary procedures involved for evaluating whether applicable criteria have been met.

Avoiding Disruptions by Small Creditors. There seem to be cases in which small creditors trigger a liquidation, despite the fact that the debtor and the major creditors or lenders were involved in informal workout discussions. While bankruptcy should be available to small and large creditors alike, it would be useful to sort those cases out in which the filing of a petition is the result of a single creditor action and not an instance of real insolvency. The new obligation on petitioners to deposit up to CZK 50,000 against the costs of the proceeding, with prospect for further deposits, may discourage some improper filings.

Effects of Commencement. The commencement of proceedings should have two major effects: (1) the institution of a moratorium on repayment of debts that arose before the filing of the petition, (2) the enjoining of actions by creditors to enforce their claims and rights against assets of the enterprise, through collection efforts, adjudication, execution, or otherwise. The effect of commencing a proceeding, whether debtor or creditor initiated, raises one of the more difficult policy choices faced in designing a bankruptcy law. The decision requires a careful balancing of competing policies—sanctity of contracts (especially as relates to enforcement rights to collateral), *pari passu* treatment of creditors,²⁶ maximizing asset values for all creditors, and rescue of viable enterprises. All systems generally impose a moratorium on repayment of debts, although there may be exceptions for set off rights, netting of financial contracts and other important interests. The second effect is more problematic: Which creditors should be prevented from exercising their collection rights and as of what moment in time?

In cases of “rehabilitation,” the issue of whether to enjoin creditor actions is fairly straightforward. A business cannot be reorganized, if it has no assets remaining to reorganize. Consequently, the policy supporting rescue of an enterprise necessitates that an injunction or stay of

²⁶ The “*pari passu*” principle holds that similarly situated creditors should receive equal treatment in respect of their claims, meaning a proportionate recovery from the proceeds of sale. The imposition of a moratorium on payment to any one creditor and the prohibition on creditors from “grabbing” assets to satisfy their individual claims is designed to give effect to the *pari passu* principle that equal creditors should receive an equal distribution in proportion to their claims.

creditor actions be imposed for a reasonable period of time to prevent creditors from disassembling the business, while the parties negotiate a rescue plan. This reasoning does not necessarily apply in the context of a liquidation.

In a liquidation, the emphasis is on selling the assets, in whole or in part, so that creditors can be repaid from the proceeds, as quickly as possible. Maximizing value is an important objective, if all creditors are to receive something. The difficult balance here is between the competing interests of secured creditors, with collateral rights, and the interests of the general unsecured creditors. More often than not, the secured creditors will hold a secured interest on the most important assets of the business. Arguably, in a liquidation, where the interest in preserving enterprises does not exist, the balance of interests should tilt strongly in favor of upholding the contracted rights, subject to respecting the “*pari passu*” principle. In other words, there should be a strong interest in protecting secured rights and allowing such creditors to recover their collateral. Because such creditors have rights that are senior to or different than those of unsecured creditors, special treatment of such rights does not violate the “*pari passu*” principle as among unsecured creditors. At the same time, the interest in protecting secured rights should be balanced against the strong interest in maximizing value in the liquidation of the business. This often means, in the first instance, attempting to sell the enterprise assets collectively, rather than in piecemeal fashion. We discuss in more detail in the next section on Creditor Rights the implications of the choices on creating incentives and disincentives for the overall process.

BCA section 14(1)(c) and (d) result in a suspension of proceedings and preclude creditor actions to collect against estate assets. A principle shortcoming in the earlier law related to the “timing” as of which the suspension of creditor actions should commence. Previously, when a petition was filed, there was a gap period between the date of the petition and the date the bankruptcy was declared. Section 12(a)(1) of the Amendments shortens the gap period to 10 days where the proceeding is initiated by the debtor. The shortened period under the new Amendments does not apply to petitions filed by creditors, in which case the gap period could continue to be as long as 6 months, if the court deems necessary and in keeping with the requirement to act “without undue delay.” During this gap period, creditors are not prevented from exercising their enforcement rights through execution procedures, the effect of which is that creditors holding junior claims or rights could potentially elevate their claims over those of other more senior creditors, including secured creditors, during the gap period. Indeed, if altogether successful in their enforcement, they may even prevent the business from being sold as a productive unit by grabbing some of the key assets, thereby diminishing the value for the remaining creditors.

To rectify this problem, ideally the filing of a petition should have immediate and automatic effect to halt or enjoin actions by creditors to obtain or enforce claims against the debtor or to recover or collect against the debtor’s assets, pending a determination by the court on declaration of bankruptcy. This would prevent creditors from gaining an advantage over other similarly situated or even senior creditors during the gap period between filing and declaration. New sections 5(a) and 5(b) now allow the debtor, in cases of petitions filed by creditors, to seek a protective order, provided the request is made within 15 days of the filing of the petition. The protection period can last for three months and is subject to one extension for up to three months. As it is obligatory that the request for a protection period be brought within the 15 day period, it is unclear whether a debtor has relief if appropriate circumstances for protection arise only after the 15 day period. In other words, will the court automatically grant a protection period when there are no overt acts threatening the enterprise or its assets, even though such threats could arise after the 15 day period expires?

This change should be useful in promoting a level playing field in which creditors can negotiate out-of-court. If one creditor seeks to gain an unfair advantage over others by pursuing actions designed to give it satisfaction on its claims, that creditor’s actions could be halted immediately or reversed by the filing of a bankruptcy petition. It is possible in such cases that more debtors may be inclined to

commence proceedings, in order to gain the automatic benefit of the injunction against real or perceived threats by creditors. However, the potential for misuse by debtors can be offset by stronger creditor involvement in the bankruptcy process, in which management loses control, as recommended below. In general, the new language on the protection period should be of tremendous benefit to preserve assets and foster negotiations during the pendency of a petition. The new Amendments also require notice to creditors, party to the proceedings, and filing with the Commercial Register and in the real estate cadastre, which should provide effective notice to non-parties.

Recommendations for Improvements in Liquidation (2): Strengthening Creditor Rights

Creditors have played a passive role to date, and have ultimately experienced very low recoveries on their claims. The impossibility for creditors to play a more active role and enhance recovery rates has tended to press risk premia and interest rates and, more recently, has also led to a rationing of credit. The general solution to this problem lies generally in strengthening creditor rights, including the right to approve or dismiss administrators, the right of access to information, and the ability to review and approve sales of assets. However, the strengthening of creditor rights also involves many specific issues that need to be examined in greater detail.

Retention of Title Holders and Secured Creditors. Consistent with the superior rights held by such creditors prior to the commencement of bankruptcy proceedings, these creditors should have among the highest rights and priorities in bankruptcy. Section 28(1) of the BCA entitles secured creditors holding mortgages to have their claims settled from the proceeds of the sale of the property encumbered by such lien or mortgage. While this has the appearance of affording protection to such creditors, they have little genuine protection under the law. First, the statute is not entirely clear as to the rights of creditors holding liens in personal property (e.g., equipment, inventory, receivables). Second, there is no time period contained in the statute that indicates when such “separated creditors” must be paid following receipt of proceeds (the language in Section 31(1) is discretionary not mandatory). Third, and perhaps most significantly, such creditors are effectively obligated to underwrite the costs of the administration for the benefit of all creditors, including those with more junior rights.

Section 28(4) entitles separated creditors to receive only 70 percent of the proceeds of “realization due them.” This latter phrase is ambiguous and subject to multiple interpretations. It could mean that they receive only 70% of the amount of their claim, irrespective of the value of the collateral. Alternatively, it could mean they are entitled to 70% of the total proceeds of the sale up to the amount of the claim. The former interpretation means that separated creditors would never realize more than 70% of their claim, irrespective of the value of the collateral, a result patently unfair where the creditor is substantially over-secured, or where the collateral has a value significantly higher than the claim. Under the alternative interpretation, the return to the creditor will depend on the value of the collateral and amount of proceeds realized. The portion of the claim not entitled to payment from the proceeds of the collateral is treated in the same class with other unsecured creditors.

There can be no commercial justification for this approach, which is apparently based on some equitable notion that all creditors should get something from a bankruptcy proceeding or that secured creditors should bear the burden of administration, even though this inures to the benefit of other creditors. Such a concept ignores commercial realities and undermines the significance of contractual bargains. As a practical matter, such a provision will lead to continued constraints on credit flows as lenders demand onerous covenants in their credit agreements, such as requiring higher collateral to debt ratios. Based on the examples given, a creditor would need to have a debt to collateral ratio of 1 to 1.43 to recover full value. In actuality, sales of assets in bankruptcy typically result in significantly lower values for the assets and delays in payment increase the time value loss to creditors. Moreover, pursuant to Section 28(2), proceeds on which the 70% rule is applied are net of the maintenance, administration,

and sale of pledged items, rights and receivables. Consequently, to properly protect itself, a secured creditor would need to take collateral in a value that is 2.5 to 3 times the amount of debt (principal and interest).

The result creates another perversion in commercial relationships. Unsecured creditors, who typically realize no recovery from bankruptcy, will be encouraged to commence bankruptcy proceedings, where they are assured of getting at least some payment, even if this is at the expense of a secured creditor or, as in one particularly egregious case described, a secured creditor on the verge of negotiating a consensual restructuring. This inappropriately tilts the negotiating leverage in favor of small unsecured creditors, who may have no genuine financial stake in the enterprise based on the relative priorities of claims under commercial laws.

With respect to the prior practice of delayed distributions, the Amendment to Section 30(3) allows for interim distributions to creditors. This might result in quicker distributions to secured creditors, but there is still no obligation for such distributions to be made, as the provision is discretionary ('may' as opposed to 'must'). Section 30 appears intended for the creditor body at large. The law should provide for an affirmative obligation to deliver the proceeds as soon as possible following the closing on the sale.

Finally, the amendment to Section 14(1)(i) seems to strengthen the anti-setoff provision, making such rights more prohibitive. The prior proposal for an exception in cases of apparent closeout netting contracts (presumably intended for derivatives) was not adopted. Thus, the treatment for netting agreements in swap and similar transactions remains even more vague after the Amendments.²⁷ In general the result of changes here further reduces the rights of secured creditors, by undermining the principle allowing setoff in the context of insolvency for mutual claims.

Given the current weak lending environment in the Czech Republic, the current treatment of secured creditors sends a strong signal to lenders that collateral and retention rights have no particular significance other than assuring partial payment from a particular property ahead of others. Even this is questionable, given that a portion of the proceeds can be diverted to the benefit of other creditors or for the costs of administering the estate for the creditor body at large. In other cases, State or junior creditors may be able to take a priming lien through adjudication proceedings, if they are able to take advantage of execution measures before bankruptcy is declared. Aside from the uncertainty of the priorities, the ability to manage the risk on assets constituting collateral often requires that such creditors be able to act quickly and decisively.

The only reason for holding the rights of these creditors in abeyance in the context of a "liquidation" procedure would be to attempt the sale of businesses as a whole, with the hope of increasing sales proceeds for all creditors, without reducing the value of secured creditors' claims. The interest in maximizing value for all must be carefully balanced against the incentives and disincentives on secured creditors with respect to lending activities, and in relation to incentives to engage in out-of-court workout procedures. Two options to address this problem are provided below.

Retention Rights. It is unclear from the BCA whether claims by holders of retention rights would be exempt from bankruptcy. This might be one interpretation of section 6(2), which excludes assets that

²⁷ The International Swap Dealers Association has developed several master agreements to govern international transactions involving currency and interest rate exchanges that rely on setoff and netting provisions. Legal opinions can be issued on the integrity and safety of such transactions where the relevant provisions of the insolvency statute assure protection for closeout netting arrangements. This is a complex area and requires careful consideration.

cannot be the subject of an execution. If so, the matter should be more clearly addressed. Retentions of title are generally recognized throughout continental Europe to confer on the holder of such rights an “ownership” interest in the property in which the retention is held, until the occurrence of an event such as full payment of the purchase price, at which time ownership or title passes to the debtor. If the retention right is valid, then technically the property should not be included as a part of the estate. Under these conditions, the debtor or administrator should be obliged to relinquish the property to the holder of the rights, upon proof that the retention rights are valid. In response, the debtor or administrator can present proof of payment indicating that it has acquired in full or in part an interest in the property.

If the debtor can demonstrate an interest in the property, meaning the value of the property exceeds the outstanding debt or liability to the retention rights holder, then either the holder of the retention right or the administrator may be allowed to sell the property, whichever is best suited. In some cases, it may be appropriate for the retention of rights holder to be allowed to take the property and offset its claim against the enterprise. Where value is realized in excess of the retention holders interest, this should be refunded to the estate, or the administrator. If the administrator decides to sell the property, the retention holder should be paid as soon as possible from the proceeds, rather than allowing the administrator to continue to utilize the proceeds to fund other collection activities. Where the proposed sale is likely to generate inadequate proceeds to repay the retention holder, it should have the option to veto the sale and take back the asset at the offered purchase price.

Rights of Secured Creditors. Under Section 28 of the BCA, secured creditors are entitled to payment out of the sales proceeds of the property that secures their claims, but otherwise have few if any rights. Significantly, secured creditors have no assurance that the value of their collateral will be protected against erosion, nor that other efforts will be made to protect the interest of their claims. The result is that the risk of deterioration in value due to delays by administrators is borne entirely by the secured creditors, ultimately rendering secured creditors less secured.

The purpose for taking the collateral is to reduce one’s risk of loss following non-payment. The decreased risk to the lender enables the enterprise to obtain credit on more favorable terms, generally at lower interest rates. Where the obtaining of collateral ultimately proves ineffectual in reducing this risk, the market and lenders will respond by passing on the costs of the increased risk to borrowers through higher financing costs. The need to encourage credit on favorable terms requires that lenders have confidence in the rights that are intended to protect them. This is equally if not more true in bankruptcy. The difficult balance in the enforcement of these rights in bankruptcy hinges on the extent to which the secured creditor can be protected pending an administrator’s efforts to sell the business or assets.

It was earlier recommended that the commencement of proceedings, or the mere filing of a petition, should automatically prohibit creditors from engaging in acts to collect their claims through adjudicative or execution procedures. Such a stay of execution and enforcement generally promotes higher sales values for the business where it enables the enterprise or particular divisions of the enterprise to be sold as an operating unit. Conversely, the enterprise may have less value if it is dismantled and sold in pieces. There is a natural tension between the objectives of maximizing the estate value for the benefit of all creditors, and the need to protect the rights of an individual secured creditor in its collateral. Should the balance of rights tilt in favor of secured rights in a liquidation, or should the balance favor all creditors. The loss of vital core assets will undoubtedly diminish the value of the remaining assets considerably, or even render them worthless, in which case the rights of unsecured creditors are entirely ignored. In most systems, the balance of policy has led to two primary options for the treatment of secured creditors in bankruptcy, as described below.

Option 1: Exemption of Secured Creditors from Bankruptcy.

- *Consequences.* The consequences of exemption would mean that secured creditors are not affected by the bankruptcy and may carry on business as usual, including enforcement of their contractual rights through collection and execution proceedings. Notably, this approach does not oblige the liquidator or administrator to surrender the collateral to the secured creditors (although this too would be an option) but merely allows them to pursue their contractual enforcement rights.
- *Arguments in Favor.* This option would encourage debtors to be more financially responsible, at least with their secured creditors, who are more likely to be major lenders. This solution also promotes lending on the most favorable credit terms, by giving the highest assurance to the market that these rights are protected. Other justification for this solution is that the specific “secured” rights should take precedence over the more general unsecured rights, especially where a secured creditor has been more diligent in protecting itself. Rewarding positive behavior will encourage more creditors to be diligent in protecting their interests. This option would also make the bad debt more attractive to buyers, making it easier to auction the bad debt that is secured. Finally, another argument for this option is that the need to preserve assets and going concern value is less significant in a liquidation proceeding, which is by nature terminal.
- *Possible Shortcomings.* Under this option, lenders may have little incentive to reach consensual resolutions, if they can immediately get their collateral. Debtors may have no incentive to use bankruptcy as a means of blocking actions by creditors to execute on their claims. Finally, faced with few options to protect itself, debtors may be induced to engage in consciously fraudulent actions or to commence bankruptcy proceedings under the composition provisions.

Option 2: Temporary Injunction on Secured Creditor Enforcement

- *Consequences.* The consequence of non-exemption is that a secured creditor might be enjoined from recovering its collateral for a period of time (e.g., 60 days), while the administrator seeks to sell the collateral. If a legitimate bid has been received within the 60 day period, the court might extend the period of the suspension of proceedings for a reasonable time to allow the sale to be consummated (e.g., 30-60 days). During this time, the secured creditor would be allowed to accrue interest on its claim. If the bid on the enterprise does not exceed the amount of the secured creditors claim, the secured creditor might be given an option to veto the sale. Conversely, the secured creditor could voluntarily agree to allow the liquidator/administrator to continue to attempt a sale of the collateral by the estate for an agreed period of time on the same or similar terms. In cases where the collateral in question has a value clearly in excess of the amount of the secured creditor’s claims, the administrator should be allowed an extended the period of time to attempt to sell the collateral. As with retention of rights holders, where collateral is sold by the liquidator, distributions of sales proceeds should be made immediately to secured creditors. Upon expiration of the temporary injunction, the secured creditor would be entitled to pursue its rights, or would be entitled to an immediate surrender of the collateral. At this point, the consequences are virtually identical to those under Option 1.
- *Arguments in Favor.* This option allows the administrator some minimal period of time to attempt the sale of the entire business in order to maximize the recovery for all creditors. It also encourages the sale of enterprises as operational and productive units rather than on a piecemeal basis. The administrator should be allowed to sell the assets to realize maximum value for all creditors, but the secured creditor should be protected by assuring that the collateral value does not erode, and by granting the secured creditor the right to be paid accrued interest on its claims. Under this option, secured creditors will also have a stronger incentive to engage in negotiations where there is a viable enterprise and the sale of the whole could lead to a greater return.

- *Possible Shortcomings.* This option introduces an element of uncertainty to secured creditors. This element of uncertainty may be only be minimized by the introduction of clear and time bound rules for the sale of enterprise and the compensation to the secured creditors for any delays that this option may entail.

Recommendations for Treatment of Secured Rights. Of the two options above, clearly either one could be justified in the current Czech environment. Option 1 tilts the balance strongly in favor of secured creditors, and would tend to create more certainty in lending decisions. This would ease credit going forward following a period of demonstration in which such rights are tried, tested and upheld. Option 2 provides a better balance in the rights and may create better incentives for all parties to engage in reasonable negotiations out-of-court. This is probably a better approach as an interim solution, in view of the need to deal with the high levels of non-performing stock, and the need to encourage consensual restructurings. If option 2 is followed, it is important to ensure that the claims of secured creditors are not diminished. This would require strict time limits on the sale of the enterprise assets, and interest accrual on the claims of secured creditors during this period. Moreover, the interest rate should be sufficiently high to compensate the secured creditors for the delay in payments and the additional costs that they would incur as a result of a delay in the enforcement of their rights.

Creditors Committee. As a general rule, the provisions pertaining to the creation of a creditors committee are not problematic. Section 11 of the BCA requires the creation of a creditor's committee where there are more than 50 creditors, and provides for appointment of a joint representative where few creditors exist. The Committee is comprised of 3 to 9 persons chosen to represent the joint interests of all creditors. There will be some cases in which it does not make sense to have a committee. In other cases, however, where there are substantial assets to be sold or liquidated, the role of the committee can be important. Given that the real stakeholders in the estate are the creditors, they should be entitled a strong role and be entitled to give approval to critical decisions. The Committee also serves as the primary check on the activities of the enterprise, the administrator or the liquidator. The Committee serves as a voice for all unsecured creditors and should be representative. Irrespective of the composition of the Committee, secured creditors should be entitled to vote on matters that affect the entire estate and their interests, such as selection and removal of an administrator or liquidator.

Under both options 1 and 2, secured creditors should not be represented in the creditor's committee, if they are fully secured or over-secured. This is because in these cases secured creditors have little in common with unsecured creditors, and their ability to participate in and potentially alter the outcome of decisions by the Committee would be inappropriate and not in the best interest of other creditors. By nature, the interests of secured creditors often conflict with those of unsecured creditors, especially where secured creditors are in favor of a quick sale of their collateral. Secured creditors might be afforded the opportunity to participate on the Committee, if their interests are reasonably aligned with those of other general unsecured creditors, which is most likely to be the case where they are substantially under-secured. Even in such cases, however, it is not clear that partially secured creditors will have similar interests, as it may be in their best interest to realize a quick sale of assets.

In other proceedings, such as composition or rehabilitation proceedings, the interests of secured creditors might be properly represented in a Committee that is charged with negotiating with the debtor and other parties. However, care should be given to avoiding potential conflicts of interest, where secured creditors have the potential to control the outcome and could be acting in their own self-interest as opposed to that of the general creditor body.

Transparency and Approval Rights. Creditors and a creditors' committee can serve as an effective check and balance on the activities of an administrator or liquidator. One of the principal complaints by secured creditors is the lack of confidence in administrators who are selected on the basis

of rotation, without requiring special skills, training or qualification for the kind of business in question. New section 8(5) allows the creditors to relieve the trustee selected and appoint another of their own choosing. The court may only reject such a motion if it has “serious doubts” about changing the trustee. While this represents a significant step forward in the activation of creditors in the process, the decisions of the committee or creditors might be undermined by vague statements such as “serious doubts.”

Section 10(1) and (2) allows a meeting to be convened at the request of creditors, the outcome of which is to be based on a majority of those present and voting in favor of the motion. At the outset of the case, the creditors meeting is called by the court, but may not occur for 2 to 3 weeks, during which time abuses could occur. While the role and power of the Committee is potentially expanded, it remains vulnerable to challenge by the court, which may on “significant grounds” recall the committee under Section 11(4). Significant grounds is not defined, so creditors and committees could be challenged on subjective grounds.

In order to effectively monitor proceedings, creditors should be afforded an opportunity to obtain relevant, accurate and current information on the debtor’s enterprise, trading activities and financial affairs. This requires that proceedings and the activities of the administrator be open and transparent, and that administrators be held accountable for their conduct. While notice to the entire creditor body may not be required, notice should be obligatory for the Committee, major creditors, including secured creditors, and fiscal creditors. Significant events might be published in an appropriate public journal to provide additional notice to creditors at large.

Finally, on significant sales, the views of creditors and/or the Creditors Committee should be taken into account by the court. They should be consulted by the administrator or the judge, and should be afforded a fair opportunity to oppose major actions that will affect their interests. Having an ability to veto actions outright is less significant where the secured creditors have already been given the right to take their collateral. On the other hand, the ability to veto sales by a majority vote should be considered as a means of keeping administrators honest. One need also consider an appropriate check on irrational creditors who have unrealistic expectations. In general, creditors tend to act in a rational manner if they have full access to information to make decisions and have a financial stake involved. All rights to information and disclosure for the Committee should be deemed to include all creditors, including secured creditors. In cases where the assets to be sold are those of a secured creditor, such creditors views should be given heavy weight.

Claims Registration and Distribution Procedures. Among the items raised as obstacles to efficient liquidation is that the claims registration and distribution procedures are overly complex and imprecise. One of the primary obstacles to efficiency stems from the process for resolving disputed claims, which apparently must be decided by another judge or may be subject to resolution in another courts, through a cumbersome process of appeals. While the amendment to Section 30(3) allowing for interim distributions should lead to greater efficiency, the rules need to be clarified with respect to treatment of distributions when “disputed” claims are pending.

To the extent possible, the claims registration process would benefit by having clearly defined time periods and standardized registration forms, if not currently in wide-spread use. Many countries employ official forms for this purpose. Such forms aide in the cataloguing process. With respect to determining the validity, amount and relative priority of claims, these issues may take longer where a large number of claims are disputed or the resolution of priority turns on complex legal analysis.

Claims disputes should be subject to summary proceedings in which multiple claims are the subject of a single petition or complaint. An administrator or liquidator need not necessarily oppose each claim in an individual pleading. Many claims in bankruptcy fall into common categories of objections

(e.g., improper amount, duplicate claim, improper classification). Such claims can often be resolved quickly, by requiring simple proof from claimant, or by dismissing claims where claimants fail to respond timely. Consideration should be given to assuring that the time frames for concluding the registration process happens as quickly as possible within reasonable parameters.

The primary function of the claims registration process is to determine the relative entitlements to distributions and pay creditors as quickly as possible. The new provisions for interim distributions, if adopted, would remove a significant constraint to efficiency. Where some claims are disputed, the pro rata portion of the interim distribution proceeds to satisfy such claims, if ultimately proved or identified, should be set aside pending resolution. The pooling of such portion of the proceeds as relates to disputed claims, enables the administrator to get on with the case for undisputed claims, while taking the time necessary to address unresolved or disputed claims.

At such time as the claims are allowed, the applicable proceeds may then be distributed. If the claim is disallowed, however, the proceeds are returned to the estate for the next interim or final distribution to creditors. Finally, the priority of distributions should closely reflect market realities for the rights held by such creditors at the time the bankruptcy was commenced. Secured creditors should be paid well in advance and at the earliest convenience from their collateral. Administrators should be discouraged from engaging in endless litigation to settle claims that have marginal or negligible value, especially where the distribution to be made to creditors is likely to be very small.

Recommendations for Improvements in Liquidation (3): Time-Bound Procedures

One of the most significant problems in the efficiency of the liquidation process is the amount of time it takes to process and close cases—from 3 to 6 years.²⁸ Clearly, one explanation for the delay has to do with the absence of a liquid market for assets—it simply takes a long time to find willing buyers who can pay a reasonable price. Another explanation for the lengthy proceeding can be attributed to inexperience among participants and professionals involved, which can be improved through long term institutional capacity building and training efforts (discussed below). However, part of the problem is also due to excessive flexibility and weak creditor rights (discussed above), with long deadlines or open ended procedures for significant events. While flexibility can enable the process to be adapted more fairly to the circumstances of each case, too much flexibility and discretion can lead to abuses.

The entire process should be contained within a reasonable time frame, which does not exceed 1-2 years, except in rare and unusual cases. This may require the inclusion of automatic deadlines, by which certain acts and events occur. For example, once a petition has been filed by a debtor, the bankruptcy might be deemed declared. The recent Amendments do impose some time-bound procedures (e.g., 10 days to declare bankruptcies when application filed by debtor). Additional provisions would further improve the efficiency, such as for the filing of key documents, claims, etc.

Because the creditors should play a key role in the process, the creditors meeting should be set at the earliest possible date by which reasonable notice can be given to creditors to attend (e.g., within 30 days). Administrators or liquidators should be obliged to perform certain administrative duties by defined dates. For example, the filing of certain reports, the commencement of solicitations for expressions of interest in the enterprise and the assets, the compiling and identification of claims, and the distribution of proceeds. Administrators should also be required to complete on a monthly or 6 week basis a form disclosing activities and the operations. Such forms can be developed to streamline the process and to

²⁸ Konsolidacni banka, a creditor in approximately 1 out of 5 cases, has indicated that the average time of bankruptcy cases in which it is involved has been approximately 5.9 years. This may imply that the duration of some cases is well in excess of 6 years.

render it more uniform from court to court. In cases where it is clear that there are little or no assets, many of the reporting and other requirements might be by-passed altogether. Where the only assets of the estate are potential recoveries from juridical acts or avoidable transfers, the creditors themselves might appoint a representative of their choosing to pursue the litigation, subject to covering costs.

While there are many other areas where clear deadlines could be set, it is worth noting that the overall time frame could be substantially accelerated by imposing Option 2 above for protecting the right of secured creditors. These creditors would be entitled to take their collateral back within a reasonable period of time (e.g., 120-180 days) if the administrator did not act with haste. The result could lead to better incentives for administrators and secured creditors, and the development of a more efficient non-bankruptcy process for disposing of assets by lenders and secured creditors, and would alleviate an enormous burden on the courts by relieving them of the obligation to continually monitor cases that linger for years. The fundamental point is that all participants should be given a clear roadmap on the timeframes and, to the extent possible, timeframes should be designed to promote an integrated and sound credit culture.

3.5. Strengthening Corporate Rescue through Fast Track Procedures

The Role and Objectives of a Fast Restructuring Track

The restructuring or composition process is virtually non-existent under the current bankruptcy system. Only a few strategic compositions have succeeded. In part, this is due to the strict burdens imposed on debtors who wish to commence these proceedings. Section 50(1)(d) of the BCA obligates the debtor to pay at least 30 percent of the debt of certain non-preferred creditors within two years of the filing of the petition for composition. Prior to the Amendments, these obligations had to be satisfied by cash payments. The Amendments relaxed this requirement and now allows for payment in kind or by the issuance of new shares. Other reasons for the lack of success in compositions is due to a shortage of adequately trained and experienced professionals, although such professionals clearly exist in the Czech Republic. However, the absence of court-led restructurings is also due to an ineffectual system, lacking appropriate incentives and disincentives.

The recent amendments make some minor changes in the composition process that might theoretically make the process easier, but there are still fundamental problems with the design of the composition track. Given the potentially large number of candidates for restructuring, the low capacity of the courts, and the need to ensure speed in the procedures, the Government should consider adopting minimal streamlined procedures to approve restructurings on an accelerated time table. This can be achieved applying the basic principles outlined below, and could be implemented in a manner that would complement an out-of-court workout process.

One of the principal goals of the fast restructuring track is to encourage parties to engage in out-of-court negotiations. With a much stronger liquidation track, debtors and creditors will be encouraged to negotiate against the backdrop of a worst case scenario. A fast track restructuring approach is designed to provide a fail safe process by which the opinion of the majority of creditors can be swiftly implemented over the objections of the minority class of creditors. The process would be streamlined to create further attraction in its use. A by-product of effective implementation of the fast track is that more conventional restructurings will be able to occur as the process becomes better understood and a track record of experience gained.

Adopting a very streamlined restructuring track, but still subject to approval by the court, is not the only possible solution to a problem of systemic corporate distress. Other countries have experimented different formal or quasi-formal schemes outside the court system. As mentioned before, Hungary and

Poland introduced special and streamlined out-of-court schemes to deal with widespread corporate distress in the early 1990s. In both countries, the scheme was introduced through a special law and operated during a relatively short period of time. Thailand introduced a scheme involving enforceable debtor-creditor contracts, strongly promoted by the Central Bank. All these schemes were formalized civil law variants of the so-called London Rules, which were originally introduced by the Bank of England in the 1980s as informal guidelines designed to facilitate voluntary workouts in a common law environment. The primary objective of these formalized schemes was the conclusion of a large number of workouts in a relatively short period of time.

The objective of the fast restructuring track elaborated below is also to streamline the procedures and promote the successful conclusion of many workouts in a relatively short period of time. However, this option may offer some advantages over other options. A fast, bankruptcy-oriented solution for corporate rescues, promotes institutional capacity and long term development within the court system for handling corporate rescues. A predictable 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. It may also be easier to bind dissenting creditors under a court-led procedure. This may prove a strong advantage when there are many commercial creditors. The fast track approach discussed below attempts to build on best international practice for efficient court led rescue models and addresses the shortcomings encountered in other transition economies.

Principal Features and Requirements

Introduction of the Fast Track in the Bankruptcy and Composition Act. The fast track would be introduced by an independent set of provisions that build on the composition statute, but which provide self-contained time frames and procedures once the process is initiated by eligible parties (debtor or creditors).

Required Changes in Other Laws. The introduction of the fast track would have to be accompanied by changes in other laws, designed to create appropriate incentives and disincentives to restructurings and workouts. Changes needed will relate to the following legislative procedures:

- Execution law amended to provide streamlined foreclosure and provide stronger rights to secured creditors. The existing proposals to create obstacles to foreclosure (e.g. by requiring debtor's consent) should be repealed;
- Bankruptcy law amended to strengthen creditor rights further, and allow speedier liquidations of non viable companies, as elaborated above;
- Commercial and Civil Codes amended to facilitate debt equity swaps, spin-offs;
- Tax laws amended to assure tax neutral treatment of debt-equity swaps and debt forgiveness, including forgiveness of tax arrears;

Eligible Enterprises. In view of the low average development of the judiciary, and the wide difference in skills across courts and professionals, it may be necessary to restrict initial access to the fast track, and also to introduce a pilot program. Threshold entry requirements should be based on viability, asset values in excess of stated amounts, liabilities in excess of stated amounts, and at least a certain number of employees.

Skills Levels. Judges selected for the pilot program would undergo training on the new fast track procedures to assure efficiency in administration, including in critical areas pertinent to restructuring of businesses (e.g., interpretation of financial statements and balance sheets, financing techniques, corporate finance issues, valuation techniques). A Fast Track handbook would be developed explaining the entire

process, step-by-step procedures, and containing appropriate standardized forms to be used in connection with the fast track rules. Designated judges in the pilot program should meet frequently, to assure consistency in implementation.

Standardized Procedural and Administrative Rules. These would be clearly expressed in the statute so as to limit discretion. Less discretion should promote greater efficiency and timely administration, while diminishing the impact of shortcomings in institutional capacity. Efficiency would also be assured by standardizing certain administrative procedures, and requiring participants to comply with these requirements. The “official forms” would assure consistency and uniformity in application of relevant criteria.

Commencement of Proceedings. In cases where substantial agreement has been reached by debtors and creditors, with requisite pre-approval of a restructuring plan, the debtor would commence proceedings. In other cases, where the process is not pre-agreed among all parties, but relies on absolute priority treatment and cram down features (discussed below), creditors holding matured or unpaid debts above a specified amount, could commence the summary proceedings against eligible enterprises.

Duration. The summary process would take approximately 2-4 months, possibly 6 months in cases where an extension is needed. Time periods would be fixed with little or no flexibility for extensions, although in exceptional cases extensions could be allowed. Time periods would depend on whether the agreement has been pre-approved in requisite number, or merely pre-agreed but not pre-approved.

Moratorium and Suspension of Proceedings. Upon commencement of the proceeding, a moratorium on payments and suspension of all enforcement proceedings would apply to all creditors. The moratorium and injunction on proceedings is critical to the success of the process, as it prevents holdout creditors or minority interests from upsetting the workout solution. In order to encourage out-of-court workouts, consideration should be given to allowing parties to apply to the court for a protection order that would stay actions by minority creditors or the filing of bankruptcy, during a limited period of time to allow for negotiation. This serves the same purpose as a standstill agreement, but would be granted upon application by lenders holding 66 percent of the claims. In “exceptional” cases, the court might have authority to enter a protective order in cases where there is a greater than 50 percent of the vote and the enterprise in question plays a significant role. These percentages could vary, but are roughly designed to equate to the percentage necessary to obtain requisite approval on a restructuring plan.

The concept for the such a moratorium or protective order is not novel. The French system allows for informal negotiations to proceed under the protection of a court ordered moratorium and injunction, but with little or no additional intervention by the court. At the appropriate point of the negotiations, which would be time bound, the parties would then submit the agreement to the court for approval or would reach a full out-of-court settlement and have the order dismissed. If an approach similar to the French model is used, it must be carefully considered to avoid creating a safe-haven for debtors to take advantage of an endless process of suspension. For example, the initiation of the moratorium on creditor actions should be granted at the request of the debtor and leading creditors or lenders holding a requisite percentage of the debt. Such a procedure would minimize the ability of small holdout creditors to upset the process by triggering a liquidation. In cases where liquidations were commenced prematurely by creditors (especially small creditors), the case might be converted to a fast track proceeding upon request or application of the debtor and the requisite creditors.²⁹

²⁹ This is not a novel and unusual approach. Indeed, the Amendments introduced a new sentence to Section 5(a)(1) that allows the debtor to file a motion requesting the granting of a protection period to be filed within 15 days of a petition filed by creditors. The protection period can last for three months and is subject to one extension for up to

Supervised Management. To encourage expeditious results, existing management would operate under the oversight or in cooperation with creditor approved supervisors. Supervisors might be qualified administrators, with substantially curtailed involvement. Alternatively, supervisors might be financial consultants who can facilitate the restructuring. The court supervisor might be selected by majority vote of those creditors holding more than 51 percent of the outstanding claims. Additional advisors and participants should include either an informal Creditors Committee, comprised of the largest creditors, or a Steering Committee for lending institutions, and/or a lead institution that could assist in the active management of the case. A short list of potential advisors or supervisors might be drawn up of the most qualified individuals or institutions.

Cramdown Feature. To further encourage consensual resolutions, a flexible cramdown feature could be used as a measure of last resort. In cases where the majority have agreed, the minority interests would be forced to accept the proposed treatment, providing they recover as much under the restructuring plan as they would have recovered under liquidation. In most cases, unsecured creditors will receive little or nothing in a liquidation, so this should be easy to satisfy. The cramdown feature embraces concepts of equity and constitutional notions that a creditor cannot be involuntarily divested of a property interest. In this case, giving the creditor what it would have received in a liquidation achieves that objective, although it is often the case that unsecured creditors receive nothing in a liquidation.

Cramdown provisions should clearly specify the mandatory prescribed treatment for distributions based on the notion of absolute priority. For example:

- costs of the proceedings to be paid up front, at three months and at closing.
- Fiscal debts reduced by penalties and interest (or as otherwise determined by the Ministry of Finance) and the principal rescheduled for payment over a period of 2-4 years. Alternatively, tax authorities would be obliged to accept the treatment accorded other unsecured creditors, accepting a reduction in claims in the same proportion as such creditors (which could include principal as well).
- Secured creditors would retain a security interest in their collateral up to the value of the collateral, but their debt could be rescheduled over a reasonable period of time. If these creditors would also have an unsecured claim, for that portion of their claim that is deemed unsecured such debt would be paid on identical terms as other unsecured creditors, meaning possibly a forced write-down or a debt-equity swap (see below).
- General unsecured bank and trade claims would receive a distribution over time in such amount as is deemed appropriate or could have their claims capitalized through debt to equity swaps.
- Where the debtor and creditors have reached an out-of-court agreement, the court would limit its cramdown focus to whether the priorities of creditor rights are respected and whether the unsecured creditors are receiving less than they would have received in a liquidation.
- Where the approval is based on a debtor cramdown, the court would require approval by a requisite majority, and would need to appoint an expert to assess the viability of the restructured enterprise, which could not carry debt beyond sustainable debt levels. This would be the benchmark for determining what portion of the debt must be written off or converted to equity.
- Employees could receive priority treatment with mandatory payments over a brief interval of time. Alternatively, they might opt-in for a distribution of equity.

three months. This indicates that the legislators are already prepared to accept the fact that there are cases in which a protective period should be enforced to maintain the status quo.

- Existing equity holders would only be entitled to retain an interest in the enterprise by agreement of the creditors, and subject to satisfying absolute priority rule. Where a plan proposes to convert debt to equity, the cramdown provisions would enable such treatment to be approved over the objection of equity holders, if the plan has otherwise been approved by those having a financial stake. These provisions in the Bankruptcy Law should be complemented by amendments to the Commercial Code, qualifying the effect of insolvency on shareholder approval requirements.³⁰
- Absent approval by the requisite majority, the case would convert to one under the liquidation provisions, with secured creditors retaining the right to enforce their collateral rights pursuant to the amended liquidation procedures, and the State retaining its priority claim over general unsecureds. The conversion feature should be time-bound so that all parties would have incentives to negotiate fairly. Such an automatic effect would potentially create a disincentive for debtors to commence a fast-track proceeding.

Valuations. The valuation of the enterprise will be crucial to establishing the negotiation environment and providing the backstop mandatory debt-equity conversion in cases where no consensual resolution is obtained. These valuations must be based on fair market values, and conducted by qualified experts. A short list of qualified experts might be drawn up. The valuation should be conducted prior to commencement of proceedings in cases where the requisite majority approval has been obtained. Alternatively, an independent evaluation expert might be appointed to review or fix the value following commencement of the proceeding to be completed within 6 weeks.

Incidental or Disputed Claims. Claims would be filed within approximately 30 days of commencement or notice of commencement filed in appropriate journals on consecutive days. Creditors failing to file claims within the requisite period would not be entitled to a distribution or, alternatively, might be entitled to submit late claims but would not be entitled to participate in relevant voting procedures. Claims resolutions would be relegated to the post arrangement period, with shares or proceeds being deposited into a claim resolution fund. As claims are resolved through appeal or negotiation, creditors would be entitled to a distribution. Left over shares and proceeds would be returned to the enterprise, increasing the value for all stakeholders.

New Corporate Entity. To facilitate the distribution of equity, upon conclusion of the arrangement, all assets and legal rights would be transferred to a new corporate entity, the shares of which would be distributed to the creditors who become new owners.

Contracts and Employees. Burdensome contracts could be rejected, with the holders of such contracts obtaining treatment as unsecured creditors. Likewise, where excess employees exist, some of these employees may be made redundant in order to improve the profitability of the new enterprise. Redundant employees would receive compensation through payments over time, or by receiving equity in the new company.

Tax Incentives. To encourage parties to resort to the restructuring procedures, the tax rules should be reviewed to allow loan write-downs and debt equity swaps without adverse tax consequences for debtors and creditors. The rules on loss carry forwards should also be reviewed in order to attract

³⁰ Equity holders would not be entitled to vote, or would only be entitled to vote if they can establish that they are getting less under a plan than they would be entitled under a liquidation procedure. Since equity holders generally receive nothing in a liquidation procedure, the burden of the proof would fall back on equity, and the courts could dismiss promptly these appeals in the vast majority of cases. These provisions could remove the obstacles to debt equity swaps currently imposed by the Commercial Code. It should be noticed that in the US, equity's views are rarely solicited in similar cases.

potential buyers and investors. Some of these tax rules should also apply outside bankruptcy, in order to facilitate purely consensual, out-of-court agreements.

Requisite Approval for Plan. Approval of the plan should probably be based on acceptance by creditors holding, say, at least 60 percent of the total claims. The higher the percentage for acceptance is set, the more difficult it will be to achieve out-of-court arrangements that can be placed on a fast track for approval.

Appeals. Appeals should be streamlined and limited only to decisions based on the final arrangement, if at all. The basis for the appeal should be limited to criteria of abuse or fraud, or instances in which a creditor has been deprived of a constitutional right. Appeals might be taken to a special panel of judges, for example bankruptcy judges, other than the sitting judge. The process of appeal should be minimized by imposing obligations on the appealing party to obtain a bond in an amount that would protect against delay losses.

Secured Lending. To attract new financing, provision would be made for recognized security over movables. Lenders providing financing to enterprises in the summary proceeding would be entitled to take a security interest in unencumbered immovables or other property that would have a recognized first priority. This pledge, security interest or lien would be registered in an interim registry pending implementation of a broader nationwide registry system in accordance with a new secured transactions law. Because the benefits of the security over movables would exist at this stage only for enterprises undergoing restructuring in connection with summary proceedings, this would encourage greater lending to the enterprises most in need of the financing and free up unused capital. This might also encourage existing lenders to provide new financing where they can be assured of protection for the new money and have a stake in the outcome.

Interface with Current Composition Provisions. The proposed fast track rules should be contained in a separate set of provisions that build on or incorporate all the composition provisions that would be necessary to avoid repetition. This also makes it clear that, while the fast track cases may be diverted to a special pilot program, all enterprises that do not meet the criteria may still take advantage of the composition provisions. Consideration might be given to allowance of fast track procedures for small and medium enterprises where there is substantial agreement, on approval of the court after submission of a request.

Consultant for the Development of a Handbook

To assure that new procedures are being properly and effectively implemented, the process would be served by the development of a handbook and materials that will be used in conjunction with training programs for the judges and other participants in the process. This could include pilot programs in which consultant advice is made available to assist the banks and enterprises in their efforts to reach a conciliatory out-of-court arrangement or in developing a strategy and approach to effectively utilizing the in-court fast track procedures.

3.6. Strengthening Institutional Capacity

A fundamental component of sound insolvency systems is the existence of an effective institutional and regulatory framework for bankruptcy. The Czech bankruptcy system does not fare well in this area either, as it continues to suffer from a complex institutional organization, and the absence of a proper regulatory framework for participants and procedures.

The institutional organization is complex for bankruptcy judges who operate under civil procedure rules as opposed to specialized bankruptcy procedures. Regional courts handle bankruptcy cases, with appeal to the Supreme Court. The largest court is located in Prague and central Bohemian region, which has 12 specialized bankruptcy judges. Judges may be exposed to lobbying and pressure. The typical case backlog is around two years, and includes a mixture of small firms and individuals, often with no significant assets, and large complex businesses. Appeals are from regional courts to the High Court and ultimately to the Supreme Court. Efforts are underway to restructure the Regional Court system.

There is no regulatory framework for qualifying participants, such as administrators, liquidators, and insolvency practitioners. Until recently, only individuals could serve as administrators, and were selected from a list of administrators held by court. There were approximately 1,600 names on the list, which included a number of individuals with no legal, accounting or business training. In some cases, those on the list had lost their jobs elsewhere and had applied to be an administrator as a way of having some employment. 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 operates on a code of conduct, but has no disciplinary powers.

There is no clear delegation of powers to the administrator, and only limited discretion. For example, the administrator has no discretion to alter the maximum allowed salaries for existing managers to be retained, no power to hire professionals and pay costs out of the estate, and the court must approve action to recover receivables from third parties. Court procedures are not tailored to bankruptcies. Rather they incorporate by reference civil procedures, which have been designed for proceedings entirely different in nature and purpose. As a consequence, the process of bankruptcy is cumbersome (e.g., bankruptcy judges may refer issues to general courts; disputes on validity of debts also go to general courts; and there are complex notice and reporting processes where there are large numbers of creditors).

The development of the institutional and regulatory framework for bankruptcy will depend on improvement in many areas, such as the restructuring of the court system, the regulation and training of all the professionals working in the system (judges, administrators, liquidators, accountants, restructuring experts, asset valuers), and improvements in administration procedures. Annex 3 provides a more detailed analysis of the institutional and regulatory framework, and a number of recommendations for improvement.

ANNEX 1: SELF-FINANCED POOL SALES OF CLASSIFIED ASSETS

1. Introduction

Pool sales of bank assets are regularly utilized by banks in modern capital markets to raise cash, reduce capital requirements, and capture capital gains and servicing fees. The most common form of such sales are retail mortgage securitizations and credit card receivable securitizations.

Pool sales of non-performing bank assets are much rarer and have typically been restricted to loans secured by residential or (more commonly) commercial real estate collateral. The first transaction of this type was executed in 1988 in the United States (*Grant Street Liquidating National Bank*), followed by a large number of transactions executed by the RTC and FDIC in the 1989 to 1994 period. More recently (1999), Thailand has seen pool sales of assets carried out by the Financial Sector Restructuring Agency.

Most non-performing asset pool sales have consisted of pools of commercial real estate-secured loans and foreclosed real estate because of the relatively predictable cash flows from this type of asset. This makes it possible to accurately value the assets in a pool and thus to establish pricing for both equity investors and for debt investors (the term *securitization* is used only if debt or equity securities are sold against the projected cash flows from the pool).

By contrast, pools of non-real estate assets, such as non-performing enterprise loans, are generally sold to pure equity investors (i.e. there is no securitization of debt) with the skills and appetite for the risks posed by the inherently unpredictable cash flows from this type of assets.³¹ This distinction is true for the most advanced market economy with well functioning bankruptcy and foreclosure frameworks, and becomes a significantly greater problem when assets must be worked out in countries with relatively hostile or undeveloped frameworks. The lack of an adequate framework increases both the uncertainty of collection (or enforcement of collateral) and, perhaps equally importantly, makes the timing of collections (i.e. cash flows) almost impossible to project accurately. Issuing debt securities secured by such unpredictable cash flows is therefore thought to be impractical.

In the Czech Republic the majority of non-performing bank assets are enterprise related³² and, at the present time, the bankruptcy and foreclosure frameworks are both hostile and subject to unpredictable delays. If asset pools were to be sold without debt financing, the equity discount rates applied by purchasers would result in very large discounts to appraised value (see Table A1-1). Alternatively,

³¹ The cash flow from a commercial real estate asset is predictable because it is based on market rents for particular types of property (e.g. office buildings), and in Western markets there is a liquid market for commercial real estate sales with generally accepted capitalization (or discount) rates to net rent cash flow to use in sale valuation. The number of creditors involved in real estate work outs tend to be limited (there are few trade creditors), those creditors are normally sophisticated (banks), and the method of work out (sale of the collateral, sometimes after some investment in renovation) is generally accepted. By contrast, non-performing enterprise assets do not have predictable cash flows (they normally pay no dividends), they may have to undergo unpredictable periods of restructuring before sale of the enterprise is possible (which allows recovery against loan principal), and the number of other creditors adds unpredictability to projections.

³² Many Czech loans are secured by enterprises' real estate assets but these do not (even if collateral were enforceable) provide the attractive and predictable cash flows of commercial real estate such as office buildings. Industrial real estate is hard to sell (because it is often purpose built) and may carry potential environmental liabilities which pose a significant financial risk if the real estate is seized. As a consequence, there is often little work out alternative to either: (a) restructuring the enterprise itself so that it can repay the debt (or be sold to pay the debt); or, (b) in extreme cases, simply writing off the debt as uncollectable.

investors might view the risks as unquantifiable, and therefore refuse to invest at all in pools of these types of assets.

Table A1-1: Impact on Pricing of Purchases Financing Structures

<i>Item</i>		<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>	<i>Total</i>
Projected Cash Flow		50	100	150	120	50	470
	<i>Required Return</i>	<i>% of Total Financing</i>	<i>Effective Rate</i>				
<u>Securitized Purchase</u>							
Equity	30.00%	20.00%	6.00%				
Subordinated Debt	15.00%	40.00%	6.00%				
Senior Debt	8.00%	40.00%	3.20%				
Discount Rate			15.20%				
Present Value of Assets							310
<u>Equity Purchase</u>							
Equity	30.00%	100.00%	30.00%				
Subordinated Debt	15.00%	0.00%	0.00%				
Senior Debt	8.00%	0.00%	0.00%				
Discount Rate			30%				
Present Value of Assets							221
<u>Self-Financed Pool</u>							
Equity	30.00%	20.00%	6.00%				
Subordinated Debt	15.00%	0.00%	0.00%				
Senior Debt	6.50%	80.00%	5.20%				
Discount Rate			11.20%				
Present Value of Assets							

Table A1-2: Advantages and Disadvantages of Self-Financed Schemes

<u>Issue</u>	<u>For</u>	<u>Against</u>
Price	<ul style="list-style-type: none"> • Low cost financing increases the price paid for assets. • The private sector demands excessively high rates because it cannot accurately estimate the cash flows from assets. 	<ul style="list-style-type: none"> • The rate charged by the State for financing does not reflect the economic risk of the financing. • There is a probability of loss which will reduce the final proceeds of the transaction, so the price should be discounted.
Discipline	<ul style="list-style-type: none"> • Self-financing can have terms which discipline work out behavior. • The ownership and control of the work out process can still be transferred to the private sector. • High rate financing encourages liquidation of assets rather than restructuring them 	<ul style="list-style-type: none"> • The financial discipline imposed by debt service forces the pool owners to move ahead as fast as possible with work out. • Providing financing increases the possibility for State (political) interference in the work out process. • The easier the financing terms, the more opportunity for owners to speculate by holding assets rather than working them out.
Creditor Environment	<ul style="list-style-type: none"> • Self-financing may make sales possible in a hostile environment by sharing risk with equity investors. • Easier financing terms allow more room for uncertainties in the timing of cash flows, allowing equity investments where otherwise the cash flow timing problems would be insurmountable. • If the environment is expected to improve, then the seller may capture some of the benefits of improvements. The seller has negotiating leverage because of providing financing. 	<ul style="list-style-type: none"> • The price offered without financing reflects the realities of the market. By financing, the State is itself indulging in speculation.

2. Self-Financed Pool Sales

Introduction

Self-financed asset work out pools have most commonly been used in conjunction with asset management contracting arrangements³³ by State institutions such as the FDIC and RTC.³⁴ The use of self-financing has a major impact on the valuation of asset pools by sharply reducing the discount rate by, effectively, having the seller provide most of the finance at its own (State) cost of funds – a cost normally below any that could be received by a private sector borrower (see Table A1-1). There are arguments both for and against self financing, and these also have to be considered in the context of the creditor environment.

Application to the Czech Republic

In the Czech Republic circumstances would tend to favor the use of self-financed pool sales over other methods for a number of reasons:

1. The volume of classified bank assets to be worked out is so large that attempting to sell or work out assets individually using direct work out by a centralized State institution is not feasible. Pool sale and management arrangements seem to be the only operationally feasible approach to the work out of all but a very small number of very large enterprise assets.
2. Local investment banks indicate that foreign and domestic capital is waiting to enter the Czech market once transactions of a suitable size, and suitable structure, are offered. Self-financing structures may provide the vehicle through which this capital can enter the market.
3. The probability of political interference in the work out process is expected to be high. Transferring ownership to the private sector may be necessary to ensure that the work out process can proceed quickly and in an economically rational way.
4. The creditor environment is presently so hostile that the use of private sector financing (securitization) is probably not feasible. Even at very low prices, the private sector may perceive the risks as unquantifiable, with the result that that no large volume sales transactions can be executed.
5. Improvements in the creditor environment are planned. Self-financing structures may allow the State to capture some of the benefit of these improvements, resulting in a reduced net cost of bank privatization.

³³ As long as non-performing assets are held on its balance sheet by a bank they may also be said to constitute a “self-financed pool,” with financing provided by deposits and the banks own capital.

³⁴ The FDIC also used the whole bank “carve in” method where it retained beneficial ownership of the assets to finance an asset pool in a limited number of cases, e.g. for the First Republic (1988) and MCorp (1989) banks in Texas. The motivation in both cases was the very large amount of cash which would have been required to carve out classified assets. The FDIC subsequently abandoned this approach due to the unsatisfactory results obtained, the cost of tax benefits transferred to the purchaser, and the administrative complexity involved. The RTC avoided this method, conducting either carve outs or whole bank sales where beneficial ownership of assets was transferred to the purchaser.

Example of a Self-Financed Pool Sale

The following describes a structure for selling a self-financed asset pool. Self financing can be designed in a number of ways, but the example given below has certain features designed to take into account the Czech economic and creditor environments.

Preparatory Steps

1. The central work out institution (“CWA”) retains a financial advisor (usually in consortium with an accounting firm) to conduct market research to identify investor demand for particular types of assets (e.g. based on regions or particular industries). The assets (classified loans) are then sorted into pools based on investor interest.
2. All claims under the control of the CWA related to each debtor in a particular pool are then consolidated.³⁵
3. The financial advisor then conducts due diligence and prepares a cash flow projection for each consolidated claim.³⁶ This is incorporated into the offering documents for the pool sale.
4. The financial adviser prepares a valuation of the collateral value securing the assets of the pool. This is used to establish the “Floor Price” of the pool.

Auction of the Pool

1. The CWA transfers the asset pool into a corporation (“PoolCo”). In exchange it receives: the common equity shares of the corporation, liquidating preferred shares; promissory notes for senior debt; and promissory notes for subordinated debt.
2. The CWA holds a public tender for the pool. Qualified investors are permitted to perform due diligence. Investors are qualified based on: financial capacity and on technical ability to carry out work out activities.
3. The pool is auctioned on the basis of the percentage of the Floor Price that investors are willing to bid (the “Bid Price”). The amount of cash to be paid by the investor to the CWA is fixed at the principal amount of subordinated debt (itself a fixed percentage of the Bid Price). The management fee offered for the pool is a fixed sum per year.
4. The investor signs a management agreement with PoolCo. No incentives are payable under this contract (see Financial Structure, below)

Financial Structure

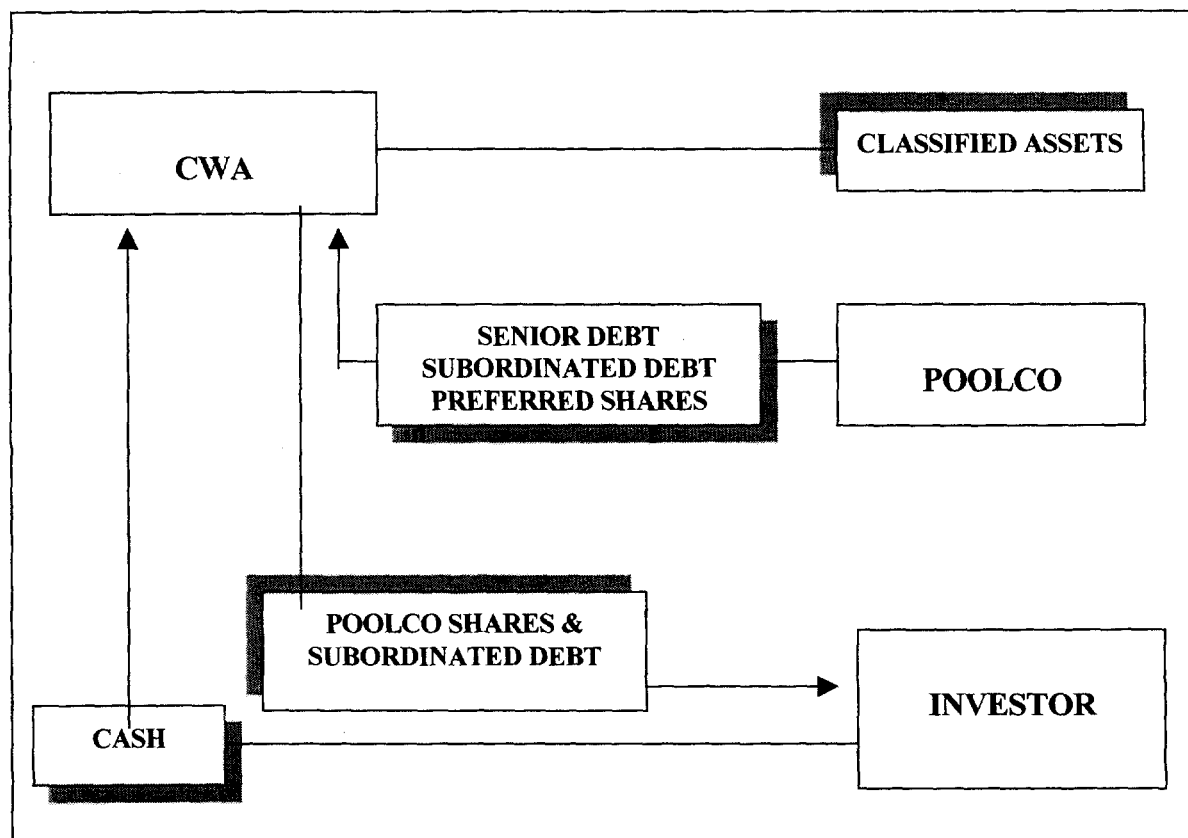
The financing terms for the pool determine the incentives for the investor working out the assets. In this example, the terms are designed to be: attractive for investors by guaranteeing return of at least a portion (but not all) of their nominal cash investments; give reasonable assurance to repayment of the

³⁵ In the Czech Republic consolidation of tax arrears claims into the asset pools would be a useful additional measure. This would remove an additional element of uncertainty for investors, and, possibly, increase revenues for the State versus self-work out of these claims by the tax administration (which itself has commented that its staff are insufficiently prepared to take an active part in the work out process).

³⁶ A project is underway at KB to perform this analysis on about CZK 57 billion of classified loans. In the event that these loans are transferred to KOB, this work may form a useful foundation for subsequent pool sales.

majority of the CWA's financing (limiting risk); and, provide rewards to both the investor and the CWA if the investor manages to create additional value from the pool or the creditor environment improves.

Figure A1-1: Self-Financed Sale Transaction



Management Fee

The management fee is a flat fee³⁷ paid with first priority from the cash flow from assets in the pool. The fee covers all expenses associated with the pool. In the event that the manager is able to operate PoolCo more efficiently, then it captures the benefit. If it is inefficient, then the manager must itself bear any uncompensated expenses. The management contract contains a provision for automatic cancellation if PoolCo defaults on its senior debt (i.e. if the investor fails to perform as a manager, it loses its entire investment and the management contract).

Senior Debt

The senior debt (held by the CWA) bears no interest but has second priority of payment from cash flow from the pool after payment of the management fee. Minimum principal amortization is according to the cash flow projection developed by the financial adviser, and prepayments are permitted. The senior debt is collateralized by all the shares of PoolCo (i.e. if there is a default on the senior debt then the investor loses its entire investment).

³⁷ In this example a flat fee of 10 percent of gross cash flow (as projected by the CWA's financial adviser) has been used.

Subordinated Debt

The subordinated debt is held by the investor (who has purchased it for cash from the CWA). Interest on the subordinated debt has third priority of payment from cash flow from the pool after payment of the senior debt amortization. The subordinated debt is pre-payable bullet debt (principal is paid only at maturity) with a very high interest rate: sufficient to return most (75 percent in this example) of the principal amount paid in cash by the investor to the CWA in nominal terms, but not sufficient to return all principal in nominal terms if the pool cash flow does not at least equal the percentage of the Floor Price bid by the investor.

Preferred Stock

The preferred stock is held by the CWA and has fourth priority of payment from cash flow from the pool after payment of the principal of the subordinated debt. The preferred stock liquidates either on the same date as the subordinated debt or after it, and bears no interest. The purpose of the preferred stock is to allow the CWA to recover the difference between the purchase price paid in cash by the investor (for the subordinated debt) and the Bid Price.

Common Stock

The common stock is held 51 percent by the investor and 49 percent by the CWA. The investor receives its shares free. No dividends can be paid on the common stock until the preferred stock is liquidated. If the investor manages the pool effectively (or the creditor environment improves) and recovers more than the Bid Price, then this gain is distributed between the investor and the CWA proportionately with their shareholdings. Control of PoolCo is placed in the hands of the investor and the CWA has no right to interfere in the management of the company's assets so long as the senior debt is serviced (thus eliminating political interference).

Table A1-3: Basic Assumptions Used in Examples

Item		Amount	
Gross Book Value		100,000	
Provisions		(50,000)	
Net Book Value		50,000	
Appraised Collateral Value		25,000	FLOOR PRICE
Winning Bid Percent	35%		BID PERCENTAGE
Value of Winning Bid		8,750	BID PRICE
Subordinated Debt	10%	875	CASH PAID TO CWA
Senior Debt	75%	7,219	
Liquidating Preferred	15%	656	
Total Debt Structure	100%	8,750	
Common – Investor	51%		
Common – KoB	49%		

Table A1-4: Gross Pool Cash Flow Equals 100 Percent of Bid Price

Item		Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Recoveries/Floor Price	35%						
Estimated Recovery	8,750						
Pattern of Recoveries		15%	20%	30%	20%	15%	100%
Estimated Cash Flow		1,313	1,750	2,625	1,750	1,313	8,750
Fixed Management Fee		(131)	(175)	(263)	(175)	(131)	(875)
Net Cash Flow		1,181	1,575	2,363	1,575	1,181	7,875
Interest on Subordinated Debt	15%	(131)	(131)	(131)	(131)	(131)	(656)
Cash Flow to Senior Debt		(1,050)	(1,444)	(2,231)	(1,444)	(1,050)	(7,219)
Net Cash Flow		0	0	0	0	0	0
Principal Paid on Subordinated Debt							0
Principal Paid on Preferred Stock							0
Common Stock Dividends							0
- To Investor							0
- To CWA							0
Total Cash Paid to CWA							8,094

Table A1-5: Gross Pool Cash Flow Equals 150 Percent of Bid Price

Item		Year 1	Year 2	Year 3	Year 4	Year 5	Totals
Recoveries/Floor Price	53%						
Estimated Recovery	13,125						
Pattern of Recoveries		15%	20%	30%	20%	15%	100%
Estimated Cash Flow		1,969	2,625	3,938	2,625	1,969	13,125
Fixed Management Fee		(131)	(175)	(263)	(175)	(131)	(875)
Net Cash Flow		1,838	2,450	3,675	2,450	1,838	12,250
Interest on Subordinated Debt	15%	(131)	(131)	(131)	(131)	(131)	(656)
Cash Flow to Senior Debt		(1,050)	(1,444)	(2,231)	(1,444)	(1,050)	(7,219)
Net Cash Flow		656	875	1,313	875	656	4,375
Principal Paid on Subordinated Debt							(219)
Principal Paid on Preferred Stock							(656)
Common Stock Dividends							3,500
- To Investor							1,785
- To CWA							1,715
Total Cash Paid to CWA							10,465

ANNEX 2: IMPROVEMENTS IN BANKING LAW AND REGULATIONS

The mission has identified a number of areas where existing banking regulations and other laws might be changed to improve the ability of banks to work out their own assets and improve the investment and creditor environments. While these changes would not assist the work out solution discussed in this report, the mission believes that strengthening the work out tools available to banks would have a long term beneficial impact on the functioning of the banking system.

1. Restrictions on Bank Ownership of Non-Financial Corporations

This constrains the ability of banks to conduct debt-for-equity swaps, a measure which is necessary in the current creditor environment to secure control over the debtor to permit restructuring without interference from shareholders. The mission recommends that an exemption be created to allow banks to own up a majority stake in a non-financial corporation for a period of up to 3 years for swaps involving debt that has been provisioned at the substandard or worse level. The aggregate ceiling on the amount of non-financial corporation investment permitted would be subject to the same exemption for the same period.

2. Provisions on Loss Loans Secured by Real Estate

The CNB's position that real estate has no value as collateral is justified by the current inability of creditors to seize and sell it collateral. Requiring full provisioning of collateral is therefore a prudent measure. The weakness of the appraisal system (see below) reinforces this position. However, the mission recommends that the CNB reconsider its current view of the value of collateral in the event that an effective law on extra-judicial auctions is passed and appraisal of real estate is improved, as suggested below. At that point, moving to a provisioning system which recognizes collateral value would be appropriate (although use of a holding period limitation – as in United States banking regulations – would still be appropriate to discourage banks from speculation).

3. Taxation of Reserves

The tax deductibility of provisions should correspond to the provisioning levels required by CNB regulations³⁸. The deductibility of provisions should be subject to regulatory certification (by the CNB). The deductibility formula presently applied to provisioning should be deleted from the law to ensure that profitable and healthy banks are not permitted to deduct for unnecessary provisions. The objective of taxation provisions related to provisions should be to ensure that troubled banks are able to gain the maximum tax relief at the time it is needed, while healthy banks do not underpay taxes.

4. Taxation of Interest and Penalty Interest on Non-Performing Loans

The tax law should be amended to permit banks to suspend penalty interest for tax purposes and full provisioning against accrued interest which is not paid within 90 days of falling due should also be allowed. The taxation of interest on non-performing loans would then be on a cash basis. This would address two problems: first, that banks are being taxed on interest that is not received (i.e. on income that is fictitious); and, second, to halt manipulation of the present system by banks which use “tricks” to get around the penalty interest provision.

³⁸ This seems to be possible under the law, but not applied in practice. See Act on Reserves, 593/1992 (as amended), Section (5), Subsection (4).

5. Appraisal Standards

Market based appraisal standards should be established to reduce the problem posed by questionable collateral valuations. A standardized and independently administered certification procedure should be created to license appraisers. Appraisers (and their employers) should have civil liability for professional negligence and be required to carry appropriate insurance.

6. Auditing Profession

The quality of auditing in a country has a major impact on creditors' willingness to lend and on the ability to attract equity investment. The mission's discussions with the Chamber of Auditors identified a number of areas where there is scope for improvement: first, auditors and their firms should have civil liability for the quality of their work. The ability of investors/creditors to bring civil actions against negligent auditors provides discipline to the profession and should markedly improve the quality of their work.³⁹ Second, auditors should be required to carry professional liability insurance. This is presently required, but the "insurance" is described as a formality rather than a real issue. Creating strong civil liability for auditors should add further discipline to the profession from insurers who will be reluctant to provide coverage to negligent auditors. Third, criminal prosecution of auditors suspected of collusion in fraud and "tunneling" schemes should be stepped up. Again, this should provide discipline to the profession, allow de-certification of unethical persons, and encourage investor and creditor confidence.

³⁹ Anecdotal evidence indicates that the US bank auditing profession became much more vigilant once the FDIC and RTC began to pursue a policy of almost automatic lawsuits against auditors of banks and thrifts which failed.

ANNEX 3: IMPROVING THE INSTITUTIONAL AND REGULATORY FRAMEWORK

1. Introduction

Bankruptcy proceedings are mainly court-based. Consequently, the role, responsibility, organization and services of a judicial authority in an insolvency system—the bankruptcy court and judges—are central to an orderly economic reformation of an economy in transition. Against this background there are a number of specific issues to be addressed for purposes of making improvements in the institutional framework and for future training and development.

2. Performance Standards and Governing Institutions

Standards should be adopted by which to measure the performance of a court in its role within an insolvency system. General standards of performance would include, among others: access to justice and to the court; court efficiency; equality, fairness and integrity in court decisions and treatment among parties; independence and accountability of the court; and maintaining public trust and confidence in the institution. Ethical standards should avoid financial or personal conflicts of interest that might affect a judge's ability to render impartial decisions. The maintenance of standards will be reinforced by developing qualification, training and continuing education criteria and programs for the judiciary.

Consideration should be given to the relative attributes of the bankruptcy court, or comparable alternative judicial authority, versus other administrative or regulatory bodies for governance of the insolvency process. A threshold determination is the nature and extent of the court's role, and the range of and limitations on its jurisdiction and authority. This will involve a determination as to the appropriate interface between the judiciary and other regulatory institutions and agencies which round out the insolvency system. Finally, although the Czech Republic does not have independent bankruptcy courts, it does have specialized bankruptcy judges in some areas of the country. Given the specialized nature of and issues that arise in bankruptcy proceedings, there is significant value in having independent, specialized commercial/bankruptcy courts or specialized insolvency judges within the courts of general jurisdiction. Clearly, the caseload in many countries may not justify the additional expense that could be attendant to an independent court system for insolvency cases. Where this is not possible, there is great benefit to be had by training specialized judges, and having independent rules and procedures governing the system.

3. Court Organization

Organization of the court broadly encompasses the structure of the judicial system, independence of the court, and elements of an effective court organization and judicial decision-making. Court organization should take stock of resources available to the court, including sufficiency and composition of judicial officers and staff, and adequacy of court facilities. Organization of and line of authority for court administration include (i) funding and finance, (ii) local budgeting and management, (iii) personnel policy, (iv) security of court, judges, and staff, (v) automation, (vi) compensation, and (vii) grievance and dispute resolution.

Another aspect of court organization relates to procedures for case management, such as those governing access to court hearings and court records and those pertaining to maintenance, dissemination and publication of court decisions, records, rules and regulations, and related information. In addition to this, it is important to have a structure and protocol governing a variety of relationships and circumstances, including: (i) relations between and communication among the judges, court administrators and staff, and members of the insolvency community including debtors, creditors,

professionals, trustees or fiduciaries, litigants, the media, and the public; (ii) relations between the court and the legislative and executive branches of government and their agencies; and (iii) to prevent, monitor, and remedy corruption, conflicts of interest, outside undue influence, inappropriate ex parte communication, or other impropriety.

Predictability in outcomes can be a key factor in court efficiency and the expectations of parties. It is not uncommon in the administration of insolvency cases that judges will frequently encounter identical questions on the interpretation of the law from one case to the next, or similar issues. Although fact patterns often vary from case to case, it may be useful to create a system of precedence in which issues resolved at a high court level have some persuasive affect on the outcomes in cases where the legal issues and facts are substantially similar. Even where no controlling weight is given to such decisions, the decisions and analysis in other court decision may be useful in guiding other courts or parties as to the likely outcomes in similar situations. To some extent, more predictable outcomes will reduce the likelihood of litigation and appeals and provide a basis for compromise among parties involved. This is best achieved by publication and dissemination of decisions and court information.

Predictability can also be created with respect to the process, timing and allocation of decision-making by the judge or other authorities. Procedures may be particularly important to assure due process where decision-making, or authority for parties to act, is not vested solely in the judicial officer but delegated to participants (e.g., regulators, trustees, etc.). Consideration should be given to practices and problems associated with too little/too much discretion in decision-making. Finally, efforts should be made to establish policies and practices that will insure *independent* judicial decision-making.

4. Court Operations

A variety of policies and practices affect the efficient and orderly operations of the courts. While efficiency in case administration is to some extent a process of the time-bound periods in the law, it is more often a result of establishing sound and effective practices and procedures, including: (i) for an orderly and efficient court, case administration, hearings and trials of contested matters, and the decision-making process; (ii) defining the roles, and prescribing relative responsibilities of and communications among the judges, court administrators, staff, research personnel, ancillary institutions, and supporting agencies; (iii) assuring access to the court by interested parties and members of the insolvency community including debtors, creditors, professionals, trustees or fiduciaries, litigants, the media, and the public; (iv) for communicating with and giving adequate notice to parties in a bankruptcy case including debtors, creditors, professionals, trustees or fiduciaries, litigants, the media, and the public; (v) which insulate the court from corruption, conflicts of interest, undue outside influences, and inappropriate ex parte communications or other impropriety; maintaining the integrity of the court; and (vi) for filing, recognizing, treating, and resolving objections to creditor claims and assuring timely and fair hearings regarding same.

Finally, transparency and accountability is a vital to establishing public trust and confidence in the system. Consideration should be given to the value and consequences of transparency in the court process and the bankruptcy system, and in establishing practices that assure transparency of and access to the court, court decisions and records, hearings and trials, public information, and debtor/financial data. Transparency requires adequate notice through dissemination of information, and to facilitate disclosure and publication of court decisions, noticing to creditors and interested parties, filing claims and pleadings, and other important information related to cases and court activities.

5. Improvements to the Regulatory Framework

Like the institutional framework, the regulatory framework serves a key function in the bankruptcy process assuring that all participants are held to a minimum standard and made accountable. This particular area is one in which the Czech system is lacking almost entirely in some respects.

Insolvency regulation consists of several components. First, there is the need for independent qualification standards and training for those who are appointed to administer particular cases. Secondly, there is the design and development of the insolvency regulatory bodies themselves, the techniques and methods they employ and the establishment of criteria to measure the benefits to be obtained from regulated procedures that promote a higher level of specification and professionalism. The following issues and questions should be considered in connection with the definition and design of a regulatory framework that safeguards the integrity and effective functioning of the insolvency system. Some of these tasks and issues may be delegated to an independent professional body or association or may be handled by a governmental body or agency.

6. Office Holder Regulation

Regulation of the office holder provides for oversight of individual cases to be undertaken by creditors and/or the court requiring the office holder, as specified by them or by the legislation to: (i) hold meetings/attend hearings; (ii) provide reports and accounts of his administration; (iii) obtain approval of particular courses of action; (iv) obtain approval of particular payments. The legislation also will set standards fixing the officeholders remuneration/fees and expenses.

Such regulation or legislation should identify risks for creditors and/or the court of appointing an office holder who is (i) unqualified, (ii) incompetent; (iii) inappropriate because of lack of independence or due to conflict of interest; or (iv) dishonest. In addition, grounds for removal and consequences of misconduct should be specified and made clear.

Regulation of the office holder may require the establishment of an independent body (or bodies) to: (i) establish qualification and suitability requirements; (ii) set professional and continuing education standards; (iii) formulate best practice and ethical guidance; (iv) monitor continuing competence, probity, compliance and insurance/ bonding; (v) take action against incompetent or fraudulent office holders; and (vi) review and revise requirements, standards, guidance and monitoring on continuous basis to maintain the standing of the profession and confidence in the regulatory system.

Ensuring that office holders are regulated simplifies for creditors and/or the court the appointment; and obviates need for inquiries into suitability, competence, insurance/bonding, etc. For example, in cases requiring a higher level of expertise for more difficult business cases, the regulatory body could establish higher qualification standards. This also limits the level of detailed oversight which may be needed/appropriate, and minimizes cost of supervision. An appropriate regulatory system enables questions of competence and probity to be referred to body for investigation. Finally, such a process streamlines procedures for replacement in the event of removal, retirement or death.

7. The Regulatory Body

Strong emphasis should be placed on assuring the following criteria in a regulatory body: (i) independence of individual office holders; (ii) standards as to suitability and competence and guidance as to probity which reflect requirements of legislation; recognize interests and rights of those involved in insolvency; and meet public expectations of a profession; and (iii) ability to take prompt and effective action against incompetent and dishonest office holders.

Among the bodies that may serve as regulators are a government department or agency; a professional body (or bodies); or a combination of the two, with the department/agency overseeing the professional body and providing (additional) assurance of system's independence and rigorousness.

A regulatory body could be an existing body for recognition and regulation of the professionals and other participants in the process (e.g., lawyers, accountants, trustees, valuation experts, etc). This generally requires specific rules and standards to recognize difference between office holder undertaking public interest functions etc and lawyer or accountant advising/acting in private interest rights. Such rules and standards should be accompanied and implemented by a system of accountability and transparency, and oversight which will assure the impartial and fair discharge of regulatory functions.

8. The Regulatory Process

The regulatory framework should set for office holders professional and ethical standards, best practice guidance, continuing professional education requirements, and insurance/bonding requirements. Regulatory body should have procedures for authorization, ensure availability of continuing professional education, ensure arrangements for insurance/bonding, and have procedures for monitoring performance and compliance. Monitoring of performance typically requires some degree of disclosure and reporting from office holders, visits to office holders, inquiries into complaints, and the use of information/data from other bodies/agencies. Emphasis should be on competence and compliance, and body should provide or make arrangements for providing advice to an office holder on proper running of practice and administration of cases.

Some additional areas of consideration might include the benefits of having a regulatory system, issues pertaining to regulation of an office holders' agents, and transitional issues in implementing a regulatory system.

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