

## **OECD ECONOMIC SURVEY OF THE CZECH REPUBLIC 2004**

### **Excerpt from Chapter 4, Improving Policy towards Business**

#### **THE LEGAL ENVIRONMENT FOR BUSINESS**

##### **The legal environment for business is hampering restructuring**

###### ***Bankruptcy: assessing progress towards a better system***

1. Productivity growth is held back by weaknesses in bankruptcy legislation. Poorly performing enterprises are able to continue operating and, even when they close down, assets can be tied up in long legal proceedings.<sup>1</sup> The bankruptcy system is an important factor contributing to asset stripping, along with a framework of corporate governance which, according to some analysis, does not adequately deal with related party transactions and other self-serving activity.<sup>2</sup> There are three key problems with present bankruptcy legislation:

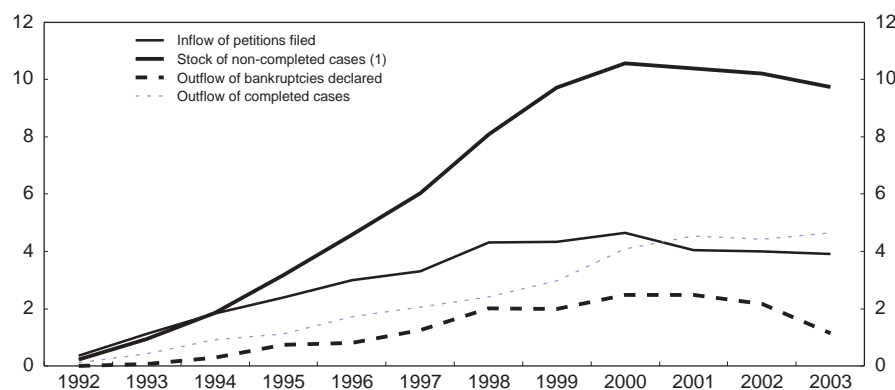
- It is relatively easy for debtors to delay the start of legal proceedings and use the time gained in asset stripping. The Bankruptcy and Composition Act (passed in 1991) stipulates that debtors have to inform courts of insolvency and provide company accounts. However, the risks in delaying formal notice are low as successful prosecutions are rare due to difficulties in proving deliberate misconduct in accounting and reporting. When stripping assets, debtors often claim that accounting records have been “lost”. Failure to produce accounts incurs a penalty of only CZK 50 000, though imprisonment is possible if it can be then proven that the accounts were intentionally lost or destroyed.<sup>3</sup>
- If a firm is declared insolvent it invariably ends up being liquidated, *i.e.* attempts to turn firms around through re-structuring, thereby boosting the prospects for creditors are rare. The courts seldom support applications for composition (re-structuring that leaves the current debtors in place but with restrictions and supervision). And restructuring by bankruptcy (re-structuring involving the takeover of the business by a trustee) is rarely successful, in part because asset stripping often leaves businesses with no viable prospects.

2. Most of the legal proceedings still under way have passed the first stage of having a decision taken on whether the firm is bankrupt or not. However, subsequent proceedings are often long, particularly in the common case of liquidation.

3. The problems in bankruptcy legislation have been recognised for some years and solutions have been sought through amendment of the Bankruptcy and Composition Act. The most recent amendment, made in May this year, aimed at removing excessive delays in proceedings. Even before this amendment comes into effect, it looks as though the case backlog has stabilised and is being

brought down a little (**Figure 4.1**). Nevertheless it is clear that there are a large number of cases in the pipeline and many have been there for some time.

Figure 4.1. **Case-loads in bankruptcy and settlement**  
Thousands



1. Where either bankruptcy has not been decided or it has, but other proceedings continue.

Source: Ministry of Justice.

4. A new bankruptcy act has long since been mooted by government officials; indeed the previous *Survey* was provided with details on a new act that was in preparation but which did not then make it through to parliamentary approval. At present the prospects of a new act being passed by Parliament look stronger. A draft act has been prepared and meetings have been held with interest groups in summer 2004 and formal ministerial consultations are set to begin end November.

5. The draft Bankruptcy Act addresses key problems of the current legislation and its finalisation and presentation for parliamentary approval should be given priority so that reform in this area is no longer delayed. The draft Act proposes to tackle the problems outlined above in the following ways:

- Firms will be encouraged to declare bankruptcy through a number of mechanisms. Contrary to the present system, debtors may file for a three month period of protection whether it is themselves filing insolvency or the creditors.<sup>4</sup> Also, firms will be able to file for “imminent” bankruptcy, from which they can withdraw at any time but which also gives time to put forward a proposal for reorganisation (see below). The attraction for debtors is that taking the lead with a reorganisation proposal may be preferable to delaying the claim of insolvency which would typically give creditors more control. The new law also promises faster proceedings when the debtor files an insolvency petition, as the court must decide on the existence of insolvency within 15 days. Normally the person filing a petition on insolvency can also submit a proposal on how to resolve the insolvency *i.e.* it is possible for the court to not only determine whether there is indeed insolvency but to give approval of the proposed solution procedure.
- Possibilities for “reorganisation” along the lines of the U.S. and German systems will be introduced. The system will enable a judge (following evidence provided by creditors and debtors) to impose a schedule for the partial repayment of debt which if successfully completed will mean the remainder of the debt being written off. The introduction of this alternative way of resolving a firm’s in financial difficulty should increase the chances for

businesses to be turned around. This should help protect creditors' interests and add to debtors incentives to file for bankruptcy, rather than engage in asset stripping.

- The new draft legislation also aims to favour creditors in other ways. In particular creditors would have more influence on the solution to insolvency chosen, the appointment of the trustee and procedural control of the trustee. It should be noted that the authorities aim to give creditors more influence over the appointment of the trustee before the new Bankruptcy Act comes into force with an amendment to current bankruptcy legislation.

6. There is no strong focus on cutting back the length of cases in the draft act, though it is aimed that better procedural provisions in the new legislation will help towards reduction in case length. Recent data indicate that there is already some shortening of case length, suggesting that previous policy efforts are paying off. In addition, the new legislation proposes the introduction of an electronic insolvency register and this should also help cut back on some of the procedural delays.

#### *Administrative requirements for setting up a business are cumbersome*

7. Administrative requirements for setting up a business have a reputation for being lengthy and cumbersome. World Bank indicators show the number of procedures to be relatively large and time consuming compared to the OECD average though it is difficult to conclude there are large differences compared with peer countries such as Hungary, Poland and Slovakia.<sup>5</sup> Preliminary results of a recent compilation of structural indicators by the OECD broadly confirm the message of the World Bank data. It is interesting to note that, according to the World Bank indicators at least, the problems in business set-up are limited to administrative burdens in terms of the time and "hassle"; the direct costs of business set-up in terms of administrative fees and minimum capital requirements are not exceptionally high.

8. Entry onto the Commercial Register is the most widely criticised aspect of setting up a business (details of the process of commercial registration are shown in **Annex 4.A1**). All firms, except the self-employed, have to enter the register and the process has a reputation of being demanding and for taking a long time to complete. There are also problems in the consistency of court decisions, uncertainties about the documentation required and there are instances where, reportedly, the Registry Court goes into excessive depth with applications. Furthermore, the complexity of proceedings often leads to demands for corrections or completion of proposals by the courts.<sup>6</sup>

9. Some steps have been taken to help firms in applying to the commercial registry. Notably, the Ministry of Justice in conjunction with the non-government-organisation *Transparency International* have prepared model application forms. The Ministry of Justice also points to an easing of the backlog of applications to the Commercial Register, indeed the backlog of applications has come down from over 30 000 in 1998 to around 15 000 in early 2004. Based on initial proposals in 2003, a new draft law on commercial registration was in preparation by mid 2004 aiming at the standardisation of forms and the introduction of electronic applications. This should help reduce delays due to incomplete forms being sent back for revision. There are also aims to shorten the deadline for standard application cases (currently 15 days), lighten the checking of applications, reduce the number of participants in the application process and to no longer require registration to be accompanied by an official court resolution. The prospect of speeding up business registration is welcome and further delays in reform should be avoided.

10. The trade licensing system is also cited as a source of frustration and delay for those setting up business. Most business activities require a trade license, with conditions for granting the license varying depending on the activity. A one-stop-shop service allowing combined application for

commercial registry and for trade licenses would help ease the administrative burden and has been considered by policymakers, but plans for implementation remain long-term.

11. One-stop-shop services in general are limited, though moves are under way to remedy this. In July 2004 plans developed by the recently formed Business Environment Development Council were presented to the government. These include the development of integrated information and application systems as well as a network of about 200 offices. The proposed system is aimed at supporting business start-up for the self-employed as well as for incorporated businesses and will assist in applications to the commercial registry and for trade licences, provide guidance on application for targeted support schemes as well as provide general advice and assistance (see below). These moves towards introducing one-stop-shop services for businesses are welcome and should be followed through.

### ***Corruption: assessing the latest policy initiatives***

12. Assessments both by international bodies and the Czech authorities acknowledge that corruption is a significant problem. For instance a report by the Council of Europe (Council of Europe, 2003) assesses corruption to be a serious problem. This was echoed by the 2003 Regular Report by the European Commission and quantitative indicators of corruption generally back this up. When compared across other OECD countries, the Czech Republic indeed ranks poorly, for example, in the World Bank's general corruption indicator.<sup>7</sup> However, it should be stressed that the Czech Republic ranks much less poorly when a wider selection of countries is considered. For instance, in the context of a broad eastern European grouping the Czech Republic has one of the better rankings according to a recent survey by the World Bank on corruption in transition countries (World Bank, 2004b).<sup>8,9</sup>

13. Current policies to reduce corruption are based on a package of measures introduced in 1999 and include legislative and organisational changes, training and media promotion and international co-operation. The measures include commitment by the Ministry of Interior to produce an annual report on corruption. In 2002 additional steps were taken, notably by increasing access to tax records for police investigation. In addition, tax officers joined special anti-corruption teams in the Ministry of Interior and Ministry of Finance to assist in securing damage claims arising from criminal activities and the identification and collection of tax arrears. In 2003 organisational changes were made with the merger of specialised police anti-corruption units.

14. Despite the continuing efforts to bolster anti-corruption measures, the Ministry of Interior's assessment of progress remains sceptical. The 2003 Ministry's annual report on corruption sees little progress in the results of measures and highlights that corruption remains a serious problem in key areas including state administration, police forces, healthcare, banking and the judiciary, as well as influencing the political sphere.<sup>10</sup> The Ministry has since established an anti-corruption commission, responsible for detecting internal corruption and telephone and email lines to most ministries have been set up for citizens to submit complaints about corruption.<sup>11</sup>

15. Looking forward, there are plans to introduce "integrity testing" for some government employees. A proposal submitted to the government in mid-2004 proposes a system of checking personal finances through an obligatory triennial asset declaration for civil servants, members of security and armed forces, judges, prosecutors and officers of self-governing entities and publicly funded organisations, such as the National Property Fund. Employers would assess the declarations and report suspicious cases to either the financial or law enforcement authorities.

16. There are also plans to introduce a "crown witness" system -- the absence of which is limiting powers of prosecution in serious corruption cases. Crown witness instruments are to be

included in a new Criminal Code currently in preparation with the aim of enforcement in 2006. The instruments are to allow discontinuation of an individual's prosecution if they disclose information that could contribute significantly to the detection of a serious crime. Eligibility for this protection requires the individual to confess to the crime for which they are prosecuted, surrender any financial gains from the crime and provide compensation for criminal damage.

17. The plans to introduce integrity testing and a crown witness system are welcome but further measures may be needed to bring corruption levels down.<sup>12</sup> Cutbacks in regulation and red tape would also help reduce opportunities to engage in corruption.

## ENDNOTES

1. For a recent in-depth account of the Czech bankruptcy system see World Bank (2004a).
2. See the World Bank's 2002 assessment of corporate governance for further detail on related party transactions (World Bank, 2002).
3. The number of criminal convictions for intentional misplacement or destruction of accounts has increased significantly in recent years, as well as criminal convictions for frustrating or seriously impeding the activity of the bankruptcy trustee. The Czech authorities view this as a positive development, reflecting improvements to legislation, increasing detection and success in prosecution, rather than increase in the level of criminal activity.
4. During a period of protection, no bankruptcy may be declared or reorganisation or composition permitted. The debtor cannot sell the business during the period of protection.
5. The World Bank's "Doing Business" database for 2003 shows the Czech Republic and Poland to have 10 procedures in starting a business, while there are 9 in the Slovak Republic and 6 in Hungary. At the same time, however the time taken to set up a business is longer in Hungary and Slovakia at 52 days compared with 31 in Poland and 40 in the Czech Republic. The OECD averages for these statistics are 6 procedures and 25 days.
6. Extremely protracted registration proceedings are typically limited to complex situations such as merger cases rather than the straightforward registration of new business. So criticism that new business registration takes too long should to some extent be diluted.
7. The World Bank's general indicator of corruption is a composite indicator based on several business surveys on corruption. These issues are discussed in Kaufmann *et al.* (2003).
8. The in-depth report on corruption by the World Bank, *Anti-Corruption in Transition 2* is a follow-up to a 1999 study. The corruption statistics come from a survey of firms conducted in conjunction with the European Bank for Reconstruction and Development -- the so-called BEEPs database. The first round of BEEPs was conducted in mid-1999 and was based on interviews with owners and senior managers in about 4 000 firms in 24 transition countries. The second round was conducted in mid-2002 and involved about 6 500 interviews in 26 countries. The report focuses on two measures of corruption, one which indicates the degree to which corruption is seen as an obstacle to business in the country and a bribe frequency index.
9. Corruption indicators are giving mixed signals on the trend in corruption. The widely published "corruption perception index" by Transparency International (a composite indicator based on several business surveys) is sometimes cited in the media and other reports as indicating that corruption has been increasing in the Czech Republic. Indeed the index has deteriorated over time but what this actually means is unclear. A lower value of the index can arise because country coverage of the index has increased over time and it is possible that the index reflects a country being pushed further down the ranking and not that the measure has deteriorated in an absolute sense. In addition, the index reflects a *perception* of corruption and experts at Transparency International think that the trend for the Czech Republic might partly reflect rising expectations about acceptable levels of corruption. Furthermore, the recent World Bank report on corruption in transition countries (World Bank, 2004b) in fact contradicts the corruption perception index. Survey results for 1999 and 2002 indicate that

fewer businesses now see corruption as a serious obstacle and that there has been a substantial reduction in the frequency of bribery.

10. The Ministry of Interior's assessment that the current anti-corruption measures are not effective enough is echoed in a recent study by Transparency International (Transparency International, 2004) which includes a survey of individuals' perceptions of the effectiveness of anti-corruption measures in the capital cities of the Visegrad countries. Prague is seen as having the weakest anti-corruption measures across respondents in the four capitals.
11. State authorities are already obliged under the criminal procedure code to report without delay to police or public prosecutors any indications that crime, including bribery, has been committed.
12. In autumn 2004 the Ministry of Justice was preparing a new act on conflict of interest which should also help in the fight against corruption. Legislation in Britain, France and Slovakia is being used as a guide to prepare the new act.

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