



EUROPEAN CENTRAL BANK

## OPINION OF THE EUROPEAN CENTRAL BANK

of 18 October 2005

at the request of the Czech Ministry of Justice

**on a draft law on insolvency and the means of its resolution and on a draft law amending certain laws in connection with the adoption of the law on insolvency**

(CON/2005/36)

1. On 29 July 2005 the European Central Bank (ECB) received a request from the Czech Ministry of Justice (hereinafter the ‘Ministry’) for an opinion on a draft law on insolvency and the means of its resolution (hereinafter the ‘draft insolvency law’) and a draft law amending certain laws in connection with the adoption of the law on insolvency and the means of its resolution (both draft laws hereinafter referred to collectively as the ‘draft laws’).
2. The ECB’s competence to deliver an opinion is based on the third and sixth indents of Article 2(1) of Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions<sup>1</sup>, as the draft laws affect the powers of Česká národní banka (ČNB) and contain rules applicable to financial institutions which materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

The draft laws

3. The draft laws replace the current insolvency framework contained in the Act on bankruptcy and composition of claims No 328/1991 Coll., as amended (hereinafter the ‘Bankruptcy Act’). The main purpose of the draft laws is to overhaul and modernise Czech insolvency law, by introducing new means of resolving insolvency other than bankruptcy, such as reorganisation, discharge of debt and other specialised proceedings for particular types of entities, including financial institutions. The provisions on reorganisation proceedings, in particular, are inspired by Chapter 11 of the US Bankruptcy Code of 1978 and similar insolvency law reforms in a number of EU Member States, including Germany and France<sup>2</sup>. The draft laws also contain provisions on special insolvency

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<sup>1</sup> OJ L 189, 3.7.1998, p. 42.

<sup>2</sup> See the German *Insolvenzordnung* (Insolvency Law) of 5 October 1994 and the French *Code de commerce* (Commercial Code), Article L. 610-1 et seq., as amended by *Loi n° 2005-845 du 26 juillet 2005 de sauvegarde des entreprises* (Law No 2005-845 of 26 July 2005 on the preservation of undertakings).

proceedings for financial institutions<sup>3</sup>, which are intended to transpose a number of EC directives in this area<sup>4</sup>. The draft laws thus mainly reform corporate insolvency procedures, but they are also relevant to banks and other financial institutions. The draft laws will enter into force on 1 January 2006.

#### Comments on the general framework for corporate insolvency and creditors' rights

4. The Czech legal framework for corporate insolvency has been closely monitored in recent years by the international financial community. The ECB understands that, despite certain constructive amendments to the Bankruptcy Act in 2000, international financial institutions such as the World Bank<sup>5</sup> and the International Monetary Fund (IMF)<sup>6</sup> have criticised insolvency proceedings under the Bankruptcy Act as being slow, inefficient and dysfunctional<sup>7</sup>. The ECB understands that the Bankruptcy Act is still widely considered to be unsuitable for current market conditions; Czech banks and other public-sector undertakings have been privatised and now compete with counterparts from other Member States which have more highly developed insolvency regimes<sup>8</sup>. The ECB also understands that the current insolvency regime is seen as hostile to creditors' rights and debt enforcement. The ECB understands that recovery rates in respect of creditors' security are particularly low, largely due to weak debt enforcement and to creditors having little effective control over insolvency proceedings, which are largely under the control of the courts (with a single judge sitting at first instance)<sup>9</sup> and the court-appointed bankruptcy administrator. This is of particular concern for banks and other financial institutions that have secured claims against a debtor. If secured creditors have no confidence that their security rights will be protected upon a

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<sup>3</sup> It should be noted that these provisions generally repeat those contained in the most recent 'harmonisation' amendment of the Bankruptcy Act, which entered into force on 29 September 2005 and is a part of the Act on financial conglomerates No 377/2005 Coll.

<sup>4</sup> These are principally Directive 2001/24/EC of the European Parliament and of the Council of 4 April 2001 on the reorganisation and winding up of credit institutions (OJ L 125, 5.5.2001, p. 15) and Directive 2001/17/EC of the European Parliament and of the Council of 19 March 2001 on the reorganisation and winding-up of insurance undertakings (OJ L 110, 20.4.2001, p. 28), as well as certain adaptations required as a result of Council Regulation (EC) No 1346/2000 of 29 May 2000 on insolvency proceedings (OJ L 160, 30.6.2000, p. 1), as amended by Council Regulation (EC) No 603/2005 of 12 April 2005 amending the lists of insolvency proceedings, winding-up proceedings and liquidators in Annexes A, B and C to Regulation (EC) No 1346/2000 on insolvency proceedings (OJ L 100, 20.4.2005, p. 1).

<sup>5</sup> See, for example, the World Bank Country Study, 'Czech Republic: Completing the Transformation of Banks and Enterprises' (in particular Section 3, entitled 'The need to reform the legal framework', pp. 24-55), November 2000. See also 'Report on Observance of Standards & Codes – Insolvency and Creditor Rights Systems: Czech Republic', April 2001. These and other World Bank reports mentioned herein are available or cross-referenced on the World Bank's website ([www.worldbank.org](http://www.worldbank.org)).

<sup>6</sup> See IMF Country Report No 04/4, 'Czech Republic – Report on the Observance of Standards and Codes – Banking Supervision – Update', p. 3, Section III.3 (entitled 'Preconditions for effective banking supervision'), paragraph (ii), January 2004; available on the IMF's website ([www.imf.org](http://www.imf.org)).

<sup>7</sup> See also the earlier World Bank Country Study, 'Czech Republic: Toward EU Accession – Main Report', pp. 118 and 119 (section entitled 'Reform of the collateral and bankruptcy framework'), September 1999.

<sup>8</sup> A World Bank comparative study, 'Doing Business, Topic Reports: Bankruptcy', of January 2003 found the average length of bankruptcy proceedings in the Czech Republic (9.2 years) to be approximately four times that of the EU average, including the acceding Member States.

<sup>9</sup> The lack of time constraints on the court's performance of its procedural tasks in insolvency cases has also been criticised (see the World Bank Policy Note, 'Czech Republic: Insolvency and Creditor Rights Systems', p. 20, paragraph 49 (in the section entitled 'Recommendations and Next Steps') and p. 9, February 2004).

debtor's insolvency, this will have a negative impact on bank lending terms and heighten systemic risks within the banking system. Against this background, the ECB generally welcomes the draft laws, which represent a serious attempt to reform Czech insolvency law and which take into account these perceived shortcomings.

5. One of the key reforms introduced by the draft insolvency law is that large corporate debtors<sup>10</sup> which are insolvent or face the risk of insolvency are entitled to file for reorganisation<sup>11</sup> of their business (i.e. a court-approved plan of protection against their creditors) as an alternative to bankruptcy. This is an important legal reform as bankruptcy proceedings in the Czech Republic, once commenced, currently only provide for the liquidation of the debtor's business and the sale of assets to satisfy creditors' claims, leaving no possibility of saving the debtor's business. The ECB notes that, under the Bankruptcy Act, the vast majority of insolvencies lead to bankruptcy proceedings and that composition of claims, which is the only alternative insolvency procedure enabling debtors to enter into voluntary arrangements with their creditors, is rarely used in practice<sup>12</sup>. The ECB understands that, under the present system, bankruptcy involves a generally slow process of auctioning off bankruptcy assets under court supervision, without the active involvement of creditors. By enabling *bona fide* insolvent undertakings to agree with creditors on a reorganisation plan, and have it approved by the courts, and by introducing deadlines by which the courts must take individual decisions within the insolvency proceedings, undertakings should emerge from insolvency more quickly than under the present regime. Additionally, if more undertakings are approved for reorganisation rather than declared bankrupt, this should over time reduce the number of bankruptcies administered by the courts, which already have a considerable backlog of bankruptcy petitions<sup>13</sup>.
6. Another key set of reforms in the draft insolvency law concerns proposed improvements to creditors' rights. For example, under the conditions of the draft insolvency law the courts will only be able to refuse a decision by the creditors' meeting to appoint a new insolvency administrator on the limited grounds set out in the draft insolvency law. Also, the courts will now be required to call a creditors' meeting, the basic creditors' body, not only upon the request of the insolvency administrator or the creditors' committee (comprising creditors' representatives) but also upon the request of at least two significant creditors<sup>14</sup>. In reorganisation proceedings, the creditors' meeting must also approve any reorganisation plan presented by the debtor. Secured creditors who have lent

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<sup>10</sup> Large corporate debtors are entrepreneurs and undertakings which have an annual turnover of at least CZK 100 million and at least 100 employees (Article 221(4) of the draft insolvency law) and are not entities which cannot be subject to reorganisation proceedings, such as commodities brokers, securities dealers and any legal entity that is in liquidation.

<sup>11</sup> In other words, as a means of rehabilitating the insolvent business. Reorganisation proceedings are defined as 'the gradual satisfaction of creditor claims whilst keeping the debtor's business operational, secured by measures for the rehabilitation of the operations of the business under a court-approved reorganisation plan together with regular controls on compliance by the creditors with that plan' (Article 221(1) of the draft insolvency law).

<sup>12</sup> See the explanatory memorandum to the draft insolvency law.

<sup>13</sup> See the World Bank Policy Note entitled 'Czech Republic: Insolvency and Creditor Rights Systems', February 2004.

<sup>14</sup> Article 31(1) of the draft insolvency law.

to the debtor against security over the debtors' assets are entitled to 100 % of their security, generally according to their ranking and after deducting the costs of realisation<sup>15</sup>. The general principle that the purpose of insolvency proceedings is the satisfaction of creditors' claims<sup>16</sup> is stated more explicitly in the draft insolvency law than in the Bankruptcy Act. In line with that principle, the provision of the Bankruptcy Act limiting the maximum amount that may be used to repay the creditor's security to 70 % of the value of the realised security is repealed<sup>17</sup>. The ECB generally welcomes these improvements to creditors' rights. Nonetheless, it is aware that the draft laws will not, on their own, improve the efficiency of insolvency proceedings in the Czech Republic. For example, the efficient resolution of any insolvency proceedings continues to depend on the high level of integrity and professionalism of insolvency administrators. The ECB understands that the Ministry plans to supplement the draft laws with a separate law on insolvency administrators and on the establishment of an association of insolvency administrators, which would include measures to enhance the professional requirements applicable to insolvency administrators. The ECB is generally supportive of the Ministry's plans in this regard.

#### Special insolvency regime for banks

7. Under the draft insolvency law, the application of insolvency proceedings to banks<sup>18</sup> is strictly limited. First, the draft insolvency law is stated only to apply to a bank whose licence has been revoked by ČNB<sup>19</sup>. Secondly, the draft insolvency law states that the only form of insolvency proceedings that the court may apply in respect of a bank whose licence has been revoked are bankruptcy proceedings<sup>20</sup>. All other forms of insolvency proceedings or related measures provided for in the draft insolvency law, such as reorganisation, discharge of debts, moratoria, and provisional moratoria, are expressly excluded from applying to a bank whose licence has been revoked. Moreover, the regulatory and administrative powers of ČNB over banks at the pre-insolvency stage<sup>21</sup> have not been changed under the draft laws, except insofar as was necessary pursuant to Directive 2001/24/EC.
8. The ECB welcomes the fact that the draft insolvency law excludes banks from insolvency proceedings while they are still licensed to carry on business<sup>22</sup>. By making revocation of a bank's licence by ČNB a precondition for the start of insolvency proceedings (i.e. the entity has ceased to

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15 Under the Bankruptcy Act, secured creditors are entitled to a maximum 70 % of the amount of any realised asset value; the balance of 30 % is treated as an ordinary claim. By contrast, under Article 1(2) of the draft insolvency law, the purpose of insolvency proceedings is stated to be to 'achieve the highest degree of ... satisfaction for the [insolvent] debtor's creditors' [claims], under the conditions laid down in this law'.

16 Article 1(2) of the draft insolvency law (see footnote 15 above).

17 Article 28(4) of the Bankruptcy Act, which is replaced by Articles 112 and 204 of the draft insolvency law.

18 As well as other types of financial institution defined therein (Articles 272(1) and 284(1) of the draft insolvency law).

19 Article 6(2)(a) of the draft insolvency law.

20 Articles 272(3) and 273(3) of the draft insolvency law.

21 Parts Six to Eleven (Articles 25-36) of the Act on banks No 21/1992 Coll., as amended, in particular enforced administration under Article 27 et seq. thereof.

22 Article 6(2)(a) of the draft insolvency law.

be a bank), the draft insolvency law acknowledges ČNB's sole responsibility for supervising banks that are in financial difficulties, and for deciding when insolvency proceedings should be commenced against such banks. Furthermore, by means of this precondition, the draft insolvency law effectively insulates the banking supervision regime, which is under ČNB's responsibility, from the general insolvency regime, which remains under the responsibility of the courts. There is consequently little risk of the two legal regimes overlapping and competing<sup>23</sup>.

9. The ECB notes that the question of whether a special insolvency regime should apply to banks, or whether the general insolvency law should apply to banks and be under the responsibility of the courts, is a matter of legitimate debate among bank insolvency experts. Many Member States have adopted the latter approach, as a result of their particular constitutional and legal traditions. In the ECB's view, whatever approach is taken, there are sound reasons for having a clear division of responsibilities between the banking supervisory authority and the courts as regards bank insolvency. It is generally accepted that banks play a special role in the economy, and for that reason their insolvency cannot be handled in the same way as that of other corporate debtors. To ensure public confidence in the banking system and generally to prevent systemic risks to other banks, the banking supervisory authority must be able to act quickly and decisively when a bank is in difficulty, not only in the interest of depositors (who should be protected by a deposit insurance scheme) and other creditors of the bank, but also in the interests of the stability of the banking and financial system as a whole.
10. In many cases the banking supervisory authority will be best placed to assess whether a distressed bank is able to continue in business or must be liquidated. In the specific Czech context, ČNB is likely to be better equipped to make such a judgement than the civil courts. ČNB has a wide range of regulatory and administrative powers under Czech law<sup>24</sup> that it may use to sanction a bank or oblige a bank to remedy any shortcomings in its activities at the pre-insolvency stage. The draft insolvency law correctly assumes that when those statutory powers prove ineffective, ČNB should be able to decide whether to refer the distressed bank to the courts. If it decides to do so, the courts are then responsible for declaring the bank insolvent and for overseeing the bankruptcy proceedings, including sale of the bank's assets and satisfaction of the bank's depositors and other creditors<sup>25</sup>, as well as for ensuring that the parties are given a fair hearing in the proceedings.

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23 Although it is noted that one of the ČNB, the delicensed bank or any one of its creditors may apply to have the bank declared insolvent (Articles 273(1) and 60 of the draft insolvency law).

24 Act on banks No 21/1992 Coll., as amended.

25 Although even in insolvency proceedings the role of the banking supervisory authority will be crucial to any solution for the bank and its depositors.

11. This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 18 October 2005.

[signed]

*The President of the ECB*

Jean-Claude TRICHET