THE IMPACT OF INSOLVENCY LAW ON FINANCIAL STABILITY[168]

This article takes as its central theme the development of insolvency law in relation to financial stability. While insolvency law does not constitute direct regulation of the financial market, it significantly affects the market and the way its participants behave. Quality insolvency law facilitates rapid exit of problem entities from the economic system and reduces the impacts of the losses incurred by insolvents on other businesses, households and financial institutions. Insolvency law therefore has an important role in terms of credit and systemic risk and directly affects the conditions for financial stability in the Czech economy. Moreover, it is a highly topical issue, because after many years of preparation the legislative process of adopting the new insolvency act[169] is nearing an end.

The following article presents the first comprehensive paper on the impact of legislation on financial stability, rendered through this Financial Stability Report. The introduction therefore briefly discusses the general relationship between the law and financial stability. Attention is then fixed on the central theme of the article – insolvency law.

1. GENERAL NOTES ON THE RELATIONSHIP BETWEEN THE LAW AND FINANCIAL STABILITY

The system of law regulates practically all relationships in society to a greater or lesser extent. Ideally, the law should eliminate instability in the broadest sense of the word, including financial system instability. Indeed, the law itself can be a source of such instability. In a normally functioning market economy and a state that respects the rule of law, however, a specific legal rule can only rarely be identified as a direct cause of financial instability. Rather, the system of law creates conditions that limit such risk. In the worse case, the law does not respond to such risk or may even increase it. The legal environment therefore is a necessary supporting element of financial stability.

The issue of the legal environment as a source of potential financial sector instability can therefore be paraphrased as an issue of deficiencies in the law that can counteract systemic stability and boost systemic risk ("contagion risk"). Deficiencies in the law include, in addition to the absence of certain rules, an excessive number of rules and poor transparency,[170] or rules that merely exist "on paper" without due implementation or supervision of compliance in practice. Relative stability, continuity and predictability of the law also contributes to the health of the economy. Excessively frequent changes of direction act negatively in this respect.[171]

As regards their impact on the financial system stability, legal rules can be divided into several categories, although the borderlines between them are to some extent artificial and blurred:

1. The first category consists of laws that significantly influence the stability of the financial sector even though financial stability or regulation of conduct on the financial market are not themselves the key objectives of such legal rules. Examples include the Commercial Code, the Act on Bankruptcy and Composition and the Act on the Protection of Economic Competition.

2. The next category comprises "macroeconomic" laws, dealing primarily with economic growth, employment, exchange rate stability, fiscal issues and so on. Examples include laws regulating taxation and public budgets in general, the exchange rate and foreign exchange, investment incentives and international investment protection treaties. Such statutes have a fundamental effect on the economic and financial stability of the state as a whole. Simplifying, however, we can say that they have roughly the same significance for banks and other financial institutions as they do for other businesses and the public.

3. The third category consists of regulations responding to extraordinary events linked with instability of the financial system. These can include both events of non-financial nature (armed conflicts, terrorist attacks, epidemics or natural disasters) and sudden and deep crises triggered by financial and economic factors.[172] These regulations try to remedy instability that has already occurred and do not usually influence the causes of, or prevent, financial instability.

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169 Act No. 182/2006 Coll., on Insolvency and Methods of Resolution Thereof (Insolvency Act). The Act will enter into force on 1 July 2007.

170 For example, one of the key factors a potential investor considers when making a decision on a cross-border investment is the transparency of the legal and administrative infrastructure of the target country.

171 The issue of "over-regulation" is discussed at the end of this article.

172 Typical examples of such "crisis legislation" include the provisions of the Foreign Exchange Act dealing with states of emergency in the foreign exchange economy, the Crisis Act and the State Aid Act.

4. The last category comprises laws and their implementing regulations that directly regulate the business of financial market participants, their conduct towards clients and the functioning and supervision of markets. Such rules should have the greatest preventive effect against systemic risk, by promoting regulation, supervision and market discipline of financial intermediaries themselves.[173]

This category of legal rules applies most closely to the activities of financial market participants and to the CNB as the financial market supervision authority.[174] Considerable progress has been made in this area compared to the situation in the 1990s, in particular thanks to the harmonisation of the national law with that of the European Communities (EC). As EC law deals heavily with financial market regulation, the Czech legal and regulatory conditions for financial market business are highly compatible with those in other EU member states and states of the European Economic Area. Harmonisation of regulations is significantly reducing systemic risk in the Europe-wide context.

With regard to systemic stability, few major changes were made to the national financial market legislation in 2005. Among the new regulations in this context, the Act on Financial Conglomerates deserves special attention.[175] Compared to the original plan (i.e. to transpose the Directive on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate)[176] the act was considerably expanded to cover additional areas. It should be noted from the systemic stability perspective that, in addition to supplementary supervision itself, the act introduced supervision of insurance companies in a group, aligned the regulations on credit unions with the rules contained in the Act on Banks and corrected certain deficiencies in the hastily adopted amendment to the Commercial Code, introducing the principle of squeeze-out of minority shareholders.[177] The act also introduced important changes from the financial market perspective into the Act on Bankruptcy and Composition.[178]

The central focus of this article is insolvency/bankruptcy law, which belongs to the first category of rules, whose development and recent changes may affect the functioning and stability of financial markets.

CZECH INSOLVENCY LAW FROM THE POINT OF VIEW OF FINANCIAL SYSTEM STABILITY

Since the second half of the 1990s, when, in response to the incipient weakening of the Czech economy, the principle of bankruptcy began to be widely used,[179] it has been pointed out that the Act on Bankruptcy and Composition, despite having been amended more than 20 times,[180] is obsolete. Critics have pointed out that the act is based on the law and business ethics of the Czechoslovak "First Republic" (before WWII) and that it is more suitable for the bankruptcy of a small enterprise with no more than a few dozen creditors located close to the debtor's registered office (place of residence) than for large companies. Another objection has been that the act is too rigid and does not in fact provide any alternative to bankruptcy as a liquidation method of dealing with insolvency (the legal requirements for composition, as mentioned below, virtually prevent composition from being applied more frequently). The act does not provide for sensitive differentiation between different types of insolvents (such as consumers, small businesses, industrial giants or financial institutions) and fails to provide creditors with sufficient legal mechanisms to take decisions on dealing with insolvency in a way that corresponds to their economically legitimate claims on the insolvent's assets. For many years the act has also been the target of serious criticism from financial market participants and regulators.

173 Examples include the Act on Banks, the Act on Capital Market Undertakings, the Insurance Act and the Collective Investment Act.

174 On 1 April 2006, the CNB assumed supervision of the entire Czech financial market under Act No. 57/2006 Coll.

175 Act No. 377/2005 Coll., on the Supplementary Supervision of Banks, Credit Unions, Electronic Money Institutions, Insurance Undertakings and Investment Firms in Financial Conglomerates and on the Amendment of Some Other Laws (Financial Conglomerates Act).

176 This issue is regulated by Directive 2002/87/EC of the European Parliament and of the Council of 16 December 2002 on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

177 Act No. 216/2005 Coll. *Squeeze-out* (formally "the right of purchase of participation securities") is a problematic principle of corporate law (and the law in general with respect to the key aspect of protection of ownership). From the point of view of the stability and development of the financial system, it is useful to note its two conflicting impacts. On the one hand, it can help to clarify and simplify ownership structures, corporate governance and the control systems of many financial groups, which is beneficial both to the group itself and to the supervisory authorities. On the other hand, squeeze-out of minority shareholders reduces the diversity of publicly traded shares and hence also the long-term investment opportunities for households.

178 More detailed descriptions of the Financial Conglomerates Act and other new financial market legislation are given in other CNB publications, e.g. Banking Supervision 2005 or Czech Capital Market Situation Report 2005.

179 More details on the number of bankruptcy petitions filed are given in section 3.1. *Non-Financial Corporations*.

180 Bankruptcy and composition are regulated by Act No. 328/1991 Coll., on Bankruptcy and Composition, as amended.

From the point of view of the financial market and financial stability, insolvency law plays an important role in influencing credit and systemic risk. Insolvency law co-determines how the insolvency of a debtor of a bank or other financial institution impacts on its stability or how the insolvency of a single bank or financial institution affects the whole system (contagion risk). This article focuses specifically on those aspects of insolvency law which are material in terms of the risks set out above. Many of these aspects have caused problems in the past and have now been successfully remedied, but some of them persist and pose a future legislative challenge.

3. SELECTED ELEMENTS OF SYSTEMIC RISK IN INSOLVENCY LAW

● ***The zero-hour rule***

A declaration of bankruptcy is associated with numerous legal effects. It results in the debtor losing the right to dispose of its assets. Upon declaration of bankruptcy, some legal acts by the debtor are deemed invalid, ineffective or challengeable. Under the previous rules, the effects of a declaration of bankruptcy commenced on the date of posting of the bankruptcy declaration decision on the official noticeboard of the court, i.e. retroactively, starting from the very first moments of the day in question, even though the decision may have been posted at, say, 2 p.m. (known as the *zero-hour rule*). The rule caused legal uncertainty to the contractual partners of the debtor and posed a fundamental problem particularly in cases of insolvency of a participant in a payment system or settlement system of an investment instrument market, as a transaction concluded on the bankruptcy declaration date but prior to the posting of the decision could be voided retroactively, with the other party to the transaction having no objective way of knowing about such declaration of bankruptcy.

On 1 April 1998, the zero-hour rule was rescinded, so that the effects of bankruptcy commence only at the moment of posting of the decision on the court's official noticeboard. In addition, the court has, since 1 January 2003 and 1 May 2004 respectively, been obliged to notify the CNB of any declaration of bankruptcy on a participant in a payment and settlement system recorded in a list kept by the CNB under special legislation.[181] The CNB then has to immediately forward such information to the system operator and to the entities performing the functions of central counterparty, settlement agent and clearing house in the system (the CNB itself is the operator of the sole payment system in the Czech Republic).

Under the new legislation, the need for easier and more accessible notification of all creditors and any other entities of the insolvency of a particular person should be provided for by a remotely accessible insolvency register and electronic posting of decisions on insolvents.

● ***Finality of transfer orders entered into a payment or settlement system***

The above issues of informing creditors about bankruptcy declarations and the effects of such decisions are connected with a requirement on the part of the financial markets and their regulators that payment and settlement systems should prevent the occurrence of secondary insolvency should any system participant become unable to pay its obligations. The systems should achieve this by ensuring finality and enforceability (i.e. execution) of transfer orders entered by such participant into the system up to the moment the system operator becomes aware that the participant has been declared bankrupt or become subject to a similar measure relating to suspension of payments. In the case of payment systems, the above requirements have been met by the Payment System Act and a simultaneously adopted amendment to the Act on Bankruptcy and Composition since 1 January 2003. In the case of settlement systems, the requirements have been met by the Act on Capital Market Undertakings and the Act on Bankruptcy and Composition since 1 May 2004.

● ***Close-out netting***

Close-out netting is a legal framework for final netting of mutual claims and obligations from derivatives transactions, loans of securities, repos or other financial transactions between institutional investors or between institutional investors and their clients where one of the parties becomes insolvent.[182] The point is to have a close-out netting agreement that is enforceable even in the event of bankruptcy proceedings which are otherwise governed by the principle of "preservation" of the balance of claims and obligations as at the moment of declaration of bankruptcy.

181 Act No. 124/2002 Coll., on Transfers of Funds, Electronic Payment Instruments and Payment Systems (the Payment System Act), as amended, and Act No. 256/2004 Coll., on Capital Market Undertakings. Until 31 March 2006, the Czech Securities Commission maintained the list of settlement systems.

182 Close-out netting usually takes place in the event of the more widely defined default by a contracting party than in the event of insolvency only.

The main argument for enacting recognition of close-out netting in bankruptcy is its contribution to eliminating the risk of contagion in the financial sector from one insolvent to its contractual partners. Their mutual transactions run to millions or billions of Czech korunas, but overall represent a single net obligation of a considerably lower amount. In addition, recognition of close-out netting reduces the capital requirements for the transactions concerned for the purposes of compliance with the capital adequacy rules. Institutions from "netting jurisdictions" are therefore, from this perspective, more attractive contractual partners in the financial market, giving them a competitive advantage over those whose bankruptcy law does not recognise close-out netting.

The main counter-argument used by the opponents of close-out netting is the inequality that would thereby arise between the creditors and debtors of the insolvent. This is often accompanied by the comment that it puts financially strong entities at an advantage over financially weaker entities. The effort to legalise close-out netting has been criticised even more given the existence of the still valid, but problematic absolute ban on the set-off of claims in bankruptcy proceedings.[183]

The first attempt to enact close-out netting rules in the Czech Republic was made at the end of 2000, when the first definition of close-out netting of profits and losses appeared in the Securities Act.[184] This merely provided for the signing of a contractual arrangement (the actual mechanism of such transactions). The Act on Bankruptcy and Composition was not amended in this respect, so the option of close-out netting remained absent from Czech bankruptcy law.

An improvement came on 1 May 2004 with the coming into effect of the new Act on Capital Market Undertakings and a related amendment to the Act on Bankruptcy and Composition.[185] By that time, inviolability of close-out netting in the case of bankruptcy and composition proceedings had been provided for to some extent. However, there was still a problem with the specific definition of close-out netting in the Act on Capital Market Undertakings, as the definition had been assumed from the aforementioned Securities Act. The definition was based on an accounting approach and talked about the setting-off of profits and losses on individual transactions covered by close-out netting. Primarily for the purposes of the Bankruptcy Act, however, it was necessary and more precise for the definition to be based on civil law terminology and to deal with concurrent mutual claims or obligations arising from such transactions.

Comprehensive legal treatment of the close-out netting issues came only with the adoption of the Financial Conglomerates Act on 29 September 2005. The act, among other things, transposed the directive on financial collateral arrangements[186] into the Czech legislation. The directive regulates close-out netting and its definition, recognition and enforceability in quite some detail. A new, more flexible yet more precise national legal definition of *close-out netting* has been introduced (now without the "profit and loss" tag). The earlier discussion as to which "eligible" parties should be allowed to enter into such contractual arrangements has been resolved by an approach under which the law does not expressly restrict or define the entities eligible to enjoy the benefits of close-out netting, although it does generally define the types of transactions that may (solely) be covered by close-out netting provisions. Recognition of close-out netting has also been enacted, along with bankruptcy and composition, for instances of forced administration imposed on one of the parties to such an arrangement.

- ***Financial collateral***

For essentially the same reason as in the case of close-out netting, i.e. to prevent the systemic risk of contagion through the financial market, market participants (including central banks) and regulators have been making efforts to introduce inviolability of realisation of financial collateral arrangements in the event of the insolvency of one of the parties to such an arrangement.[187] The arguments used by the opponents of such initiatives are again based on the violation of the principle of equality of creditors during bankruptcy proceedings and the favouring of financial institutions.

183 The new Insolvency Act should largely overturn this ban.

184 Act No. 591/1992 Coll., on Securities, as amended by Act No. 362/2000 Coll.

185 For details, see Act No. 257/2004 Coll., Amending Some Laws Relating to the Adoption of the Act on Capital Market Undertakings, the Act on Collective Investment and the Act on Bonds.

186 Directive 2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.

187 The risks in payment systems are discussed in section 5 *The Financial Infrastructure*. Interbank contagion risk is discussed in the article *Summary of the Results of Stress Tests in Banks*.

The legislation providing for inviolability of financial collateral was implemented on two levels. First, it was harmonised with the directive on settlement finality[188] through the Payment System Act (as of 1 January 2003) and the Act on Capital Market Undertakings (as of 1 May 2004) and related amendments to the Act on Bankruptcy and Composition. In addition to the above finality and enforceability of transfer orders entered into a payment or settlement system on the date of declaration of bankruptcy on a participant therein, systemic risk was eliminated by enactment of the entitlement of other system participants to exercise their right to collateral provided to them by the insolvent participant and used to secure its obligations arising from its participation in the system. For these purposes, collateral was defined very broadly, if not vaguely, as the rights to an asset used to secure the relevant obligation. Inviolability and realisation of collateral provided by an insolvent participant to the CNB, the ECB or the central bank of another member state was enacted at the same time.[189]

The second phase, which impacted on a much wider range of transactions in the financial market, was introduced by the Act on Financial Conglomerates. This act, in line with the directive on financial collateral arrangements, incorporated the issue of financial collateral into the Commercial Code.[190] Under the Commercial Code, "financial collateral" means collateral provided for claims arising from transactions, the subject of which is solely cash or financial instruments, and which has been arranged between the collateral provider and the collateral taker as:

a) a security interest on a financial instrument,
b) a security interest on a deposit claim,
c) a title transfer of a financial instrument, or
d) a title transfer of cash.

In the event of the insolvency of a collateral provider, the collateral taker is entitled to satisfaction of its secured claim from the collateral provided[191] or close-out netting occurs between them. No special formal administrative or judicial steps are required to exercise this right. The new legislation overturns the ban on so-called forfeiture of pledge, as it allows the claim of a collateral taker to be satisfied by appropriation of the pledged financial instrument, provided that such option has been arranged and the arrangement also includes the method of valuation of the relevant financial instrument.

By contrast with close-out netting, however, a financial collateral arrangement may be agreed solely between selected entities. One party to the contract must be a professional domestic, foreign or international financial institution, a state or a self-governing unit, and the other party must also be an entity of the same kind or a large enterprise.[192] This is meant to prevent the misuse of financial collateral arrangements to evade the effects of bankruptcy or composition proceedings in "retail" relationships. Likewise, it serves to avoid situations where a bank or another financial institution uses a financial collateral arrangement solely to manage the credit risk of non-institutional clients, to the detriment of other potential bankruptcy creditors. Financial collateral should therefore primarily fulfil its role of protection against systemic risk.

Under the Act on Bankruptcy and Composition, a creditor that is a taker of collateral provided by an insolvent does not have the status of a separate (secured) creditor, or of a bankruptcy creditor at all, and receives satisfaction from financial collateral entirely outside bankruptcy proceedings. In addition, the bankruptcy rules relating to the invalidity and challengeability of some legal acts performed within a statutory period prior to the declaration of bankruptcy do not apply to provision and realisation of financial collateral. Inviolability of financial collateral arrangements is similarly regulated in cases of composition or forced administration of the collateral provider, and, on the other side, in cases of payment difficulties of the collateral taker.

188 Directive 98/26/EC of the European Parliament and of the Council of 19 May 1998 on settlement finality in payment and securities settlement systems.

189 Neither the act nor the directive define the reason based on which such inviolable collateral may be provided to the central bank.

190 Specifically, Article 323a et seq. of Act No. 513/1991 Coll., the Commercial Code, as amended by Act No. 377/2005 Coll.

191 Financial collateral is cash or financial instruments (i.e. investment instruments and claims and rights relating thereto) provided by a collateral provider as the subject of a financial collateral arrangement. Hence, a financial collateral arrangement is a type of collateral arrangement based on either a security interest or a security transfer of a right (usually a title transfer), while the financial collateral is the asset functioning as security.

192 The law talks about legal entities that meet at least two of the following three criteria: total assets of at least CZK 600 million, net annual turnover of at least CZK 1.2 billion and equity capital of at least CZK 60 million.

● ***Bank insolvency***

In the mid-1990s, when minor banking institutions began to go bankrupt, in addition to procedures and rules to prevent bank insolvency (banking regulation and supervision), the issue of special legislation covering the exit of banks from the sector began to be discussed. Numerous reasons were identified for which the application of general legislation to resolve bank insolvency appeared inappropriate. However, no comprehensive legal solution was ever adopted or proposed. Given the completed consolidation and stabilisation of the banking sector, this fact no longer poses any serious systemic risk. However, in the event of a major bank or group of banks running into problems that threaten its existence, the legislation in force offers no special solutions (except, perhaps, for forced administration).[193] From the point of view of system stability, the deposit insurance legislation, of course, mitigates the risk of runs on banks in distress and lessens the impacts of potential bank insolvency on depositors, most notably households.

However, a series of provisions has been adopted over the years which reflect the specific features of banks or former banks in bankruptcy. In 2000, the principle of subordinated debt, or claims bound by a condition of subordination which are satisfied in bankruptcy proceedings only after satisfaction of all other claims except for other subordinated debts (and, of course, shareholders), was incorporated into the Bankruptcy Act and the Act on Bonds. This established the legal justification for a principle previously applied only in the capital adequacy regulations and thus clarified all the doubts as to whether or not banks in the Czech Republic should be allowed to use subordinated debt as a cheaper source of capital.

The most special rules for resolving bank insolvency were introduced into the Act on Bankruptcy and Composition by the Act on Financial Conglomerates of 2005.

a) First, the act introduced a ban on the application of the Act on Bankruptcy and Composition to any bank with a valid banking licence. Among other things this helped to prevent the previously occurring "artificial" petitions for the declaration of bankruptcy, which can cause losses even to a healthy bank if its clients respond with alarm to news of the opening of bankruptcy proceedings.
b) In line with the acquis communautaire,[195] however, the amendment mainly consisted of rules addressing cross-border insolvency of banks, i.e. of banks having a branch in one or more states of the European Economic Area. From the current perspective of Czech banks, the regulation is not of key importance (even if one of them was to collapse), as Czech banks as a rule have no foreign branches. From the perspective of branches of foreign banks operating on the Czech market under the single European licence and their clients, however, the act should be given attention. In the Europe-wide context, it is a comparatively significant systemic solution, long in preparation, which enacts the principle of universality of bankruptcy or reorganisation proceedings at the expense of the territoriality principle previously applied in many countries. This means that bank insolvency is addressed in a single process conducted by the home country authorities of the credit institution without the option of conducting separate insolvency proceedings in host countries vis-à-vis its branches located there.
c) Beyond the framework of harmonisation, this amendment introduced one more change into the bankruptcy legislation – a different method for determining the claims of bankruptcy creditors in the case of an insolvent bank. Given the huge numbers of often poorly eligible bank creditors with minor claims (most notably depositors after payment of 90% of their claims from the Deposit Insurance Fund), a rule was introduced that the claims of the bank's creditors are based on their amounts in the accounting documents of the bank – and the claims are deemed lodged in such amounts. If the creditor disagrees with this amount, which the bankruptcy trustee must notify him of, the creditor may file objections, which, should the disagreement with the trustee persist, are decided by the court. This should substantially simplify the determination of claims.[195]
d) Similar rules for cross-border insolvency proceedings and determination of claims, as well as the inapplicability of the Bankruptcy Act to institutions with a valid business licence, also apply, in compliance with EC laws, to the insolvency of a credit union or an insurance company.[196] In the case of insurance companies we should mention that satisfaction of insurance claims prevails over any other claim on the insolvent except for the cash expenses and fee of the trustee and costs related to the maintenance and administration of the estate.

193 Also, the provision of any financial assistance by the state or the CNB in seeking a solution to the problem bank's situation would be complicated by the relative prohibition of state aid under EC competition law.

194 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.

195 Moreover, the bank's creditors can no longer contest each others' claims. Only the trustee may dispute their existence, nature and amount with the creditor.

196 EU law is in this respect represented by 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.

197 Until 1 May 2004, a mortgage loan was defined as a loan provided for investment in residential real estate and secured by this type of real estate. Currently, it is defined as any loan secured by any real estate. This expands the amount of such assets, but may somewhat diminish their quality.

e) Also fairly important for both banks and their creditors is the provision of the amended Act on Bankruptcy and Composition regulating so-called mortgage estate and satisfaction of claims from mortgage bonds in the event of issuer insolvency. The assets backing mortgage bonds, i.e. primarily mortgage loan claims, constitute mortgage estate, and the proceeds of its realisation are used *pro rata* to satisfy the claims of mortgage bond holders. If any part of the proceeds remains after satisfaction of these claims it is used to satisfy the other claims. In the opposite case, the part of the mortgage bond claims which has not been satisfied is included among the other bankruptcy claims. The implementation of this measure means that mortgage bonds have acquired in full the features of asset-backed securities and hence also an improved credibility. Previously, the claims of their holders had priority only over ordinary unsecured creditors, and the assets covering these bonds were deemed an inseparable part of the bankruptcy estate.[197]

● ***Separation of assets in case of insolvency of an investment firm***
Unlike deposits in banks or credit unions, investor assets (investment instruments and cash entrusted to an investment firm to perform an investment service for a client or such assets procured for a client) do not become the property of the investment firm during the provision of investment services. Therefore, they are not included in the bankruptcy estate in the event of its insolvency. During the first insolvency cases in the field of investment firms, however, this interpretation was not unanimously supported in particular by bankruptcy trustees. Since 2002, therefore, the act has stated[198] the bankrupcy trustee must release client assets to clients without undue delay. If there are insufficient client assets available to comply with this duty, the trustee himself must lodge, on behalf of the client, the unsatisfied part of such claim in the bankruptcy proceedings as an "ordinary" bankruptcy claim.

4. SOME ELEMENTS OF CREDIT RISK IN INSOLVENCY LAW[199]

● ***Debtor's duty to initiate insolvency proceedings***
Successful resolution of insolvency, or minimisation of the losses for creditors, is based on timely initiation of insolvency proceedings and prevention of deterioration of the value of the insolvent's assets. Such a move should naturally come from the debtor, as nobody else has a better knowledge of insolvent's financial and economic condition. Especially in the 1990s, however, debtors deferred bankruptcy for so long that there were later often insufficient assets to cover the costs of the bankruptcy proceedings.

On 1 April 1998, the duty of an entrepreneur to file a bankruptcy or composition petition immediately after becoming insolvent was included in the Act on Bankruptcy and Composition. This duty was linked to personal liability for any loss caused to the creditors by any delays. Two years later, the criminal offence of excessive debt was included in the Criminal Code, with sanctions not only for both bringing excessive debt upon oneself, also for anyone who deliberately or due to deliberate negligence accepts a new obligation or establishes a security interest despite knowing that he is excessively in debt.[200] At the same time, barriers were enacted in commercial law to carrying on business or holding a position in a statutory body of a company by persons who, putting it simply, have previously contributed to the insolvency of another business.

These legal principles force debtors – both legal persons and entrepreneurs, or persons acting on their behalf – to comply with the duty to file petitions to initiate insolvency proceedings in a timely manner. This duty, however, does not apply to natural persons – consumers – so insolvency law does not directly prevent them from getting further into debt.[201]

● ***Immediate maturity of a debtor's claims***
In the event of declaration of bankruptcy, all claims of the insolvent become due and payable, which inherently carries the risk of secondary insolvency. This is particularly important with respect to long-term claims (e.g. immediate maturity of mortgage loan claims or long-term business contracts) and can also prove counterproductive in terms of the proceeds of bankruptcy proceedings. In addition, given the well developed market in sales of claims, such assets are often easy to sell on favourable terms. The new act (with effect from 1 July 2007) should rescind this rule.

198 First in the Securities Act and later in the Capital Market Undertakings Act. It basically involves an indirect amendment of the Bankruptcy and Composition Act.

199 Credit risk may, in the case of major insolvents or considerable frequency, trigger problems of a systemic nature. Credit risk is traditionally the most significant risk faced by Czech banks. An analysis of interbank contagion is given in the article *Summary of the Results of Stress Tests in Banks*.

200 Specifically Article 256c of Act No. 140/1961 Coll., the Criminal Code, as amended by Act No. 105/2000 Coll.

201 Various registers of information on client creditworthiness thus play a preventive role in such cases.

● ***Satisfaction of claims of separate creditors***
A problematic issue from the perspective of banks and any other providers of secured loans is a provision of the amended Bankruptcy Act of 2000 which, with the aim of increasing the satisfaction of unsecured creditors, has limited the rights of separate (secured) creditors whose claims on the insolvent are secured by asset-type collateral.[202] Currently, separate creditors may be satisfied only up to 70% of the proceeds of the sale of the collateral falling to them. The remainder of the claim can be then satisfied in the relevant class of unsecured creditors. Under a ruling of the Supreme Court, 70% of the realisation proceeds falling to a secured creditor means 70% of the amount generated by realisation of the asset securing the creditor's claim (net of the costs associated with the maintenance, administration and sale of the said asset) up to the amount of the secured claim. [203]

The above ruling allows for the credit risk associated with this provision of the act to be eliminated through "oversecuring" of the claim so that the net proceeds from the sale of the pledge cover the amount of the outstanding obligation of the debtor. On the other hand, this fact reduces the availability of loans to both households and companies. The new act should (as from 1 July 2007) rescind the "70% rule".

● ***Failed groups of businesses (concerns)***
One of the unresolved issues of insolvency law, and consequently also a risk to financial stability, is the issue of failures affecting business groups (concerns/consolidated groups). The law addresses insolvency of a business with a branch network in the EU,[204] but does not address insolvency of a group whose members operate in various countries. From the economic perspective, the two schemes are often quite close to each other, but from the legal perspective they are fundamentally different. Each entity in a concern is considered absolutely independent in terms of bankruptcy law. This has at least two negative implications.

Firstly, in the event of insolvency threatening any of the entities in a concern, a tendency to perform "bankruptcy arbitrage" may arise, i.e. to move assets and liabilities around within the group in order to create a situation where the entity domiciled in the country with the legal system offering the most favourable insolvency conditions is deliberately targeted to become the bankrupt. Secondly, if the whole concern or more than one of its members become insolvent, there are no binding rules for co-ordinating separate insolvency proceedings conducted against the group members concerned, or of co-ordinating the actions and interests of creditors of individual insolvents.

● ***Methods of resolving insolvency without liquidation***
Composition is an alternative method of resolving insolvency. Unlike bankruptcy, composition is aimed at discharging the insolvent's debts and ensuring continued operation of its business under an arrangement with its creditors.[205] This method, however, has failed in practice. One of the legal reasons is that the bankruptcy resolution method has to be proposed and determined essentially at the beginning of the proceedings. Also, the use of this principle is restricted to petition by the debtor. While such petition should be the priority option for composition petitions, in cases where the debtor does not make use of this option or submits an unacceptable proposal, the creditors should be given the opportunity to resolve the insolvency without liquidation. Another problematic provision of the act ties approval of composition to the condition that creditors who hold no priority claims should be offered payment of at least 30% of their claims (or even 45% until 30 April 2000) within two years of the filing of the petition.

A functional non-liquidation solution for a debtor's insolvency is vital with respect to both large enterprises and personal (consumer) insolvency. The latter is becoming ever more frequent. In both cases it is desirable for the debtor, provided that it acts honestly, to have the opportunity discharge its debts in insolvency proceedings and to have the right to a "new economic life". To that end, the new Insolvency Act (as of 1 July 2007) should apply the principles of reorganisation (for businesses) and debt discharge (for non-businesses).

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202 In particular a security interest, a lien, a title transfer or an assignment of a claim. It does not apply to financial collateral arrangements (see above).

203 See Ruling of the Supreme Court of the Czech Republic Rc 18/2003 Odo 519/2001. Until this ruling, a legal interpretation had quite often been applied according to which a separate creditor should never be entitled to satisfaction from collateral in excess of 70% of the value of his claim.

204 Council Regulation of 29 May 2000 on insolvency proceedings (1346/2000/EC). The issues are also covered by the preceding passages on insolvency of banks, credit unions and insurance companies.

205 Even in bankruptcy proceedings, it is possible to sell a business or a part thereof, including employees, to a new owner and so provide for its ongoing operation. Creditors, however, have to rely on the distribution of the outcome of the sale of the bankruptcy estate, which includes the price obtained in this sale.

5. CONCLUSIONS

In the context of the upcoming new insolvency legislation, this article set out to highlight some of the problems that the current Act on Bankruptcy and Composition has caused or is still causing. The new Insolvency Act should, *inter alia*, strengthen the positions of unsecured and secured creditors, improve the quality of bankruptcy trustees,[206] introduce alternative insolvency resolution methods (reorganisation and debt discharge) to replace the current composition process, and also allow insolvency that is only just threatening to be addressed. The provisions reducing systemic or credit risk which have been already successfully incorporated into the current bankruptcy law should be adopted – and, where necessary, further specified – in the new act.

As already noted in the introduction, the domestic financial market regulations are, given the strong influence of EC law in this area, a factor assisting stability of the financial system. Even the best regulations and strictest supervision, however, cannot forever prevent problems arising in the financial sector with a potential adverse impact on the client and business partners. Banking and financial market activity is a type of business (using others' money), but it is a business based on exposure to risk. Therefore, problems affecting individual entities cannot be entirely ruled out. On the other hand, the systemic stability of the financial sector should not be threatened by deficiencies in the legal and regulatory environment.

Somewhat paradoxically, however, there may be a risk of "over-regulation" of the financial sector (and not only of the financial sector). At a time of globalisation and free trade, there are no legal obstacles that would, in principle, prevent entities from doing business in a particular segment of the financial market or on an international scale. However, one has to be concerned about the quantity of rules governing business in the interests of systemic stability, fair competition, the soundness of individual institutions, market efficiency, customer protection etc. In addition to the extent and content of these rules, we also need to take into account the fact that they are undergoing frequent changes compared to the past and that the legal environment is thus losing its transparency and long-term stability. Although the regulations are consequently becoming more and more relaxed and sensitive to the entities they are targeted at, their number and sophistication and the frequency of the changes to them are increasing. It is therefore becoming increasingly challenging and costly for regulated entities to respond in time to the new regulations. A similar problem is also faced by the authorities responsible for supervising compliance with these rules, and also by the courts.

This situation is by no means confined to the transition economies, but is a problem faced by essentially the entire European Union, and in particular those states with a legal tradition of written law. The European Union is aware of this fact and its adverse impacts on the development of markets, small and medium-sized enterprises and the entire EU economy.[207] Finding the way out is more a matter of philosophical and political considerations than legal ones and would seem to be one of the key challenges going forward, at least on the European scale. The aim is to provide for the sound development of the financial system.

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206 The issue of the quality of bankruptcy trustees is addressed in a related, but separate, act on insolvency trustees. At the time of writing, the relevant bill had been returned, complete with proposed amendments, to the lower house of Parliament by the Senate. The estimated effective date of the act is 1 July 2007.

207 Such as the European Commission White Paper *Financial Services Policy 2005–2010*; section 2 (*Better Regulation*), especially sub-section 2.5 (*Simplification, Clarification, Codification*); Annex II, p. 10.