

REPORT ON OBSERVANCE OF STANDARDS & CODES

SLOVAK REPUBLIC

INSOLVENCY AND CREDITOR RIGHTS SYSTEMS

Prepared by a staff team¹ from the World Bank on the basis of information provided by the Slovak authorities.

June 2002

CONTENTS

EXECUTIVE SUMMARY

I.	INTRODUCTION	1
II.	DESCRIPTION OF COUNTRY PRACTICE	2
A.	CREDITOR RIGHTS AND ENFORCEMENT	2
B.	LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY	4
C.	REGULATORY FRAMEWORK FOR INSOLVENCY	6
D.	CREDIT RISK MANAGEMENT/INFORMAL CORPORATE WORKOUTS	8
III.	SUMMARY OF ASSESSMENT FINDINGS AND CONCLUSIONS	10
IV.	POLICY RECOMMENDATIONS	13

Executive Summary

Slovakia has made considerable strides in recent years to reform its creditor rights and insolvency frameworks, including improvements in banking, bankruptcy, collateral and tax legislation. Although many of these reforms have been slow in coming throughout the transition, their pace has been stepped up aggressively in recent years by a reform minded government and to meet the requirements for European Union accession. Notwithstanding these changes, the legal framework supporting creditor rights has been fragmented, inadequate and inefficient, rendering credit largely inaccessible to all but the upper echelon of corporate borrowers.

Creditor rights have been plagued by poorly developed collateral mechanisms (other than the traditional mortgage) and slow and unreliable judicial enforcement procedures. Most lending is secured by real estate. Alternative forms of finance have emerged to circumnavigate regulatory shortcomings, such as lease financing, receivables factoring and assignments of rights. The most significant recent development is the adoption of a new security law that comes into effect in January 2003, coupled with a national centralized pledge registry that boasts to be among the more progressive in the region. Notwithstanding other improvements in enforcement procedures, realization on collateral currently ranges from 3 months for movable property (in an ideal uncontested case) to 2-4 years for execution on real estate. Expedited procedures exist, but rely on debtor cooperation, which is rare. Cumbersome valuation, market value minimum bids, and other deficiencies in the auctioning procedures contribute to delays.

Bankruptcy proceedings, the worst option for a creditor to recover debt, have been oriented almost exclusively to liquidation and take between 3-7 years, or longer in some cases. Unsecured creditors typically recovery nothing, while secured creditors report unusually low returns of 5-10 percent, if there is any recovery at all after paying administrative costs. For this reason, lenders have resorted to bankruptcy mainly as a tool to fully write off their bad debts. New provisioning/write-off rules may obviate the need for this approach. In August 2000, bankruptcy amendments were adopted to strengthen creditor rights, promote going concern sales, and make the process more efficient by introducing strict time-bound procedures to complete the process. Notwithstanding these changes, widespread creditor participation and discipline remains low, while genuine business reorganizations are elusive.

Although reforms are moving in the right direction, the institutional and regulatory environment in Slovakia, as throughout the region, is relatively weak and constitutes the main impediment to efficient exits from the system. The government has backed efforts to strengthen institutional capacity and regulation of the bankruptcy profession with assistance from the World Bank through an Institutional Development Fund (IDF) grant aimed at developing a new modern insolvency law that incorporates principles of international best practice and a regulatory framework for assuring and maintaining integrity and quality among professionals and participants in the process.

¹ The team was led by Gordon Johnson (Senior Counsel, World Bank).

I. INTRODUCTION

1. The World Bank assessed the Slovak creditor rights and corporate insolvency systems pursuant to a joint IMF-World Bank initiative on observance of standards and codes (“ROSC”). The review was carried out using the World Bank *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (“Principles”) adopted by the World Bank Board at its meeting in April 2001,² in connection with a joint IMF-World Bank mission to assess the Slovak Republic’s financial system (FSAP) from February 17-28, 2002.

2. The assessment team interviewed a cross section of country stakeholders regarding the effectiveness of the legal infrastructure and its implementation supporting debtor-creditor relationships, corporate insolvency and credit risk management and resolution practices, including among others, with: (a) senior officials and staff members of the Ministries of Economy, Finance (Tax Department) and Justice (Bankruptcy and Executions Department); (b) bankruptcy and district court judges in Bratislava and Banska Bystrica; (c) debt recovery teams in the SKA and 5 commercial banks; (d) representatives of the registry (Cadastre) office; (e) members of the Inter-Agency Commission for the preparation of a new insolvency law, and members of the drafting team for the new collateral law; and (f) various professionals serving as trustees, executors, lawyers and accountants. Excellent cooperation was received.

3. The conclusions in this assessment are based largely on the above interviews, a review of applicable legislation,³ data and information, various reports prepared by the World Bank between 1999-2001 and other reports or analyses pertaining to the areas assessed, including the project on the new collateral legislation and registration system for pledges (charges).⁴ Some laws unavailable in English at the time of the mission were discussed in a number of meetings with institutions and professionals in the public and private sectors, and translations have been requested for follow-up. In addition, at least three commercial banks provided responses to a questionnaire pertaining to credit risk management and corporate recovery practices with respect to distressed assets. The mission met with each of the three responding banks, and two non-responding commercial banks, to discuss their responses, practices and experience in resolving and collecting non-performing loans. The mission also reviewed statistics and data on the numbers and dispositions of insolvency and execution proceedings over a period of years, and obtained and reviewed tax statistics on tax arrears and experience of the tax authorities as a creditor.

² World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (April 2001) <<http://wbln0018.worldbank.org/Legal/GILD/csadmin.nsf/wblaunchtext?readform&Best+Practices>>.

³ Primary legislation reviewed in relevant part includes: Bankruptcy and Composition Act, Act No.328/1991 (as amended through and Act 397/2001 Coll.); Commercial Code, Act No. 513/1991 Coll. (as amended through Act 263/99 Coll.); Civil Procedure Code, Act No. 99/1963 Coll. (as amended Act No. 223/1999 Coll.); Civil Code, Act No. 40/1964 Coll. (as amended). Laws unavailable in English but discussed with practitioners and specialists included the Execution (Foreclosure) Law, Act No. 233/1995 (as amended); Income Taxes Act, Act 366/1999; and other tax related legislation.

⁴ These included reports prepared by a World Bank EFSAL team in connection with various missions from 1999-2001, and a Foreign Investment Advisory Service report on barriers to investment in the Slovak Republic. See FIAS, *Slovak Republic: Administrative Barriers to Investment* (August 2001) (specifically, Ch. VI deals with securing transactions). The final report was updated to reflect the adoption of the new collateral law in June 2002.

II. DESCRIPTION OF COUNTRY PRACTICE

A. CREDITOR RIGHTS AND ENFORCEMENT

4. **The commercial and financial community agree that the legal framework supporting credit and creditor rights remains highly fragmented, inadequate and inefficient, rendering credit largely inaccessible to all but the upper echelon of corporate borrowers.** As a general rule, creditor rights remain weak, plagued by poorly developed collateral mechanisms (other than the traditional mortgage) and slow and unreliable enforcement procedures through the courts. Legal and regulatory weaknesses have fueled a growing business in lease finance and receivables factoring, where ownership resides in the lender or creditor, making asset recovery more efficient and predictable. Perhaps the most significant development is the recent adoption of a new security law that comes into effect in January 2003, coupled with a national centralized pledge registry that boasts to be among the more progressive in the region. Other recent improvements in enforcement procedures have strengthened creditors' rights somewhat, but the system has yet to embrace these reforms in a predictable manner.

5. **To offset the high regulatory risk, lenders routinely insist that loans be fully secured in nearly all corporate transactions and have relied on other financing techniques designed to avoid the need for enforcement (e.g., lease and receivables finance).** Loans are generally secured by a mortgage on real estate. To date, security in movable property has proven ineffective and unreliable, as the present regime requires possession to perfect the security interest, which is not feasible for businesses. This should change when the new pledge law and registry become effective next year. In practice, obligations are often secured by an assignment of a right, including a right of title. There is very little legislation regarding this security mechanism. The transfer generally occurs as a conditional transfer of title, subject to a condition precedent, or an outright transfer of title, subject to retransfer to the debtor upon satisfaction of the secured obligation. Accounts receivable are most often secured through assignment, or factoring. In a receivables assignment, the lender typically authorizes the borrower to collect the receivables until such time as the lender notifies the account debtors that it has taken an assignment and directs payment to itself. Leasing companies use the assignment of title method to provide lease financing of equipment and vehicles. Most assignments are reasonably predictable and constitute a preferred form of security, even though little legal regulation exists for this method of security.⁵ Third party guarantees are also commonly used as security.⁶ Other forms of security allowed under the Slovak system are transfers of present or future rights or claims against third parties and stock pledges.⁷

6. **The land registry has functioned relatively inefficiently due to large backlogs of cases in the land registry (cadastral) offices.** Recent automation has improved the situation somewhat. A continuing problem is that the law fails to provide adequate

⁵ Sections 524 to 528, Civil Code Act No. 40/1964 Coll. (as amended).

⁶ Section 546, Civil Code Act No. 40/1964 Coll. (as amended), Sections 303-312, Commercial Code, Act No. 513/1991 Coll. (as amended through Act 263/99 Coll.)

⁷ Section 132, Civil Code Act No. 40/1964 Coll. (as amended).

guidance on the sufficiency of documentation to be recorded at the land registry. As the cadastral office is responsible for approving the documents, and tends to be conservative, the absence of clear criteria often leads to refusal to register transfers of property, leading to delays, and sometimes rendering sales difficult.

7. **The government recently adopted a new modern security law for movable property that should strengthen creditor rights and foster a new wave of asset based lending secured by movable assets.** The inability to effectively pledge movable property has been a significant hindrance to asset-based lending and credit protection. The problem has been further exacerbated by the lack of a pledge registry system for giving notice to third parties of rights that have been pledged or alienated. A new collateral law, developed with assistance of the European Bank for Reconstruction and Development (EBRD), was recently adopted and will come into effect in January 2003. The new law affords the widest potential for taking security in movable property. Consistent with international best practice in this field; it adopts and complies with both the World Bank's Principles and the EBRD's core principles for a secured transactions law. The new law provides for non-possessory pledges, establishment of a registry for movables, non-judicial procedures for enforcement of collateral rights, including the Public Auction Law, and subordinates the priority previously afforded to tax claims making them subject to the first-in-time rule for registration filings. The new law also provides for a lien on a fluctuating stock of assets.

8. **Court system weaknesses and inefficiencies are the most significant detriment to debt enforcement.** Whenever the court system is involved, whether in execution of a lien or enforcement of a debt, or through a bankruptcy, delays are the rule rather than the exception and serve to diminish the value of assets and reduce recovery based on time value of money. Enforcement of unsecured debt must go through the courts, as the creditor requires a payment order to collect on a debtor's assets. In Slovakia, a first but non-final, non-appealable judgment is not sufficient for execution. Unsecured lenders can avail themselves of expedited proceedings that allow for execution/payment orders to be issued by a court and become final within 15 days for commercial claims under SKK 1,000,000, and within three days for bills of exchange and cheques. The latter encompasses any sort of payment agreement.⁸ Though the Slovak Republic has instituted expedited proceedings and non-judicial enforcement procedures, if a debtor objects to the enforcement, the action is referred to regular court proceedings. The debtor can and often does easily interfere with expediency in creditors' actions.

9. **The introduction of a system of private professional bailiffs (executors)⁹ establishes non-judicial procedures for execution and foreclosure that greatly enhance the prospects for secured creditors to foreclose on their collateral.** When the security documents are in the form of a notarial deed, the creditor is able to avoid court proceedings and recover the collateral with the debtor's cooperation through expedited proceedings. Expedited proceedings and special procedures apply to both secured and unsecured lending. Still, secured creditors face substantial obstacles to efficient

⁸ Civil Procedure Code §§ 172-174, Act No. 99/1963 Coll. (as amended through Act No. 223/1999 Coll.).

⁹ Foreclosure (Execution) Law in 1995, Act No. 233/1995 (as amended).

enforcement and foreclosure. A debtor's objection at any stage of the process can convert a non-judicial executory proceeding to a full-fledged court proceeding. Consequently, even with the use of executors, realization on collateral ranges from a low of 3 months for movable property (uncontested) to 2-4 years for execution on real estate, if contested.

10. **Cumbersome valuation procedures, market value minimum bids, and other deficiencies in the auctioning process contribute to delays.** Both inside and outside bankruptcy, procedures for auctioning assets are obstacles to maximizing asset value. Valuation procedures can be long, and a debtor's objection routinely requires a second valuation. Minimum bids are generally fixed at unrealistic estimations of market values and can be lowered only with court approval in successive auctions. The need for court approval, and unrealistic minimum bids can result in substantial delays, which in many cases serve to devalue the asset and hence a creditor's recovery on its claim.

B. LEGAL FRAMEWORK FOR CORPORATE INSOLVENCY

11. **The Bankruptcy and Composition Act ("Bankruptcy Law") governs liquidation and rehabilitation proceedings. In August 2000, the law was amended to improve efficiency, strengthen creditor rights, and promote going concern sales.** The law has been amended 14 times in 10 years, most recently to increase efficiency with time-bound procedures, strengthen creditors' rights, increase management accountability, and salvage of viable businesses. As Table 1 below reveal, between 1993 and 2000, when the law was amended, the stock of bankruptcy cases steadily increased, exacerbating the delays in the opening and processing of cases. For example, in 1999, over half of the total cases filed remained unprocessed, while cases in the systems averaged 3-7 years (or longer) to process.¹⁰ Unsecured creditors realize little or nothing, while secured creditors report dismal returns of 5-10 percent, after administration costs. These results have led lenders to view bankruptcy as a last resort to write off bad debts.¹¹ The mere opening of a case used to take 9-12 months, during which time the debtor is entitled to continue operating its business to the detriment of creditors. The new amendments require a decision on declaration within 30 days of the filing of the petition, and completion of the liquidation within 18 months of declaration, unless the court in its discretion extends this period based on the circumstances of the case.

Table 1: Bankruptcy Statistics, Cases on File

Disposition of Cases	1993	1994	1995	1996	1997	1998	1999	2000	2001
Annual bankruptcy filings (cumulative filings all years)	538 (538)	1115 (1653)	1530 (3183)	1321 (4504)	1755 (6259)	1831 (8090)	2161 (10251)	2008 (12059)	2351 (14410)
Annual declarations	11	43	117	315	742	1396	2061	N/A	1042
Cumul. dismissed/terminated	158	592	1109	1583	1644	1692	2316	N/A	894
Non-processed cases (yr end)	369	649	939	2663	3896	5025	5897	N/A	N/A
Control line (tot unprocessed)	369	1018	1957	2606	3873	5002	5874	N/A	N/A

Source: Slovak Republic Ministry of Justice

¹⁰ The percentage of non-processed cases to total pending cases in 1999 (e.g., after subtracting previously dismissed and terminated cases) is actually closer to 70%.

¹¹ Notably, this practice may become unnecessary as more flexible and permissive provisioning and write-off rules allow for full write-off without commencing and bankruptcy case.

12. **Although the bankruptcy amendments were designed to strengthen creditors' rights, creditor participation and creditor-imposed discipline remain low, partly due to a general lack of appreciation by creditors of their new found rights and in part due to inconsistent recognition and enforcement by courts.** Creditors are entitled to participate in a creditors' committee, be consulted on decisions regarding the bankruptcy, and approve the final distribution plan. If creditors are dissatisfied with the progress of the case or performance of the trustee, they may even vote to replace the trustee. These rights do not necessarily protect the rights of creditors. Notwithstanding the quicker declaration requirement (30 days), the court is not required to convene a meeting of the creditors' committee until 80 days after the bankruptcy declaration. By this time, significant decisions may be made by an interim trustee, or even ignored pending the creditors meeting, with detrimental affect to the rights of creditors and the value of the assets. While creditors report increased participation, on the whole they are largely inactive.

13. **Secured creditors are entitled to separate settlement of their claims through execution on their collateral, but may only collect 70% of the amount realized if the bankruptcy estate is short on cash for administrative expenses.** Secured creditors complain of their collateral being sold only to maintain a bankruptcy proceeding's administrative costs. Set offs are also prohibited, upsetting arrangements where setoffs were the security, and especially undermining the potential for well established swaps and derivative type contracts. In addition, the law prescribes too many exceptional preferential categories, and unnecessarily interferes with pre-bankruptcy arrangements and understandings.

14. **Auction procedures inhibit maximum return on assets in liquidation.** The initial price is set at the official appraisal price. Official appraisals, based on book value or other outdated valuation methods, tend to inflate the minimum price for assets. Judges often stand in the way of lower prices at auctions, due to past abuses and collusion between trustees and buyers. Bid-rigging or collusive arrangements are commonly reported.

15. **Enterprise rehabilitation is elusive in practice, due to the lack of a corporate rescue culture and outmoded provisions in the law.** Debtors may pursue a formal rehabilitation through a compulsory arrangement with creditors in court, or may seek approval of an arrangement with creditors without bankruptcy. Both proceedings invoke similar protections for creditors and have threshold requirements for approval and distribution. The arrangement with creditors invokes a 6 months stay on creditors, and the arrangement must be approved within 3 months of the declaration by the court authorizing the procedure. This procedure is almost never used.

16. **Reorganization provisions within bankruptcy have been enhanced, but to date the process is rarely attempted with success.**¹² The law lacks the requisite criteria and detail to make rehabilitation feasible. Without the provisions necessary to facilitate reorganization, it is unlikely to increase in frequency. For example, during the time

¹² In one successful case, creditors worked to allow the major employer in a region to remain operational (through a strategic sale). The banks decried the two-year long procedure as having been time-consuming and complex, even though the company continues to operate one year after the restructuring.

between filing and declaration of bankruptcy the debtor remains unprotected by a stay on creditor action. During this period (9-12 months), secured creditors may succeed in executing on collateral before the case is formally declared, leaving few or inconsequential assets for a restructuring. There is no full discharge of debts for the reorganized enterprise, nor are there provisions to encourage priority financing of the debtor entity to sustain business operations. Despite these shortcomings, the 2002 amendments introduced more flexible provisions for disposing of assets that have in fact enabled some viable businesses to be saved through “creative liquidations.” The new provision authorizes the sale of the entire business or its productive units as a going concern, free of liabilities.

17. **An Interagency Commission was established in February 2001 with the aim of modernizing the framework for bankruptcy.** The Commission has analyzed the effectiveness of recent amendments and identified weaknesses in the current framework. The Commission also concluded that the defects in the current system are so significant that comprehensive reform is required. To that end, the Commission plans to oversee the development of new comprehensive legislation. Fundamental guidelines include a modern law that is properly integrated with and suited to the broader commercial and legal framework in Slovakia, consistent with EU regulations, and that complies with the basic principles identified in the World Bank *Principles on Effective Insolvency and Creditor Rights System*, including new effective procedures for rehabilitation.

C. REGULATORY FRAMEWORK FOR INSOLVENCY

Institutional Framework

18. **Judicial and administrative inefficiency is widely cited as the most significant and intractable problem facing the system.** There are a total of 1172 district and regional court judges in Slovakia, of which 21 are specialized bankruptcy judges, who deal exclusively with bankruptcy and composition proceedings. The bankruptcy judges are situated in three district courts (Bratislava, Banská Bystrica, and Košice). The recent changes to the law drastically reduced a judge’s role in bankruptcy proceedings. Much of the power to direct bankruptcy liquidations and other proceedings shifted to creditors and trustees. Now, the judge is responsible to open a case, appoint a trustee (though creditors may replace him), approve trustee actions, and administer, but not direct, the case. Though it should lighten their caseloads, some judges have had difficulty relinquishing certain decision-making powers.

19. **Courts have been overburdened due to inefficient rules of procedure and ineffective constraints on abusive filings.** Debtors have numerous legally sanctioned opportunities to resort to the courts, which is used as a calling card for delay by debtors intent on avoiding their obligations. The sheer overload means that proceedings are sometimes delayed to the extent that assets may be rendered valueless by the time the court can reach decisions. While the 2000 amendments introduced an 18 month deadline within which cases are to be finished, the time limit is permissive (not mandatory) and may be extended by the court. It is too early to determine whether court practice complies with the new time limit. Trustee incompetence is also considered a factor contributing to delay.

20. **Lack of automation and transparency has also constrained the courts' ability to process an increasing number of cases.** Recent automation through an IDF grant has improved case management in the bankruptcy courts, but backlog remains a substantial problem. Each court maintains computerized records identifying the debtor, creditors, assets and actions taken in the case. These systems, although computerized, and not connected between courts. Judges do not yet have personal computers and email access, though the IDF grant contemplates further hardware to accommodate the courts. Computerized access for the public, currently unavailable, is also being considered. Moreover, court practices are not standardized, transparent, or predictable and vary from court to court. Decisions in similar situations can be widely divergent in different bankruptcy courts, or even among judges in the same court, as decisions are not widely published, or shared between courts. The Supreme Court does publish decisions in cases where it deems guidance is required for lower courts, but lower courts are not bound by these guidelines. Public access to records is difficult, and financial data regarding the debtor is not available even to creditors.

21. **Judges have not received adequate training in commercial law generally, nor in bankruptcy law in particular.** Beyond the apprenticeship period of three years, no training or continuing education is mandated for judges. They are therefore not well-equipped to handle bankruptcies, and particularly reorganizations, and may hinder them by resisting allowing creditors, as the true stakeholders, to direct the course of the proceedings. There is a government-run facility for judge training at Trencianske Teplice, but it is considered inadequate. Court case overload is also cited by judges and trainers as leaving judges little time for training. Time and lack of sufficient training programs are obstacles to adequate education of judges.

22. **Judicial corruption has been a problem throughout the region, and the Slovak courts are no exception.** The bankruptcy law in various places provides for the consequences of fraud, such as in dealing with fraudulent transfers, insider transactions, and repeal of the plan if it was procured by fraud. However, guidance on what constitutes fraudulent conduct is inadequate. Under the law, the court has sufficient authority to act on fraud when it has determined that it exists and prejudiced the estate and creditors. However, the courts are currently too weak an institution to do this effectively, especially given the lack of specific guidance and procedures. Directives that are to be issued by the Ministry of Justice to govern certain aspects of the bankruptcy procedure await development and issuance. Some areas of recognized abuse of judicial discretion have been addressed through reforms to limit discretion or shift the decision-making authority to creditors. While there is some benefit to these changes, they suggest a systemic problem that can be improved only with wider regulation of the system.

Regulatory Framework

23. **The lack of professional development of trustees as an association is cited as one of the pivotal weaknesses in the insolvency system.** Creditors, debtors and judges are uniform in complaining about trustees. There is a widespread perception that the profession is corrupt and incompetent, although to be sure such an indictment cannot be leveled at all practitioners, many of whom are capable and conscientious. The main

criticisms have to do with collusion between judges and debtors (or creditors), tunneling of assets back to owners at a fraction of their value through collusive sales. The power to have a trustee of choice appointed is perceived as the power to control the proceeding, rather than as a way to ensure fairness. To date, trustees have not been accountable to any governing body. The Ministry of Justice has oversight, but has not enacted legislation or regulations to properly ensure that trustee's are held to a high standard and to provide for monitoring, investigation and discipline for misconduct or incompetence. Requirements in the Bankruptcy Law for appointment are minimal and general, i.e. no criminal record, "appropriate professional qualifications" (undefined), and unbiased individuals. Once appointed, trustees enjoy life tenure. There is no procedure for challenging or revoking a trustee's right to practice.

24. **There is no formal education process or mandatory training for trustees.** There are currently over 1000 licensed trustees. They may be lawyers who do not have business/economics training, or non-lawyers who do not have legal training. Further, only individuals may be appointed as trustees, which precludes the appointment of a legal entity, such as a firm engaging in trustee work that may bring specialized services of different professionals to a case. In practice, such legal entities have sometimes produced better results than individual trustees, though they may not officially be appointed as an entity. The Slovak Insolvency Administrators' Association, a newly formed trustees' association, is seeking to introduce qualifications, an entrance exam, continuing education, and legal regulation of trustees. The World Bank has provided an IDF Grant to the authorities that aims, among other things, to strengthen the regulatory framework.¹³

D. CREDIT RISK MANAGEMENT/INFORMAL CORPORATE WORKOUTS

25. **The law remains inflexible as to the mechanisms for resolution of debts, inhibiting workouts of debt.** Cash payments are generally required, and within bankruptcy, debt-equity swaps are not allowed. A lender cannot write off a debt without paying taxes on the full amount until the debtor has been declared bankrupt, though a bank lender may do so once the credit has been fully provisioned under existing banking regulations. Genuine debt forgiveness and restructuring are limited. In particular, tax creditors insist on full payment of tax liabilities, and place themselves at the front of the creditor queue. As tax liabilities in 1998 represented 10% of GDP in Slovakia, and are a large portion of claims in individual bankruptcies, sometimes leaving the tax authorities as the largest creditor, this limits the scope for genuine restructuring of the enterprise. There are some signs that when rehabilitation appears possible, the government is lenient and even cooperative in rehabilitation efforts, and does not insist on liquidating companies to collect tax arrears. The government has amended banking laws regarding provisions for

¹³ Specific goals of the IDF grant include: 1) development of bankruptcy educational program for bankruptcy trustees, liquidators, administrators and enterprise restructuring experts; 2) establishment of professional criteria for bankruptcy trustees and liquidators; 3) designing the procedures for trustee/liquidator compensation; 4) preparation of a handbook for trustees, liquidators and enterprise restructuring experts; and 5) provision of assistance to establish a private, voluntary, self-regulatory organization which can certify professional trustee/liquidators. The Slovak Insolvency Administrators' Association is moving to develop professional criteria, and develop into a self-regulatory organization to oversee trustees

write-offs, and is currently working on new legislation concerning criteria for write-offs by corporations or businesses and corresponding tax treatment rules.

26. **As a general rule, commercial banks in the Slovak Republic are adopting reasonable internal policies and procedures to manage credit risk and resolve distressed loans.** Credit institutions in the Slovak Republic have internal guidelines for monitoring debt. Banking regulation requires review of debts once a year or four times a year, depending on size. Debts are then classified as to their collectability, based on debtor's financial information and collateral. Banks must then provision between 5% and 100% of the nominal value of a loan based on the classification.¹⁴ As for resolving distressed loans, the preferred methods in order of preference are: (i) debt rescheduling, including time and payment extensions or adjustments; (ii) executing via executor on a notarial deed that has been the basis of the secured loan; (iii) execution through courts; (iv) selling the receivable; and (v) bankruptcy. One method may be more suitable than another depending on the debt and the collateral. Where the cost of collecting a debt outweighs the recovery and even the tax penalties, a debt may be written off. Different banks may also have slightly different practices.

27. **Informal workouts are a practice among bank lenders, but they face legal obstacles.** When implemented in appropriate situations, where the bank assesses that the default is temporary, and resulting from a temporary condition, rescheduling is attempted, and according to one bank, when tried, is effective approximately half the time in resolving the problem. Such rescheduling is generally an extension of time or payment terms. More complex workouts, such as forgiveness of debt, or any arrangement that impairs the lender, is more difficult. Tax laws may severely penalize the creditor for forgiving debt unless the debtor is in bankruptcy, a bankruptcy has been declared, and the creditor has submitted a claim, though recently banks have been able to write off the debt after provisioning for it. Tax laws also make transfer of debt between a parent and subsidiary difficult, inhibiting transfer and sale of receivables. Genuine debt forgiveness is difficult. Debt-equity swaps face obstacles as well. Though lenders do not generally find debt-equity swaps appealing, even when allowed, due to the low value of the equity, some pursue it. There are problems, however, with tax treatment and restrictions on affiliate transactions when a bank takes equity, leaving the bank unable to make loans to the entity in which it has taken a share. The bank is also conflicted out of participation in management, without which it may not wish to take equity in a company with bad management.

28. **To restructure and privatize the largest Slovak banks, the government supported the transfer of bad assets to the Slovak Consolidation Agency (SKA).** In December 1999 and June 2000, SK 105 billion in bad assets were carved out and transferred to SKA and Konsolidacna Banka (KOB), and replaced by State-guaranteed loans, from the restructured banks, to SKA and KOB. Bonds were sold to fund the loans.¹⁵ Further amounts have been transferred since then. The transfer of further bad debts, including some tax debt, is contemplated. These operations have restored the profitability

¹⁴ Decree No. 3 of the National Bank of Slovakia of 3rd March 1995 on Rules for Evaluating Bank Claims and Off-balance Sheet Liabilities in Terms of Risk Exposure and for Reserving Funds as Provision against such Risks.

¹⁵ Bond payments have been timely made through February 2002, according to officials in the government.

of the banks and increased their Capital Adequacy Ratios (CARs) to above 12 percent, according to International Accounting Standards (IAS). The performance of the banking sector prior to the consolidation is reflected in Table 2. The SKA's has two major sections, the business and portfolio management divisions. The portfolio management departments analyze acquired assets, monitor payments and executions, and package assets to sell. The business management division runs SKA's operations.

Table 2: Size and Performance of Banking Sector Before the Reforms (June 1999)¹⁶

Bank Assets/GDP (%)	Bank Loans/GDP (%)	Classified Loans (2 to 5)/Total Loans (%)	Classified Loans (3 to 5)/Total Loans (%)	Capital Adequacy Ratio (%)	Return on Equity (%)
83.0	50.3	54.7	39.3	0.7	-13.1

Source: NBS

29. **SKA's performance to date in resolving bad debts has been lacklustre.** One package of SKK 13 billion in bad debt was sold for roughly 3.5 to 4 percent of the nominal value. An additional SKK 6 billion has been resolved, with a recovery rate of about 23%. Overall, the recovery rate is estimated at about 10%. However, the amount of debt resolved debt is small relative to the remaining levels of distressed assets at SKA. The vast majority of the SKA portfolio relates to companies that are in bankruptcy proceedings.¹⁷ Given the historical performance and recoveries in bankruptcy, it is unreasonable to expect a high recovery on bankruptcy related claims. Moreover, SKA must incur a cost with respect to protecting and monitoring its claim in bankruptcy, which in some instances may require active participation. To date, active participation has been limited to those companies where the entity is viable or has substantial assets. To increase its effectiveness, SKA is seeking a strategic joint venture partner for SKK 50 to 60 billion in debt. Bids from interested parties were to be submitted in March 2002. It is too early to determine the value to be added by a joint venture partner.

III. SUMMARY OF ASSESSMENT FINDINGS AND CONCLUSIONS

30. The creditors' rights enforcement framework remains weak and inefficient. Though there have been some improvements, many more are needed. There are a number of deviations from the World Bank Insolvency and Creditor Rights Principles (CP) both in the letter of the law, and due to weaknesses in institutions.

- ***The ability of tax creditors to exercise priming liens, along with weak creditors' rights in general, leads to low incentive for creditor-imposed discipline.*** The coordination of legislation in different areas that affect creditors' rights is poor, and cannot satisfy CP 1. Tax creditors ability to exercise priming liens at any time during enforcement, considering that most companies have large accumulated tax debts, can reduce creditors' already low recoveries to nothing. Such a right, combined with the other weaknesses in creditors' rights, discourage creditors from engaging in the expense and committing the time involved in enforcing their rights.

¹⁶ Loan classifications are as follows: Category 1—standard; category 2—watch; categories 3-5 include doubtful, substandard and non-performing loans.

¹⁷ Approximately 77.5% of SKA's debts are with debtors in bankruptcy.

- ***Auction Procedures.*** A main problem in achieving observance of CP 2 and 5 is that auction procedures are inefficient with respect to execution and enforcement proceedings and foreclosure. The rules allow multiple frivolous objections by the debtor and establish overly strict requirements on minimum bids and multiple auctions, with no real value added.
- ***Land registry is functioning but recording rules need to be clarified.*** The land registry is generally functional, but fails to operate efficiently, due to lack of resources to manage the backlog. Further, unclear rules on sufficiency of documentation needed for land transfer leads to a high level of rejected documents. The lack of clarity in the law, and varying practice at different district land registry offices, hinder transactions, and make the time and cost unpredictable.
- ***Pledges on movables inhibited due to lack of a pledge registry.*** The inability to effectively secure movable assets has been a significant obstacle to development of a modern credit system. Pledges generally require possession for perfection. To date, there has been no pledge registry where creditors could publish their interests in movables and thus adequately determine their relative rights and priorities. This is expected to change with the adoption of the new secured transactions law and the creation of a centralized registry, recently adopted by the Parliament.
- ***Debtors have inordinate power to object and cause delay during enforcement proceedings, out of proportion to the need to protect their rights.*** (CP 2 and 5) Debtors' extraordinary power to interfere with and delay sale of assets leads to many of the inefficiencies and delays in the system that are bemoaned by creditors. The law does not provide for enforcement of first but not final judgment, nor are summary proceedings sufficiently available to prevent unnecessary, unproductive debtor delay. Once a debtor objects, resolution must be made through the cumbersome, overloaded, and inefficient court system, resulting in realization times of up to 2 to 3 years, and sometimes longer.

31. The bankruptcy law, despite recent amendments, continues to conflict with other legal systems, and remains inadequate to protect companies and creditors and promote rehabilitation. The mission is informed that a new insolvency law and regulations will be developed.

- ***Management Accountability.*** Though the letter of the law mostly complies with CP 7, and management has become liable to shareholders and creditors through amendments to the Bankruptcy Law and Commercial Code, enforcement of the provisions remains difficult due to lack of definitions of due care and fraud, and low initiative on the part of those who have the right to pursue such actions. Resources to watchdog and investigate abuses are also lacking. This has led to excessive levels of asset stripping and insider collusion to defraud creditors.
- ***Governance: Creditors and the Creditors' Committee.*** New changes in the law substantially comply with CP 12, although certain provisions undercut their effectiveness. Creditors' committee meetings are called much too late into the process, months after the declaration of bankruptcy, which may be many months after filing, when their participation may have become moot through dissipation of the estate. Creditors do not have sufficient access to debtors' financial information.

Their right to supervise dealings of the trustee are not sufficiently developed in the language of the law, and regulations or directives are conspicuously lacking.

- ***Auction Procedures.*** As described in the discussion on auction procedures related to execution on collateral, auction procedures inhibit greater return on assets due to inflated minimum bids, provisions allowing debtor objection and delay, and required court approval for price reduction, interfering with compliance with CP 13. Judges also often stand in the way of successful auctions by interfering with prices they consider too low, in response to the extensive bid-rigging that has occurred in the past, and continues. Any benefits or protection conferred by the procedure are far outweighed by the devaluation of assets that occurs due to the substantial time delay involved in auctions. Corruption in auction procedures that lead to bid-rigging are also a substantial problem. Few provisions address corruption directly, and regulations or directives prescribing anti-corruption procedures are conspicuously lacking.
- ***Fraudulent and Preferential Transactions.*** The letter of the law has moved toward compliance with CP 15, but is not quite compliant. Actions are avoidable, but may face enforcement problems unless fraud is better defined. Preferential transactions, which favor one creditor over another and thus upset priority, are not addressed in the Bankruptcy law, therefore denying creditors recourse when their rights are violated.
- ***Treatment of Stakeholder Rights and Priorities.*** The proliferation of exceptional preferential categories nullifies the “pari passu” rule and help to prevent compliance with CP 16. The imposition of such priorities changes the legitimate commercial expectations and erodes confidence in the sanctity of the contract, without compelling reason.
- ***Rehabilitation.*** The Bankruptcy Law has numerous deficiencies that demonstrate either a lack of understanding of the process of reorganization, or a lack of belief in it. The process is still heavily geared toward liquidation. Practical provisions to help sustain business operations, and a full discharge of debts for a reorganized debtor emerging from bankruptcy, are missing. (CP 17-23)

32. The regulatory framework represents the weakest part of the system. Some recent automation through the IDF grant has improved court case management, but the courts have a long way to go before they are efficient and effective.

- ***Institutional Capacity.*** Principles relating to the institutional framework (CP 28-33) received the lowest rating on compliance. The bankruptcy court system is overloaded with cases. Further resources are needed to deal with the backlog and incoming cases. Judges are also in great need of training in commercial and bankruptcy matters, in particular in the area of rehabilitation. Donors conducted some training, but should not be relied upon for what should be institutionalized to maintain an effective bankruptcy judiciary. The IDF grant includes funds to develop such training.
- ***Regulatory Framework.*** The regulatory framework is considered to be another area where there has been little progress. Accordingly the rating on CP 34 and 35 is considered to be materially non-observed. Trustees are effectively subject to no oversight or regulation. There is no formal qualification procedure, and no avenue

for discipline or removal from the trustee's list. The lack of regulation and oversight feeds the public perception that trustees are incompetent and corrupt. Lack of public confidence undermines the entire bankruptcy system. The newly formed Slovak Insolvency Administrators' Association is working to enact legal regulation and promote the professional development of the trustees. Given trustees' central role in bankruptcy proceedings, the importance of their professional development and regulation cannot be understated.

33. The tax treatment of debt write offs, and other legislation inhibiting workout mechanisms, such as the absolute priority of tax debt over other debt, interferes with the incentives and abilities of debtors and creditors to engage in informal workouts. The disincentives in the law to debt forgiveness and workouts lead to almost complete noncompliance with CP 25, Enabling Legislative Framework. The recent adoption of the new secured transactions law will improve priorities and certainty as between pledge holders under the new system and tax claims, but there are still many other uncertainties in regard to tax claims and the write off of such claims that should be addressed.

IV. POLICY RECOMMENDATIONS

34. Creditors' rights and enforcement procedures need development as follows:
- Rules or legislation on sufficiency of security/transfer/ownership documents should be promulgated to remove the discretion of the land registry and prevent delay of transactions due to refusals of district land registry offices to register documents.
 - Auction procedures should be refined to allow for more realistic minimum bids, more transparent and corruption-resistant procedures, and less court involvement.
 - Debtor mechanisms for delaying enforcement of their creditors' rights should be reduced, and in many cases eliminated. Debtor's rights can be protected through summary proceedings, in a different forum dedicated to routine debt enforcement.
 - Enforcement of first but not final judgments should be allowed subject to posting of appropriate bond.
35. The Bankruptcy Law and related provisions in other laws requires comprehensive, coordinated, and well-planned revision to modernize the system to be integrated with the broader commercial and legal framework in Slovakia, consistent with EU regulations, and to comply with the basic principles identified in the World Bank *Principles and Guidelines on Effective Insolvency and Creditor Rights Systems*, including new effective procedures for rehabilitation. The Interagency Commission's work should be pursued aggressively.
- The Bankruptcy Law should be further amended to include mandatory deadlines, with time-bound procedures, to avoid the decimation of asset value over time.
 - The moratorium on creditor action should be effective from the time of filing the petition, and the stay on secured creditors counter-balanced by safeguards to protect and preserve the value of a separate creditors' interest in collateral from deteriorating in value.
 - Creditors' committee meetings should be convened within 30 days of petition filing, and creditors' powers to supervise dealings of the trustee, should be better

defined. Creditors should have the right to propose, and not just approve, liquidation or reorganization plans.

- The Bankruptcy Law, combined with regulations or directives, should provide for greater creditor access to the debtor's financial information, including provision for special investigation or examination of the debtor by creditors. The creditors' committee should also be convened much earlier, at the outset of the case, rather than the current substantial period after declaration of bankruptcy.
- The Bankruptcy Law should incorporate more provisions promoting reorganization, rather than only liquidation, of enterprises when viable. The process of separating viable businesses during liquidations from other assets is commendable. The trend should be extended toward true reorganization of viable businesses, with full discharge upon successful rehabilitation, and provisions that allow the business to operate during the bankruptcy period while the reorganization plan is being developed. Greater creditor participation in the reorganization process should also be incorporated into the law.
- Creditor priorities should be reduced significantly and conformed, as near as possible, to priorities created under applicable non-bankruptcy law to uphold commercial expectations.
- Secured creditors' interest should be safeguarded by adoption of rules that protect collateral against erosion in value. Payout within a specified time period after collateral is sold should also be mandatory to prevent trustees' bankrolling administration costs at the expense of secured creditors.

36. The institutional framework for bankruptcy requires resources in order to be developed into an effective, functioning implementer of the bankruptcy and creditors' rights system, and to create public confidence in the system.

- More resources should be dedicated to courts to eliminate backlog and help them run efficiently. The IDF grant funds many such activities, and should be implemented to assist in this area. However, a more long term commitment to funding and development of the courts will be required in order to sustain improvements over time.
- Judges require substantial education and training in commercial law, and particularly, bankruptcy issues. Training should be provided regularly to bankruptcy judges.
- Trustees require regulatory oversight, either through a private or governmental body, and training. The IDF grant provides for the development of the trustees as a profession, and should be implemented. The development of trustees is central to improving the functioning of the bankruptcy system.

37. Informal workout procedures have begun to develop, but legislative and other institutional impediments to informal workouts should be addressed.

- Tax rules on debt forgiveness should be amended to allow debt forgiveness when debts become bad and to promote effective financial restructurings and workouts.
- The SKA is an important institution as a major creditor in the Slovak economy, and as a continuing repository for an increasing amount of distressed debt. Its performance must be improved, both on past-acquired, and on to-be-acquired debt.