PRE-PACKED INSOLVENCIES

Tereza Voráčková, Alexandr Potůček, Filip Sýkora, Jaroslav Schönfeld[*]

Abstract

This paper focuses on pre-packed insolvencies prepared in the Czech Republic according to Act No. 182/2006 Coll. on bankruptcy and settlement. The analysed time period covers the years 2008–2017. The data sample contains all identified pre-packed insolvencies from the insolvency register and the financial data was extracted from the Albertina corporate database. Pre-pack insolvencies are insolvencies that begin with an insolvency proposal and accompanied by a reorganisation plan already approved by creditors. First, the paper describes the sample from different points of view and is focused on the size of the enterprise, the field of activity, the length of insolvency proceedings and the proposed insolvency administrator accompanied by an expert. Second, the paper analyses the financial situation of affected companies. The evaluation of the financial situation is based on IN indices. The insolvency proposal with a suggested reorganisation can be solved differently. The reorganisation does not need to be approved by the court or if approved, can be turned in the bankruptcy during the insolvency proceedings. The results of pre-packed insolvencies in the case of successful rehabilitation or bankruptcy are the most important findings.

Keywords: insolvency, insolvency proceedings, bankruptcy, Czech Republic
JEL Classification: G33

Introduction

The Insolvency Act (Act No. 182/2006 Coll. on bankruptcy and settlement), which has been in place in the Czech Republic since 2008, enables two possibilities for solving insolvency – a reorganisation procedure and a liquidation procedure. The reorganisation procedure relates to corporate rehabilitation and maintaining the going concern principle. The European Union (EU) has attempted to move the insolvency law away from liquidation towards more reorganisation-friendly insolvency regimes (de Weijs and Baltjes, 2018). The option of pre-packed insolvency ("pre-pack") is perceived as a fast and effective way of reorganisation in the Czech Republic (Schönfeld, 2018). Reorganisations, in general, are subject to the size and other constraints set out in Section 316 Article 4 of the Insolvency Act in the Czech Republic. The size conditions particularly enable

* T. Voráčková, University of Economics, Prague, Faculty of Finance and Accounting; A. Potůček, University of Economics, Prague, Faculty of Finance and Accounting; Filip Sýkora, University of Economics, Prague, Faculty of Business Administration; Jaroslav Schönfeld, University of Economics, Prague, Faculty of Business Administration (jaroslav.schonfeld@vse.cz).

the use of the reorganisation procedure only for large companies (annual turnover of over 50 million CZK or a minimum of 50 employees). The pre-pack is the only case in which these criteria do not have to be met, which means that the reorganisation procedure is also open to SMEs when their creditors agree with the rehabilitation procedure and a suggested reorganisation plan. The pre-pack prepares the ground for further derogations in distressed companies' behaviour and has the advantage that the creditors already agree with the suggested reorganisation plan before the insolvency proposal. This avoids the negotiation processes during the insolvency proceedings and can potentially shorten the insolvency proceedings and achieve other positive effects. Therefore, this topic as an area of the insolvency proceedings deserves to be studied more closely. This paper will introduce the research of this problematic.

1. Literature Review

The worldwide known solution that enables the corporate reorganisation procedure relates to Chapter 11, which is applied in the US. Although Chapter 11 is mentioned many times as one of the best practices, there are also conflicts (see Ayotte and Morrison, 2009). The reorganisation procedure in the EU must be harmonized. A critique of the European legal framework in the area of company reorganisation can be found in Eidenmüller and van Zwieten (2015). The European Union attempts to fully avoid the insolvency regime in the case of the corporate rehabilitation so, therefore, a Draft Directive on Preventive Restructuring Framework and Second Chance was produced.[1] De Weijs and Baltjes (2018) compare the reorganisation to the principle-based procedure and the liquidation to the rule-based procedure and explains why the liquidation procedure must follow the Insolvency Act. On the other hand, rehabilitation could be more of an economic issue than a legal one. Unfortunately, corporate insolvency is also a social issue so the government attempts to minimise the social cost of failures (Eklund, Levratto and Ramello, 2018) and the impact on the entire economic system (Lee et al., 2011).

The Czech Republic belongs among the post-transition economies in Central and Eastern Europe and entered the European Union in 2004, which has influenced the Czech legal framework. There were also many changes in business as well as the insolvency law and this also impacted the global economic crisis (Čámská, 2016). The data proves that the insolvency reorganisations have not been used much in the Czech Republic (Kislingerová, Richter and Smrčka, 2013). Although there were many expectations connected with the reorganisation procedure, these expectations have not been fulfilled yet (Smrčka, Arltová and Schönfeld, 2013). On the other hand, the insolvency proceedings have not been, in general, successful in the Czech Republic. Low recovery rates for different groups of creditors are frequently discussed (Smrčka and Čámská, 2017) and are caused by a lack of company property (Kislingerová, Richter and Smrčka, 2013; Čámská, 2013). Pre-packed insolvency provides a way of how to shorten the insolvency proceedings and achieve better results. This specific issue has not been studied in any literature until now.

---

1   Directive of the European Parliament and of the Council on Preventive Restructuring Frameworks, Second Chance and Measures to Increase the Efficiency of Restructuring, Insolvency and Discharge Procedures and Amending Directive 2012/30/EU, COM(2016) 723.

2. Methodology and Objectives

The main objective of this paper is to evaluate the success of the pre-packs performed in the time period 2008–2017. The analysis was conducted with a special focus on the frequency of pre-packs across industrial sectors, as well as on the relevance between the presence of a moratorium in the insolvency proceedings and the pre-pack results. The success of pre-packs was also reviewed in terms of relevance to the size of the subject, the link between the presence of an insolvency administrator and an expert (appraiser), and from the point of view of repeated cooperation between the insolvency administrator and the expert. The analysis is also focused on the length of the insolvency proceedings, which are divided into three phases. The methods used are based on the descriptive statistics as absolute and relative frequencies and, in the case of the length of the insolvency proceedings, mean and median are used. The financial aspect is also conducted. The achieved recovery rates for unsecured creditors are monitored and compared with the planned values. The financial situation of the analysed companies is evaluated by bankruptcy indices from the family IN, specifically IN95, IN99 (Neumaierová and Neumaier, 2002) and IN05 (Neumaierová and Neumaier, 2005).

These indices are used to predict corporate financial distress. Their computation is based on financial data published in annual financial statements. These models are frequently used in the Czech Republic and Slovakia (Klečka and Scholleová, 2010; Gavurová et al., 2017; Čámská, 2016). Their popularity is because they were created as the Czech national tool for the prediction of corporate financial distress. The following equations present the models IN95, IN99 and IN05.

$$IN95 = X_1 * \frac{A}{L} + 0.11 * \frac{EBIT}{I} + X_2 * \frac{EBIT}{A} + X_3 * \frac{R}{A} + 0.1 \frac{CA}{SL} - X_4 * \frac{L_O}{R} \,, \qquad (1)$$

$$IN99 = -0.017 * \frac{A}{L} + 4.573 * \frac{EBIT}{A} + 0.481 * \frac{R}{A} + 0.015 * \frac{CA}{SL} \,, \qquad (2)$$

$$IN05 = 0.13 * \frac{A}{L} + 0.04 * \frac{EBIT}{I} + 3.97 * \frac{EBIT}{A} + 0.21 * \frac{R}{A} + 0.09 * \frac{CA}{SL} \,, \qquad (3)$$

where
A – Assets;
L – Liabilities;
$EBIT$ – Earnings before Interest and Taxes;
R – Revenues;
CA – Current Assets;
SL – Short-term Liabilities;
I – Interest;
L_O – Liabilities overdue.

The value of items from the financial statements is entered into the equation and the final score of the specific index is computed. This final score is evaluated according to the evaluation table. Table 1 contains the evaluation zones for the abovementioned IN indices.

Table 1 | Evaluation table for IN indices

Zone / Index	IN95	IN99	IN05
Company creating value	IN95 > 2.00	IN99 > 2.07	IN05 > 1.6
Grey zone	2.00 < IN95 < 1.00	2.07 < IN99 < 0.684	1.6 < IN05 < 0.9
Company not creating value or risk of bankruptcy	IN95 < 1.00	IN99 < 0.684	IN05 < 0.9

Source: authors based on (Neumaierová and Neumaier, 2002; 2005)

3. Results

The pre-packs are analysed because it is expected that this option for the insolvency proceedings would be a contributing factor to the successful finalisation of the financial rehabilitation process. The analysed time period covers the years 2008–2017. These cases were then shortlisted, as some would not provide relevant data for the intended analyses (e.g. Private Individuals). Ultimately, a list of 65 cases of the pre-packs was derived from the insolvency register.

As Figure 1 suggests, the number of unsuccessful cases (27 cases turned into bankruptcy) significantly outweighed the successful cases (18 cases of successful rehabilitation). The remaining portion in the figure represents the currently unfinished cases where the pre-pack insolvency was only formally approved by the court.

The next feature described is the field of company activity. Almost 50% of the analysed subjects (31 cases) are classified by CZ-NACE as the manufacturing industry. However, only 12 pre-packed insolvencies of these 31 cases were successfully completed. Other significant cases fall under the construction industry (16 cases, 2 successful) and the real estate sector (7 cases, 3 successful). The remaining sectors accounted for only four or fewer cases. Such findings are proof that the product itself is an important aspect for distressed companies to engage in pre-packed insolvency proceedings.

**Figure 1 | Pre-packed insolvency results**
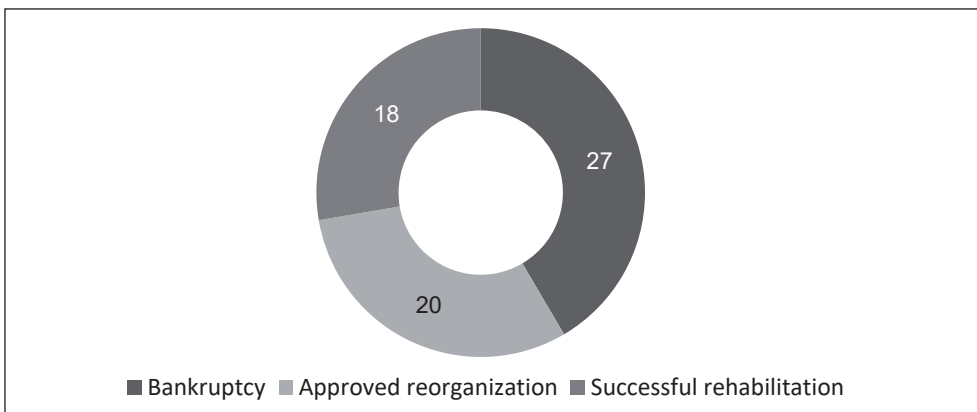
Source: authors based on ISIR

Next, we focused on the relevance between the presence of a moratorium (safeguard procedure) in the insolvency proceedings and the result of the pre-packed insolvency. The safeguard procedure offers temporary protection from creditors. The company is not obliged to pay long-term debts and the business can be kept running and the financial rehabilitation can start. This can lead to the long-term functioning of a company. Before the declaration of bankruptcy, only 10 subjects (15%) underwent the moratorium process, of which only one case successfully completed the pre-packed insolvency process (SCB Foundry, a.s.). However, even though the insolvency was successful, the subject entered repeated insolvency proceedings five years later and these are still ongoing. These findings demonstrate that the moratorium, an instrument with the objective of protecting the debtor from creditors, in most cases, failed to halt bankruptcy. In contrast, the moratorium appears to be only an instrument for buying more time before bankruptcy is declared.

The next characteristic analysed is the company size. Rehabilitation, according to the Insolvency Act, is only an option when the size of the company meets the conditions in Section 316 Article 4. The annual turnover of the company should exceed 50 million CZK one year before declaring the insolvency proposal or the company must have a minimum of 50 employees. This size condition has been valid since 2014. Prior to 2014, companies had to be twice the size (annual turnover of over 100 million CZK or more than 100 employees). As previously mentioned, companies that enter pre-packed insolvency are exempt from the conditions (regarding the size) as described in Section 316 Article 4 of the Insolvency Act.

Figure 2 | Relevance between company size and the pre-packed insolvency success rate
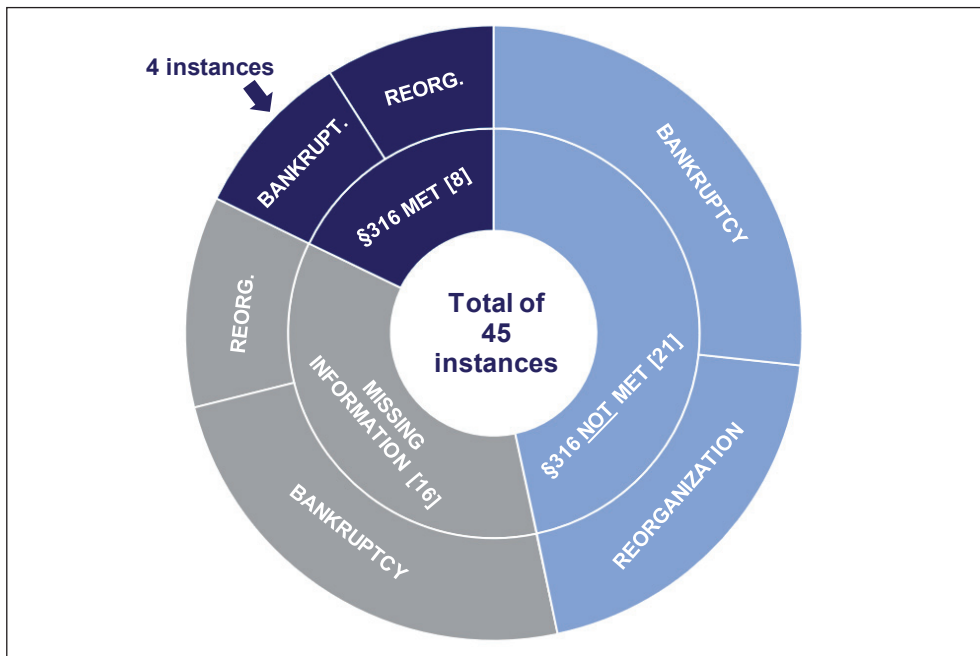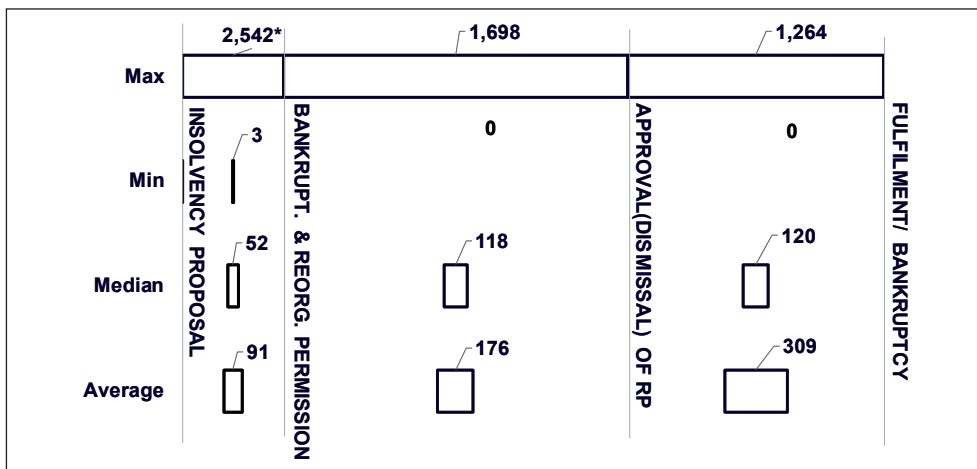

Source: authors based on ISIR and Albertina

The evaluation of a subject's size and its impact on the success of the insolvency proceedings was set in motion. From a total of 65 companies, we selected those processes that are considered as completed (45). From these 45 cases, only 8 (18%) did not meet the size requirements. Four of the eight succeeded in the process of pre-packed insolvency and the remaining four cases entered bankruptcy. Sixteen companies in the sample did not publish the information needed to evaluate these criteria. However, it is likely that these would be representatives of small companies rather than large ones. The full picture is summarised in Figure 2.

With respect to the number of cases and the success rate (50%), the authors were unable to confirm any impact of the company size of on the successful pre-packed insolvency.

The next objective was to review the companies' Insolvency Administrators (IA). One-third of the companies cooperated with an IA on a single basis and 80% of these used an expert (the rest of the companies entered bankruptcy before the appraisal). Almost 20% of companies used AS ZIZLAVSKY v.o.s. as their IA, followed by Jiří Hanák (12%). The most utilised expert was Equity Solutions Appraisals s.r.o. (20% of the companies cooperating with an expert). The analysis of IA and expert cooperation was conducted in all 65 cases. We found seven cases where IA AS ZIZLAVSKY v.o.s. cooperated with Expert Equity Solutions Appraisals s.r.o. This cooperation resulted in four cases succeeding with pre-packed insolvency. Other cooperation that was found more than once was between IA Daniela Majzlíková and the expert Kvita, Pawlita & Partneři, spol. s.r.o. They cooperated on two cases of which one was completed successfully. The same results were achieved by the cooperation between IA Ivo Hala and Expert EQUITA Consulting s.r.o.

Figure 3 | Pre-packed insolvency – phases (in days)

*for the purpose of this chart, such an extreme value (2,542) was replaced with a lower value to preserve its legibility.

Source: authors based on ISIR

One of the key attributes of the pre-packed insolvency is a hypothetically shorter timeframe as opposed to a standard reorganisation process. Figure 3 shows the length of the phases of the insolvency proceedings.

The insolvency proceedings can be divided into three phases: (1) from the tabling of the insolvency proposal to the Court until the declaration of insolvency and reorganisation permission; (2) until the approval/dismissal of the reorganisation plan (hereafter "RP") by the Court; (3) until fulfilment of the RP or the declaration of bankruptcy. According to Section 134 of the Insolvency Act, theoretically, the shortest duration of phase 1 is 1–10 days. Phase 2 can take less than one day, considering voting on RP outside the Creditor Meeting (Section 346 Article 2) and tabling it together with the declaration of insolvency and reorganisation permission. No minimum period for phase 3 is set by the Insolvency Act.
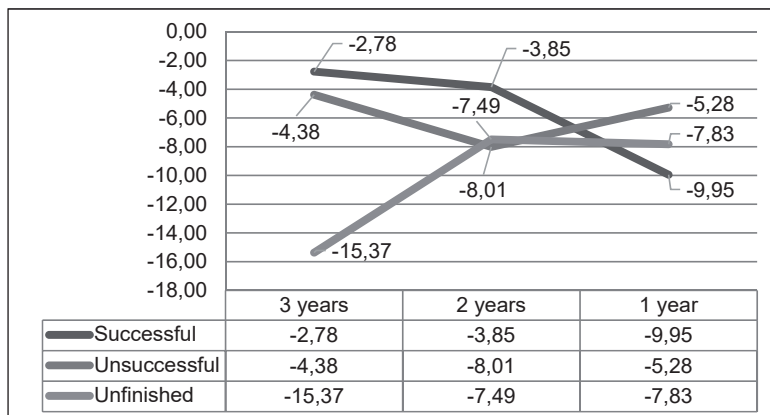
The length of phase 1 (91 days on average) is mainly caused by the creditor first tabling an insolvency proposal, thus huge pressure on the negotiating power of the debtor in the preparation of pre-packed insolvency is evident. The length of phase 2 indicates that Courts usually judge RP after registration of all receivables, subjecting them to further review proceedings. This disproves the assumption based on Section 346 Article 2. In addition, phase 2 enables the presence of several disputes. Regardless of the success of pre-packed insolvency, fulfilment of RP (phase 3) took as long as 304 days on average. Moreover, two cases of dismissal of RP by the Court together with the declaration of bankruptcy were observed.

Furthermore, both successfully financially rehabilitated companies and those overturned to bankruptcy were compared, and the following relations were observed. Phase 1 was proved to be shorter in the case of successful rehabilitations. Phase 2 was rather long in successful cases and phase 3, by contrast, was shorter at the successful companies.

Our research was intended to measure the length of the insolvency proceeding as ex-post analysis although also conducted to find a clue that would lead us to better identify the subjects that are preparing for pre-packed insolvency in the future. Therefore, we decided to run the analysis using indices IN05, IN99 and IN95. The analysis was conducted on the financial data of all cases taken in the three years preceding the insolvency proposal. Overall, we found that the index values were highly sensitive to extreme values, which may also deflect the analysis output.

Evaluation of the indices IN05 and IN99 did not confirm that the cases with successful pre-packed insolvency achieved better values than those that would enter bankruptcy during the insolvency proceedings.

Figure 4 | IN95 – average values of analysed companies

	3 years	2 years	1 year
Successful	-2,78	-3,85	-9,95
Unsuccessful	-4,38	-8,01	-5,28
Unfinished	-15,37	-7,49	-7,83

Source: authors based on Albertina

However, index IN95 confirmed the objective. This means that successful pre-packed insolvencies achieved better values than the unsuccessful ones in the three 3 years preceding the bankruptcy. This relation can be seen in Figure 4 above. The main difference between indices IN05, IN99 and IN95 is that IN95 works with overdue liabilities within the calculation. In addition, index IN95 indicates that a considerable amount of overdue liabilities two or three years prior to bankruptcy may be the correct indicator.

With all the data in one place, we decided on one last view of the pre-packs. We wanted to know whether the pre-packed insolvency has a return for the unsecured creditors. We compared the planned and reached recovery rate for unsecured creditors and found that the average of the planned recovery rate for the unsecured creditors is about 27%; considering only those in the pre-packed insolvency that was completed then this is 20.3%. The recovery rate reached, in most of the cases, is similar to that planned. The highest recovery rate is achieved by the unsecured creditors in the construction industry.

Conclusion

The analysis of 65 pre-packed insolvencies conducted between 2008 and 2017 shows the following findings. The presence of the relevance between the industry and the success of the process confirmed that the product is an important determinant in the pre-packed insolvency proceedings. Most pre-packs were identified in the manufacturing and construction industry branches, followed by the real estate sector. The moratorium tends to work as a tool used to buy more time before bankruptcy is declared and does not help companies to successfully complete the pre-packed insolvency proceedings. The relevance between the size (Section 316 Article 4) of the company and the success rate could not be clearly confirmed due to insufficient access to complete information. Even though most of the companies used an insolvency administrator and an expert on a single basis, they most frequently cooperated with IA AS ZIZLAVSKY v.o.s. and Expert Equity Solutions Appraisals s.r.o. Moreover, their cooperation was observed in seven cases, of which four companies were financially rehabilitated. However, the pre-pack should be a short process and the analysis showed that this is not true. The evaluation of the pre-packs according to the results of the IN05 and IN99 indices did not confirm that cases with successful pre-packed insolvency reached better values than the unsuccessful cases. On the other hand, index IN95 confirmed the objective. The average planned profit for unsecured creditors is around 27%, more precisely 20.3% when only considering the successfully finalised pre-packs. In most cases, the profit attained is similar or the same as that forecast with the highest rate attained reported in the construction industry.

Further research can lead to a detailed description of the pre-packed insolvencies in the Czech Republic and searching cross-sectional dependencies. Corporate characteristics that have a serious influence on the success of the pre-packed insolvency can be found. The results acquired can be compared with the general results on insolvency proceedings in the Czech Republic, which have been collected by the research team led by Smrčka. The comparison can prove if higher recovery rates for creditors can be expected in the case of pre-packs or traditional insolvency proceedings.

References

Ayotte, K.M., and Morrison, E.R. (2009). Creditor Control and Conflict in Chapter 11. *Journal of Legal Analysis*, 1(2), pp. 511–551. https://doi.org/10.1093/jla/1.2.511

Čámská, D. (2013). Basic Characteristics of Enterprises in Insolvency. In *Conference Proceeding of International Scientific Conference on Hradec Economic Days 2013 – Economic Development and Management Region* (pp. 83-88). Hradec Králové: Gaudeamus.

Čámská, D. (2016). Accuracy of Models Predicting Corporate Bankruptcy in a Selected Industry Branch. *Ekonomický časopis (Journal of Economics),* 64(4), pp. 353–366.

de Weijs, R., and Baltjes, M. (2018). Opening the Door for the Opportunistic Use of Interim Financing: A Critical Assessment of the EU Draft Directive on Preventive Restructuring Frameworks. *International Insolvency Review*, 27(2), pp. 223–254. https://doi.org/10.1002/iir.1305

Eidenmüller, H., and van Zwieten, K. (2015). Restructuring the European Business Enterprise: The European Commission's Recommendation on a New approach to Business Failure and Insolvency. *European Business Organization Law Review*, 16(4), pp. 625–667. https://doi.org/10.1007/s40804-016-0042-2

Eklund, J., Levratto, N., and Ramello, G.B. (2018). Entrepreneurship and Failure: Two Sides of the Same Coin? *Small Business Economics*, pp. 1–10. https://doi.org/10.1007/s11187-018-0039-z

Gavurova, B., Packova, M., Misankova, M., and Smrcka, L. (2017). Predictive Potential and Risks of Selected Bankruptcy Prediction Models in the Slovak Business Environment. *Journal of Business Economics and Management*, 18(6), pp. 1156–1173. https://10.3846/16111699.2017.1400461

Kislingerová, E., Richter, T., and Smrčka, L. (2013). *Insolvenční praxe v České republice v období 2008–2013* [Insolvency Practice in the Czech Republic in the Period 2008–2013]. Praha: C. H. Beck.

Klečka, J., and Scholleová, H. (2010). Bankruptcy Models Enunciation for Czech Glass Making Firms. *Economics and Management*, 15, pp. 954–959.

Lee, S. H., Yamakawa, Y., Peng, M.W., and Barney, J.B. (2011). How Do Bankruptcy Laws Affect Entrepreneurship Development around the World? *Journal of Business Venturing*, 26(5), pp. 505–520. https://doi.org/10.1016/j.jbusvent.2010.05.001

Neumaierová, I., and Neumaier, I. (2002). *Výkonnost a tržní hodnota firmy* [Company Performance and Market Value]. Praha: Grada.

Neumaierová, I., and Neumaier, I. (2005). Index IN05, [online]. In *Proceedings of European Financial Systems*. Brno: Masarykova univerzita, pp. 143–148. Available at: https://is.muni.cz/do/1456/sborniky/2005/evropske-financni-systemy-2005.pdf [Accessed 15 Jul. 2018]

Smrčka, L., Arltová, M., and Schönfeld, J. (2013). Příčiny neúspěchu prosazování sanačních postupů v insolvenční realitě [Reasons for the Failure to Implement Financial Rehabilitation Procedures in Insolvent Reality]. *Politická ekonomie*, 61(2), pp. 188–208. https://doi.org/10.18267/j.polek.894

Smrčka, L., and Čámská, D. (2017). Methods of Enforcing Receivables and Results in the Czech Republic. *International Advances in Economic Research*, 23(1), pp. 125–126. https://doi.org/10.1007/s11294-016-9616-6

Schönfeld, J. (2018). *Transformace a restrukturalizace podniku* [Transformation and Restructuring of the Firm]. Praha: C. H. Beck.