

# “Is the protection of the rights of unsecured creditors in restructuring in the present reality?”

## AUTHORS

Ol'ga Kmet'ová  
Magdaléna Freňáková

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Oľga Kmeťová (Slovakia), Magdaléna Freňáková (Slovakia)

## Is the protection of the rights of unsecured creditors in restructuring in the present reality?

### Abstract

The authors of the article respond to the current issue of unsecured creditors' protection in the restructuring process of the company. The aim of the authors is to explore legal possibilities of the position and of the rights of unsecured creditors in restructuring proceedings, to identify results of the legislative changes in the legal and property sphere of unsecured creditors, to point out critically the pitfalls and to formulate options of the future legislation of the unsecured creditors' status in the restructuring. The authors offer in the article a comparative look at these questions, comparing the relevant rules in Act. No. 87/2015 Coll., amending and supplementing Act. No. 513/1991 Coll. Commercial Code, as amended, and supplementing and amending certain laws, which, with effect from 29 April 2015 changed the law no. 7/2005 Coll. on bankruptcy and restructuring, as amended, in particular with a view to conclude whether this change will be positive contribution for the status of unsecured creditor and for the enforcement of its rights in restructuring proceedings and if that will bring more legal certainty compared to the previous state.

**Keywords:** unsecured creditor, protection of the rights of an unsecured creditor, restructuring, legislative changes.

**JEL Classification:** D72, E50, G34.

### Introduction

The response to the question, whether the legislators create such legislation the society needs and cannot dispense and which must be the part of the law of the Slovak Republic, is the burning issue of everyone. We are unfortunately not fully convinced that legislation is formed as necessary reasonable and unavoidable. This can be demonstrated by the example of last amendment to Act No. 7/2005 Coll. on bankruptcy and restructuring<sup>1</sup> carried out by Law No. 87/2015 Coll.

In order to help certain unsecured creditors in the restructuring of the Váhostav – Sk, Inc., (next only “Váhostav”), and in order to react to the current problems related with this situation, on 23 April 2015 there were relatively extensive amendments to the Act on Bankruptcy and Restructuring and to the Commercial Code (also called familial “Lex Váhostav”) approved by parliament. Lex Váhostav does not only solve the primary problem of restructuring of Váhostav – Sk, Inc., but brings several changes with an impact on all entrepreneurs.

Since this is a new regulation and this amendment has not been particularly analyzed in detail, we will try to provide an analysis especially with concluding if this change will be positive contribution for the status of unsecured creditor and for the enforcement of ones rights in restructuring proceedings and if

that will bring more legal certainty compared to the previous state.

### 1. Reasons leading to the amendment

The laws of bankruptcy law in Europe in the last period approach active the solving of the economic situation by creating legal institutes, the use of which can avoid bankruptcy of debtor.

Restructuring procedure is quite interesting, but very difficult issue. It is, however institute, which is successfully used not only in countries of European Union, but also in the US.

Decline<sup>2</sup> is the negative feature that is not regular in the market environment. The law on bankruptcy and restructuring provides two options for solution of decline: liquidation bankruptcy and restructuring. Liquidation bankruptcy represents the physical sales of assets of debtor for the purpose of proportional satisfaction of its creditors and subsequent destruction of debtor. Restructuring represents healing process, which seeks to proportional and gradual satisfaction of creditors' subscribers while maintaining the operation of the business.

Legislation imposes to the debtors an obligation to prevent the decline. Persons who are responsible for accounting, have a special obligation to monitor the status of own property and development of financial and commercial situation so that they can timely detect the threat of bankruptcy and take effective action.

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Oľga Kmeťová, C.Sc., Department of Financial Management, Faculty of Business Economy with seat in Košice, University of Economics in Bratislava, Slovakia.

Magdalena Freňáková, Ph.D., Department Economics, Faculty of Business Economy with seat in Košice, University of Economics in Bratislava, Slovakia.

<sup>1</sup> Law No. 7/2005 Coll. on bankruptcy and restructuring and supplementing certain acts as amended.

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<sup>2</sup> Decline of debtor is in §3 of Act No. 7/2005 Coll. defined as insolvency or extension. Insolvent is the one who is unable to perform 30 days overdue at least two financial liabilities to more than one lender. In extension is enterprise that is obliged to keep accounting (according to the Act no. 431/2002 Coll. on accounting, as amended), and has more than one creditor and the value of its liabilities exceeds the value of its assets.

Major benefits of restructuring as a form of solution of debtor decline is that debtor in restructuring process is not obliged to pay old commitments and provide him sufficient time to re-start-up his business. This allows the debtor to be able to pay to creditors in a given proportion after restructuring. Restructuring as a new way of organizing equity ratio of the debtor in bankruptcy or impending bankruptcy is permissible only in the case where based on a judgment of restructuring administrator is obvious that in this case there is a chance of rescuing an enterprise of the debtor, and simultaneously restructuring brings creditors of debtor greater satisfaction than it was in the context of bankruptcy. In this case the restructuring plan may also contain for example capitalization of claims, e.g. their exchange for shares and so on.

Restructuring is the opposite of bankruptcy. In restructuring process the effort is mainly to preserve the debtors' enterprise, so the debtor could generate new profits from which will satisfy the creditors. These creditors should sense the restructuring positively because this process should offer them higher returns than they would get in the case of liquidation bankruptcy. On the other hand, the creditors, giving up part of their claims, which they own against the debtor, possibly agree to an extension of the period of maturity of their claims, or both at once. The Act, though, there is no strict and restructuring plan, which represents a dispositive consensus of the debtor and the creditors may determine also some other way of resolution of debtor obligations, which primarily depends on the nature and capabilities of the debtor.

The law in the Slovak Republic allows entry to restructuring proceedings to any business entity that meets the conditions set out in §109 of the Act on bankruptcy and restructuring. The administrator appointed to draw up a restructuring assessment may recommend restructuring if the debtor is insolvent or is threatened with bankruptcy (if the debtor still carries on business), this means that even the threatened or impending decline of business activity has been not suspended. Another and next condition is that it can be reasonably assumed that during and after the restructuring will be maintained at least a substantial part of the business operations of the debtor and thus the debtor will be able to satisfy its creditors. The last and the most important condition, which determines routing between bankruptcy and restructuring is that in the case of authorization of restructuring, can be reasonably assumed greater extent of the creditors' satisfaction than in case of bankruptcy. Determination of the extent of creditors' satisfaction is based on assumption of the value of assets and of quantification of the supposed

satisfaction of the creditors from those assets in bankruptcy. All the above mentioned conditions must be met cumulatively (Kaselyova, Tkáč, 2014).

During 2009, the impact of the global economic crisis manifested in all areas of the economy, with the slump in world trade resulted in a decrease for products and services and the uncertainty caused by the economic crisis slowed down the processes forming the menu. This resulted in a global recession. As the economy in the Slovak Republic is highly open, global economic crisis caused a slowdown in economic growth. Expected economic growth is not sufficient to improved market at present. A result of the time series and specification market meant that at this time resulting in a large number of companies in bankruptcy or vice versa company asked the court for recovery through restructuring.

Application practice has shown that in our conditions, institute restructuring procedure did not help much the majority of restructured enterprises, but this was mainly due to lack of expertise, whether the restructuring trustee, crisis management company, or even the court itself, has implemented the supervision of such procedure. It was mainly due to the fact that during the restructuring procedure faulty processes and decisions were not removed that led to the bankruptcy of the company, and after a relatively short time, firms found themselves in the same situation. Despite the fact that the restructuring proceedings are legal institute, which is strictly governed by law, it requires considerable economic expertise not only on the part of the administrator, but also on the part of the court which without them is not able to relevantly assess the proposed measures, which in practice results in both affirmed by the court of unrealistic plans, or vice versa not affirmed realistic plans.

An unavoidable reality not only for the company in restructuring, but also for the whole competitive environment is that restructuring provides a considerable competitive advantage, mainly due to the longer period of time may not be the borrower to repay its debts incurred prior to the commencement of restructuring proceedings, which would result in the accumulation of certain financial capital, respectively reserve and also the fact that after restructuring it mainly leads to remission of liabilities of the debtor by creditors.

Many experts and the public perceive these facts as distortions of competition by providing a competitive advantage. On the other hand, it should be noted that it would be a mistake to allow enterprises to cope with the problem itself if there is a real chance for a bailout. Particularly in large companies it would give rise to huge losses

not only to job losses but also major financial losses for creditors because the restructuring indeed is based on the fundamental principle of higher satisfaction of creditors than satisfaction in the event of liquidation bankruptcy<sup>3</sup>.

Each sector of industry has specific needs for restructuring and therefore needs a special approach. Precisely for this reason it is essential that while allowing the company to enter into restructuring was not only from the management of the debtor, but also from the expertise of the administrator and the court of eliminating or removing the reasons for the bankruptcy of a debtor, primarily to provide benefits in the form of restructuring brought not only for borrowers but also for society far greater effect than his competition. It is important to note that, as major companies went bankrupt, besides increasing unemployment, there is also a substantial deterioration of the market environment, as it often leads to major financial losses for creditors, which could cause them just so secondary insolvency and chaining effect occurs when the bankruptcy of one large company will cause the subsequent collapse of several other smaller companies.

Overview of the number of ongoing and declared bankruptcy in the Slovak Republic for the period 2007-2014 is presented in Table 1.

Table 1. Ongoing and declared bankruptcy in Slovakia

Year	2007	2008	2009	2010	2011	2012	2013	2014
Ongoing bankruptcy	260	615	706	1044	1325	1762	2310	2899
Declared bankruptcy	169	251	276	344	414	463	585	682
Open small bankruptcy	45	92	90	145	235	257	345	450

Source: own processing on the basis of statistics bankruptcy proceedings in the district courts in Slovakia, available at: <http://www.justice.gov.sk/Stranky/Informacie/Statistika-konkurznych-konani-OS.aspx>.

<sup>3</sup> There are two key certificated means of resolving insolvency of the debtor under the law on bankruptcy and restructuring namely the bankruptcy and the restructuring. There is no doubt that restructuring is more gentle way for the debtor. While bankruptcy has a liquidation character, a condition of restructuring (even of recommendation of restructuring by administrator) is to maintain at least a substantial part of the business operations of the debtor and the assumption of large-scale satisfaction of the creditors of the debtor as in the case of bankruptcy proceedings [§ 109 section 3 point c) and d) ZKR]. Restructuring protects the debtor from creditors (do not permit the execution or performance of security rights [§ 114 section 3 point b) and c) ZKR], but this ultimately pursues the interests of all creditors to higher extent of satisfaction of their claims than in the event of bankruptcy) (the Finding of the Constitutional Court, Ref. I. US 375/2014, 4 February 2015). It can not therefore compare form of legal protection afforded to the debtor in the process of restructuring on the one hand and in the process of bankruptcy liquidation on the other hand. The form of legal protection in both cases has its own impacts on further debtor's action in business environment, as well as on his property sphere (the Finding of the Constitutional Court, Ref. III ÚS 218/2014, 12 September 2014).

Overview of the number of ongoing, allowed and completed restructuring in the Slovak Republic for the period 2007-2014 is presented in Table 2. Allowed restructuring recorded its highest number in 2013. There were 22 more than in 2010, which was still a record in this regard. In 2013 were approved 108 restructuring of legal entities, one of civic associations and four unincorporated businesses. Most restructuring was approved in industry, trade and construction.

Table 2. Ongoing, allowed and completed restructuring in Slovakia

Year	2007	2008	2009	2010	2011	2012	2013	2014
Ongoing restructuring	9	7	45	110	98	110	142	161
Allowed restructuring	8	10	58	87	86	73	109	93
Completed restructuring	2	11	15	49	67	54	62	96

Source: own processing on the statistics restructuring proceedings in the district courts in Slovakia available at: <http://www.justice.gov.sk/Stranky/Informacie/Statistika-restrukturalizacnych-OS.aspx>.

Legislation in Slovakia has so far failed to ensure the performance of a balanced and transparent way of restructuring, as evidenced in particular the fact of the total number of successful completion of the restructuring, whether through legal or even formal aspect, which demonstrates the ability of other operations of the company after the completion of the restructuring.

But restructuring of company Váhostav remains total and final authorization of debt relief the most memorable, not only because of its scale, but also because of media and political influence. The results are new, more stringent rules for entry to restructuring, higher statutory responsibility deleveraging companies and suggested the possibility of meeting with new unsecured creditors.

Overview of the number of declared bankruptcy and of the allowed restructuring in the Czech Republic for the period 2008-2014 is presented in Table 3.

Table 3. Declared bankruptcy and allowed restructuring in the Czech Republic

YEAR	2008	2009	2010	2011	2012	2013	2014
Declared bankruptcy	1141	1553	1601	1778	1899	2224	2403
Allowed restructuring	6	13	19	17	17	12	31

Source: own processing on the statistics restructuring proceedings in the district courts in Slovakia available at: [http://www.creditreform.cz/fileadmin/user\\_upload/CR-International/local\\_documents/cz/Presseartikel/Insolvence\\_2014.pdf](http://www.creditreform.cz/fileadmin/user_upload/CR-International/local_documents/cz/Presseartikel/Insolvence_2014.pdf).

To compare the relationship between the development of declared bankruptcies and restructurings allowed in Slovakia and in the Czech Republic, we quantified the correlation coefficient. The Spearman

correlation coefficient for bankruptcies declared in the Slovak Republic and in the Czech Republic is 0.969538 and means strong positive correlation. The Spearman correlation coefficient for restructurings allowed in Slovakia and in the Czech Republic is only 0.589405 and represents positive correlation but not so strong. The reason is that in the Czech Republic by the end of 2013 was a prerequisite for approval of reorganization (restructuring) condition that turnover of a company that got into trouble was in front of insolvencies at least 100 million Czech crowns. The second criterion for approval of reorganization was that the company had at least 100 employees. Those strict conditions did not meet a number of companies that might otherwise use reorganization to solve decline. To these facts new Insolvency Act responded the which is in force since 1st January 2014, while there are new lower criteria for approval of restructuring (annual net turnover of company was reduced to 50 million Czech crowns and the number of employees to 50 employees). Newly also at least one of these criteria

is sufficient. Newly is enough to meet just one of the criteria.

For a general overview we provide information about development of corporate insolvencies in Western Europe (Table 4).

“The insolvency figures for Western Europe reflect the economic recovery after years of crisis. The number of corporate insolvencies fell by around 10 000, from 189855 in 2013 to 179662 in 2014. This was the first marked improvement on the insolvency front since the start of the financial crisis, following a virtual stagnation of the relevant total in 2013 (plus 0.9%) and an ongoing upward trend in 2012 (plus 8.6%). But despite the easing of the economic situation, the number of insolvencies noted in the course of the year in Western Europe was more or less on a par with that recorded in 2009 (178 235) and thus considerably higher than before the financial crisis began in 2007: 130910). In the eurozone, the number of business failures eased by 4.6% to 147649 (Creditreform, 2015b, pp. 1-2).

Table 4. Corporate insolvencies in Western Europe

	2014	2013	2012	2011	2010	Change 2013/14 in percent
Austria	5.600	5.626	6.266	6.194	6.657	-0.5
Belgium	10.736	11.739	10.587	10.224	9.570	-8.5
Denmark	4.049	4.993	5.456	5.468	6.461	-18.9
Finland	2.954	3.131	2.956	2.944	2.864	-5.7
France	60.548	60.980	59.556	49.506	51.060	-0.7
Germany	24.030	26.120	28.720	30.120	32.060	-8.0
Greece	330	392	415	445	355	-15.8
Ireland	1.164	1.365	1.684	1.638	1.525	-14.7
Italy	16.101	14.272	12.311	10.844	10.089	+12.8
Luxembourg	845	1.016	1.033	961	918	-16.3
Netherlands	6.645	8.375	7.763	6.176	7.211	-20.7
Norway	4.803	4.564	3.814	4.355	4.435	+5.2
Portugal	7.200	8.131	7.763	6.077	5.144	-11.5
Spain	6.392	8.934	7.799	5.910	4.845	-28.5
Sweden	7.158	7.701	7.737	7.229	7.546	-7.1
Switzerland	5.867	6.495	6.841	6.661	6.255	-9.7
UK	15.240	16.021	17.765	18.467	17.468	-4.9
Total	179.662	189.855	188.076	173.213	174.463	-5.4
Eurozone*	147.649	154.750	150.665	135.322	138.045	-4.6

Note: \* without Malta or Cyprus.

Source: Creditreform, 2015b. [online]. Available at: [http://www.creditreform.cz/fileadmin/user\\_upload/CR-International/local\\_documents/cz/Presseartikel/analyse\\_EU-2014-15\\_englisch.pdf](http://www.creditreform.cz/fileadmin/user_upload/CR-International/local_documents/cz/Presseartikel/analyse_EU-2014-15_englisch.pdf).

“In 2014, only two countries posted year-on-year increases: Norway (plus 5.2%) and Italy (plus 12.8%). 15 countries registered declining totals, with the number of corporate collapses actually falling by double-digit percentages in seven of them. The most marked drop, of 28.5%, was in Spain, followed by the Netherlands (minus 20.7%) and Denmark (18.9%). More modest falls were posted

by France (minus 0.7%) and Austria (minus 0.5%). Germany occupied a good midfield position with 8 % fewer insolvencies than the year before. In Western Europe as a whole, business failures fell by 5.4% compared with 2013. This was the first year-on-year decline since 2010/11, when the fall was only marginal, though, at 0.7%” (Creditreform, 2015b, pp. 2-3).

“It must be borne in mind that in some cases insolvencies represent only a fraction of the total number of business liquidations in a country. Business difficulties often lead to the closing down of microenterprises, for instance, without any regular insolvency proceedings; they are then simply erased from the commercial register. The extent of such occurrences vary between one country and the next” (Creditreform, 2015b, p. 3).

## 2. New regulation

The amended Act on Bankruptcy and Restructuring had to respond to restructure Váhostav resolve the issue of harming creditors in these processes. According to the promoter itself (Minister of Justice) “the purpose of the bill is to respond to the current problems associated with the process of bankruptcy and restructuring in the Slovak Republic and the related issues of business relationships and related social impact”. The main purpose of the Act of the Minister to be in this part is “to avoid damaging creditors in insolvency and restructuring proceedings”<sup>4</sup>. The speed of the changes (note: they were adopted in an accelerated legislative procedure) and the absence of comment procedure, however, in our opinion, signed under their quality.

Doubt that the new regulation may not have followed the effect resonated by the experts at the time of preparation and approval of the amendment in parliament and even today, several months after its entry into force and effect from 29 April 2015 (the effectiveness of some provisions have been moved to 1 July 2015 or up to 1 January 2016) is questionable whether the “Lex Express Váhostav” was a good system and not just a quick and politically acceptable long-term solution of the problem of satisfying creditors in the restructuring of the debtor.

**2.1. Satisfaction of unsecured creditors before the change in restructuring.** Only creditors who according to the law on bankruptcy and restructuring register their claims have right to apply their demands during the restructuring. If these entitlements will not be proper and applied on time in application form in restructuring, the right to enforce these claims against the debtor in the case of confirmation of the restructuring plan, the court shall terminate. The application must be delivered to the administrator within 30 days of the authorization of restructuring. The legal consequence of an absence of the application within the prescribed period is that the application will not be considered.

<sup>4</sup>The explanatory memorandum to the Act 87/2015 Coll., amending and supplementing Law no. 513/1991 Coll. Commercial Code as amended, and amending and supplementing certain laws. Available at: <[http://www.epi.sk/dovodova\\_sprava-k-zakonu-c-87-2015-Z-z.htm](http://www.epi.sk/dovodova_sprava-k-zakonu-c-87-2015-Z-z.htm)>.

From the perspective of the creditor, restructuring was dangerous especially at two levels – login own claim to restructuring in a relatively short 30 day period after the statement of restructuring permitted publishing in the Commercial Bulletin and after successful login receivables wait for a range satisfying a claim under the restructuring plan drawn up by the administrator of the debtor. The rate of satisfaction of unsecured creditors was on average worth 15-30% of the entire amount of their claims. In other words, the debtor legally was not required to pay its creditors up to 80% of their debts. No wonder that especially in the last period there is “bag ripped” of restructuring.

**2.2. Satisfaction of unsecured creditors after the change in restructuring.** The period for logging into debt restructuring has not changed. It remains 30 days. But if creditor properly login his claim within the statutory period, so creditor becomes a participant of restructuring proceedings.

It changed the whole concept of the plan as an instrument regulating creation, amendment or termination of rights and obligations of persons therein. What was most expected, thus introducing the legally stipulated minimum limit to satisfy unsecured creditors, similarly as in the regulation of some other countries in the law in this form, we do not find.

Even after the amendment the restructuring plan can still count on any the claims of unsecured creditors (e.g. only an average value of 15-30% of the established amount receivable). After completion of the restructuring plan (e.g. after payment of 15% of the claim) remains the creditor’s claim in the amount of 50% recoverable, that means it does not expire, as it was before the amendment to the Act. But it can be satisfied only from the profits which the debtor will develop. This means that the part of the claim till the amount of 50%, which was not paid under the restructuring plan, will be able to be paid from the profits of the debtor. For a better understanding of the legal concept there is an example:

The Creditor company, Ltd., login the claim in the amount of 10 000 EUR to restructuring of Debtor company, Ltd. Administrator of the Debtor company, Ltd. draw up a restructuring plan under which the creditor should get 20% of its login in time period of six years (but beware, it can also be 15 years, the time limit is not anchored), for a total of 2 000 EUR. The restructuring plan was approved and Creditor company, Ltd., gradually for several long months really gets its 2 000 EUR.

We see, therefore, that other regulatory adjustments leaves to Creditor company, Ltd., their right to other 3 000 EUR (the amount equivalent to value 50% of the debt). These 3 000 EUR, however Creditor

company, Ltd., can not satisfy from any of the assets of the Debtor company, Ltd., but only from profit or from other own resources which Debtor company, Ltd., gains while these resources should be paid as well to owners. In actual practice, it may happen that Creditor company, Ltd., will look at the owners of the Debtor Company, Ltd., as they “ride on expensive cars”, which are written on the Debtor company, Ltd., and are used for commercial purposes, but Debtor Company, Ltd., officially shows no profit, so that 3 000 EUR will remain to the Creditor company, Ltd., still unpaid.

It can be stated that the new provision of §155a of the Act on Bankruptcy and Restructuring, effective since 29 April 2015, states that the debtor or the acquiring person can not divide profit or other own resources among its members after the restructuring, sooner than creditors’ claims of the unsecured claims in the amount of their established entitlements are satisfied. For these purposes, the original claim up to 50% does not expire and the rest of it is understood as other property rights of the creditor and it should be satisfied within the profit or within other own resources<sup>5</sup>, thus creating false hope for small creditors, that the restructuring will meet their claims up to 100%. For this purpose, in our opinion, the legislator managed to create legally incomprehensible institute “quasi non-property right” of creditors to be met (satisfied) from future (hope against hope) the debtor’s profits.

The question is how the practice and the courts stand up to such a situation. Will they take into account the targeted making “losses” by companies that have undergone restructuring? In our opinion, fair and lawful equity at least in value of last two years profit distribution and own resources, either:

- ◆ for new deposits (i.e. the benefits of the capital in the company),
- ◆ or in form of replacement of claims of unsecured creditors in the restructuring for these deposits (i.e. capitalization of receivables).

Failure to meet such a condition will result in rejection of the plan. The explanatory memorandum states that “it is the fundamental measure to combat fraudulent restructuring”. Unfortunately, this shows

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that the submitter of the proposal is strongly detached from practice. Legislator both missed that in the case of troubled companies in recurrent losses may be the amount of such deposits and the capitalization equal, zero and both completely forgotten employed natural persons.

In addition motivation of creditors to capitalizing their claims will be not high – we can not personally imagine typically creditors in restructuring, for example institution of social insurance, health insurance companies, tax authorities and banks in the unsecured part, as happily they capitalize their receivables example up to 10% of the total share capital of the debtor. Moreover, a creditor who, in accordance with the restructuring plan acquires the share capital of the debtor in exchange for its claims, it may happen in the future restructurings or bankruptcy processes against the debtor of a related person, who has the worst position in all aspects.

## Conclusion

This article has aimed to critically evaluate the current rules governing the protection of unsecured creditors in restructuring and on some specific examples demonstrate the negative attempts of legislators in drafting legislation in this area.

The authors in its interpretation expressed an opinion on some of the provisions at issue and thus contributed to the plurality of views of professional and general public.

It should be noted that bankruptcy law must prefer the restructuring proceedings. Legislation must be economically attractive, legally easy and must provide sufficient safeguards for unsecured creditors to prevent its abuse.

The authors thought also of the question how the whole area of our social reality, activity in the state, not excluding restructuring legislation, is influenced by correct or incorrect or less correct political decisions.

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<sup>5</sup> A claim can be enforced only on profit or other own resources of the debtor or the person acquiring. The amendment established a protective limitation period of ten years, starting from the ineffectiveness plan (Ďurica, 2015).

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