

INSOLVENCY OF COMPANIES WITH VIRTUAL HEADQUARTERS

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Abstract

The work focuses on the hitherto unmapped problem of registration of companies with virtual headquarters on the territory of the Czech Republic, especially on the territory of the capital city of Prague, where approximately 80% of such companies from the entire number are registered. Although registration of companies at a so-called virtual address is entirely in abidance with the Czech legal code, specifically with Civic Act No. 89/2012 Coll., which amends the institute of company headquarters in Section 136, fears dominate especially among the professional public that this institute markedly abets the functioning of grey-area economy.

The following facts could be considered the main arguments for this hypothesis:

- a) these businesses often demonstrate a lower level of organization structure transparency;
- b) seeking out and personally contacting the proprietors and statutory representatives is for the most part hindered;
- c) there are encumbrances which hinder audits by administrative bodies – especially by the tax and trades licensing office.

The above-mentioned are thus an extremely favourable climate for the unfair conduct of these organizations, which can lead to inability to repay and to their consequent insolvency.

Key words: insolvency, virtual headquarters, bankruptcy, risk

JEL Code: G30, G33, K22

Introduction

Although it is not necessarily the case that all companies and entrepreneurs which have their registered headquarters at a virtual address operate in the so-called grey area of the economy, it was found from the preliminary results of a survey of insolvency register data

that the probability of declaring the bankruptcy of a company registered at a so-called virtual address is higher than among companies registered outside of these virtual headquarters. From available statistics, however, one can also deduce significant differences among individual virtual headquarters given that it was found at one virtual address that almost 10% of registered companies have ended in bankruptcy since 2008 (Smrcka, et al., 2013).

A further significant aspect is the possibility to trace the property of these companies. From research up to the present, it stems that almost 76% of insolvency proceedings are closed without declaration of bankruptcy, especially due to lack of property in the debtor's assets. In the case of the remaining 24% of insolvency proceedings with declaration of bankruptcy, approximately one third of proceedings result in a situation where the insolvency proceedings are closed by the court for lack of property (Plaček, 2015), (Kislingerova, 2013), (Kislingerova, et al., 2014), (Smrcka, 2013). These data clearly declare that the profitability and enforceability of accrued receivables is very small and the risk of working with such entrepreneurial subjects high (Strouhal, et al., 2012).

1 Insolvency in the conditions of the Czech Republic

The problem of insolvency proceedings in the conditions of the Czech legal code is comprehensively adjusted by the act on bankruptcy and its settlement methods, otherwise known as the Insolvency Act (Ministry of Justice of the Czech Republic, 2015), (Camska, 2013). While the process of individual enforcement by means of asset forfeiture is based on the *first come – first served* principle, collective enforcement is founded on the principle of relative satisfaction of all duly registered receivables (for more see i.e. (Smrčka, 2013)). Duly registered receivables are receivables which are presented to the court in the required form and within the fixed deadline. Submissions filed after the expiry of this deadline are therefore rejected by the insolvency administrator and these creditors completely lose their entitlement to repayment of their receivables.

Probably the most important change in the new Insolvency Act was the adjustment of conditions of insolvency proceedings in the Czech Republic in the form of implementation of the possibility for natural persons – non-entrepreneurs to enter into insolvency (Čámská, 2015) (Bonaci, et al., 2012). Although the institute of debt clearance is in some cases more or less misused to halt the process of individual enforcement, the process of debt clearance – following fulfilment of precisely defined legal requirements – can once again designate

natural persons - non-entrepreneurs in bankruptcy into the economic processes of the country (Kislingerova, et al., 2013).

One of the amendments of this act, then, was the adjusted (alleviated) requirements for the entry of trading companies and firms into the process of restructuring, for this institute is viewed as an endeavour towards the preservation of the social values of a business. Restructuring as such should be approved especially with respect to the assumed impact thereof into the property of the business. The process of restructuring should, first and foremost, bring greater satisfaction for the creditors of the business; other societally positive impacts in the form of retention of employment, regional economic activity etc. can be viewed rather as secondary contributions (Camska, 2014), (Camska, 2013).

The preliminary conclusions of the research collective of the Business Economics Faculty (TACR) thus suggest that the Insolvency Act is a significant contribution to the economic environment in the Czech Republic and influences the level of transaction costs of the economy to a significant degree, for the predictability of the result of enforcing receivables enables economically active subjects to calculate the risk level as early as at the formation of economic relations, whilst the level of uncertainty is markedly eliminated in this regard (Čámská, 2015), (Smrcka, et al., 2013). Research of insolvency dossiers, among others, found that companies which are registered at so-called virtual addresses frequently appear in the insolvency register, and from the initial conclusions of the survey, which has been realized in the bounds of the research intention of IGA (IG309025) at the Strategy Department, Faculty of Business Economics at the University of Economics in Prague, it is clear that these “virtual companies” have a greater tendency towards default than companies registered outside of these virtual headquarters.

1.1 Virtual headquarters

The problem of virtual headquarters is markedly broad, and is at present a sparsely-described chapter of the functioning of the economy of the Czech Republic; this is because an entire range of factors enter therein. Besides the problem of solvency, it is also the so-called local competence from the tax perspective, escape from supervision and audit by the state administration, which indeed suits the activity of non-transparent companies. A virtual address is often provided to other entrepreneurial subjects, which for a payment and on the basis of a contractual relationship enables other entrepreneurial subjects to register the formal

headquarters of a company at a selected address (usually for the need of fulfilling the letter of Civil Code Act 89/2012 Coll.).

The new Civil Code (Act 89/2012 Coll.) remembers the problem of virtual headquarters through Regulation Section 137, para. 1, where it applies that anyone can reach the real headquarters of a corporate body. The problem of inability to contact certain corporate bodies is solved by this institute, at least from the formal perspective.

To the defence of companies with virtual addresses, it has to be added that this institute is used not only by companies which have the intention of hiding their organization and property structure to escape the supervision of a nosy official from the financial authority, or as the case may be, to complicate and hinder creditors' endeavours to contact their debtor. Virtual headquarters are often the only possibility for starting entrepreneurs to establish trading companies and are also, for instance, the solution for companies when a lessor does not enable placement of the headquarters of a corporate body in rented business premises (Barner-Rasmussen, a další, 2007). Virtual place of business also often provides at least basic services, i.e. it sorts all postal communication and serves as a place of contact for authorities and the public.

By the end of Q1/2015, the authors were safely able to identify 18 addresses which are offered as virtual headquarters on the territory of the capital city of Prague, whilst 16, 463 trading companies are registered at these addresses (Commercial Register, Ministry of Justice CR), which means that an average of 914 companies have their headquarters registered at one address.

The aim of the survey was to identify as broad of a spectrum of virtual headquarters as possible and assess the level of effectiveness in comparison with companies registered outside of these virtual headquarters.

1.2 Current effectiveness

The aim of the conducted survey was to assess the effectiveness of companies registered at virtual addresses only over the period of the effect of the Insolvency Act 182/2006 Coll., i.e. as of 1 January 2008. Insolvency proceedings commenced prior to this date do not fall under the effect of the Insolvency Act, and from a statistical perspective they cannot be included in the surveyed sample (Smrcka, et al., 2014). Values from Creditreform (Creditreform s.r.o.,

2015), which has monitored and assessed the area of insolvency in the Czech Republic over a long period (Smrcka, et al., 2014), were used for comparison of effectiveness of companies with virtual headquarters.

The **Table 1** (Creditreform s.r.o., 2015) contains statistics of filed insolvency proposals from 2008, including proposals for debt clearance of natural persons. From the overview it is univocally clear that the volume of filed insolvency proposals grew dramatically especially in the period 2010 and 2011, when the number of filed debt clearance proposals always practically doubled in comparison with the preceding year.

Table 1 - Insolvency proposals in the CR (certain filings may be repeated)

Year	Insolvency proposal total:	Companies	Consumers
2008	5,354	3,418	1,936
2009	9,492	5,255	4,237
2010	16,118	5,559	10,559
2011	24,353	6,753	17,600
2012	32,228	8,398	23,830
2013	36,909	*6,021	**30,888
2014	35,140	*3,563	**31,577

Source: Creditreform (Creditreform s.r.o., 2015)

* excluding non-entrepreneurial tradesmen

** including non-entrepreneurial tradesmen

Table 2 – Number of companies in insolvency

Number of companies in insolvency (2013)	Number of companies in insolvency (2014)	Registered companies (2013)	Registered companies (2014)	Number of insolvencies per 1,000 reg. companies (2013)	Number of insolvencies per 1,000 reg. companies (2014)
5,113	3,046	2,768,269	2,724,155	1.84	1.11

Source: Creditreform, own calculation (Creditreform s.r.o., 2015)

1.3 Effectiveness of companies with virtual headquarters

As stated above, by the end of Q1/2015, the research team identified 18 addresses about which it can safely be declared that so-called virtual headquarters of companies are at issue. 16,463 companies listed in the commercial register were registered at these addresses,

and at the same time 631 insolvency proceedings were recorded at these addresses. In a similar conversion as used by Creditreform, i.e. conversion to 1,000 registered companies, we thus gain a value from which it is clear that for every thousand registered companies there have been more than 38 insolvency proceedings since 2008.

In this regard, comparison with entrepreneurs who are registered outside of these virtual addresses is especially important. Implemented calculations show that the average number of insolvencies per 1,000 registered companies in the republic-wide average is 8.15.

This suggests that the riskiness of company bankruptcy is diametrically divergent in companies with virtual headquarters and outside of it; it can then specifically be said that the risk of insolvency is 4.7 multiples in companies with virtual headquarters.

Table 3 - Effectiveness of companies with virtual headquarters

	Number of insolvency proceedings (as at 30. 3. 2015)	Registered companies (as at 30. 3. 2015)	Number of insolvencies per 1,000 reg. companies
Companies (other)	22, 176	2, 718, 984	8.15
Companies with virtual headquarters	631	16, 463	38.32

Source: Own calculation, CSO, MJ

Conclusion

The conclusions from the survey up to the present clearly confirm the accepted hypothesis, i.e. the assumption that companies registered at a virtual address are more susceptible to insolvency. The extent to which this fact appears, however, is also a significant finding.

It stems from the survey up to the present that insolvencies occurred 4.7 times more frequently among companies with virtual headquarters than among other companies. Although this is a preliminary finding which was implemented on a relatively small sample of virtual addresses (18 out of approx. 250), the existing results indicate that this is a broad problem which creditors should monitor over the long term, for it can and for now it seems that it also does have an influence on the enforceability of receivables from commercial relationships.

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