THE NEW CZECH INSOLVENCY ACT – NEW INSOLVENCY REGIME FOR CZECH CORPORATE DEBTORS AND THEIR CREDITORS

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Published in The Butterworths Journal of International Banking and Financial Law, June 2006, (2006) JIBFL 271

After many years of trials and errors, the Czech Republic has enacted a wholesale reform of its often criticised insolvency law. The new insolvency act, promulgated in May 2006, contains a number of rather innovative solutions, in particular as regards the risk (witnessed in other jurisdictions) that the reorganization procedure, introduced by the act, could be misused to transfer wealth from senior creditors to equity and junior creditors. By putting control into the hands of creditors, the new act aims to mitigate against the country's slow and unpredictable judiciary, while trying to recognise the heterogeneous nature of creditors' claims, as well as some of the other risks related to a creditor-controlled bankruptcy process. The article reviews some of the key goals and policies of the reform.

On 9 May 2006, the new Czech Insolvency Act 182/2006 Coll. (the 'Act'), approved by the Czech Parliament earlier this spring, was promulgated in the Czech Law Gazette. When the Act takes effect on 1 July 2007, it will repeal the current Czech Bankruptcy and Composition Act of 1991.

The Act represents a wholesale reform of current Czech bankruptcy law. Lenders and borrowers, as well as other parties dealing with Czech counterparties, would be well advised to take notice of the changes in advance of the effective date. This article aims to point the reader to the more important conceptual changes in the bankruptcy regime applicable to Czech corporate debtors, introduced by the Act, with the goal to highlight some of the new opportunities as well as new risks that the Act will bring about for creditors and other counterparties.

THE NEED FOR REFORM

Current Czech bankruptcy law has for many years been the subject of critique from all quarters. Topping the list of complaints were non-transparency of the bankruptcy process, bottlenecks at the bankruptcy courts, low professional standards among the bankruptcy trustees and even allegations of corruption at bankruptcy courts and among the trustees, closely followed by insufficient creditor control over the process, violations of substantive pre-bankruptcy entitlements, general unpredictability, especially as regards the treatment of antecedent transactions, and the lack of both a viable non-liquidation route for businesses with positive going-concern value and a route to discharge for the honest but unlucky private debtor.

The Act aims to deal with all these and other problems. In response to problems arising from unsound or confused bankruptcy policy of the current law, the Act aims to offer economically efficient solutions (subject to the occasional political trade-in). In response to problems arising from unclear drafting, the Act strives to provide bright-line rules. Finally, in response to institutional weakness in the court system and among the insolvency professionals, the Act follows a mixture of policies aimed chiefly at: (i) limiting judicial decision-making on valuation and other commercial issues; (ii) encouraging creditor involvement in the proceedings, including involvement in the selection of the trustee; and (iii) introducing relatively tough regulation of the bankruptcy trustees (this is the subject of a related Act, still pending in the Parliament).

CZECH REORGANIZATION AND THE GATE IN AND OUT OF IT

In relation to corporate debtors, probably the single biggest change is that it will now be possible, subject to certain conditions, to reorganize the debtor's capital structure rather than to sell the assets of the estate. The new procedure is called reorganization (in Czech reorganizace) and although, as the name suggests, it does resemble the US Chapter 11 proceedings in some respects, it is markedly different from them in others.

To start with, a debtor must be insolvent or at least threatened by insolvency (as those terms are defined in s 3 of the Act) in order to be able to file for reorganization. Secondly, the debtor must believe in good faith that all conditions for the approval of a reorganization plan are or will be met (s 317(2)). Thirdly, and most importantly, not all debtors are automatically eligible for reorganization. Reorganization is by definition an expensive transaction – the direct transaction costs to creditors will be substantial, the direct transaction costs to the debtor will be substantial as well and, importantly, to a large extent 'fixed', ie unrelated to the value of the debtor's business or assets. Also, it is legitimate to assume, as the Act does, that 'large' businesses are more likely to have going-concern value on their own, ie independently of their owner/manager, than small businesses. It is for these reasons, and due to the Act's reluctance to entrust either the bankruptcy judges or the bankruptcy trustee's with the role of the gatekeeper, that the Act introduces in s 316 what could be called the 'critical size test' gate to reorganization. The Act pitches the critical size at either CZK 100m (approximately €3.3m) annual turnover or 100 full-time employees (s 316(4)). Debtors who meet this test will be automatically eligible for reorganization. Debtors who fail to meet the test can still reorganise – but only with the prior approval of the majority of both secured and unsecured creditors (s 316(5)). In this case, the creditors will effectively be approving a pre-packaged reorganization plan – an option that is also available to debtors automatically eligible for reorganization (s 148(2)).

Where, in respect of an automatically eligible debtor, reorganization is not pre-packaged, ie agreed and pre-approved by creditors, creditors will still be able to stop reorganization that they do not wish to take place – but only through a vote by special majorities under s 151 of the Act. Under that section, creditors may themselves decide on whether the debtor should be reorganised or whether its estate should be sold, either by (a) a vote of a simple majority of secured claims present or represented and a simple majority of unsecured claims present of represented, or (b) a vote of at least 90% of all claims present or represented.

A debtor who commences reorganization proceedings will stay under the control of its management. However, the management will always be monitored by a bankruptcy trustee (s 331). The debtor will have 120 days to submit a proposal of a reorganization plan (s 339(1)). A court may extend this limit by a maximum of another 120 days. Once a plan is proposed, it must be presented to creditors together with a disclosure statement (s 343) and will be subject to a creditors' vote. To be approved, a plan requires the approving vote of all classes of creditors (s 348(1)(c)). Each secured creditor will be in placed in a separate class, as will be the debtor's shareholders (s 337(2)). Within a class, the votes of a majority of all claims belonging in the class are required for approval (s 347(1)).

To take effect, the plan must be approved by the court (s 348). As part of the approval process, the court will be checking if the plan is in the best interest of all creditors, ie if each creditor is to receive, in terms of net present value, at least an equivalent of its share in the hypothetical liquidation value of the estate, as determined by an outside valuer (ss 348(1)(d) and 153). Importantly, the court may approve a plan over the objection of a class (s 348(2)), if the plan was approved by at least one other class (other than the class formed by equity, s 335) and if the plan respects absolute priority of claims, as expressed in s 349.

CREDITORS' RIGHTS IN THE PROCEEDINGS

Although highly visible and containing some interesting solutions, reorganization is not the only important feature of the Act. Through a number of provisions, the Act aims to strengthen creditor control over the proceedings and to protect creditor's substantive rights and non-bankruptcy priority of their claims.

As regards control over the proceedings, the chief power to decide whether the debtor should or should not be reorganised was already mentioned above. Quite importantly, the Act also gives creditors the power to recall the initial trustee (s 29), appointed at the opening of the proceedings by the bankruptcy court (s 25). Thirdly, because of the importance of valuation of collateral and other assets in reorganization proceedings that do not result in market valuation of the debtor's assets, the Act allows the creditors to choose an outside expert valuer whose valuation, when approved, will be binding (ss153 to 157), inter alia for the purposes of the various tests applied by the court when approving the reorganization plan. All these new powers could, of course, create a risk that the proceedings will be 'hijacked' by someone who wrongfully claims to be owed more than he or she actually is. The Act tries to mitigate this risk by imposing stiff penalties for filing artificially inflated proofs of claims (s 178) and also by only allowing creditors to recall the initial, court-appointed trustee after the proofs of claims have been examined and verified (s 29(1)).

The new insolvency proceedings are structured as unitary proceedings in which the decision whether or not to reorganise is made separately (as a rule on a later date) from the decision whether the debtor is insolvent or not. To protect the estate's value, the Act imposes a stay on individual creditor collection action (s 109). The stay prevents creditors from realising collateral or enforcing their claims individually. The stay comes into effect at the date of the insolvency filing (s 97). This is because the making of the filing will be made public within two hours through an electronic insolvency register (s 101); the estate will therefore require protection from a 'run' by the creditors. A petition may be filed by the debtor as well as a creditor (s 97(2)). But, given the effects of the stay, the filing creditor will face liability to the debtor and other creditors if the filing turns out to be unsubstantiated (s 147).

As regards creditors' substantive rights, the most notable change is the return from a partial priority of secured creditors' claims (which is the rule under current Czech Bankruptcy Law, limiting secured creditors' priority to 70% of the proceeds of the sale of collateral, minus costs of the keeping and the sale of the collateral) to a regime of full priority (subject to capped costs of the keeping and the sale of the collateral, and to the trustee's fee) (s 167(1) (general rule), s 298 (the rule applied to sale of the estate) and s 349(1)(the absolute priority rule applied to secured creditors). Related to this change is a new rule that the secured creditors' claims earn interest while foreclosure rights are suspended by the stay (s 171). The paradigm change in Czech insolvency law is also illustrated by the fact that the Act allows, subject to certain restrictions, insolvency set-off (s 140(2) and (3)), whereas under current Czech bankruptcy law, set-off is prohibited.

The Act also introduces new rules on avoidance of antecedent transactions, aimed at allowing avoidance of fraudulent conveyances and unlawful preferences, while not disrupting legitimate commercial dealings (s 231 to 243).

Parties to derivatives transactions will be pleased to hear that under the new Act (as well as under the current law), the Czech Republic remains a netting jurisdiction (s 366(2)).

CONCLUSION

There are many more important changes than this short piece could hope to describe. For example, and quite separately from the main thrust of this article, the Act introduces a consumer bankruptcy proceeding that will allow the debtor, subject to certain conditions, to achieve discharge of a portion of his or her unpaid debts. These provisions will clearly have an impact on lenders in the retail market as well as on others, since the Act allows access to the discharge proceedings not only to individuals, but also to non-commercial juridical persons.

Overall, the Act represents a major step ahead for the Czech bankruptcy law and for the Czech credit market. It remains to be seen how the market reacts to many of the novel solutions offered by the Act to parties affected or potentially affected by corporate insolvency.

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