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The 2013 guide to

Restructuring & Insolvency

In association with INSOL Europe

Co-published with

Andreas Neocleous & Co
bpv Braun Partners
Chiomenti Studio Legale
Futej & Partners
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INSOL International
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A supplement to International Financial Law Review IFLR

What you need to know

Arthur Braun and David Vosol of bpv Braun Partners provide a comprehensive practical guide to insolvency in the Czech Republic

Foreign investors may be affected by Czech insolvency laws in many different ways: as secured creditors, unsecured creditors, business partners, shareholders or, last but not least, potential buyers of real estate. They must be aware of the fact that Czech insolvency laws were completely re-codified in a new Insolvency Code (Act no. 182/2006 Coll.) which has been in effect since 2008. In its short existence, the Code has already had to cope with the financial crisis as a significant stress test of the new legislation. First experiences with the law have led to several amendments.

Bankruptcy and its resolution

Bankruptcy as defined by the Insolvency Code may have two key forms: insolvency and over-indebtedness (which applies only to legal entities or individual entrepreneurs). The test for insolvency is:

(i) the existence of multiple creditors;

(ii) outstanding financial liabilities more than 30 days overdue; and

(iii) the inability to satisfy such obligations, which may be shown by

- the debtor's suspension of a substantial portion of its payment obligations,
- outstanding financial liabilities which are more than three months overdue, or
- the satisfaction of any outstanding financial receivables against the debtor being unable to be made simply by the enforcement of a decision or execution against property.

The over-indebtedness test requires the existence of multiple creditors and looks at whether the sum of all liabilities exceeds the value of the debtor's assets. For this test, the continuing operation of business is taken into account if there is a justified presumption that the debtor will be able to continue operation of his business and so trade through his financial difficulties.

A third cause of bankruptcy – impending bankruptcy – may only be applied for by the debtor. Such cause would be given if it can reasonably be assumed that the debtor will not be able to duly and timely fulfil a substantial portion of the debtor's financial liabilities.

There are several methods of resolution. The first is reorganisation, which corresponds to US Chapter 11 protection. Here, an early start to bankruptcy proceedings in the case of impending bankruptcy has particular importance. The debtor, and creditors who wish to avoid liquidation, may apply for reorganisation, usually combined with an application for a protection period (moratorium). If they get court approval, they have 120 days to prepare a reorganisation plan, which again has to be submitted to the court for approval. The debtor must either have more than 100 employees, a turnover of CZK100 million ($5.3 million) or obtain approval from the majority of both its secured and unsecured creditors.

The number of successful reorganisations is still quite small: very often they turn into insolvent liquidation, which is still by far the prevailing method and basically provides for the sale of the debtor's assets.

> "The number of successful reorganisations is still quite small"

Filing for insolvency

Once the criteria for insolvency described above have been fulfilled, the managing director or a member of the board of directors (in the case of a company), the liquidator, or a natural person who is an entrepreneur is responsible for filing an application for insolvency without undue delay. Members of the supervisory board, *prokurista* or other managers in an employment relationship with the indebted entity do not have such obligation.

The resignation of managing directors occurs quite often in such critical situations, but this does not entirely protect them. If they held their position one year before the opening of insolvency proceedings, they are prevented from taking a similar position in another company for the duration of the proceedings and three years thereafter – unless the shareholders' meeting of the new company decides otherwise with a qualified majority, having been made aware of the former position.

The application must be well-prepared as the obligation to file for insolvency is not fulfilled if the proceedings have been discontinued or the application has been dismissed due to the applicant's fault. After the application is filed and proceedings have been opened, special attention must be given by the management when performing any acts that might lead to diminishing the value of assets outside the normal course of business.

Late filing is not a criminal offence, but any delay may lead to civil liability.

If the application is filed by employees for their wages or salaries, as an exception to all other applicants they do not have to pay the deposit for the costs of proceedings.

Once the application is filed, the court has 15 days to decide whether or not to declare insolvency (in practice it usually takes longer).

> "The fact that an application for insolvency must be published immediately results in many applications being filed frivolously"

Fraudulent or frivolous applications

In the past 20 years, filing a petition for insolvency against a business partner who refuses to pay has often proven to be more efficient than enforcing a claim in tedious civil litigation. Nevertheless, the fact that an application for insolvency must be registered immediately, without any investigation of the merits of the alleged claim, results in many applications being filed frivolously. Such applications effectively blackmail the company concerned. The publication of an application for bankruptcy proceedings usually leads to a complete loss of trust and credibility by business partners, suppliers and other creditors, and will likely result in the termination of contracts or exclusion from public tenders. The courts have recently been given the right to refuse an application filed by a creditor for obvious lack of cause; nevertheless, the damage has often already been done and the penalty of CZK50,000 for a frivolous or vexatious application is payable to the state – only a small consolation to an honest businessman.

Early attempts to claim damages against such blackmailers were not successful. Now, a deposit of CZK100,000 must be paid to the insolvency court at the time of the creditor's application in order to cover such possible damage. In more serious cases, such deposit is of course rather symbolic; however it does amount to a certain deterrent against such creditors pursuing their claims against their business partners through insolvency, particularly when the claim is small.

Online insolvency register

Czech civil procedure is known for its widespread use of electronic communication. Every Czech company has an electronic data box into which court decisions and official correspondence may be delivered – for instance, a court letter giving notice

About the author

Arthur Braun studied law and political science at the University in Passau and at Charles University in Prague (where he was the first Western law student after the revolution). He has worked with international law firms (Gleiss, Noerr, Haarmann Hemmelrath) in Prague since 1994. Since 2006 he has been the managing partner of bpv Braun Partners, part of bpv LEGAL, with a focus on the entire CEE region.

His main practice area is corporate law and M&A, including a triple-digit number of cross-border transactions for international clients. His expertise includes purchases of distressed assets in several countries. From these transactions comes his deep expertise in the restructuring, antitrust and labour law aspects of such transactions.

Braun is author of various publications (including the country section for Insol on employee entitlements in insolvency, 2005) and he is often invited as a speaker at professional seminars and conferences. He is country rapporteur for the IBA Antitrust Committee. Since 1999, he has been lecturing at HAW Weiden/Amberg, and since 2001 at IPFM (FIBAA accredited MBA-programme). He speaks German, English, Czech, French and Italian.

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of a filed application for insolvency against the debtor and giving him a short period (usually 15 days) to provide a list of assets and liabilities.

Not only does the online commercial register (www.justice.cz) contain some information on insolvency proceedings against registered entrepreneurs, but a special insolvency register exists (https://isir.justice.cz/isir/common/index.do) in which the notice of insolvency and also the entire insolvency proceedings including claims filed by creditors, are registered. Any petition for the opening of insolvency proceedings is to be entered in the register within two hours following the delivery thereof to the court. The register is administered in Czech only. Decisions made by insolvency courts are deemed to be effective upon publication in the electronic register.

Effects of ruling on bankruptcy

The court will look first to see whether the debtor's assets and the deposit are sufficient to cover the costs of proceedings, and if not the court will refuse the application due to lack of assets and the company will be deleted from the commercial register.

Once bankruptcy has been declared, an insolvency trustee (who may have already been appointed before as a preliminary trustee or administrator) will be appointed. There are certain requirements as to who a trustee can be, and an insurance policy is also required. So far, the Czech Republic has not seen any large specialised insolvency firms springing up. The trustee is usually a local lawyer who is quite often unskilled in handling international transactions. Creditors may replace the trustee with another at the first creditors' meeting. Voting rights at such meetings are proportionate to the amounts of the claims of creditors.

The trustee, and any creditor, may investigate suspicious transactions effected before insolvency. They may reject acts and contracts up to five years back if there was an obvious intent to harm creditors. Due to the costs involved, actions taken in foreign countries are less likely than cases when a Czech decision can be enforced.

As opposed to other countries, acts performed before the insolvency are much less scrutinised under criminal law, even though various acts performed before and during insolvency proceedings are subject to the provisions of the Criminal Code.

Filing a claim

Registration of claims with the insolvency court is a task that should not be underestimated by the creditor and is one that requires an individual who speaks Czech and has an experience with such registrations. Claims must be filed in the court along with sufficient evidence on a special form in Czech. All registrations must be denominated in CZK and are immediately visible in the electronic register.

Whereas the claims may be filed any time after the insolvency proceedings has been opened, the first surprise for many creditors is the effect of the term to file these claims. For Czech and non-EU creditors, the term comes to an end within 30 days (on rare occasions within 60 days) in the decision on bankruptcy of the debtor and there is no possibility of any later filing. Due to this very strict sanction, it is worth checking the insolvency register or using special software operated by many law firms and commercial providers announcing any changes in the insolvency register.

Should the trustee reject a claim, an action must be filed with the court. The competent court is always the insolvency court, even if the original contract stipulates another jurisdiction. The court fee (CZK1,000) for such an action is modest and the insolvency court usually does not take too long to decide. Any settlement in such disputes requires the approval by the creditors committee,

Under certain circumstances, such as warranty cases, it is possible and recommended to file a conditional claim.

Great prudence must be taken when filing a claim as the Czech insolvency law applies unique sanctions for exaggerated claims. Should the claim not be asserted in later proceedings, or be found to have been filed by at least 50% more the actual amount due but the creditor has voted at the creditors' meetings for the full amount, the creditor will not only lose the entire claim but also be obliged to pay the difference between the claim as finally determined and the original amount of the filed claim as penalty. Moreover, the person signing the claim registration document (unless a lawyer acting under a power-of-attorney) is personally liable for such penalty.

There is no possibility under the Insolvency Act to register claims later than the standard 30 days granted in the court decision on insolvency, unless it is for creditors from other EU member states. Known creditors from other EU member states must be informed by the court, without undue delay, of the commencement of proceedings provided the existence of the creditor was known to the court and only then their term for registration of claims begins to run.

About the author

David Vosol was admitted to the bar in the Czech Republic in 2004 and to the bar in the Slovak Republic in 2007. He studied law at Charles University in Prague and at the Ruprecht-Karl-University in Heidelberg, Germany. He also studied economics and holds an MBA degree from the IPFM in Prague (university programme of Charlotte and Göttingen universities accredited by FIBAA). He has been a partner of bpv Braun Partners since 2006.

His main practice area is banking and finance law, company restructuring and M&A, but he also advises on energy law and litigation. He is often involved in solving complex legal issues within project financing transactions, and restructuring of companies, where he can employ his legal expertise as well as his understanding of the business environment and its needs.

Vosol has been lecturing at the IPFM since 2006 and at the Charles University in Prague, and is author of various professional articles and publications. He speaks Czech, German, English and Russian.

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Upon declaration of bankruptcy, set-offs are possible only to a very limited extent.

Secured creditors, property and employees

Secured creditors do not have to, but are well advised to, register their claims if they also wish to have any say in insolvency proceedings. The new act removed the former rules stipulating that such creditors were to receive only 70% of the proceeds of sale of the registered property of the estate, and they will now receive at least 91%. Nevertheless, they should not rely too much on the opinion that the trustee will discover their rights, in particular if the debtor, in the usually chaotic time before the insolvency, manipulated its bookkeeping and contractual documentation.

Liquidation proceeds are used first for settlement of claims against the property of the estate as well as the costs of administration of the property of the estate. The state does not have any priority rights; however, the state is usually quite fast in establishing pledges on the property of the indebted estate before the insolvency begins and thus obtains the advantage of having the position of a secured creditor.

For the insolvency trustee, selling the property of the estate as an enterprise (meaning including employees and their contractual relations, assets, contracts) is the preferred method for the sale of property of the estate as he will only sign one contract and save considerable additional work and expense. Persons connected with the debtor must not obtain any of these assets from the estate within three years from the end of the bankruptcy proceedings.

Any sale of an enterprise will require approval of both the court and the creditors' committee, often mere formalities and much influenced by the trustee.

Any such enterprise will be debt-free and free of encumbrances. Another great advantage compared to a standard purchase is that it is possible to acquire property from a non-owner; on the other hand, the trustee will not give any representations and warranties in the contract.

Employees' salary claims are guaranteed by the state for three months. In addition, employees have the right to hand in notice with immediate effect, should their wages be more than 15 days late, giving them a claim for severance payment of up to three months' salary.

Effects of insolvency of a foreign shareholder

The Czech Commercial Code has quite undesirable consequences in the event of the insolvency of a shareholder in a limited liability company (s.r.o.), the most common legal entity in business. Upon declaration of insolvency on the shareholder, the participation in a Czech limited liability company ends (unless it is the only shareholder) and the trustee of the shareholder only has a claim for the settlement payment. Such payment might or might not correspond to the actual value of the share, as a rule being calculated according to the equity in the company. The payment is due within six months after the declaration of insolvency.

> "The law may have been modernised but the people applying it remain the same"

This consequence is worsened by the prohibition of the so-called chaining in Czech limited liability companies, meaning that a Czech s.r.o must not have as a shareholder another (even if foreign) limited liability company. This often leads to a 99%:1% constellation. If the majority shareholder falls into bankruptcy, the s.r.o. is usually unable to satisfy the claim for settlement, which leads to a secondary insolvency of the Czech company.

It is highly recommended to keep this effect in mind in the case of financial difficulties of a shareholder, even if it is domiciled in another country.

Very often, the foreign parent company is also in insolvency. The courts have already heard the first cases of cross-border insolvencies where an EU-parent company is a party to insolvency proceedings under its national law and such proceedings also cover Czech subsidiaries under the EU regulation 1346/2000.

Be prepared

Foreign creditors must be aware of several significant differences to other international insolvency laws and practices: the term for registration of claims is very short and final. Exaggerated claims must be avoided. Proceedings require much stronger creditors' involvement than in other jurisdictions. They are fast but not always as transparent as the idea of the online insolvency register seems to convey.

The practice of insolvency proceedings in the Czech Republic is the greatest difference experienced by many foreigners. The law may have been modernised but the people applying it remain the same, even if the administrators now have to pass a competence test. Quite often, non-Czech creditors will find out that other creditors, frontmen of the debtor, the trustee and the court, seem to have made a deal already, or that they simply failed to react in time and their receivable is simply lost.

Good preparation, local presence and a fighting spirit is still advisable, particularly if someone intends to buy property from an estate. Nevertheless, the first five years of the new Insolvency Act have brought more improvement to the Czech business environment than the prior 17 years of post-communist insolvency law, in particular by speeding up proceedings to an average duration of something between one and two years.