

MEMORANDUM ON NEW CZECH INSOLVENCY LAW

On July 1, 2007 the new Czech Insolvency Act (the “Act”) will take effect.

We would like to take this opportunity to introduce you to the most important changes under the new Act which may be relevant to your business activities in the Czech Republic.

1 INITIATION OF INSOLVENCY PROCEEDINGS

Similarly, as under the current legislation, a debtor is insolvent if it is unable to pay its debts as they fall due (*in Czech: v platební neschopnosti*), or (ii) it is over-indebted (i.e. its liabilities exceed its assets) (*in Czech: předlužen*).

What is new is:

- threatening insolvency (*in Czech: hrozící úpadek*). A debtor will now be insolvent even if there are only reasonable expectations that it will be unable to pay the majority part of its debts as they fall due
- over-indebtedness. In this case, all of the debtor’s debts will be taken into account, irrespective of whether they are already due or not. In contrast, only due debts are relevant under the present legislation.

2 LEGAL EFFECTS OF INITIATION OF INSOLVENCY PROCEEDINGS

Under the current legislation, a debtor becomes bankrupt upon the relevant court’s decision on the declaration of bankruptcy. (This decision is not published until later). Under the new Act, a different procedure applies:

- The insolvency proceedings commence upon the filing of a petition;
- The filing of the petition is immediately recorded in the newly established Insolvency Register;
- The entry in the Insolvency Register has similar effects to the declaration of bankruptcy under the current legislation.

3 DECISION ON INSOLVENCY AND INSOLVENCY PROCEEDINGS TYPE

There will now be two separate court decisions in insolvency cases:

- (i) **Declaration of Insolvency:** This must be issued within 15 days from the filing of the petition (whether filed by a creditor or by the debtor itself).
- (ii) **Decision on insolvency proceedings type** (see section 4 below)

4 TYPES OF BANKRUPTCY SETTLEMENT

Under the new Act insolvency can be dealt with in one of the following ways:

(i) **Bankruptcy** (*In Czech: Konkurs*)

Similarly as under the current system, the debtor's assets are sold and its business liquidated. Creditor's claims are then settled proportionately using the proceeds from the sale of the assets.

(ii) **Restructuring**

This is an entirely new type of insolvency proceedings under which the debtor's business is preserved and operated under a restructuring plan supervised by creditors. The creditors' claims are then satisfied based on the approved plan using the proceeds from the business operations. Unless specifically agreed between the debtor and the creditors, restructuring is only available for debtors whose last annual turnover was at least CZK 100,000,000, or which have at least 100 employees.

(iii) **Debt clearance** (*In Czech: Oddlužení*)

This is only available to debtors which are not entrepreneurs. Debt clearance means that all of the debtor's unsatisfied claims will be extinguished.

As a rule, the court must decide on the type of insolvency proceedings within 3 months from the decision on insolvency.

The type of insolvency proceedings may also be selected by the creditors at their first meeting. This decision will be binding on the court.

5 SET-OFF AGAINST BANKRUPTCY ESTATE

The new Act:

- allows for the set-off of a creditor's claims against a debtor's counter claim even after the insolvency declaration. This is not possible under the current legislation.

The creditor and the bankrupt debtor may set off their claims if:

- the creditor pays into the bankruptcy estate the amount, if any, by which the debtors claim exceeds the creditor's claim;
- at the time of acquiring the claim, the creditor was not aware of the debtor's insolvency;
- the creditor has registered its claim in the insolvency proceedings and the insolvency administrator has recognised it.

The set-off will therefore only be legally effective if the insolvency administrator does not reject the creditor's claim.

6 SECURED CREDITORS

Under the current legislation, secured creditors are only entitled to 70% of the net proceeds of the assets serving as security (The remainder is distributed among all unsecured creditors *pro rata*).

Under the new Act:

- a secured creditor will be entitled to 100% of the net proceeds of the sale of the relevant assets, the costs and expenses of the sale are capped at 9% of the sale proceeds;
- only if the net proceeds exceed 100% of the secured claims will such excess be available to the unsecured creditors.

7 PENALTIES FOR WRONGLY REGISTERED CLAIMS

If a creditor's claim is registered in the insolvency proceedings and then disputed, and the court finds that the creditor's actual claim amounts to less than 50% of the registered claim, then:

- Such creditor will lose the right to have its claim satisfied in the insolvency proceedings and
- Such creditor will have to pay the difference between the actual and registered amount of the claim into the bankruptcy estate, and
- If the creditor's claim is secured, it will lose the right to have the claim satisfied from the sale of the debtor's assets serving as security.

Moreover, the above payment obligation will be guaranteed by operation of law by the person(s) who signed the creditor's claim application, i.e. in general, the statutory body of the creditor.

The penalty for wrongly registered claim will not apply if the creditor does not exercise its creditor's rights during the proceedings related to its claim, and particularly, if it does not vote during creditors' meetings.

8 ADAPTING CURRENT CONTRACTUAL DOCUMENTATION

As discussed above, the Act will lead to the separation of the court's decision on insolvency from its decision on the type of insolvency proceedings.

This may affect the termination provisions in your business contracts. We would therefore recommend that you review your contracts and other relevant instruments to identify whether the current provisions related to insolvency and bankruptcy are flexible enough to cover the new concepts under the Act, or technical amendments are needed to avoid ambiguity and potential disputes. In particular, you should ensure that any termination provisions remain applicable in case of:

- (i) the initiation of insolvency proceedings over the other party, or
- (ii) a decision on the declaration of such party's insolvency (even if not yet effective).

Should you have any questions regarding the above, or require a more detailed analysis of the new Insolvency Act and its effects on your business, please, do not hesitate to contact us.

Prague, June 13, 2006

JUDr. Dana Schweigelová / JUDr. Martin Dančíšin