

# NEW CZECH INSOLVENCY LAW ON ITS WAY

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On 1 July 2007 the new Czech Insolvency Act (the 'Act') will take effect. The Act implements new principles that aim, among others, to increase the powers and rights of creditors, especially secured ones, and make insolvency proceedings in the Czech Republic more transparent and effective. The Act will have a considerable impact on the financial and banking sectors, allowing many financial institutions to reassess their lending policies.

## KEY POINTS

The new Czech insolvency legislation will:

- materially increase the rights of secured creditors;
- introduce a new Insolvency Register; and
- introduce new insolvency remedies.

## DEFINING INSOLVENCY

In line with current legislation, the Act defines a debtor as insolvent if it cannot settle its debts when they fall due, or it is over-indebted (ie its liabilities exceed its assets).

In an important change, the Act now stipulates that a debtor will also be found insolvent in certain threatened insolvency situations, ie if there are reasonable expectations that it won't be able to duly settle most of its debts once they mature.

## LEGAL EFFECTS OF STARTING INSOLVENCY PROCEEDINGS; NEW INSOLVENCY REGISTER

At present, a debtor becomes bankrupt only after the court issues its decision declaring the debtor's bankruptcy. This decision isn't published until some time later and many creditors encounter problems when searching for reliable and up-to-date information about declared bankruptcies. The Czech Ministry of Justice currently operates a publicly accessible bankruptcy database, but this is not definitive.

The system will change under the new Act. Insolvency proceedings will start formally as soon as the insolvency petition is filed, and this filing will be recorded straight away in the new Insolvency Register. Entry in the Insolvency Register will have a similar legal effect to a bankruptcy declaration under current laws. In practice, this will give creditors easy access to an up-to-date list of commenced insolvency proceedings.

## INSOLVENCY DECISIONS AND SOLUTIONS

Under the new Act, courts will issue two separate decisions in insolvency cases:

**Insolvency Declaration** to be issued within 15 days after a petition is filed (by either a creditor or the debtor itself).

**Decision on type of insolvency solution** to be issued within three months from the decision on insolvency declaration, which will impose one of the following insolvency solutions:

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

As under the current system, the debtor's assets will be sold and its business liquidated. Its creditors' claims

will then be settled proportionately from the proceeds of the assets sale.

- **Restructuring**

This new insolvency solution will ensure the preservation of the debtor's business to be operated under a restructuring plan supervised by creditors. The creditors' claims will then be met from the proceeds from the business operations based on the approved plan. Unless specifically agreed between the debtor and its creditors, restructuring is only available if the debtor's last annual turnover was at least CZK100m or it has at least 100 employees.

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

All unfulfilled claims against the debtor will be extinguished. This solution is only available to debtors which are not entrepreneurs.

Creditors may also decide on the type of insolvency solution for the debtor at their first meeting. Their decision will be binding on the court.

## SET-OFF AGAINST BANKRUPTCY ESTATE

Significantly, the Act introduces the possibility of setting off a creditor's claims against the debtor's counter-claims even after insolvency has been declared. No such set-offs are possible under the current legislation.

These set-offs will be allowed if:

- the creditor pays the bankruptcy estate the amount, if any, by which its claim falls short of the debtor's counter-claim;
- the creditor did not know about the debtor's insolvency when it acquired its claim against the debtor; and
- the creditor's claim has been registered in the insolvency proceedings, and it was recognised by the insolvency administrator.

## SECURED CREDITORS

The Act also substantially improves the position of secured creditors in bankruptcy situations.

Under the current legislation, secured creditors are only entitled to 70 per cent of the net proceeds of the sale of the debtor's relevant assets serving as security. The remainder is distributed *pro rata* among all of the debtor's unsecured creditors. This fact obviously increases the need for financial institutions to demand additional security for their loans.

Under the new law, secured creditors will be entitled to 100 per cent of the net proceeds of the sale of the relevant asset(s). Sale costs and expenses are jointly capped at 9 per cent of

these proceeds. Unsecured creditors may then only settle their claims from the net proceeds of the sale of a collateral asset if these proceeds exceed 100 per cent of the claims secured by that asset.

In another major change, secured creditors will have special rights over the secured assets even during the bankruptcy proceedings. The administrator will be bound by the creditors' instructions about the management and administration of the relevant asset(s) and also the execution (ie sale) of the asset(s).

Furthermore, secured creditors' claims may be satisfied at any time during the bankruptcy proceedings, ie even before the final decision on the termination of proceedings and the distribution of the remaining bankruptcy proceeds.

### PENALTIES FOR REGISTERING UNFOUNDED CLAIMS

The Act now imposes penalties on creditors if they register unfounded claims in the insolvency proceedings.

If, after a creditor's claim has been registered in the proceedings and contested, the court finds that the actual claim amounted to less than 50 per cent of the registered claim, the creditor (even a secured one) will not be entitled to satisfy such claim. Further, this creditor will have to pay

the bankruptcy estate the difference between the actual and registered amounts of the claim.

The penalties for registering an unfounded claim will not apply if the creditor does not exercise its rights during the proceedings related to its claim, and particularly, if it does not vote at creditors' meetings.

### FINAL REMARKS

The new Act is a major step forward in Czech insolvency legislation, and it should lead to positive changes in insolvency proceedings. Nevertheless, like many new laws, it fails to address all of the issues facing the jurisdiction, and it offers no clear answers to various practical questions that may arise during its application. The new Act is also certain to pose a challenge for Czech insolvency judges and courts during the changeover from the longstanding current regime.

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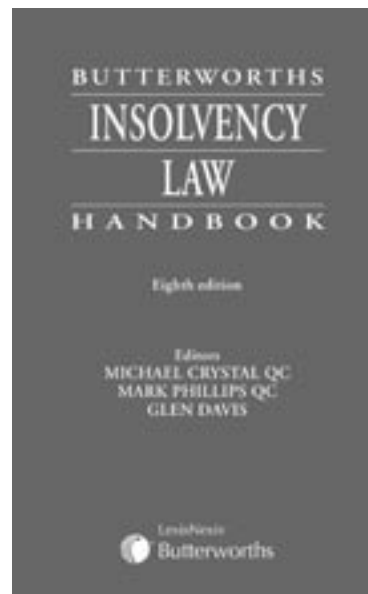
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