

# The New Insolvency Legislation in the Czech Republic

On April 14, 2006, President Václav Klaus of the Czech Republic signed a new bankruptcy reform act into law. The new Czech Insolvency Act (the “New Insolvency Act”) will become effective July 1, 2007. The adoption was the culmination of several years of continuous and intense legislative initiatives aimed at instituting modern legal regulations for the treatment of debtors in financial trouble and eliminating certain shortcomings of the current insolvency legislation.

## Need for Modern Insolvency Legislation

During the period beginning in 1950 when the country was veiled behind the Iron Curtain and ending in 1991 when the Bankruptcy and Composition Act of 1991 was enacted (the “Old Bankruptcy Act”), the Czech Republic had no insolvency law. In the fifteen years following its enactment in 1991, the Old Bankruptcy Act was amended more than twenty times. Essentially all of the amendments to the Old Bankruptcy Act strengthened creditors’ rights, yet universally recognized shortcomings in the Czech system remained, resulting in poor recoveries for creditors.

The New Insolvency Act makes sweeping changes to insolvency proceedings for both businesses and individuals. The New Insolvency Act is designed to, among other things, shorten insolvency proceedings, make these proceedings more transparent, provide a more influential or stronger position to creditors and render the entire insolvency process more efficient. To accomplish these goals, the New Insolvency Act has been given a more extensive structure, the terms it uses have been made more exact, deadlines have been implemented, and a number of crucial decisions have been passed directly to creditors.

## Changes Under the New Insolvency Act

### Threshold Test of “Insolvency”

Under the Old Bankruptcy Act, every natural person considered as an entrepreneur in the sense of the Czech Commercial Code or any legal entity was eligible to submit a proposal declaring bankruptcy if the entrepreneur or legal entity was considered “insolvent” based on having two or more creditors *and* the inability to repay debts as they fell due. Alternatively, the entrepreneur or legal entity could demonstrate “insolvency” if the sum of the debtor’s debts exceeded the value of the debtor’s assets. The tests under the New Insolvency Act are similar, although they have been relaxed to some extent. Under the New Insolvency Act, the nonpayment test is met if there is a *reasonable expectation* that the debtor will be unable to pay the *majority* of its debts as they come due. With regard to the balance sheet test, the New Insolvency Act compares the value of the debtor’s assets to *all* of the debtor’s debts, and not merely the *past due* debts, as was the case under the Old Bankruptcy Act, to measure over-indebtedness.

### Types of Proceedings

Under the New Insolvency Act, there are three types of bankruptcy proceedings, two of which did not exist under the Old Bankruptcy Act:

- **Bankruptcy.** In this type of proceeding, the debtor’s assets and business are liquidated; creditor’s claims are settled proportionately using the proceeds of the liquidation. This type of proceeding also existed under the Old Bankruptcy Act.
- **Restructuring.** In this type of proceeding, the debtor’s business is preserved and operated under a restructuring plan supervised by creditors.

The creditors' claims are satisfied based on an approved plan using the proceeds from the debtor's operations. Once the obligations of the debtor as set forth in the plan are fulfilled and the aims of the reorganization plan achieved, the bankruptcy proceedings are terminated and the debtor's enterprise can continue with its ordinary activities as it did before the reorganization. Unless agreed between the debtor and its creditors (both secured and unsecured), a restructuring is only available for entrepreneurs whose annual gross revenue was at least CZK 100,000,000 (about \$4,500,000) or which has at least 100 employees.<sup>1</sup>

- **Debt Clearance.** In this type of proceeding, an eligible debtor is able to propose a payment to creditors of less than 100 percent and that portion of the debtor's debts that is unsatisfied is extinguished. Debt clearance proceedings are only available to debtors with no more than 50 creditors and which are either natural persons or businesses with less than CZK 2,000,000 (about \$90,000) in gross revenues in the last fiscal or calendar year. In a debt clearance, the debtor applies to the court for approval to use a debt clearance proceeding and presents to the court an estimate of its total income for the next five years and a statement of its total income for the past three years. It also discloses its proposed payout to creditors either by way of a prompt sale of the debtor's property and lump sum payment to creditors, or over time with a series of installment payments. If the projected payout to creditors as proposed by the debtor is less than 30 percent of the debts owed, the debtor must obtain the consent of its unsecured creditors before the proposed debt clearance is approved by the court. Once a debtor obtains the consent of its unsecured creditors, the insolvency court must still determine whether or not the debtor

should be permitted to settle its debts by debt clearance. This is a discretionary test applied by the insolvency court with no established criteria.

The New Insolvency Act provides that the creditors may select the type of proceeding at their first meeting, and that this determination is binding on the Court. Alternatively, the Court may determine the type of insolvency proceeding within three months after a Declaration of Insolvency is issued.<sup>2</sup>

### Access to Collateral

Under the Old Bankruptcy Act, a secured creditor was entitled to 70 percent of the net proceeds of the assets serving as security for the debts owed to such secured creditor, and the remaining 30 percent was made available for distribution among the unsecured creditors pro-rata. Under the New Insolvency Act, secured claims are entitled to payment in full from the proceeds of the sale of the collateral for such claims. Only if the net proceeds from the sale exceed 100 percent of the secured claims will any proceeds be available to unsecured creditors.

### Increased Role of Unsecured Creditors

One of the frequent criticisms of the Old Bankruptcy Act was the fact that creditors had little influence on bankruptcy proceedings. This fact, coupled with the very low recovery rate for unsecured creditors (on average, only 1 – 4% of the face value of claims registered), resulted in little participation by creditors. Although secured creditors typically played a slightly more active role, in general, the whole bankruptcy process was primarily under the control of the bankruptcy judge and the bankruptcy administrator.

Under the New Insolvency Act, unsecured creditors are given a stronger position and more powers than they had under the Old Bankruptcy Act. For example, now it will be the creditors that determine

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1 Although the Old Insolvency Act had a procedure known as "composition," which is similar to a reorganization, this procedure was virtually unused and debtors' financial difficulties were almost exclusively solved through bankruptcy proceedings, which always led to the liquidation of the debtor.

2 A Declaration of Insolvency is issued within 15 days from the filing of the petition, which may be filed by the debtor or a creditor. Under the Old Bankruptcy Act, a debtor became bankrupt only after the court granted the declaration of bankruptcy. The New Bankruptcy Act changes this procedure and provides that an entity is a "debtor" once (i) the entity or a creditor files a petition, and (ii) the petition is recorded in the Insolvency Register established by the New Bankruptcy Act.

in a reorganization or debt clearance procedure how the bankruptcy of a particular debtor should be resolved. The new law also provides creditors with a host of procedural tools that give them more control over the actions of the bankruptcy administrator, including the power to remove and replace the bankruptcy administrator at practically at any time if creditors are dissatisfied with the performance of the bankruptcy administrator. These changes likely will induce greater creditor participation in insolvency proceedings than was the case under the Old Bankruptcy Act.

### **Claims**

Like the Old Bankruptcy Act, the New Bankruptcy Act provides that, once an insolvency proceeding is commenced, creditors must register their claims within a time-limit set by the court. The court then delivers copies of the claims to the bankruptcy administrator, who prepares a list of admitted and disputed claims. The New Bankruptcy Act changes the process of liquidating disputed claims. Specifically, if a creditor's claim is disputed, and the court finds that the creditor's actual claim was less than 50 percent of the registered claim, then the creditor (i) loses the right to have its claim satisfied; (ii) must pay the difference between the actual and registered amounts of the claim into the bankruptcy estate; and (iii) for secured claims, loses the right to have the claim satisfied from the sale of the collateral. In addition, the foregoing payment is deemed guaranteed by operation of law by the person(s) who signed the creditor's claim.<sup>3</sup>

One change under the New Insolvency Act is that creditors may set-off their claims against a debtor's counterclaims even after a Declaration of

Insolvency is issued. A creditor may setoff a claim if: (i) the creditor pays into the bankruptcy estate the amount, if any, by which the debtor's claim exceeds the creditor's claim; (ii) at the time of acquiring the claim, the creditor was not aware of the debtor's insolvency; and (iii) the creditor registered its claim in the insolvency proceeding and the claim was recognized by the bankruptcy administrator.

### **Other Modifications**

The final sections of the New Insolvency Act are dedicated to special bankruptcy proceedings for banks, savings banks, insurance companies and credit cooperatives.

Notably, cross-border insolvencies within the European Union are directly regulated by Council Regulation (EC) No. 1346/2000 on insolvency proceedings. All of the EU laws and regulations, including the insolvency regulation, became binding on the Czech Republic when it joined the EU on May 1, 2004. The New Insolvency Act, however, does not contain any cross-border insolvency provisions. Accordingly, the omission of such provisions results in uncertainty with cross-border insolvencies in relation to countries that are not members of the EU.

### **Conclusion**

It will take some time before the legal and business communities become accustomed to the New Insolvency Act and are able to utilize its advantages for the benefit of all parties involved. Nevertheless, it is a positive development that a new and modern insolvency law was finally adopted in the Czech Republic.

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<sup>3</sup> These penalties may not apply if the creditor does not exercise its rights during the proceedings relating to the claim and if the creditor does not vote during creditors' meetings.