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How safe is the avoidance safe harbour in Czech insolvency law?

In a recent case, the Czech Supreme Court had the first opportunity to define the contours of the "contemporaneous exchange of adequate value" safe harbour applicable in avoidance cases under the Insolvency Act 182/2006.

The court drew the boundaries very narrowly. In conjunction with earlier case law on disqualification of lenders from participation in creditor committees, the judgment means that creditors of Czech debtors in financial difficulties should think long and hard before they decide to take new security and not to extend new loans at the same time.

In 2008, Czech insolvency law abandoned the rigid six-month hardening period that had applied under previous law in favour of a more nuanced approach towards security interests created on the onset of insolvency.

Under current rules, security interests created by a debtor over an estate's assets can be avoided if they were created within one year prior to the commencement of insolvency proceedings and if the debtor either was insolvent when the security interest was granted or became insolvent as a result (a longer claw-back period and tougher tests apply to intra-group transactions). The above applies to both undervalues and to preferences, but a security interest would typically be characterised as the latter.

In a recently decided case, the Supreme Court reviewed the grant of a security under the rule applicable to avoidable preferences. The facts of the case were familiar: approximately 10 months prior to the commencement of insolvency proceedings, a chargor had created a security interest over its movable and immovable assets, securing the debts of another debtor to which the chargor had acceded on the same date. The chargor's insolvency trustee brought an action to avoid the charges as avoidable preferences.

In the avoidance proceedings, the chargee bank pleaded a number of defences, including the fact that, in consideration of the grant of the security, it had decided not to enforce the debt, impose contractual sanctions or pursue other collection rights that would have led to the dismemberment of the chargor's business. In the bank's view, this forbearance amounted to a "contemporaneous exchange of adequate value", which constitutes a safe harbour from avoidance of preferences under Section 241(5)(a) of the Insolvency Act.

The Supreme Court dealt with this quickly and unequivocally. It held that the extension of maturity of the secured debt, non-imposition of contractual sanctions for default, non-collection on promissory notes issued by way of security and, in general, non-foreclosure on the debtor's business, do not constitute "contemporaneous exchange of adequate value" under Section 241(5)(a) of the Insolvency Act.

The Supreme Court did not say more to explain its view and did not indicate what might constitute a qualifying "contemporaneous exchange of adequate value". Under present circumstances, however, it should be assumed that creditors will find it difficult to use the safe harbour under Section 241(5)(a) unless they actually extend new credit to the chargor.

This should be combined with the lessons learnt from previous High Court case law. For instance, two Czech lenders were disqualified from creditor committees based on allegations that they took additional security at a time when the debtor was, in the court's opinion, insolvent or very close to insolvency (the insolvency proceedings were *Palcor Czech* and *Oděvní podnik*). Although the circumstances in which those decisions were handed down were highly controversial, they remind us of the perils of taking security from a financially distressed debtor without extending new loans in exchange.

The new Supreme Court decision, read together with the previous disqualification cases, should make lenders of Czech borrowers think twice before they take security in the circumstances described above. It may well be that the game has changed from "when in doubt, go ahead and take whatever security you can" to "when in doubt, do not".

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