Changes to the Czech Insolvency Act: Implications for Corporate Insolvencies

On 1 July 2017, a set of amendments to the Czech Insolvency Act will come into force, which will have important implications for Czech corporate debtors and their creditors. This client publication highlights the most significant of these changes.

Key features

- The Amendments will impact on ongoing proceedings.
- New voting prohibitions will affect creditors connected with the debtor or with other creditors.
- Debtors will be able to prove they are not insolvent by submitting a liquidity gap report.
- Creditors' insolvency petitions will be subject to court scrutiny prior to their publication.
- Creditors filing for insolvency will have to substantiate their claims by providing one of four prescribed forms of evidence.

Intertemporal regime

As has become customary with changes to Czech insolvency law, the amendments introduced by Act 64/2017 (the "Amendments") will also affect proceedings commenced and underway as of 1 July 2017, with the caveat that any steps taken in proceedings prior to that date will remain unaffected. One should therefore be alert to the changes brought in by the Amendments even where proceedings have been ongoing for some time, as these changes could yet impact on aspects or procedural situations that will only arise later in proceedings.

New voting prohibitions

One such instance concerns creditors' meetings held after 1 July 2017, to which entirely new rules on creditors' voting rights will apply. While the law as it currently stands does not grant many actual opportunities for disqualifying voting rights pertaining to claims admitted in proceedings, the Amendments will take a wholly different tack by introducing sweeping prohibitions on voting in two key sets of circumstances. Firstly, creditors will generally be prohibited from voting where the creditor is connected with the debtor. Secondly, creditors will be prohibited from voting on transactions or matters involving the creditor or another creditor connected with him or her. Unfortunately, the Amendments use rather ambiguous terms to establish what constitutes a "connection", the result being that it may be difficult to predict which creditors will be found to be connected with whom. In addition, the Amendments also grant discretionary power to the insolvency courts in narrowly defined circumstances, both to prohibit voting even where there is no explicit statutory prohibition on voting, and to allow voting even where a specific prohibition would otherwise apply.

The practical upshot of these changes is that while some abusive or fraudulent conduct might indeed be prevented, there is likely to be a protracted period of time after 1 July 2017 before a consistent judicial approach to the application of the new rules develops. This uncertainty will be exacerbated by the fact that decisions on voting rights are normally exempt from appellate review and may only be appealed in limited circumstances – essentially only when another appealable decision by the insolvency court hinges upon such first decision on voting rights.

The cash-flow test of insolvency

The Amendments will introduce an entirely new method of assessing the debtor's insolvency under the cash-flow test. Currently, the law defines a debtor as insolvent under the cash-flow test if the debtor has more than one creditor, owes debts which are more than 30 days overdue and is unable to pay those debts. The law also establishes certain rebuttable presumptions concerning the *debtor's inability to pay debts*, including where the debtor is more than 3 months late on his or her payable debts, where an attachment levied against the debtor has not led to the attaching creditor's claim having been satisfied, or where the debtor has failed to submit the requisite schedules of assets and liabilities.

The Amendments will introduce a rebuttable presumption that *the debtor is able to pay debts* if the debtor can prove that the difference between the amount of his or her liquid assets and his or her due and payable debts (the "liquidity gap") is not greater than 10 per cent of the debtor's due and payable debts, or that any gap greater than this will fall below 10 per cent within a prescribed time period. The debtor will only be able to prove that such circumstances exist by submitting a report drawn up by an authorized person, typically an auditor or sworn expert, to the insolvency court within two weeks of insolvency proceedings having commenced. Further details of these reports are to be set out in a regulation yet to be issued by the Ministry of Justice. The current draft of this regulation envisages that reports will normally have to be drawn up based on figures current as at the end of the month preceding the month in which the insolvency petition was filed. The draft regulation also foresees that for a debtor to rebut insolvency, it will normally have to be proven that the liquidity gap will fall below 10 per cent within a period of eight weeks. Narrow exceptions are proposed for both of those time limits.

Readers familiar with German insolvency law and practice will recognise that inspiration has been drawn from German auditing standard IDW S 11, which has indeed been used as a point of reference in the legislative process. Unlike in Germany, however, where analysis of the liquidity gap is mainly used to establish whether management may lawfully attempt an out-of-court workout without running the risk of incurring civil and criminal liability for violating the strictly formulated and enforced duty to file for insolvency, the liquidity gap reports set out in the Amendments are much more likely to be used to thwart creditors' insolvency petitions. And whilst honest debtors will certainly welcome the new tool as far as fraudulent or otherwise doubtful petitions are concerned, there will unfortunately be room for abuse by dishonest debtors facing entirely legitimate creditors' petitions. One must hope that instances of the former will greatly outnumber those of the latter.

Creditors' insolvency petitions

Although the total number of fraudulent insolvency petitions filed by dishonest creditors may be marginal,

these have indeed given rise to some serious concerns in individual, highly publicised cases. The chief reason why unscrupulous persons may resort to fraudulent petitions is that all petitions, whether filed by a debtor or a creditor (or indeed someone who falsely claims to be a creditor), are promptly published in the online insolvency register, triggering an automatic moratorium. Although the moratorium mostly affects the collection rights of creditors, it also restricts the debtor's ability to freely deal with his or her estate. Even more importantly, and since the insolvency register is open to the public, even groundless petitions will become a matter of public record and may cause a PR nuisance to the debtor.

The Amendments follow a gradual trend in successive changes to the law whereby insolvency courts have been equipped with increased powers with which to deal with groundless petitions. Under the Amendments, the insolvency courts will have to promptly review each creditor's petition and take a preliminary view as to whether or not the petition is legitimate and should thus be published in the insolvency register. If the court takes a negative view, it will issue a decision on the "non-publication" of the petition (which will be exempt from appellate review), after which it will have seven days in which to review the petition in detail and, if it decides that it is manifestly groundless, summarily reject the petition. This process, and that of any appeal filed by the creditor against a rejection order, will be kept entirely out of the insolvency register, and therefore out of the public eye. As the result, the automatic moratorium will not be triggered at all, except perhaps as the result of the creditor prevailing on appeal. Clearly, while this new process may well serve to protect honest debtors against frivolous petitions, it may also act as a double-edged sword. One must hope that the majority of rejected creditors' petitions will indeed be those filed by frivolous and fraudulent, rather than by diligent and legitimate, creditors.

In addition to granting judicial discretion on the publication of creditors' petitions, the Amendments also bring in other restrictions on creditors' petitions. Firstly, an advance of CZK 50,000 (approx. EUR 1,900) will automatically be payable each time a creditor files a petition against a corporate debtor. Secondly, any creditor filing an insolvency petition will have to prove that he or she has a claim against the debtor by submitting one of four prescribed forms of evidence:
(a) written acknowledgment of the debt by the debtor, bearing the officially certified signature of the debtor, (b) an enforceable judgment, (c) a notarial or executor's protocol in which the debtor has acknowledged the debt and agreed that it shall be directly enforceable against him or her, or (d) a certificate issued by an auditor, sworn expert or tax adviser verifying that the claim is duly registered in the creditor's accounts.

Finally, the power of the insolvency courts to fine creditors who have filed a groundless petition has been increased ten-fold under the Amendments, and fines of up to CZK 500,000 (approx. EUR 19,000) may be imposed. Moreover, if a creditor's petition is rejected as groundless, the creditor filing the petition will be automatically disqualified from filing any new petition against the same debtor for a subsequent six-month period.

Further changes

The Amendments will also bring in a host of other changes as regards both the finer details of the rules briefly described above and a number of other points.

Of importance to foreign creditors, for instance, is the stipulation that non-EU creditors who have acquired their claims via assignment during insolvency proceedings or within six months prior to the commencement of proceedings will have to disclose their ultimate beneficial owners on pains of forfeiting their voting rights. The insolvency courts will also have the power, subject to requirements of reciprocity, to order such foreign creditors to pay a bond against any potential damages which they may cause by participating in proceedings. These rules clearly aim to curb abusive practices whereby local fraudsters sometimes attempt to hide behind SPVs incorporated in offshore havens which are very difficult to bring to account.

The Amendments will also alleviate certain risks faced by secured creditors in instances where a secured claim only arises after insolvency proceedings have commenced. Recent (and highly controversial) case-law of the Supreme Court suggested that such security interests are at risk of being unenforceable in insolvency despite them having been duly perfected prior to proceedings having been opened. This should no longer be a concern once the Amendments have come into force.

A number of additional rules will also be changed or brought in as a result of the Amendments. Parties dealing with Czech debtors should acquaint themselves with these in detail as many of them may impact on their legal position.

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