Czech Republic:
Ground-breaking Czech Supreme Court decision on balance-sheet insolvency

The definition of insolvency is a key element of the insolvency law. It opens the gate for tools that enable creditors to safeguard their rights vis-à-vis their debtors. On 19 August 2019, the Czech Supreme Court published a ground-breaking decision which addresses a crucial aspect of balance-sheet insolvency. Many other issues, however, still remain unresolved.

Definition of insolvency

As in other jurisdictions, the Czech Insolvency Act anticipates two forms of insolvency: cash-flow insolvency (illiquidity test) and balance-sheet insolvency (over-indebtedness).

Cash-flow insolvency, in short, occurs when a debtor has multiple creditors with *past due* claims for more than 30 days which the debtor is unable to satisfy with his (liquid) assets. On the other hand, an over-indebted debtor also has multiple creditors, but concurrently the sum of his liabilities exceeds the value of all of his assets. An important factor taken into consideration is the debtor's potential future development and whether the debtor may reasonably be expected to continue managing his assets or conducting business.

Whereas the former test is overwhelmingly used, the latter form of insolvency has been successfully availed of only exceptionally, the main reason presumably being the information asymmetry between creditors and debtors regarding the existence of all assets and payables and uncertainty about the valuation of the debtor's assets.

Supreme Court decision

It has been unclear whether the definition of balance-sheet insolvency requires the existence of two creditors with past due claims. As it follows from the text above, unlike the definition of cash-flow insolvency, the provision on over-indebtedness does not contemplate two creditors with matured receivables; it simply requires the plurality of creditors without specifying further conditions regarding the maturity of their claims.

However, a provision on dismissal of an insolvency petition in another part of the Insolvency Act states that in case of a creditor's insolvency petition, the insolvency court shall dismiss the petition if it is not ascertained that another creditor has a matured claim.

In the case considered by the Supreme Court, the debtor had several matured claims. In order to avoid insolvency proceedings, it allegedly deliberately agreed upon the prolongation of its claims with some of its creditors, while repaying all the remaining creditors with the exception of the claim of the insolvency petitioner. On the basis of the above-mentioned rule, the High Court in Prague as an appellate court ruled that both forms of insolvency (illiquidity and over-indebtedness) require establishing the existence of at least two creditors with *past due* claims. Consequently, the court dismissed the insolvency petition with the reasoning that the insolvency petitioner failed to establish the existence of another creditor with a matured claim.

Upon an extraordinary appeal, the Supreme Court rightly reversed the High Court of Prague decision and ruled that in order to establish balance-sheet insolvency, it suffices that the petitioner has one past due claim so that all other claims do not necessarily have to be mature. The Supreme Court, in effect, concluded that the provision on dismissal of an insolvency petition related solely to cash-flow insolvency and not to balance-sheet insolvency.

Other issues unresolved

Although one can praise the Supreme Court decision at hand, several issues are still unresolved. One major question relates to the valuation of businesses and its determination. To my best knowledge there is not a single decision which thoroughly addresses over-indebtedness in detail. In the light of a potential slowdown in the economy, this does not bring any certainty to the respective playing field. ■

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PETR SPRINZ
Partner, Havel & Partners s.r.o.
Prague, Czech Republic