Czech Preventive Restructuring – Some key implementation choices

Tomáš Richter goes through some of the key choices made for the implementation of the EU Directive

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The Czech Republic has chosen to introduce a restructuring framework outside current insolvency law, also the choice of some other Member States

Following a delay of over a year, the Czech Law on Preventive Restructuring has implemented the EU Restructuring Directive 2019/1023 into domestic law.[1] This article explains some of the key choices made for the implementation process.

Interplay of implementing legislation with existing law

By implementing the Directive via a self-standing Law on Preventive Restructuring, the Czech Republic has chosen to introduce a restructuring framework outside current insolvency law, also the choice of some other Member States. However, existing Czech insolvency law has not been comprehensively revised in response to the new law. This is a questionable choice since the existing Insolvency Act already provides for a reorganization option, in which the debtor (subject to a size threshold) remains in possession and is protected by an automatic stay while proposing a plan, which in practice takes an average 12 months from commencement.

Recourse to this option has not been restricted in any way by the adoption of the new law, which means that some debtors are likely to explore the successive use of both options. In the extreme, given the upper limit on duration of restructuring stays of 12 months, this could mean a distressed debtor spending around two years in possession of its estate and shielded from both individual debt enforcement and collective enforcement through liquidation. The risks of this implementation are plain to see and it will be interesting to observe how the courts will address these.

Eligible debtors

All corporate debtors will be eligible to use the preventive restructuring framework, unless excepted under Article 1(2) of the Directive. Thus, the framework will not be available to individual debtors, nor will creditors have standing to initiate the process.

In order to be able to use the new framework, the corporate debtor will have to be in a state of financial distress, defined by reference to a "bandwidth of distress". As a threshold, the debtor must be in a state in which its financial difficulties would, upon a comprehensive assessment, lead to its insolvency unless restructuring measures are implemented. All this sounds rather vague and the vagueness is amplified by the fact that the new law provides for no particular timeframe over which the "likelihood of insolvency" is tested.

The upper end of the "bandwidth" is pegged at cash-flow insolvency, reasonably well defined in the Insolvency Act, and beyond which the framework is not available. Within the "bandwidth", the restructuring framework will be available to all corporate debtors who remain sufficiently liquid throughout the restructuring attempt to pay operational and financial costs of the restructuring process.

Restructuring protections

Consistent with the Directive, the new law offers the restructuring debtor two protective tools – the general stay and the individual stay, both requiring a court order.

General Stay

In order to apply for the general stay, the debtor must formally commence the restructuring by sending out a "rehabilitation project", a sort of restructuring plan "light", defining a number of key parameters of the proposed restructuring, including, in particular, affected parties and rights, as well as any non-affected parties. In addition to mandatory disclosures in the project, an application also requires the debtor to file a statement of the liquidity gap (as defined for the purposes of the Insolvency Act's definition of cash-flow insolvency) to demonstrate that the debtor is within the eligible "bandwidth of distress" and, in particular, that it is not cash-flow insolvent.

A successful application will lead to a general stay (i.e., against all creditors or such classes of creditors as defined in the petition) for an initial period of 3 months, unless the application is for less time. Subject to, *inter alia*, the consent of the majority of claim-holders affected, the court can extend the stay by a further three months. A majority of affected claims can also achieve the lifting of the general stay. Once in place, a stay will protect the debtor (and potentially also any affiliates to whom the order extends) against enforcement actions by all creditors, including by way of insolvency petitions, and also

against discontinuation of essential executory contracts.

Individual Stay

An individual stay will offer similar protection in scope, but only against individually specified creditors (limited to three in number). An individual stay may be applied for and ordered before restructuring is commenced (and therefore before the mandatory information is available). However, in such cases, the debtor must commence restructuring within 30 days subject to losing the benefit of the stay.

Restructuring measures and affected rights

The restructuring plan may contain just about every measure imaginable on the left-hand and right-hand sides of the balance sheet, as well as in its operations. In line with the Directive, employee claims are immune from impact, as are several other rights, including, in particular, "contested rights". For these purposes, the new law provides for an accelerated claims-review process by the restructuring trustee of what are claimed to be "contested rights". Controversially, the new law explicitly assumes that restructuring may affect not only monetary claims, but non-monetary rights as well. This is a choice likely to bring surprises. Moreover, the new law is unclear on the line between "old" and "new" claims, insofar as susceptibility to the effect of a restructuring is concerned.

Drafting and adopting the restructuring plan

The debtor must present the plan within six months of restructuring commencing. The new law does not provide for creditor committees or other means to facilitate or finance the negotiation process, which is likely to prove unhelpful, particularly in cases where the creditor portfolio is dispersed. Once presented, the plan will be put to a vote taking place at a creditors' meeting or via postal ballot. Unlike in insolvency proceedings, the debtor, not the court, organises the plan meeting, though its outcomes are certified by a notary public or the restructuring trustee.

Voting takes place in classes of affected parties as defined by the plan. Within a class, a 75% majority of claims (and not by number) is needed for approval. The plan will need to structure separate classes, *inter alia*, for each secured creditor, connected parties and for shareholders. Nevertheless, a plan aiming to alter share capital or effect other changes requiring shareholder approval under the law or articles will also require a vote at a shareholders' meeting, thus giving a relevant minority of shareholders a *de facto* veto. This is not only a retrograde development compared to the Insolvency Act which, since 2008, has allowed reorganization plans to change share capital of corporate debtors without a shareholders' meeting, but a questionable implementation choice in light of the Directive's Article 12 requiring Member States to ensure shareholders do not unreasonably block preventive restructurings.

The best interest test and the priority rule in cross-class cram-down

A restructuring plan requires court confirmation, if not all the affected parties voted for it. Among the checks a court will undertake is compliance with the best interest test, which the new law formulates as the test of whether a dissenting affected party would be better off if the insolvency was resolved in formal proceedings. However, the debtor can shift any controversy over the best interest test into separate litigation outside the plan confirmation process, provided the debtor deposits a sufficient cash reserve with the restructuring trustee for the purposes of compensating any dissenting affected parties invoking the test, subject to the total amount of such claims being under 20% of the total amount of affected claims.

For the purposes of cramming the plan down on a dissenting class, the new law applies a strict absolute priority rule to dissenting secured creditor classes (subject to bifurcation of claims based on the assessed value of their collateral) and what could be called a "modified absolute priority rule" to dissenting unsecured creditor classes. Under the latter rule, the new law will allow shareholders to keep their interests in the company provided that:

(a) no creditor class junior to the dissenting unsecured class receives or retains any value under the plan;
(b) the dissenting class will receive in cash at least as much under the plan as it would receive in insolvency proceedings;
(c) the shares are entrusted to the restructuring trustee;
(d) independent directors and auditors are appointed and retained throughout the period of plan performance; and
(e) the debtor pays dissenting creditors all of its profits for a period of 5 years or up to the full amount of their claims.

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Procedural matters

Restructuring cases will be dealt with by eight regional courts, i.e. the same ones dealing with insolvency, and restructuring trustees will be appointed from among specially licensed insolvency trustees. Despite the intention to maintain restructuring files via an electronic restructuring register, the government has failed to put the register in place, resulting in a rather unsatisfactory makeshift solution. This is all the more disappointing, given that the Czech Republic was one of the first Member States to launch a fully electronic online insolvency register in 2008. ■

Footnote:

1 Czech Law no. 284/2023 (in force as of 23 September 2023).