

# The Czech Insolvency Act, 2.0

Tomáš Richter, who was consulted by the Czech government on the Insolvency Act in its original version as well as on its recent amendments, reports on the recent changes

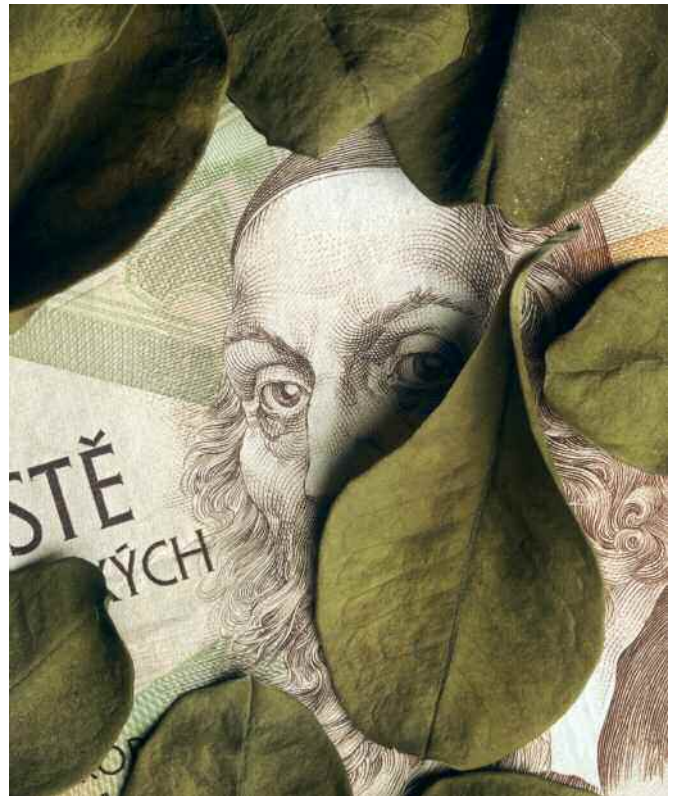


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**I**n a major revision of the Czech Insolvency Act, the Czech Parliament introduced a set of amendments aimed at codifying the lessons learned from the Act's five-year history. The changes came into force on 1 January 2014 and took the Czech insolvency code one step closer to a functioning framework of formal market exit. But support of informal processes is still lacking, as is a reliable conduct of the formal proceedings from the part of the judiciary and other institutions.

Prior to the fall of the Berlin Wall, English lawyers used to quip that they would rather be prosecuted under Soviet law applied by an English judge than under English law applied by a Soviet judge. The joke brings home the important insight that no matter how good, the law in the books only gets you so far. If the institutions applying the law are weak, you might not get very far at all.

The Czech Republic has now got to a stage where its insolvency law in the books scores quite well on most tests usually applied to national laws, be it the *UNCITRAL Legislative Guide on Insolvency Law* or the various World Bank indices. In the WB *Doing Business* database, the country now scores 29th in the "Resolving Insolvency" chart, which is the country's highest score among all the criteria surveyed and ranked (see <http://www.doingbusiness.org/data/exploreeconomies/czech-republic/#resolving-insolvency>). Among the new EU member



states, only Cyprus ranks higher in "Resolving Insolvency", and several old member states rank substantially lower.

Arguably, this ranking is well deserved.

## Consumer insolvencies

As amended by Act 294/2013, the Czech Insolvency Act now offers a debt discharge procedure to both consumers and self-employed individuals. In spite of high threshold criteria (required payback to unsecured creditors has been - and remains even under the 2013 amendments at 30%), the proceedings are frequently used by consumers overwhelmed by debt (there were

approximately 23 consumer filings per 10,000 inhabitants in 2012). The 2013 amendments also made the proceedings available to self-employed individuals and it will be interesting to see whether that option turns out to be helpful. The 2013 amendments also brought about new procedural solutions for joint insolvency cases of spouses, an issue that the original version of the law neglected and that caused courts to resort to makeshift solutions.

Consumer cases now make up the vast majority of the insolvency docket and are a strain on the insolvency courts. The 2013 amendments introduced several procedural simplifications,

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but they retained the role of the insolvency trustee throughout the entire five-year process. This adds to the costs of the proceedings (debtors need to pay the trustee's fee) but maintains oversight of the debtors' conduct.

### Business insolvencies

Business insolvencies continue to show large numbers of impecunious proceedings. According to some empirical studies, these may account for up to 75% of all business cases. Based on data provided by the Ministry of Justice in connection with the 2013 amendments, there were only about 350 liquidation cases among the several thousand business cases commenced and closed in the first four and a half years of the Insolvency Act being in force, that resulted in any distribution to creditors at all. Over the same period, some 70 reorganisation attempts were allowed to proceed, suggesting that the reorganisation option introduced by the original version of the Act provides a viable, if not predominant, alternative to business debtors entering formal proceedings as going-concerns.

In the original version of the Insolvency Act, the use of the reorganisation proceedings was subject to a size test on the part of the debtor; the results of which could be changed by creditor decision-making. Although this concept has been retained, the size test has been halved to a minimum of CZK 50 million in annual sales, or 50 employees. It remains to be seen whether the 50% reduction in the size test will lead to a corresponding increase in the use of the proceedings. The fact that among the debtors who have made use of the reorganisation option some 20% already did not meet the size test (i.e. they were able to attempt reorganisation only because their creditors agreed to them doing so) suggests that the reduction in the size test might not produce a one-to-one effect – although this remains to be seen in practice. Further changes concerning reorganisation relate to the powers

to deal with the estate (a reduction in the shareholders' power to decide on the identity of management of the debtor-in-possession, as well as a better definition of the management's duties), with creditor voting rights (a debtor's challenge to a creditor's proof of claim will not affect the voting rights relating to the claim) or with the introduction of a time limit by which appellate courts must decide appeals against approved reorganisation plans.

In business liquidations, the rights of secured creditors have been boosted as the result of the 2013 amendments clarifying their powers to decide on the sale of collateral as exclusive powers, compared to some pre-amendment case law under which the creditors' committee was held to share that power.

As regards the governance of proceedings, the 2013 amendments provide for the appointment of insolvency trustees based on a system of rotation which, however, takes account of trustee specialisation. The amendments also enhance the creditors' power to replace the trustee appointed initially by the court by lowering the requisite voting majority. The rules on trustee fees were amended, making the success-based scale applicable in liquidation steeper than before, creating more brackets of the monthly fixed fees applicable in reorganisation by reference to the debtor's sales, and introducing separate remuneration for the claims verification agenda. Creditors' committees will continue to be composed of both unsecured and secured creditors, however, some rules on the election and removal of members, as well as on the assumption of the committee's powers by the creditor's meeting, have been clarified.

Proceedings should become more transparent as the result of new procedural rules governing communication between the court and the parties taking part in the proceedings. New and more expedient rules have been introduced governing the impact of insolvency proceedings on

pending bilateral suits, as well as adversary proceedings unresolved by the time the main proceedings close. The largely defective rules on executory contracts (probably the single biggest blunder in the original version of the Insolvency Act), were replaced by amended rules, by and large following international best practice.

### New and remaining difficulties

In spite of the many improvements, difficulties remain.

Ill-conceived rules allowing procedural measures adopted in criminal proceedings to intrude upon the status of the insolvency estate and the ranking of creditors remain in place. A newly created priority of claims for the return of VAT paid on debts proved in the proceedings might skew creditors' incentives and force debtors into liquidation even if commercially, they might have been able to reorganise. The law provides no support to informal restructuring agreements reached by a majority - but not all - of the creditors (a proposal has been shelved in 2012). But most of all, the system and its various players keep showing a disturbing propensity towards "non-standard behaviour" in large business insolvency cases, where the stakes are high and valuable assets change hands. As one observer commented recently, like in other markets, there are shady spots in the local insolvency market, and at times they can get very, very dark.

This last issue, however, cannot be solved through legislative drafting. The jury is still out on the extent to which societies can control these problems other than via internalised self-restraint, a trait that in plain English can also be called "being civilised". ■



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