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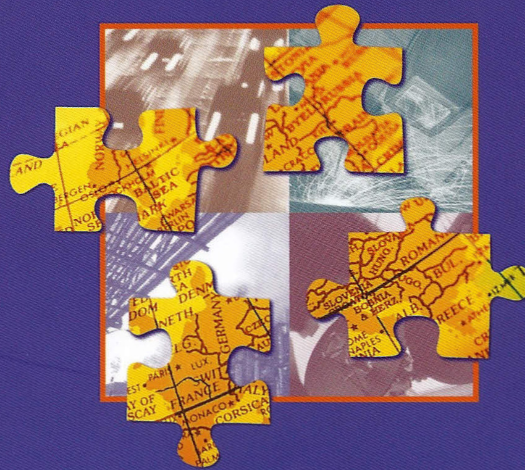
The European Restructuring and Insolvency Guide 2002/2003

(incorporating central and eastern Europe and the CIS)



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The Czech Republic

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Country overview and commercial context

The Czech Bankruptcy and Composition Act (the 'Act') provides for either the rescue of the debtor through voluntary or involuntary composition, or distribution of the proceeds from the sale of the debtor's assets among its creditors through bankruptcy. By far the most commonly used procedure is court administered bankruptcy. Other formal procedures – voluntary and involuntary composition – are used very rarely, accounting for less than 1 per cent of formal proceedings. However, given the proposals put forward by the new act, which are discussed below, the use of such procedures can be expected to increase.

On the other hand, legal practitioners have developed certain out-of-court restructuring procedures that focus on the rescue of companies and include procedures such as debt to equity swaps, mergers and settlement agreements with some creditors. These procedures are subject to the consent of the debtor, its shareholders and the creditors and are not managed or supervised by the court.

The official version of the law is published in Czech only, but unofficial translations of certain acts (such as the Act) are also available in English.

The main problem of Czech insolvency law is that creditors cannot effectively influence the process. Also the position of secured creditors is uncertain, because the percentage of their secured debt that they are entitled to recover on an enforcement is not fixed. Secured creditors are entitled to receive up to 70 per cent of the proceeds from the sale of the related security, but the proceeds can also be used to cover the costs of the bankruptcy proceedings. In practice it is also often the case that a debtor manages to dispose of its property (or a significant part of it) before the bankruptcy procedure starts.

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The Ministry of Justice and the government decided not to continue the practice of making frequent minor amendments to the Act (so far the Act has been

amended 17 times). Instead, they are now preparing a completely new draft of the Act. The new act will be discussed by the legislative bodies in the near future, provided that the parliamentary elections coming up in June 2002 do not change that.

The new act will be based on U.S. and German bankruptcy legislation, but it will not completely abandon the principles of the current Act.

The new act will provide for three formal ways of dealing with a bankruptcy situation namely:

- bankruptcy – focusing on the recovery of value from the debtor's assets;

- composition – providing for the rescue of the debtor and the partial satisfaction of debts owed to creditors; and

- restructuring – a currently unknown procedure in Czech bankruptcy law, which will focus on the rescue of the debtor and the repayment of debts owed to creditors over time from the proceeds of the debtor's business, which the creditors will control.

The new act will make it possible for creditors to force the debtor into bankruptcy where relevant tests are satisfied, thus preventing the debtor from disposing of its assets before the bankruptcy process commences. It will also motivate the debtor to declare bankruptcy earlier and will allow secured creditors to receive up to 100 per cent repayment of their secured claims. Related and potentially important events include the proposed introduction of legislative acts defining a more general concept of charges and pledges and out-of-court forced auctions of collateral.

Specific areas

1 The legal framework and the effectiveness of court processes/legal remedies

1.1 What are the nature and effectiveness of the following:

(a) Debt recovery remedies where the creditor has no security?

To recover its claim, a creditor can proceed either via the court or through arbitration. Arbitration is possible only if all parties consent and the debtor has not been declared bankrupt.

Recovery of the claim from a debtor in business

The court procedure is rather time consuming and, including the appeal procedure, may take from six months to two years. To speed up the process, creditors usually ask the court to issue a payment order. A payment order is issued without a court hearing and may thus be issued within a month, but it only becomes final and binding if the debtor does not appeal. The debtor normally does appeal. If it does, normal litigation follows.

If the debtor does not pay a debt even after final judgement is issued a creditor can enforce the judgement/payment order via the court or a private executor. The enforcement procedure may take from three months to one year.

Recovery of a claim from a bankrupted debtor

If the debtor has been declared bankrupt, its creditors may only recover their claims via the bankruptcy procedure. Creditors must file their claims with the bankruptcy court within the time limit prescribed by the court (usually 30 days, but never longer than three months). If creditors do not file their claims within

two months of the revision meeting (see below), their claim extinguishes.

The value and ranking of all claims filed by the creditors may be contested by the bankruptcy administrator, or by any other creditor during a revision meeting, which the court orders after the end of the period for filing claims. The first revision meeting is usually ordered within two months of declaring the debtor bankrupt.

The court must decide on whether to accept or refuse contested claims. Uncontested claims and claims accepted by the court are satisfied from the proceeds of sale of the debtor's assets as described in section 7.2 below.

(b) The enforcement of security?

Enforcement of security – general

Enforcement of security is possible on the basis of a final and binding court/arbitral/or other state or municipal authority ruling against the debtor, or an agreement with the debtor in the form of a notarial deed, in which the debtor consents to the enforcement of security. This agreement can be concluded before the maturity of the claim.

The enforcement of security can be carried out via court or public auction. Enforcement via a public auction is not legally possible in certain cases (eg for a sale of securities). When possible, it is recommended to proceed via public auction, as it is quicker.

Enforcement of security when a debtor is in bankruptcy

The enforcement of security during a bankruptcy is only possible via the bankruptcy court. The secured creditors' claims will be satisfied from the proceeds of sale of the security, and the creditor receives up to 70 per cent of the value of the proceeds.

(c) Corporate bankruptcy/liquidation processes that are available to corporate debtors and creditors?

The company can be liquidated either:

(i) by a shareholder resolution to liquidate the company (voluntary liquidation), if the company's assets are more than its liabilities, or

(ii) as a result of bankruptcy.

Voluntary liquidation

If shareholders voluntarily decide to liquidate a company, the company enters into liquidation as of the date of the shareholders' resolution. The liquidation must be registered in the Commercial Register and the company must use the suffix 'in liquidation' (*v likvidaci*) in its name so that third parties are sufficiently informed.

Depending on the legal form of the company, the liquidator is appointed by either the shareholders or a statutory body of the company. The court will appoint the liquidator, only if the company's bodies do not appoint one, or if the liquidation is ordered by the court. Once appointed, the liquidator is entitled to act on behalf of the company in relation to its liquidation. The main difference between this and bankruptcy, is that the company has sufficient assets to repay its debts in full.

During liquidation, the liquidator must close out the company's transactions and settle its debts. The liquidator must therefore announce the liquidation's commencement to all known creditors and invite them to file their claims with the company. The law does not prescribe the method of sale of the company's assets in a liquidation. It is therefore at the liquidator's discretion whether the sale will be organised as a public auction or by a direct sale. However, the liquidator is personally liable if he acts in breach of his duty to act with due care.

Upon payment of all the company's debts, the company's books are closed, the company is deleted from the Commercial Register and it is extinguished.

Bankruptcy

If the company is insolvent, and no remedies can be expected, bankruptcy follows. A company is legally insolvent when it is unable to pay debts owed to more than one creditor for a length of time (in practice at least three months). The Act also provides for a balance sheet insolvency test, (ie the company is insolvent when liabilities to more than one creditor exceed its assets). Both the company itself and its creditors may file for bankruptcy.

On the day the court orders bankruptcy, it posts the bankruptcy order on the court's official notice board and publishes it in the Commercial Bulletin (an official gazette providing certain information on Czech commercial entities). As of that day the debtor is considered bankrupt and the following consequences occur:

(a) the rights of the debtor to dispose of its property pass to the bankruptcy administrator and any legal transactions undertaken by the debtor in relation to its property become ineffective against its creditors;

(b) all amounts owed by the debtor to its creditors become due; and

(c) any security over the debtor's property created in the two months prior to the declaration of bankruptcy becomes void, as do any powers of attorney granted by the debtor prior to the bankruptcy order.

The bankruptcy order includes the appointment of a bankruptcy administrator and an invitation to creditors to file their claims. After the revision meeting (referred to above) the bankruptcy administrator proceeds with the sale of the debtor's assets. The debtor's assets can be sold either as a whole enterprise or as individual assets and either via public auction or in a sale supervised by the court and creditors.

(d) Formal corporate rescue processes?

The Act provides for two types of corporate rescue process: voluntary and involuntary composition. Neither practice has been broadly accepted.

Voluntary composition

A debtor may propose a voluntary composition to satisfy its debts before a bankruptcy order is issued. The debtor must present a plan, which provides for 100 per cent satisfaction of the priority claims, satisfaction of secured creditors' claims, as in a bankruptcy (see 7.2 below), and a minimum of 30 per cent satisfaction of unsecured creditors' claims within two years of filing the petition for voluntary composition. Unless the creditors agree otherwise, they must all be satisfied proportionally to the amounts and ranking of their claims.

The court may accept the proposal for voluntary composition provided that it is agreed upon by creditors with claims representing 75 per cent of the value of all claims held by creditors with voting rights (secured creditors have limited voting rights – see Section 7.4 below). If the court accepts the proposal, creditors are not allowed to file for bankruptcy or to enforce their non-priority claims. The debtor's compliance with the terms of the composition will extinguish any unsettled part of claims against the debtor.

Involuntary composition

After the bankruptcy order is issued, a debtor may also file a petition for an involuntary composition. In the petition, the debtor must present a plan which provides for the same satisfaction of claims as in a voluntary composition (see above) except that at least 15 per cent of unsecured creditors' claims must be

satisfied within one year of the filing. The rights of secured creditors must not be affected.

The court may accept the proposal for involuntary composition provided that it is approved by creditors with claims that amount to 75 per cent of the value of all claims held by creditors with voting rights (again secured creditors have limited voting rights – see Section 7.4 below). If the court accepts the proposal, the bankruptcy order is cancelled. The debtor's compliance with all the terms of the composition will constitute a full satisfaction of the claims against it.

(e) Informal corporate rescue processes?

These have been developed by legal practitioners as a reaction to the fact that the effectiveness of formal procedures is limited. Standard processes of corporate law are used to restructure companies, eg debt to equity swaps, additional contributions to company's equity, mergers and settlement agreements with creditors (for more detail see section 3 below).

1.2 What are the formal processes to effect a liquidation of the company's assets?

Please see 1.1 (c) above.

1.3 What is the effect on debt collection and the enforcement of security of:

(a) An adjudication of corporate bankruptcy/ liquidation?

Debt collection or security enforcement is interrupted by operation of law. Claims against the debtor must be registered with the bankruptcy court or the liquidator, otherwise they cannot be enforced or settled.

(b) The commencement of a formal corporate rescue process?

Commencing a formal rescue procedure gives rise to a moratorium on executions by secured and unsecured creditors. Claims against the debtor must be registered with the court managing the composition, otherwise they cannot be enforced or settled.

(c) The initiation of an informal corporate rescue process?

The initiation of an informal corporate rescue process has no effect.

1.4 Are insolvency procedures started in another jurisdiction in respect of a corporation incorporated in your jurisdiction recognised?

Czech courts will only recognise a foreign court judgement that declares an entity incorporated in the Czech Republic insolvent, if there is an international treaty to that effect to which the Czech Republic is a party. We are not aware of any international treaties dealing with the recognition of bankruptcy proceedings. In the absence of an international treaty, Czech courts will apply the test of reciprocity. A bankruptcy declared abroad will have effect and be recognised provided that, *inter alia*, the Czech secured creditors' claims have been satisfied.

1.5 In what circumstances would the directors or officers of a company in financial difficulties face potential personal liability for continuing to trade?

If a company in financial difficulties continues to trade, its management may be liable under civil and criminal law.

There is a general duty for company management to file for bankruptcy without undue delay if the company is insolvent. Prior to that, the management of a limited liability or a joint-stock company must call a

general shareholders' meeting to decide on measures to overcome the insolvency. Management is liable for any damage caused by a breach of these obligations.

A person who is the manager of a company at the time it is declared bankrupt, or during the period of up to one year before the bankruptcy order was issued, will be disqualified from managing other companies for three years after the bankruptcy proceedings have ended unless the shareholders of the other company decide otherwise.

The Czech Criminal Code makes it a crime to perform illegal actions during bankruptcy, for example to dispose of the debtor's assets or to continue to trade. Management actions leading to over-indebtedness of a company and failure to file for bankruptcy can also be criminal offences. The Criminal Code also makes it a crime to unlawfully satisfy the claims of one creditor to the detriment of others. However, in practice, criminal prosecution is rarely enforced.

2 What are the advantages and disadvantages of triggering a formal procedure?

In bankruptcy, existing management is replaced by the bankruptcy administrator who is answerable to the court and the creditors, and the debtor is not allowed to dispose of its property. In practice, there are many disadvantages, because only a small part of creditors' claims (especially for unsecured creditors) is normally satisfied in bankruptcy. Also, the proceeds from the sale of secured assets are often used to satisfy priority claims (see 7.2 below) thus leaving the majority of the secured claims unsatisfied.

There is no special law regulating the bankruptcy of banks, cooperatives, insurance companies, travel agencies and others entities whose bankruptcy could have a significant effect on customers.

Triggering a formal rescue procedure brings several advantages in terms of running the business. For example, there is a moratorium on executions by secured and unsecured creditors. In addition, it is possible to continue the company's operations and subordinate a majority of its pre-bankruptcy debt to new creditors, helping to secure funding for continued operations (but see 7.1 below). Typically, triggering a formal rescue procedure does not incur any significant associated costs, with the exception of the fees related to the initial court proceedings and the appointment of an administrator.

On the other hand, once the formal rescue process starts, all the executive management powers are transferred to the administrator, and the existing management is legally bound to co-operate with the administrator. The administrator and the court are the parties that decide on the continuation of business operations once the formal rescue is triggered.

The success of implementing the formal rescue process depends to large extent on the judge and the administrator. With the exception of a voluntary composition, the judge and the administrator are the key parties that decide on the insolvent company's future. If they decide against a formal rescue, it almost certainly means the end of the company and its business.

3 What are the practical options for out-of-court restructuring?

Given the complicated procedures for court-supervised composition procedures, out-of-court restructurings have developed in the Czech Republic.

The structure of an out-of-court settlement depends on what is agreed upon by the debtor, its shareholders (if applicable) and the creditors and varies from one case to another. Generally, the following options exist, and they can be combined:

- Settlement agreement: In a settlement agreement, the creditors waive part of their claim in return for immediate satisfaction of the other part. This may not be tax efficient.

- Debt-equity swap: In a debt-equity swap, the creditors transform (part of) their claim into

shares in the failing company. Creditors can also contribute part of their claim to the debtor's other capital funds. Such a contribution does not increase their shares in the debtor, but it can be recovered once the debtor makes a profit. The shareholders' approval is required for all of the above steps.

- Merger: In certain cases, a bankruptcy can be avoided by a merger with a financially strong company.

4 What is the effect on the management of a company of:

(a) An adjudication of corporate bankruptcy/ liquidation?

Bankruptcy

On an adjudication of a bankruptcy order, the right to dispose of the debtor's property passes to the bankruptcy administrator. Any transaction undertaken by the debtor's management relating to its property is ineffective against creditors. All powers granted by management are voided, and management may not operate the company. This right passes to the bankruptcy administrator.

Liquidation

In liquidation, managerial powers pass to the liquidator, who is entitled to perform any legal acts which further the liquidation of the company (eg settling the company's debts, disposing of its assets, etc). The liquidator may conclude new contracts only if they are necessary for preserving the value of the company's assets, or are in the normal course of the company's business.

(b) The commencement of a formal corporate rescue process?

Voluntary composition

When the court approves a voluntary composition, the managerial powers of the debtor's management become limited. The court or the court-appointed composition administrator can specify which legal acts the management can only perform with the administrator's previous consent and which they are forbidden to perform.

Involuntary composition

Executive management powers are initially transferred to the composition administrator. If the court decides to accept the debtor's request for an involuntary composition, managerial powers transfer back to the debtor's management.

(c) The initiation of an informal (ie out-of-court, non-statutory) corporate rescue process?

In an informal corporate rescue process, there is no effect on the management of the company, unless the parties to the restructuring stipulate otherwise.

5 Parties in interest/key players

Who is responsible for the 'case management' control and administration of

(a) A corporate bankruptcy/liquidation?

In both corporate bankruptcy and liquidation, the court-appointed administrator plays a crucial role in case management. The administrator is controlled by the judge and creditors, or the creditors' committee. The judge, however, can overrule some of the creditors' decisions, such as a creditor's veto over the administrator.

(b) A formal rescue?

In a formal restructuring, the same parties as in (a) above are involved, however, the creditors' position is stronger. The creditors play crucial roles in addition to the administrator and the judge. Creditors can require information, as well as veto or seriously complicate the rescue procedures. They cannot, however, impose their choice of how to sell the assets onto the administrator or judge. The creditors approve the final schedule of payments and the final report prepared by the administrator, which enables them to protect their interests and financial claims.

(c) An informal rescue?

In an informal rescue, management is responsible for the restructuring process. It frequently engages professional advisors (accountants and lawyers) to assist.

5.1 Who is responsible for preparing the restructuring plan in a formal or an informal rescue?

In both bankruptcies and formal rescues, the restructuring plan can be prepared by the administrator. In formal restructurings, however, the debtor's management can also formulate the plan. In either case, the plan has to be approved by the judge and, in more complicated cases, also by the creditors or the creditors' committee.

There are no legal provisions for informal restructurings, and therefore no rules on who prepares the plan in an out-of-court settlement.

5.2 Who are the key players? What are their roles and responsibilities?

While insolvency practitioners are typically considered experts under Czech law and have to be on a court-administered list of practitioners, there may be other specialists involved in insolvency cases, namely accountants and lawyers. These specialists are normally chosen by the administrator and approved by the judge. In larger or sensitive insolvency cases, administrators typically consult the creditors on the selection of specialists and appoint the special advisors jointly. The exception to this is the selection of an advisor under the approved restructuring plan. In such cases, the management may choose an advisor for specific tasks (such as for an asset sale), and the administrator supervises the process, but keeps the right to veto this selection. Another exception is when the management prepares the restructuring plan without using the available protection period. In this case, the management decides who will advise the company.

6 What financial information is available to creditors?

All companies in the Czech Republic are required to prepare their financial accounts in accordance with Czech accounting principles. Since 1 January 2002, consolidated accounts may be prepared in compliance with IAS rules even for statutory purposes in the Czech Republic. Companies traded on the Prague Stock Exchange Main Market are required to provide IAS compliant information as well.

Since 1 January 2002, Czech accounting principles conform closely with IAS principles. However, some differences still remain, such as the absence of specific rules for impairment of assets, construction contracts, segmental reporting and investment property.

The law requires audited accounts from companies that exceed two of the following three criteria for two consecutive financial periods:

(a) revenues exceeding CZK 80 million,

(b) equity exceeding CZK 40 million, and/or

(c) number of employees exceeding 50.

Generally, financial statements audited by international auditors are reliable, however, quality of locally audited financial statements may vary.

Public companies have to file their financial statements with the commercial register and make them available to the public. Since 2001, Czech companies may choose their financial year-end, however, the period-end must be the last day in a calendar month. The general filing deadline for publicly traded companies is 30 April.

7 Common questions

7.1 Funding and the priority given to new money

(a) If an insolvent corporation requires urgent working capital funding, what difficulties are likely to be encountered in the provision of such funding?

Czech law does not forbid the bankruptcy administrator from entering into a loan agreement in order to obtain working capital funding. There are new cases in which such financing is being provided. Still, in practice, banks are reluctant to provide such funding, as bankrupt companies usually do not have enough assets to repay such loans, despite the priority basis for such funding as described below.

(b) Are lenders providing new money, or 'DIP' financing, given any statutory priority?

Lenders providing new money have a priority claim (see section 7.2.1 below) which can be satisfied at any time during the bankruptcy proceedings.

7.2 Ranking of creditors

In what order are creditors paid in a corporate bankruptcy/liquidation?

(1) Priority claims, including expenses and remuneration of the bankruptcy administrator, cost of maintenance and disposal of the debtor's assets, claims of the state authorities (taxes, fees, levies, social security payments), claims from agreements concluded by the bankruptcy administrator, alimony claims (all aforementioned claims only if accrued after the court issued the bankruptcy order) and salary payments due to the debtor's employees accrued in the three years preceding the declaration of bankruptcy.

If the bankruptcy proceeds are not sufficient, these claims are satisfied in the following order: expenses and remuneration of the bankruptcy administrator, cost of maintenance and disposal of the debtor's assets, court fees for bankruptcy proceedings and then alimony claims. All other claims rank equally and are satisfied pro rata.

(2) Secured creditors' claims are satisfied up to 70 per cent of the value of the proceeds of the sale of their secured assets at any time during the bankruptcy proceedings. The portions of their claims not satisfied in this way are treated as second class claims (see number 4 below).

Proceeds are then distributed between:

(3) First class claims, ie payments, other than salary payments, due to the debtor's employees accrued in the three years preceding the declaration of bankruptcy, supplementary pension insurance claims and alimony claims accrued before the bankruptcy order was issued.

(4) All remaining claims (so-called second class claims) are satisfied from bankruptcy proceeds.

Generally, if all the claims in one category cannot be satisfied fully, they are satisfied pro rata within that category.

Bankruptcy proceeds are distributed to each class only after priority claims and secured creditors' claims are satisfied. Thirty per cent of the remaining proceeds are attributed to first class claims and 70 per cent to second class claims.

Interest accrued after the bankruptcy order cannot be satisfied in bankruptcy.

7.3 Avoidance of antecedent transactions

Are there any legal provisions that might operate to invalidate the creation of security, the disposal of an asset or the payment of a creditor by a company in financial difficulties?

To protect creditors against a debtor's fraudulent behaviour the Act has the following provisions:

Ineffectiveness of debtor's legal acts

All acts performed by the debtor within six months prior to the filing for bankruptcy by which the debtor:

- participates in the founding of, or acquires an interest in, a legal entity;
- disposes of or burdens its assets, rights or other property values for no or disproportionately low consideration, with the exception of ordinary gifts to family members;
- accepts inappropriate obligations; or
- refuses gifts without having a good commercial reason for doing so

are ineffective as against its creditors by operation of law. The bankruptcy administrator or any creditor can apply for the loss suffered as a result of such ineffective legal acts to be repaid to the bankruptcy estate.

Challenging the debtor's legal acts

The bankruptcy administrator or any creditor can apply to the court seeking to have the debtor's acts that were performed within the past three years set aside, if such acts reduced the creditor's recovery. If the court sets the transaction aside, the loss suffered as a result of such legal acts must be returned to the bankruptcy estate.

Extinction of security

Security over the debtor's assets created within two months prior to filing for bankruptcy becomes void on the issuance of the bankruptcy order.

7.4 'Cram-downs'

What is the position of both unsecured and secured creditors who vote against, do not agree with, or do not consent to, either a formal or an informal rescue plan?

Voluntary composition

The secured creditors' vote is limited to the value of their claim which cannot be satisfied from the security proceeds (see section 7.2 above). Unsecured creditors' votes are generally not limited. Creditors who voted for the composition may appeal, if the court does not approve the composition, while dissenting creditors may appeal against the court's composition order.

Involuntary composition

Secured creditors do not have the right to vote on the involuntary composition, as their claims cannot be adversely affected (otherwise the court would not allow

the composition). Unsecured creditors whose claims were accepted by the court can vote on the composition. Unsecured creditors who do not vote in favour of the composition may appeal against the composition order.

Informal rescue plan

An informal rescue plan cannot commence without the consent of the debtor, its shareholders and creditors. Generally, consent of all parties involved is required.

7.5 Creditor protection

What actions can creditors take if they are not satisfied with the conduct of either a formal rescue procedure or a corporate bankruptcy/liquidation?

Bankruptcy, voluntary and involuntary composition

The bankruptcy/composition administrator is responsible for the proper carrying out of the bankruptcy/composition. He answers to the court and creditors, and, being liable for damage caused by breach of his obligations, he must conduct his activities with due care. A creditor may ask the court to review the administrator's activities, to impose a penalty of up to CZK 100,000 on the administrator, or to replace him.

In voluntary liquidations the shareholders of a statutory body of the company may replace a liquidator who does not carry out his duties properly. In all liquidations, a person with a legal interest (including the creditors) may request the court to replace a liquidator that breaches his duties.