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JUDGMENT CALL

Velvet bankruptcy

Despite some problems, the Czech Republic's new insolvency act is a vast improvement

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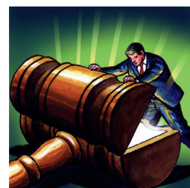

Since the Velvet Revolution in 1989, the Czech Republic has become an active member in important European and international organizations such as the European Union, NATO, the World Trade Organization, the International Monetary Fund and World Bank, International Bank for Reconstruction and Development, the Central European Free Trade Agreement, the Council of Europe and the Organization for Security and Cooperation in Europe.

That fact notwithstanding, since emerging from the Iron Curtain the Czech Republic has had a history of having ineffective insolvency laws. The current efforts to reform Czech insolvency law have been ongoing since 2001, finally resulting in the Act On Insolvency and Its Resolution (No. 182/2006) (the "New Act"), dated March 30, 2006, and signed into law on April 14, 2006.

The New Act, to take effect Jan. 1, is expected to be a huge leap forward. If properly implemented, the law will create restructuring opportunities in the Czech Republic that are virtually unknown in Europe in general.

With the porous borders of the European Union, it is not fantasy to imagine that businesses might establish headquarters within the Czech Republic to capitalize on a good work force and favorable economics, and also to take advantage, if necessary, of restructuring opportunities that do not exist in other European laws. The New Act, while it has its challenges, does things no other European bankruptcy law does. For example, the New Act provides for "cramdown," i.e., judicial approval of a plan even if it has been rejected by classes of creditors. The New Act follows in many respects the U.S. model on cramdown, which should greatly enhance the distressed company's ability to negotiate with creditors.

For the first time in Czech law the New Act creates the concept of a "debtor-in-possession" (called a "debtor with disposal rights" in the Czech legislation). This should break the virtual stranglehold over Czech restructurings held by court-appointed trustees. While trustees still have a role in the process, their participation is limited under the New Act. What's more, the New Act further provides a form of post-bankruptcy financing that was not present in any of the prior laws. All of these changes should greatly enhance the ability of financially distressed business enterprises in the Czech Republic to restructure and remain viable entities.

However, there are still at least four problematic areas in the New Act that should be addressed in order for the new legislation to realize its full potential.

First, the New Act must provide a more effective means for post-bankruptcy financing. For financially distressed businesses to survive to reach reorganization, it is essential that there be some mechanism for post-bankruptcy financing of operations. While some businesses can operate based upon collection of accounts receivable and post-bankruptcy sales, most businesses require an operating line of credit to keep a steady cash flow. This benefits employees and trade vendors who deal with the financially distressed business in an insolvency situation while a formal restructuring is being negotiated.

The New Act does provide for "credit financing." However, the only assurance of repayment of such financing is that the lender will receive a priority claim senior to all other unsecured claims (except for remuneration and reimbursement of out of pocket costs for an insolvency trustee). To the extent that a company's assets are encumbered by liens, mortgages or charges, there is no express provision for "priming" of existing liens for the benefit of the post-bankruptcy lender (such as the concept of "super priority financing" found in the U.S. Bankruptcy Code). Instead, the New Act provides for a quasi super priority against unencumbered assets; with respect to encumbered assets, it allows for a "sharing" of collateral on a pro-rata basis with other secured creditors.

While this may incentivize creditors who hold senior liens against assets of the company to provide post-bankruptcy financing and perhaps incentivize junior lienholders to extend credit because it will give them an opportunity to leapfrog over senior liens at least to the extent of new financing, third-party financing sources are unlikely to find the protections afforded a post-bankruptcy lender sufficient to make loans. While at first blush this may appear unfair or violative of existing lienholder rights, in fact it leads to a robust competitive market for post-bankruptcy financing, which provides a distressed company

with numerous options for such financing.

Such competition also gives the distressed company the ability to negotiate the best terms it can under the circumstances. It is not unusual in a U.S. reorganization for the company to be inundated with proposals for DIP financing from funds that specialize in such financing and have the ability to close the financing and make funds quickly available to a financially distressed company.

Second, the "two-step" reorganization process can render potential reorganizations dead on arrival. In the New Act, creditors effectively vote twice regarding reorganization. First, there is a vote by creditors early in the process to determine if they wish to allow a reorganization attempt, and later there is an affirmative vote to determine if the plan proposed by the debtor would be approved (assuming, of course, that the debtor ever got past the first vote described earlier). The problem with such a two-step process is that the first vote to determine if the debtors should be allowed to propose a reorganization plan (which binds the debtor and the court) will occur within 60 days of filing of a motion to allow a reorganization.

Within the first 60 days in any case, the creditors are still not fully organized (usually) and are often also not fully conversant with the facts. Moreover, there may be some hard feelings or knee-jerk reactions from creditors. The other problematic issue of having the earlier vote (the outcome of which binds the court) is that it occurs before the claims are determined and allowed. Accordingly, it is entirely possible that creditors with invalid claims could crush a reorganization prospect early on. In addition, the voting threshold to allow a debtor to proceed in a reorganization is fairly high—either 90% of the claims of all creditors who are present at the vote must consent, or 50% of secured and 50% of unsecured claim amounts must consent. Generally speaking, in any reorganization dynamic it is best to give a little bit of time for hard feelings to cool before having dispositive votes.

Another drawback: The New Act's provisions dealing with creditor committee composition and duties are unworkable. The New Act establishes a legal regime and practical dynamic with respect to creditors' committees that will prove to be a challenge. The New Act provides that creditors' committees will comprise both secured and unsecured creditors. Moreover, the New Act provides that there will be an equal number of secured and unsecured creditors represented on that committee, and additionally provides that debtors' employees may also have representatives on the committee. The New Act then goes on to admonish the creditors' committee to "protect the common interest of the creditors." In fact, creditors' committee members would be liable for damages caused by breach of duties or failure to act with due diligence in this pursuit of the "common interest."

A creditors' committee that has divergent interests in its membership is inherently conflicted and ineffective. Secured creditors have different rights from unsecured creditors under Czech law, and unpaid employee wages also have priorities over other claims. Having a committee with creditors holding different legal and practical rights leads to the unintended consequence of having a "fractured" committee that is unable to agree or participate meaningfully in the process. There is a very real possibility that creditors' committees will deadlock and spend their time arguing among themselves. How, precisely, does one define "common interest" when there really is none?

Finally, the New Act still does not provide a mechanism to deal with unviable executory contracts. For example, if the debtor has a long-term lease that is entirely above market and too expensive, given the current market, there is no provision in the New Act to allow that debtor to shed itself of this contract to increase its cash flows for the benefit of all creditors. Interestingly, an insolvency trustee has the ability to rescind a lease in a bankruptcy situation and otherwise deal with contracts in a bankruptcy liquidation. But there is no corollary provision in the New Act. Accordingly, where the issue is most acute in order to save an otherwise viable business from financial distress, a major tool for such an endeavor is not provided for in the act.

If these open issues are adequately addressed and Czech judges, administrators and professionals are properly trained in the administration of the New Act, the Czech Republic will take a massive leap forward in having a legal regime wherein financially distressed business can be rehabilitated. This will result in larger payouts to creditors, preservation of jobs and retention of a productive tax base. ■

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Salerno and McGehee were involved in the drafting, analysis and commentating of the new Czech Insolvency Act from 2001 until its passage. Salerno has assisted in the training of Czech judges related to the new law and has addressed the Czech Parliament on the implementation challenges of the new legislation.

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