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Limits of the Bankruptcy Code: foreign restructuring tools in a Czech environment

KEY POINTS

- Currently there are insufficient institutional safeguards of creditors' interests in the Czech law of corporate reorganisation. This is related to certain transplantations of foreign law concepts into Czech insolvency law.
- Implementation of the trusteeship under the new Czech legislation later in 2014, allowing establishment of trusts following the German model, is to be welcomed.
- The combination of the trusteeship with a restructuring is the best option for the Czech model of business turnaround, to adequately align stakeholder incentives.

Czech insolvency law was materially modified, certainly for the better, by reforms in 2006. However, the reorganisation model, while useful as a transaction tool, appears inadequate for dealing with the high-powered conflicts between the majority shareholder and bank creditors which are present in many distressed situations. This article argues that some of the elements of the reform are not as efficient for dealing with this particular type of high-powered conflict as in their country of origin. This is partly due to the lower institutional quality and concentrated ownership of most Czech businesses. In such an environment, the reorganisation model with debtor-in-possession inspired by US law, lacks the independent third party – the management. Also, reliance on insolvency practitioners inspired by English law is not warranted given their weak regulation. A solution can be drawn from Germany, where restructurings should be based on proper restructuring opinions and are often supported by a double-sided trusteeship. In this structure, a neutral trustee holds the shares of the debtor undertaking for the joint benefit of the shareholder and the lenders to support the turnaround.

Under the current Czech model of reorganisation, the debtor remains in possession of its assets during the entire phase of reorganisation, unless ordered otherwise by the court. The debtor enjoys a stay on enforcement by secured creditors, compensated by interest payments which are payable only several months after the opening of the insolvency proceedings. The system of approving a reorganisation plan is based on the US model, ie, by class with the possibility of a cram-down based on absolute priority and best interest tests, as long as at least one class votes in favour of the plan.

High-powered conflict naturally arises as financial difficulties of an enterprise mount up between the shareholder-manager (the owner) and the creditors as a class, but, in particular, financial creditors. The owner understands insolvency as a threat of losing most of his personal wealth and often follows a strategy of delay, searching in a haphazard way for a third party to save the business, or trying to divert assets or activities from the indebted/collateralised entity. When insolvency proceedings finally start, the liberal reorganisation regime allows the owner, absent grave mistakes, to pursue this strategy and hope to force through a reorganisation plan. The conflict with financial creditors escalates.

Lenders have a strong incentive to engage in a conflict through the insolvency framework. Unlike trade creditors, they usually cannot preserve their specific investment, despite some losses by trading with the successor firm and do not have much commercial leverage (payment up front for future supplies). Financial creditors are threatened with a complete deprivation of their investment upon insolvency and have to rely on the legal instruments available under the insolvency legislation to recover their investment.

US INSPIRATION – THE DIP AS THE PLAN PROPONENT

The Czech model of corporate reorganisation basically follows the US Bankruptcy Code, with some minor changes. However, the US Bankruptcy Code is designed for large enterprises, usually public companies, with numerous shareholders and creditors. In both cases, the debtor is left in possession and has a rather long period of time to submit a plan of reorganisation (up to 18 months in the US, 240 days under Czech law, with numerous unofficial extensions). While Czech creditors can block reorganisation early in the process by a super-majority vote, such majority is rarely achieved.

In the US, the Bankruptcy Court acts as a referee in disputes over particular matters, such as disclosure of information to the creditors, approval of post-petition financing, using cash collateral, lifting the stay on secured creditors, approving the professional fees, etc. The governmental office of the US Trustee supervises the entire process and appoints certain officers, such as members of the creditors' committee. Under Czech law, the court can act as a referee, but the rules for its interference are rather unclear. There is a creditors' committee, but its powers are limited. There is no independent regulator and the creditors vote by a simple majority on most of the appointments (eg, the choice of creditors' committee or trustee).

However, the debtors' position is significantly different under Czech law. In a firm with dispersed ownership, the managers (ie, employees) are perhaps well placed to find a compromise between the interests of shareholders and creditors. They risk lawsuits from both sides and their own investment at stake is limited. As such, giving the exclusive right to submit the plan to the debtor has strong rationale.

On the other hand, an owner/manager is not in such a neutral position. While his primary personal interest is to preserve his personal wealth, the only real solution often involves getting a new investor into the business, leaving limited space for the former owner. As a result, his incentives for devising an efficient plan, fairly

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allocating the value of the estate among the participants, are skewed.

Furthermore, Czech courts often cannot be relied on to make bold decisions, providing clear guidance to lead parties to consensus. Courts often try to avoid decisions on commercial matters and standards for approval of reorganisation plans suffer from significant lack of clarity. As a result, despite many good judges, the institutional framework is not strong enough to deal with many conflicts.

UK MODEL – THE TRUSTEE

Czech law places significant reliance on the insolvency trustee, who supervises the debtor in a reorganisation (and takes over in the case of liquidation). The 2006 reform created a licensing scheme. However, despite the presence of a number of honest trustees, the trustee profession currently does not provide a reliable guarantee of integrity for insolvency cases. The regulation is light-touch; there is no self-regulation and no supervision over compliance. In a reorganisation, the trustee's role is weak and s/he needs the court's intervention to obtain stronger powers.

On the other hand, a sophisticated system of licensing and self-regulation of insolvency practitioners in the UK enables the IPs to be regarded as the key safeguard of the proper functioning of an insolvency system. Given that the Czech Republic lacks such a regulatory network, the institution of the insolvency trustee does not appear to be a sufficient safeguard for preservation of value in the high-powered conflicts described above.

GERMAN INSPIRATION

In the 1994 version of the German Insolvency Order, debtors remained in possession after commencement of a case only in exceptional circumstances and only if the petitioning creditor agreed and the debtor showed that that its DIP status would not lead to negative consequences. Cram down, ie, approval of a reorganisation plan against the will of particular creditors, is possible only if a majority of classes approve the plan. While the law became more liberal in 2012, previously developed tools remain very important:

- restructuring opinion (*Sanierungsgutachten* or *Sanierungskonzept*) prepared usually by a reputable advisor acceptable to the lenders, usually an independent auditor, which describes in detail the current situation of the debtor and analyses the possibilities of its sustainable recovery; and
- double-sided trusteeship – an agreement, under which the shareholders of the debtor transfer the shares in the debtor to a third party trustee (not a representative of the banks), who holds them in trust (*Treuhand*) for both the shareholders and the banks.

The trustee administers the shares and his position as the legal owner ensures (in contrast to a standard pledge or title transfer security interest), that the shareholder cannot carry out many of the steps that often destroy trust between stakeholders, such as share transfers without notice to lenders or changes to the board. If the restructuring fails, the trustee is authorised, under the initial trust agreement and without any further approval by the shareholder, to carry out an M&A process and take any such action as is required to ensure as high a recovery for the bank creditors as possible.

A restructuring opinion must be prepared according to a standard developed by the German institute of auditors, which sets out detailed parameters for its content. The need for such a proper restructuring opinion is heavily supported by the German case law.

A combination of these two tools, if properly implemented, appears to be a proper reaction to the high-powered conflicts that arise between the lenders and the shareholders in a restructuring situation. The tools can be combined with a work-out, such as partial waiver of loans, extension of maturities or provision of additional financing. The shareholder/manager continues to manage the firm, ie, he does not lose his influence on the undertaking and the related self-esteem, but also keeps responsibility for the daily operations. The shareholder also has a chance of getting its shareholding back after the successful restructuring, which is supported by the restructuring opinion. On the other hand, the lenders have sufficient safeguards against any opportunistic behavior on the side of the shareholder, as the trustee can intervene quickly, having been selected for his ability to take bold decisions. In the worst case, the trustee can cause the debtor undertaking to enter liquidation.

The combination takes the insolvency court to a significant extent out of the restructuring relationship and leaves it in the background in the form of the threat of liquidation. This appears to be a natural reaction to the institutional weakness and concentrated ownership.

CZECH IMPLEMENTATION

New Czech legislation, in force as of 2014, enables a structure similar to the double-sided trusteeship in a common law style trust. The trustee must be a natural person and takes the trust property in administration from the former owner(s), subject to a due care duty. The trust deed must be evidenced by a notarial record and the law gives significant flexibility regarding its content. The shareholders and the lenders can be defined as beneficiaries of the trust; potentially also with the right for the lenders to participate in a future upside, without taking an actual equity position. Proper drafting of the trust documentation and a good restructuring opinion (for which no standards exist, but the German standard is easily replicable) can thus provide a solid basis for a successful restructuring in the Czech Republic going forward.

CONCLUSION

The above analysis leads to an unsurprising conclusion that only owners who are ready to act in consensus with the lenders are worthy of supporting in any restructuring efforts, whether out-of-court or in formal proceedings. In the realities of the Czech economy and institutional framework, a real and honest consensual approach can be well tested by verifying, whether the owner is ready to establish the double-sided trusteeship structure for the benefit of the lenders and to mandate a reputable advisor to provide a proper restructuring opinion, ie, to dig deep into the debtor's books.

Consequently, it appears a reasonable conclusion that if the debtor is not ready to cooperate in this manner, the rational strategy appears to be to put the company into liquidation by available legal means. Insisting on this strategy through multiple cases can help making any, even the most moderately toned threats of such approach, credible. ■