ALFERY
Audit Tax & Legal Services

NEWS 3/2011

News No. 3/2011
Defence against vexatious insolvency petitions

Insolvency proceedings aim mainly to find a complex solution to the financial standing of a debtor who has gone bankrupt according to one of the laws (Act No 182/2006 Sb., on Insolvency and the Methods of its Solution; hereinafter referred to as the "Insolvency Act") in the way set forth, especially in order to secure the claims of creditors. In practice, some institutes of the Insolvency Act are used in ways that contrast with its general purpose.

One of the distinct examples is the filing of so-called spurious insolvency petitions by which creditors try to satisfy their claims even if there are no clear indications of the debtor's insolvency. In some cases these are debts that really exist and are due, but sometimes they do not exist or are highly disputable debts. An insolvency petition replaces, in such cases, de facto an action for performance (whereas the petitioner is not even obliged to pay a court fee) and, consequently, the insolvency proceedings substitutes inadmissibly the finding procedure regarding payment of a disputable debt. The filing of an insolvency petition therefore becomes in many cases an instrument of improper competition or inadmissible pressure on the debtor, forcing the debtor to satisfy even disputable claims of creditors. As a matter of course, the mostly negative public perception of insolvency proceedings plays a certain role in this situation, since the public does not distinguish between the commencement of the proceedings, the decision on the debtor's insolvency and the decision on the method of its solution. Publishing an announcement notifying the commencement of insolvency proceedings leads to the discrediting of the presumed debtor and disturbance of relations with suppliers, customers or public contractors, banks or even with their own employees.

One of the reasons actual or alleged creditors act in this way is to regulate the effects of the commencement of insolvency proceedings. Contrary to the concept contained in the Act on Bankruptcy and Settlement, according to which the creditors themselves take care of publicity after the bankruptcy petition has been filed, the Insolvency Act ensures in Section 101 (1) virtually immediate and fully accessible information about the commencement of insolvency proceedings, by publishing this information in the Insolvency Register. Moreover, as soon as the effects relating to the commencement of insolvency proceedings arise the debtor is (pursuant to Section 109 (2) in connection with Section 111 (1) Insolvency Act) in principle obliged to refrain

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com

from disposing of the bankruptcy estate as well as any assets that may fall in the bankruptcy estate, regarding significant changes in the structure, use or designation of those assets or a not inconsiderable lessening of those assets. This regulation aims at the best possible securing of the justified interests of creditors against the debtor who has not managed his business activities and has therefore gone bankrupt, in order to preserve those assets as a part of the bankruptcy estate, the proceeds from the sale of which shall ensure future satisfaction of the creditors. In a situation where the debtor is actually bankrupt those restrictions are, of course, fully appropriate, but in the case of an unfair insolvency petition the effects are sometimes difficult for the alleged debtor to overcome.

It can be assumed that large companies can overcome the negative effects of vexatious insolvency petitions easier than small business entities, for which the commencement of insolvency proceedings may have detrimental results. In particular, it can threaten companies that are financing their activities mainly through banks. After the commencement of the insolvency proceeding, banks often take precautions (such as requiring additional security or restraint with respect to granting additional funds). Such reaction may subsequently cause further negative effects and worsen the economic situation of the company concerned. Besides the cautious approach on the part of banks, the alleged debtor must expect the same of business partners who are not willing to conclude further transactions with an entity registered in the Insolvency Register or demand advance payments. In fact, such a situation may then eventually lead to the bankruptcy of a business entity that had had previously faced any economic problems.

Rejection of an insolvency petition

The first barrier against a spurious insolvency petition should be its review and possible immediate rejection by the insolvency court. The court should reject an insolvency petition in particular in the situation where the requirements for the issue of the decision on bankruptcy in compliance with the Insolvency Act are not met. The problem is that the court may not be able to assess immediately the debtor's situation on the basis of the insolvency petition, even if it contains all the set elements.

Although the insolvency court is obliged to issue an announcement notifying the commencement of insolvency proceedings and publish it in the Insolvency Register very soon (within two hours of receiving the insolvency petition) it must preliminarily investigate both the registration of the creditor's claim

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com

and the insolvency petition itself. If, for instance, the court ascertains that the claim registration shows such ambiguities that need further evidence, such a finding should be a typical reason for rejecting the insolvency petition. Nonetheless, only the prepared amendment to the Insolvency Act modifies its wording in such a way so as to provide the insolvency court with the explicit possibility to reject the creditor's insolvency petition on the grounds of being clearly unjustified (within 7 days). Simultaneously, the amendment proposes to lay down in which cases the petition shall be deemed clearly unjustified (e.g. failure to document due claims of the insolvency petitioner, failure to deposit documents to be published in the Collection of Documents in the Commercial Register, nonexistence of statutory bodies etc.).

Under the present legislation, an insolvency petition should also be rejected in such a case that the creditor attempts to avoid standard court proceedings by filing an insolvency petition. In existing judgments on this issue, the courts decided several times that it is not possible that an insolvency proceedings substitutes other types of proceedings, in particular when all claims enforced in the insolvency proceedings are disputable and their assessment would require extensive evidence. However, in many cases the court will not be able to reach such a conclusion within a short time after receiving the insolvency petition, not least because the assessment of the existence of bankruptcy represents not only a legal but also an economic issue, so the decision making may require additional time and evidence.

Debtor's reaction

A relevant part of the defence against an unjust insolvency petition is the debtor's fast and qualified reaction to the facts stated in the petition. In view of the negative effects of a filed insolvency petition, the debtor should not underestimate the insolvency proceedings even if the insolvency petition is clearly unjustified. Even in such a case the debtor should react immediately and inform the court of the reasons why the petition is not legitimate, or why he considers the creditor's claim, which the petition is based on, to be disputable. Since the debtor's economic situation must be assessed, the court requires further information on the debtor's economic position, even if those data are apparently indisputable and generally available.

Action for damages

Section § 147 of the Insolvency Act provides another option for the debtor's defence in connection with filing a spurious insolvency petition, namely the

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com

ALFERY
Audit Tax & Legal Services

NEWS 3/2011

possibility of claiming damages and other harm against an unsuccessful petitioner. However, in this way the negative effects of the commencement of insolvency proceedings cannot be prevented; rather, this possibility is designed to discourage presumed creditors from filing spurious insolvency petitions. However, for the time being, concern among creditors that they would have to compensate for damage incurred as a result of unjustified insolvency petition does not seem to be too great.

Thus, if the insolvency petition has been rejected because the petitioner was at fault, the debtor is entitled to claim damages or compensation of other harm caused by the commencement of insolvency proceedings and the measures taken during its course against the petitioner. In case of doubt, it shall be presumed that the petitioner has caused the rejection of the petition.
In this connection, the Supreme Court judgment file No 29 Cdo 3137/2007 must be mentioned, which does not concern an insolvency proceedings, but is highly relevant to it. The judgment concerns the possible liability of the state for damage caused as a result of a preliminary ruling that was issued in the course of a court proceedings and which unjustifiably restricted and harmed the counterparty. The Supreme Court stated the reasons for the petitioner's sole liability for the damages incurred in its judgment and decided that the liability of the state is excluded in such cases. A similar interpretation can be applied to compensation for damages caused by filing an unjustified insolvency petition, and only the creditor (petitioner), not the state, is obliged to compensate those damages, even if the measures that caused harm to the debtor were taken by the insolvency court in such insolvency proceedings.

In case the legal entity is the insolvency petitioner, according to Section 147 (3) Insolvency Act, the members of its statutory body are held liable for the fulfilment of the duty to compensate for damages or others harmed jointly and severally, unless they prove that they have informed the insolvency court without undue delay after the insolvency petition was filed that the insolvency petition is not justified or that some further statutory requirements for the adoption of a decision on bankruptcy has not been met. However, this concept cannot rule out individuals using the insolvency petition as a tool.
The debtor must bring the action against the creditor, or its statutory bodies, no later than within three months of the day of receiving the decision by which the insolvency proceedings is terminated. In case the action is not filed within the statutory time limit the debtor's right to compensation for damages or other harm shall become forfeit.

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com

Preliminary ruling

Since a subsequent action for damages does not solve the immediate impact on the economic position of a person against whom the insolvency petition has been filed, there is an effort to use preliminary rulings as an effective instrument of defence, with the argument that if the insolvency petition is filed in bad faith in order to exert pressure on the debtor, the court should nullify all effects connected with the commencement of insolvency proceedings by issuing a preliminary ruling. The undisputed advantage of such a measure is that it has a virtually immediate effect, as the decision to order a preliminary ruling takes effect at the moment of its publication in the Insolvency Register (Section 89 (1) Insolvency Act). By the decision to issue a preliminary ruling, the insolvency court neither decides on the debtor's bankruptcy nor anticipates such a decision but only eliminates the impacts of the insolvency proceedings, considering the circumstances of the case in question (apparently spurious nature of the insolvency petition). Interim regulation of the relations reduces the pressure on the debtor and prevents, at least partially, from further worsening the economic situation and discrediting, without preventing the continuation of the insolvency proceedings and enforcement of the creditor's claims.

The Insolvency Act regulates the preliminary ruling in particular in Sections 82, 112 and 113. The general power of the insolvency court to order a preliminary ruling is stipulated in Section 82 (1) Insolvency Act, according to which a preliminary ruling can be issued in an insolvency proceedings without being applied for. The possibility of regulating the relations of the parties to the insolvency proceedings preliminary by excluding the effects connected with its commencement is derived from Section 5 (a) Insolvency Act, according to which the insolvency proceedings must be conducted in such a way so that none of the parties to the proceedings is harmed unfairly or favoured in a manner that is not permitted and that a fast, economical and the highest possible satisfaction of creditors is reached. In the case of a vexatious insolvency petition the enforcement of effects related to the commencement of the insolvency proceedings may represent a fundamental negation of the principles which the Insolvency Act is based on and, eventually, an inadmissible denial of justice.

At the same time, the opposite view must be mentioned, which is based on the opinion that, in accordance with the Code of Civil Procedure (CCP) whose provisions are applied also to the area of insolvency proceedings, the issue of a preliminary ruling can only be considered if it is necessary before the com-

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com

mencement of the insolvency proceedings to regulate provisionally the relationships of the parties, or if there are concerns that the execution of judgment might be threatened (see Section 74 CCP). Simultaneously, a duty may be imposed on another person than the parties to the proceeding by issuing a preliminary ruling according to the Code of Civil Procedure, but only if it is just and reasonable. In such a way, a preliminary ruling can be ordered even after the proceedings have commenced if it is necessary to provisionally regulate the relations of the parties or if there are concerns that the execution of judgment might be threatened (§ 102 CCP).

From the above mentioned it follows that neither the Code of Civil Procedure nor the Insolvency Act provides for the regulation of filing an application for preliminary ruling through which the applicant (debtor) strived to eliminate the effects of the commenced insolvency proceedings. Consequently, although the application for a preliminary ruling seems to be logical, and the only possible method of defence against such spurious insolvency petitions, it faces the fact that legal regulations do not explicitly allow this possibility.¨

Not surprisingly, courts do not react to such applications in a very clear way and reject applications for a preliminary ruling aiming to render a commenced insolvency proceeding ineffective, arguing that there is no support in the present legislation for the issue of a preliminary ruling. The same conclusion is to be drawn from the explanatory report to the prepared amendment to the Insolvency Act where it is stated that, under the current legislation, it cannot be deduced clearly that the court may exclude or at least limit in the way specified in the preliminary ruling any of the effects connected with the commencement of the insolvency proceedings, or impose on the insolvency petitioner in any way the duty to place a security deposit to secure compensation for damage or other harm incurred by an unjust insolvency proceedings and the measures taken during its course.

Summary

Damages can be caused to the alleged debtor against whom a spurious insolvency proceedings has commenced (such as costs connected with the defence against the petition or loss of profits as a result of the loss of orders due to loss of confidence on the part of business partners) and, last but not least, the debtor can be discredited by such proceedings. There is practically no possibility for instant and efficient defence on the debtor's part.

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com

ALFERY
Audit Tax & Legal Services

NEWS 3/2011

Moreover, it is to be noted that the Insolvency Act contains a guaranty against the artificial creation of creditors, which has a vexatious nature. The condition of plurality of creditors stipulated in the Insolvency Act is not fulfilled if the petitioner transferred one of his claims against the debtor or a part thereof to a third person within six months before the insolvency petition was filed. If such a purposeful transfer of claim, or a part thereof, has been carried out, whereas there are no other creditors, the court shall dismiss the insolvency petition. However, no provision of the Insolvency Act prevents the creditor from assigning the claim to an offshore company and to file an unjust insolvency petition through this company. Naturally, it will be difficult and inefficient for the debtor to claim damages against that company or its statutory body.

The Ministry of Justice is preparing an amendment aimed at lessening the risk of vexatious insolvency proceedings; for instance, the basic principles of the new regulation should contain the introduction of a court fee amounting to CZK 5,000 as an option for the court to reject an insolvency petition on the grounds of being clearly unjustified, or, as the case may be, the imposition of a fine for a clearly unjustified petition as well as other similar measures. Also a modification of the sample announcement notifying the commencement of insolvency proceedings is being considered, so that it is clear whether the insolvency petition has been filed by the debtor or the creditor and that it is stated that this announcement and consequently the commencement of the insolvency proceedings are of informative character only, which does not mean that the filed insolvency petition is justified and therefore that the debtor's bankruptcy has been proven. However, the defending debtors against unfair insolvency petitions will remain very difficult until the above-mentioned measures are taken.

Václavské nám. 40, 110 00 Praha 1
Tel.: +420 221 111 777
Fax: +420 221 111 788
E-mail: info@alferypartner.com
www.alferypartner.com