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C H A N C E

CORONAVIRUS – CZECH LOAN MORATORIUM: ITS TRUE IMPACT IN THE FIELD OF LARGE CORPORATE FINANCING

On 7 April 2020, the lower house of the Czech Parliament, the House of Deputies (in Czech *Poslanecká sněmovna České republiky*), approved a draft bill on certain measures regarding loan repayments in relation to the COVID-19 pandemic (in Czech *návrh zákona o některých opatřeních v oblasti splácení úvěrů v souvislosti s pandemií Covid-19*) (document no. 813) by decree no. 1024. The revised draft bill, under Senate document no. 229, will be discussed in the upper house of the Czech Parliament, the Senate, in the near future, and subsequently presented to the President for his signature, sealing the legislative procedure. As such, the new rules could become effective by their publishing in the Collection of Laws this post-Easter week by the middle of this week.

A detailed reading of the version of the bill presented to the Senate raises a number of questions and uncertainties about the impact of the proposed rules on relationships between borrowers and lenders. If adopted in their current form, the rules, in addition to their ambiguities, will affect the dynamics of commercial relationships throughout the loan market. This briefing provides a review of the likely impacts of such rules in the field of large corporate financing. Although there will be a relatively low number of such cases, the impacts will be magnified by the huge amounts of money in question; the future of big domestic companies and their holdings may be (negatively) influenced. In this context, the ambiguities found and questions raised within the contemplated rules may be surprising. We focus and briefly discuss a selected number of such rules below.

WHAT IF WE HAVE A CROSS-BORDER (INTERNATIONAL) FINANCING IN PLACE?

Unlike e.g. a moratorium on loan repayments which is being discussed and enacted in parallel in the Slovak Republic, local legislation does not consider in any respect any international aspect of the proposed rules. The explanatory note to the draft bill (in Czech *důvodová zpráva*) acknowledges the issue and states that – although the intended territorial scope of the act is not expressly provided for – it shall apply to all loans provided within the territory of the Czech Republic irrespective of the lender and/or the borrower being Czech entity/ies and/or irrespective of the governing law of the loan (agreement).

The first level of uncertainty arises from the very fact that the above wording is not included in the operative provisions of the act but is provided for in the explanatory note only. As such, it will not be binding other than by way of judicial interpretation. Furthermore, though it is clear that the phrase "loans provided within the territory of the Czech Republic" is basically in line with the general principle that laws are fundamentally effective only in the territory of the state who enacted them, it unfortunately ignores the scope of *ratione personae* and is ambiguous even in circumstances where there is only one borrower and one lender. To attempt to predict the interpretation of such contemplated rules becomes even more difficult in situations where there are multiple entities involved on the borrowers' and/or lenders' side which are from more than one jurisidiction, such circumstances, which typically exist for this type of financing.

In respect of the above question, in most typical scenarios, the likely answers in our view will be as follows:

- if the borrower is a Czech entity and the lender is a foreign entity, the loan moratorium will likely be imposed; the same would apply to situations where there are multiple lenders where some lenders are Czech entities and others are foreign entities;
- if the lender is a Czech entity and the borrower is a foreign entity, the loan moratorium will likely be imposed provided that the purpose of the loan is to finance acquisitions or other projects and activities in the Czech Republic; and
- if there are multiple borrowers whereby some borrowers are Czech entities and other borrowers are non-Czech entities, the loan moratorium will likely be imposed in relation to the local borrowers only, but not necessarily in relation to the foreign borrowers (with the uncertainties outlined above). In such a scenario, the use of a Czech loan moratorium could result in or trigger an event of default in respect of that particular member of the group under the relevant provisions of the in-place loan agreement, which, in turn, could result in a default of the entire group.

The above answers shall likely apply irrespective of the governing law of a loan agreement under international private law provisions. However, the above answers are subject to a high degree of uncertainty due to the fact that the legislature has not attempted to answer the above questions and, therefore, the answers thereto should and can only be sought on the basis of general legal principles.

WHAT IF WE HAVE A REVOLVING OR OVERDRAFT FACILITIES IN PLACE?

The act implicitly states that it shall not apply to revolving or overdraft facilities (i.e. typically short term facilities used for financing of operating needs) – the loan moratorium can only be imposed with respect to long-term term loans. However, the loan moratorium will not apply to the whole debt service, as the act distinguishes between repayments of principal and payments of appurtenance (interest and loan-relating fees) in different regimes applicable to different classes of borrowers: the loan moratorium in relation to borrowers who are legal entities will apply only to repayments of principal. They will have to continue to duly pay interest and fees.

WHAT IF WE HAVE ISSUED BONDS?

Considering the trend of extensive bonds issuance within the last few years, this is certainly not a rhetorical question. The loan moratorium does not apply to obligations arising under or in connection with a bonds issuance as obligations arising from investment instruments fall outside of the scope of the act. Nevertheless, it may be possible that if a bond issuer elects to opt for the loan moratorium with respect to its other (loan) indebtedness to which the act does in fact apply, such action will result in an event of default under the respective indenture and, as a result, the bonds will become due and payable.

WHAT IF WE HAVE UTILISED THE LOANS IN THE FORM OF BANK GUARANTEES OR LETTERS OF CREDIT?

Financial guarantees (including bank guarantees) are explicitly excluded from the scope of the act. Unfortunately, it is not clear whether such exclusion includes all relationships arising under or in connection with financial guarantees.

As the act does not contain any specific provision regarding letters of credit, two contradictory interpretations are thus possible: the first interpretation being that the exception shall, by analogy, include letters of credit; the second interpretation –the exact opposite of the first one – is based on an argument that if the legislature, despite their similarity, did not rule relationships arising under or in connection with letters of credit are indeed out-of-scope of the act, then no exception shall apply. Although we tend to lean in favour of the former, more reasonable interpretation, we are not in a position to make a determination as to whether such interpretation will be adopted by courts.

WHAT IF WE HAVE A SECURED FINANCING IN PLACE?

At first glance, security shall not affect the applicability of the loan moratorium. This however applies only if loans are not secured by financial collateral arrangements. Whether or not such arrangement is a financial collateral arrangement may not be obvious in the first instance due to the manner in which the relevant European Directive has

been implemented in the Czech Republic. Unless explicitly excluded by the parties to the relevant security arrangement, it cannot be ruled out that security provided in relation to ordinary corporate loans such as charges over shares or over bank account agreements receivables will be considered financial collateral. Although, according to the explanatory note and the information available to us, this has not been the intention of the legislature (and one can argue that such interpretation will be in contradiction of the purpose of the act under which the relevant European Directive has been implemented) such interpretation, if obtained, would effectively eliminate the possibility of application of the act in relation to loans secured by financial collateral arrangements. Unfortunately, this ambiguity was not removed during the discussion of the bill in the House of Deputies.

In general, the act shall apply only with respect to loans concluded and utilised before 26 March 2020. However, provided that an unutilised loan concluded post 26 March 2020 is secured by a mortgage or other *in rem* security over the real estate in question, the act will apply to such loan. Disregarding the obvious intention to provide relief to individuals with housing mortgages, the adopted wording will apply also with respect to many commercial real estate financings.

WHAT IF WE HAVE HEDGING ARRANGEMENTS IN PLACE?

The first version of the draft bill sent to the House of Deputies (as document no. 813) contained an exception regarding loans secured by an interest rate hedging arrangement. Such exception was nevertheless removed based on the amendment proposed during discussions on the draft bill. As such, interest rate, currency or any other hedging arrangement no longer prevents or prohibits imposition of a loan moratorium.

WHAT IF WE WERE IN DEFAULT EVEN PRIOR TO THE PANDEMIC?

The loan moratorium will not protect borrowers who had difficulties in fulfilling their monetary obligations prior to the outbreak of the Covid-19 pandemic. Therefore, the condition for application of the loan moratorium is that the borrower was not in default of its payment obligation for more than 30 days as at 26 March 2020.

HOW DO WE IMPOSE THE LOAN MORATORIUM?

The loan moratorium is not imposed automatically – the borrower has to actively opt for its application by expressing its intention to utilise the act's temporary payment protection. The act does not prescribe the form for such "opt-in"; it may be in the form of a simple notice sent to the borrower's lender(s).

FOR HOW LONG WILL THE LOAN MORATORIUM APPLY?

Following the "opt-in", payment of the borrower's pecuniary obligations will be deferred by an amount of time equal to a protection period (in Czech *ochranná doba*) selected by the borrower; the protection period will end either on 31 October 2020 or, if so selected, on 31 July 2020. The date of the "opt-in" shall not affect the final date of the protection period – the act sets it by (either of) these two particular and prescribed dates.

Although the intention of the act is clearly to overcome the current unfavourable economic conditions caused by the Covid-19 pandemic, the linguistic interpretation of its wording cannot lead to any different conclusion other than that the loan moratorium will affect not only payments of instalments of term loans due and payable during the protection period but also payments of "bullet" type loans payable on their final maturity date (this falling beyond the end of the protection period). If the currently agreed final maturity date of such a loan is, by way of example, 31 December 2020, the maturity date will be postponed by the length of the protection period selected by the borrower. Given that the moratorium does not affect a lender's right to receive interest during the period of time in which a loan is outstanding, the cost of a loan will effectively increase as a result of the "opt-in".

If a borrower elects to "opt-in", the borrower has to specify precisely in respect of which loan(s) the "opt-in" is being made – otherwise the conclusive legal presumption applies and the "opt-in" will apply with respect to each of the loans concluded between the borrower and the lender in respect to whom the "opt-in" has been performed. The draft bill does not take into account situations where a borrower (i) has in place (has concluded) a major loan (agreement) with several lenders (so-called club or syndicated financing) as well as fractional, bilateral financings with individual members of the club / syndicate, (ii) applies for the loan moratorium to apply in relation to a "big" club / syndicated loan and (iii) does not sufficiently specify that loan within the notice. It is unclear whether the loan moratorium in such

a scenario will apply automatically with respect to bilateral loans and, in our opinion, such a scenario is laden with too much uncertainty, to comment on.

WILL APPLYING FOR THE LOAN MORATORIUM RESULT IN US BEING REGISTERED IN THE "REGISTER"?

As a consequence of the concept introduced by the legislature in which a borrower who decides to apply for the protection period, accepts public interference into its private law obligations, there will be no need to reclassify the credit risk relating to the respective loans. This is to prevent the negative effects of the loan moratorium on borrowers in respect of the eventual negative entries within borrowers' registers as well as the consequential negative effects on lenders, in particular banks or other financial institutions, who will not need to consider the loan moratorium when assessing the credit risk or creditworthiness of a borrower or borrowers. This approach is in line with recommendations of the European Banking Authority regarding moratoria on loan repayments applied in light of the COVID-19 crisis[1].

WILL OUR "OPT-IN" FOR THE LOAN MORATORIUM CAUSE US OPERATING ISSUES?

Section 10(2) of the draft bill stipulates that during the period of the loan moratorium, a borrower who is a legal entity must not dispose of its assets, which might be used for satisfaction of its lender(s)' claims, if such disposition would result in a material change in the composition, use or designation thereof or in a not insignificant reduction. This language has been taken verbatim from Section 111(1) of the Czech Act on Insolvency. However, in the Czech Act on Insolvency, such prohibition is qualified by paragraph 2 of Section 111, which contains, *inter alia*, an exception regarding acts performed in the ordinary course of (the borrower's) business. Further, Section 111 of the Insolvency Act contains paragraph 3 which provides for the acts taken contrary to paragraph 1 being ineffective unless consented to by the court.

The contemplated legislation of the loan moratorium regulates neither the extent of the above prohibition nor the consequence of its breach. Given the extraordinary disruption the act imposes on lenders' rights, it can be argued that legal actions taken by borrowers in breach of the aforementioned restriction will be held invalid, at least upon a lender's invocation of invalidity (i.e. voidable).

It must therefore be assumed that, by applying for the loan moratorium, the borrowers will impose a considerable degree of legal uncertainty on their transactions concluded within the period of the moratorium.

Further, in addition to the above outlined disposals of its assets, pursuant to the explanatory note, a borrower shall not during the period of the loan moratorium (i) pay any dividends or funds from its other resources or pay any advances to dividends or funds from its other resources, (ii) provide to its shareholders or controlling or controlled persons any loans (in Czech *úvěry* or *zápůjčky*), (iii) dispose of or encumber its assets without due consideration, (iv) provide to (members of) its statutory body or executives any extraordinary remunerations, (v) reduce debts within its group or (vi) repay loans provided by its affiliates. Fortunately, the explanatory note states that these limitations do not apply to, *inter alia*, legal acts required to comply with obligations under other laws for the purpose of the operation of an enterprise in the ordinary course of business – however the proposed wording of the bill does not introduce such exceptions and it is thus unclear whether such acts are indeed not subject to these limitations. Reasonable interpretation must lead to the conclusion that it is; otherwise, it would be contradictory to one of the primary purposes of the act – to prevent the forced cessation of businesses affected by the Covid-19 pandemic.

WHAT IF WE HAVE ALREADY REACHED AN AGREEMENT WITH OUR LENDER?

Based on an amendment proposed during discussions on the draft bill in the House of Deputies, arrangements with respect to the unfavourable economic impact caused by the Covid-19 pandemic on a borrower agreed among the parties within the period commencing on 12 March 2020 shall cease to be effective once the loan moratorium is imposed. Borrowers may thus by electing to "opt-in" "override" certain already agreed arrangements in respect of amounts payable during and after the protection period. Whether it is worth doing this will need to be carefully considered on a case by case basis, taking into account, *inter alia*, the questions and answers outlined above.

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[1] European Banking Authority. *Final Report: Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis.* EBA/GL/2020/02 2 April 2020, available here.

WHAT TO DO IF WE WANT TO REACH AN AGREEMENT WITH OUR LENDER?

In view of all the legal uncertainties created by the new rules, it may seem more appropriate for the parties to contractually agree on how to overcome the current situation caused by the Covid-19 pandemic. As is typical when the "government comes to help" and causes potentially more harm than good to private parties, the question arises as to whether the adoption of the new rules regarding the loan moratorium will result in, and preclude, a possible agreement between the parties themselves.

Although we assume that any reputable legal counsel would draw the attention of its clients to the risk of a different interpretation, we believe that there is much more in favour of the view that the above legislation does not prevent or prohibit a different agreement being reached and concluded between the parties. This should apply in particular if a borrower is a truly strong business entity and, in any case, if the agreed contractual arrangement is generally more favourable to the borrower than the "opt-in" effects of the proposed legislation.

Should you have any other questions regarding the Czech loan moratorium, please do not hesitate to contact us as we would be happy to discuss these with you.

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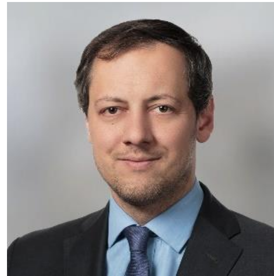

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