

## Slovakia: A new subordination rule entered into force: the role of related party creditors in bankruptcy post Amendment to the Slovak Bankruptcy Act

### Introduction

*As of January 1, 2012, the Slovak Act on Bankruptcy and Restructuring (Act No. 7/2005 Coll.) has been amended to introduce a statutory subordination of claims of related creditors (Section 95(3) of the Slovak Bankruptcy Act). The Amendment affects the ability of creditors to obtain satisfaction from companies in bankruptcy by classifying claims by "related" parties as subordinate to other claims.*

In a nutshell, the new rule stipulates that for anyone to make a claim against a business in bankruptcy, the focus will be on the relationship of the creditor to the bankrupt debtor. Thus, if the creditor **ever** was a related party to the debtor **-at any time-** before, during or after the claim arose, the claim will be subordinated. Further, if the creditor obtained, in any way, interest in the claim from a third party, then the same scrutiny applies to the third party, i.e. were they ever a related party to the debtor? If the answer is "yes", then the claim will be treated as a subordinated claim, and will only be paid once (and if) all other creditors in the bankruptcy have been fully compensated.

The new regime also invalidates attempts to secure a subordinated claim. In addition, the Amendment removes the voting rights associated with the claims against a related party and the right to be elected into the creditors' committee for the related creditor.

### What does related party mean under the new law?

Any person or company which has a 5% interest in the debtor falls under the new Amendment. Additionally, any person or company with the power to influence the management of the debtor to the same extent that a 5% interest holder could also is deemed to be a related party. The definition is especially broad because it covers indirect interests as well.

### When must the claim be held by the related party?

The claim does not have to be held by the related party at the time of the debtor's bankruptcy. It is sufficient that the related creditor held the claim **anytime in the past**. The motivation for this rule is understandable- it prevents the bypassing of related party status by transferring the claim to a third party. However, automatic subordination of all claims once held by a related party will damage day-to-day business life more than it will help to cure undesirable practices.

### Which claims are covered?

Unlike in other jurisdictions, all claims are covered by the newly introduced subordination rule, irrespective of how they arose.

Accordingly, the crucial determiners to apply under the new subordination rule are formal instead of content driven: Simply put: who holds or has held the claim?



#### Contact

Gudrun Stangl Lutz  
Partner  
T: +421 2 571 007 01  
E: g.stanglutz@schoenherr.eu



#### Contact

Juraj Steinecker  
Attorney at Law  
T: +421 2 571 007 01  
E: j.steinecker@schoenherr.eu

**Lawmakers' intentions and possible side effects**

Obviously, lawmakers wished to eliminate the practice of shareholders and other related parties creating claims against a bankrupt company to secure their interest during bankruptcy proceedings. Whether the Amendment will be able to resolve this issue remains to be seen.

On the other hand, the Amendment raises serious concerns that it is overbroad for the purpose of achieving its goals. Remember: a claim is considered a related party claim if it belongs, or belonged, to a person or company who is, or was, a debtor's related party. Thus, the new subordination regime has the potential to produce obviously unintended (and even absurd) results if applied literally.

Especially troublesome, the new provision applies to claims of parties that were related at any point in the past. Consider the following: Two entities which were originally state-owned companies and subsequently privatized may be caught by Section 95(3) because they may qualify as related parties. This would substantially affect transactions between (among others) banks and large companies which were state owned prior to 1989. The claims of banks, based upon loans to such companies, could reasonably end up with subordinated status should the company go bankrupt. Results like these suggest that Section 95(3) should be read and applied narrowly.

The Provision went into force on January 1, 2012, and covers all claims arising thereafter. Further, as it lacks transitional provisions for claims that existed as of that date, the subordination rule is retroactively applicable to all claims in existence prior to January 1, 2012 as well. In the absence of a rule that excludes existing claims from the new subordination rule, it is possible that the subordination rule violates the prohibition of retrospective legislation.

**Conclusion**

The subordination regime is new and untested, and Slovak courts have little expertise in dealing with related issues. The following, however, can be definitively said:

The subordination regime embodied in the Amendment goes far beyond what the laws of other European countries prescribe. It covers any claim, irrespective of its origin, so long as the claim was ever held by a creditor who was, is, or will be, a related party to the bankrupt company. And, it takes little to qualify as a "related party" creditor. Therefore, the changes made by the Amendment may have the unintended consequence of driving companies to seek creative structures for the purpose of disguising relationships between parties. Attempts may be made to disguise ownership, or related party relationships, by working with intermediary structures, or by having a parent or sister company incorporated in a jurisdiction that normally does not disclose ownership information.

In addition, the subordination rule may deter ordinary course of business relationships such as the factoring business, and interfere with the commercial decision-making of parties. Creditors will have to accept that the anticipated rate of satisfaction of related party claims is very low. Usually, there is not enough money to satisfy all primary creditors. The broad definition of related party, together with the possibility that a claim may have ever been held by a related party, will force banks and other relevant companies to carefully review the history of a particular claim and of the parties they are dealing with.

Finally, from a procedural perspective, the new Amendment will likely cause further delays to an already lengthy process of bankruptcy in the Slovak courts. Since it allows for creditors to challenge the claims of others participating in the bankruptcy, the new rule will almost certainly result in extensive side-litigation to determine the primacy of claims.

Ultimately, all of the foregoing issues may result in calls for further clarification or amendment of the relevant provisions.