Main elements and risks for creditors under the new Estonian Restructuring Act

The new Estonian Restructuring Act is a long-awaited revolution in the regulation of corporate insolvencies in Estonia. The Restructurings Act was adopted on 4 December 2008 and entered into force on 26 December 2008 with the aim of avoiding unnecessary bankruptcies and giving an alternative solution for distressed corporations. The law established a completely new legal procedure enabling distressed corporations on the verge of insolvency to reorganize themselves operationally, restructure their debt, and apply other measures to regain financial health and restore profitability. The restructuring procedure is designed as an alternative to bankruptcy, similar to the US Chapter 11, the German Insolvenzordnung, and the Finnish Saneerauslaki.

Background Stats and Interest Groups

Estonian court practice during the first 9 months of 2009 shows that surprisingly many entrepreneurs have entered into restructuring proceedings – over 70 applications have been filed and there are around 40 restructuring proceedings ongoing. Several restructuring plans have been left unconfirmed and proceedings have been terminated. There are only a few of proceedings that can be considered successful where the restructuring plan has been confirmed by the creditors and by the court. One of these is the restructuring of the construction corporation advised by Sorainen.

Apart from debtors, the Restructurings Act is intended to be beneficial also for creditors, large and small, secured or unsecured, who are provided a clear nonbankruptcy means of maximising the amount they are able to collect from their corporate debtor.

The new law is also appealing to turnaround investors and venture capitalists whose business is acquiring debt or equity in troubled corporations for a fraction of their face value, injecting new capital, improving management, and adding other value in order to restore the target's profitability. The new Restructuring Act has already dragged to the marketplace a number of distressed corporations that may be of interest to turnaround investors.

Overview of the Proceedings

A precondition to opening the restructuring proceedings is that the debtor corporation files an application to court giving proof of that the corporation is likely to become insolvent in the future, the corporation requires restructuring and the sustainable management of the corporation is likely after the restructuring. The list of debts and financial reports of the corporation have to be appended to the application.

If the court decides to satisfy the filing, then the enforcement proceedings against the corporation and the calculation of a fine for delay or a contractual penalty on claims against the corporation are suspended. A suspension also applies to the deciding on commencement of bankruptcy proceedings. Additionally, there's the possibility to terminate court proceedings regarding a financial claim against the corporation. This is intended to give the corporation time to work out its problems through the automatic stay of collection attempts against it, while still continuing to run its business.

If the court opens the restructuring proceedings, then it also appoints a restructuring advisor who will advise the debtor in preparing the restructuring plan. Among other duties, the advisor also has to monitor the solvency of the debtor and the purposefulness of the transactions the debtor enters into as well as check the legality of the claims brought into the restructuring estate.

The entrepreneur has 60 days to prepare and file the restructuring plan to the court. In order for the restructuring plan to become effective, the plan must be accepted by creditors and confirmed by the court. The plan is accepted by the creditors if at least 1/2 of all the creditors are in favour and at least 2/3 of all the votes are in favour. The court shall approve a restructuring plan if the creditors have received notice of the amount of their claim and the restructuring plan and if the plan complies with legal requirements. On certain circumstances the court can even confirm a plan that has not been approved by the creditors. This is subject to, among others, that two additional experts confirm that the restructuring of the entrepreneur is likely to be successful and that the entrepreneur is an significant employer.

Risks for Creditors

It is clear that given the current state of the economy, some businesses are more viable than others. Also, it seems that in many restructuring proceedings there may have occurred abuse of the restructuring proceedings by way of these proceedings being initiated by corporations that do not have a realistic perspective of making a successful turnaround. In other cases, there appear to have occurred violations of creditor rights. However, it is likely that additional court practice and implementation of certain changes to the existing restructuring law will solve these problems. There are many problematic and unclear clauses in the current language of the Restructuring Act that are difficult to overcome by way of interpretation. Proposals for amending and improving the current Restructuring Act are under way and will hopefully reach the Parliament within a couple of months. Some of the dangers and risks to the creditors in the current regulation are listed below:

• Restructuring procedure is initiated with respect to corporations whose business is not sustainable and whose insolvency may be permanent

This may result in a situation where a creditor's claim is not satisfied in the same extent as it would have been if bankruptcy proceedings had been instituted instead of restructuring. On the other hand, Estonian courts restructuring practice shows that less than half of the restructuring applications have been granted and proceedings opened.

This indicates that courts are not too eager to institute restructuring proceedings, but certainly the practice to evaluate the financial situation and sustainability of corporations is still insufficient. Thus, for example, restructuring procedure has been initiated with respect to several corporations who engage only in real estate development and lack a proper business plan.

• If the value of a creditor's security reduces abruptly, the creditor does not have the right under the Restructuring Act to demand termination of the restructuring procedure or give the creditor any preferential status in the restructuring procedure

This may entail a significant risk for a secured creditor considering that the market may still be in decline, meaning that the value of property may reduce quickly in a short time. To mitigate the risk, it may be helpful if the corporation's liquidation value is considered in preparing the restructuring plan.

• The restructuring plan focuses only or mainly on the restructuring of claims and capital, disregarding operational restructuring measures and opportunities for continuing business

Failure to implement operational organisational measures is often the main reason of potential insolvency of a corporation going through restructuring. Restructuring can hardly be successful if the real causes of insolvency are not cured. Such causes may include wrong strategy or communication (both internal and external), marketing and sales plans, nature of assets, and the number or profile of employees. Likewise it is difficult to reorganise a corporation who currently has no business activity and plans to overcome difficulties only by expecting the market situation to improve.

• In Estonia certain essential restructuring principles to protect creditors, which have been in place in US court practice, for example, for tens of years already, have not been rooted in court practice

These principles include the Best Interests Test, where claims of all creditors who disagree with the restructuring plan must be satisfied in the course of the restructuring procedure at least at the liquidation value of the claim. Another important principle is the Feasibility Test, which means that a restructuring procedure must be realistic (not relying on wishful thinking) and there must be a reasonable opportunity to fulfil the plan. Feasibility of the debtor is evaluated mainly by considering its prior rate of return.

• The value of business of a debtor going through restructuring does not increase in the course of restructuring procedure, but reduces

This in its turn may reduce the extent to which creditors claims are satisfied. Restructuring advisors, who have the obligation arising from law to verify expediency of transactions and solvency of the debtor throughout the restructuring procedure and to prepare reports for each half year, can help mitigate this risk.

• Unjustified unequal treatment of creditors and impairment of their interests

The Restructuring Act gives a corporation being reorganised freedom to choose which debts and to what extent to satisfy in the course of restructuring. This poses a risk of damaging creditors' interests. The factors that mitigate the risk are supervision exercised by the court and restructuring advisors, and the creditors' right to file a motivated petition with the court for non-approval of the restructuring plan and termination of the procedure. Further, it is very likely that damage caused to creditors by unjustified preferential treatment or impairment of interest can be recovered in course of potential subsequent bankruptcy proceedings. On the other hand it may be difficult for a creditor to decide whether he has been treated unfairly compared to other creditors as the law does not require disclosure of claims that are not restructured in the course of the restructuring proceedings. Supplementation of the Restructuring Act with principles of creditor treatment would certainly enhance transparency of the restructuring procedure.

• Many restructuring advisors are not covered by liability insurance

If restructuring advisors wrongfully violate their obligations thus causing damage to creditors, it may be difficult for the creditor to enforce its claim with respect to an uninsured restructuring advisor because the current Restructuring Act does not require liability insurance from restructuring advisors whereas liability insurance taken by trustees in bankruptcy and lawyers may not necessarily cover the practice of restructuring advisors.

• Initiation of restructuring procedure does not suspend expiry of the period of limitation of transactions

In certain cases the Bankruptcy Act allows to revoke transactions which were made before bankruptcy proceedings were declared and which impair creditors' interests. The time between making the transaction (e.g. 6 months, 1 year, etc) and initiation of the bankruptcy proceeding is important here. Initiation of a restructuring procedure does not suspend the limitation periods for recovery and therefore certain transactions that impair the creditors' interest may remain unrecovered.

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