REPRINT FINANCIER WORLDWIDE

APRIL 2014

FINANCIER WORLDWIDE corporatefinanceintelligence

BANKING & FINANCE

Refinancings and consensual restructurings in Finland

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In the current economic climate, the number of debtors experiencing difficulties in servicing their loans is increasing. In many cases, the debtors' businesses have not developed favourably and a number of banks are unwilling to take on significant new risk.

We discuss in this briefing certain legal issues and risks relevant to refinancings and consensual restructurings in Finland and the options available for the parties.

Repayment

To date, most borrowers have been able to sort out their financing problems through various refinancing arrangements which have in some cases been coupled with asset disposals.

The proceeds from a disposal are often utilised for repayment of existing loans. A repayment may, however, be subject to a recovery risk if the borrower becomes insolvent during a three-month period following the repayment. The risk exists, in particular, where: (i) the amount of the repayment is significant

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in relation to the borrower's assets in a subsequent insolvency, meaning in practice an amount in excess of 10-15 percent of the gross assets of the insolvent debtor; or (ii) the repayment exceeds the already matured portion of the loan.

A loan repayment exceeding the original repayment schedule is regarded as an early repayment under the avoidance rules even if the loan had been accelerated and the repayment would therefore not be voluntary.

In light of the avoidance and other insolvency law rules, any restructuring measures involving early repayment of debt become risky where the debtor is insolvent or approaches insolvency. The earlier the restructuring measures are commenced, the easier the legal risks are to manage.

Debt-to-equity swap

The creditors of an overindebted company may consider converting a part of their receivables into an equity investment in order to strengthen the borrower's balance sheet. Such an arrangement can be effected by means of a directed share issue to the relevant creditor whereby the subscription price is set off against the lender's receivable.

From the converting lender's perspective, a problem with a traditional debt-to-equity swap is that the converted receivable can no longer be reinstated if the rescue attempts prove unsuccessful and the borrower later becomes insolvent. The converted receivable therefore retains its equity character and remains last-ranking when distributing the debtor's assets in bankruptcy.

There are mechanisms to effect a debt-to-equity swap also in a manner which allows the converted receivable to be reinstated if the rescue is unsuccessful. Instead of a traditional debt-to-equity swap, the borrower may issue warrants entitling the holder to subscribe for shares at a low subscription price, or direct a free issue to the lender. In such cases, debt owed by the borrower is not used as payment of the subscription price and the debt reduction therefore can be separated from the share issue. The lender and the borrower can then make an agreement on reduction of debt which provides for the lender's original receivable to be reinstated in circumstances specified in the agreement and expected to occur a significant time before a potential insolvency, e.g., where certain financial indicators deteriorate below agreed levels.

Enforcement

When softer restructuring measures are not available or are not expected to bring relief, lenders may consider enforcing any security they may hold.

The method on enforcing a share pledge can be chosen by the security holder. Pledged shares can be sold in a private transaction or a public auction. By contrast, certain security assets such as real estate may only be realised by an execution officer following an enforcement order by the court.

The law requires that the interests of the pledgor be taken into account when enforcing the pledge. This is particularly relevant in the case of a share pledge where enforcement can be carried out as a private sale. The basic requirement in this respect is that the pledgor may not realise the pledge at a clear undervalue. It is advisable that the pledgee obtain one or more independent valuations of the pledged property before effecting a private sale in order to verify the market value of the asset.

In principle, the pledgee may, instead of a sale, take possession of the pledged property against deduction of the debt corresponding to the value of the property. In such circumstances, the valuation of the property is even more important than in an enforcement sale to a third party. Provided that the value of the pledged property can be demonstrated in a reliable manner, the pledgee may sell the pledged assets to a company controlled by it or even itself take title to the pledged assets against a corresponding reduction of the secured debt.

Insolvency proceedings

Borrowers facing creditor action sometimes apply for initiation of corporate restructuring proceedings in order to maintain control over their assets. Corporate restructuring proceedings may also be utilised by creditors where there is disagreement among creditors as to the appropriate reorganisation measures. Although not standard practice, it is also possible to use corporate restructuring proceedings as a method of transferring the debtor's business to an entity owned by the creditors.

Bankruptcy represents the borrower's choice of last resort and results in the borrower losing control of its assets. Creditors may utilise bankruptcy proceedings to realise the debtor's assets and/or to transfer assets to a new company.

Corporate restructuring

Finnish corporate restructuring proceedings are debtor-in-possession proceedings with the stated objective of revitalising the debtor. The initiation of restructuring proceedings results in a statutory freeze of payments from the debtor and a ban on enforcement of collateral. Secured debts are protected, up to the current value of the collateral, against reduction of the capital amount of debt but may be subject to other reorganisation measures. These other measures are: (i) change of maturity of debt; (ii) appropriation of payments first to repayment of debt capital and then interest; and (iii) reduction of interest.

The reorganisation measures are set out in a restructuring program which must be approved by creditors and affirmed by the court. For voting purposes, creditors are divided into four groups: (i) secured creditors; (ii) creditors holding a business mortgage; (iii) unsecured creditors; and (iv) subordinated creditors. In ordinary voting, the plan must be approved, in each group, by creditors which represent a majority of the creditors participating in voting and hold a majority of the debts held by creditors participating in voting.

Rules concerning so-called mandatory approval constitute in practice a significant exception to the main rule requiring majority approval in each creditor group. Under this alternative, a restructuring program is adopted if it is approved by a majority of creditors in one creditor group (the majority is determined in the same way as in ordinary voting, i.e., creditors which in that group represent a majority of the creditors participating in voting and hold a majority of the debts held by creditors participating in voting) and the claims of all creditors who have voted in favour of the plan represent at least 20 percent of all known debts.

Although originally intended as a safety valve, the rules on mandatory approval have become a common way of obtaining approval of a restructuring plan.

Bankruptcy

A secured creditor is entitled to enforce the collateral even if the pledgor is bankrupt. The estate is, however, authorised to prohibit the sale for a period of two months if it is necessary to safeguard the interests of the estate. The court may also authorise the estate to sell pledged assets if the estate has received an offer which exceeds the likely auction value of the collateral.

Board liability

Board members at distressed

companies face an increased risk of having their actions scrutinised by courts later on. In particular, if the company becomes insolvent, the bankruptcy estate or individual creditors may launch a claim for damages questioning the board's decisions, or its inaction.

The current Companies Act no longer imposes an explicit obligation to place the company into liquidation upon loss of equity. Instead, the board is required to notify the loss of equity for registration in the Trade Register. Failure to make such a notification may result in board members' personal liability for loss sustained by a creditor which is deemed to have a causal connection to the breach of the registration requirement.

It is less clear, however, whether, and under what circumstances, board members may otherwise become liable for continuing a loss-making business. While business decisions which are based on reasonable grounds and taken without conflicting interests do not give rise to personal liability, there a risk that a continuation of unprofitable operations in circumstances where there are no reasonable prospects for recovery be considered as a violation of the board's general duty of care towards the company. In such a case, the bankruptcy estate would be entitled to claim damages from the board members.

From a liability perspective, the requirement of equal treatment of creditors is often a pressing concern in a restructuring. Such a requirement is indirectly imposed by the criminal law provision concerning favouring of a creditor. Arrangements involving selective payment of debts, granting of new security for an old debt or discharge of debt through payment in kind in circumstances where the debtor is insolvent or near insolvency are particularly risky. In some cases, it may be possible to remove or alleviate those risks through an agreement with other creditors. ■