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FINANCE & CAPITAL MARKETS

> FINNISH SUPREME COURT RULES ON EFFECT OF CREDITOR'S MERGER ON PLEDGE AGREEMENT

by Tove Johansson

In its ruling from May 2009 (KKO 2009:41), the Finnish Supreme Court ruled on the question whether a security agreement covers debts arisen after the merger of the creditor company.

Background

The debtor company had given a pledge over real estate mortgage notes to another company as security for all its current and future debts. The pledge was agreed to be in force as long as the creditor had receivables from the debtor. Some years later the creditor merged with another company and the debtor continued its business relations with the merged company.

The debtor was subsequently declared bankrupt and its bankruptcy estate contested the creditor's claim for precedence based on the real estate mortgage arguing that the debts resulted from purchases that the debtor had made after the merger.

Effects of merger on pledge agreements

Under Finnish law, the assets and liabilities of a merging company are directly transferred to an acquiring company following the implementation of the merger. The Supreme Court noted that rights and obligations based on a pledge agreement are part of such assets and liabilities which are directly transferred to a receiving company. The agreements are deemed to remain in force unless the agreements provide otherwise.

Although the Supreme Court emphasized the general principle of automatic transfer of rights and obligations through a merger, it specifically noted the legislation regarding general guarantees. According to the Finnish Act on Guarantees and Third-Party Pledges, a guarantor who has given a general guarantee, *i.e.*, a guarantee covering more than a specified debt, shall be liable for debts which have arisen after a merger of the creditor company only if the guarantor has been notified of the merger. The guarantor may then set a cut-off time for the validity of the guarantee, thereby declining liability for debts incurred after a certain date.

The rationale of this rule is to protect the third party providing the guarantee (or collateral) from being liable for debts that arise after a merger and that could not have been foreseen when granting the security. The regulations restricting a guarantor's liability are mandatory in favor of the guarantor if the guarantor is a natural person. Where the guarantor is not a natural person, these restrictions can, however, be derogated from by agreement.

Decisions and motivations of the Supreme Court

The Supreme Court found that the pledge agreement had been agreed to remain in force as long as the creditor had receivables from the debtor, it contained no conditions regarding a possible merger and the pledge was intended to cover receivables of varying amounts. As the debtor furthermore continued a similar business relationship with the merged company as previously with the creditor, the Supreme Court considered that neither the purpose nor the contents of the pledge agreement had changed as a consequence of the merger.

Security for own debt

The Supreme Court further held that the rules regarding general guarantees given by a third party were not applicable in this case as the security was granted by the debtor for its own debts. It was therefore not necessary to protect a third party and the regulations of the Act on Guaranties and Third-Party Pledges could therefore not be generally applied to security agreements.



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FINANCE & CAPITAL MARKETS

> FINNISH SUPREME COURT INTERPRETS RULES ON RECOVERY AND FAVOURING A CREDITOR

by Juha-Pekka Mutanen and Johanna Ijäs

On 10 September 2009, the Supreme Court issued two judgments (KKO 2009:69 and 2009:70) arising from the same set of circumstances concerning, respectively, grounds for recovery to bankruptcy estate and the criminal offence of favouring a creditor.

Facts

The managing director and board member of a debtor company had after the company had decided to close down its business and around six months before commencement of bankruptcy selectively paid some of the company's debts in full. Among the debts paid in full was a receivable for which the managing director and two other board members had personally given guarantees in favour of the creditor as well as a debt owed to a company whose owner was indirectly a major shareholder in the debtor company.

In addition, the company had sold fixed assets to its creditors setting off the purchase price against those creditors' receivables.

In its judgments, the Supreme Court considered, on the one hand, whether the managing director had by authorising the debt payments committed the criminal offence of favouring a creditor and, on the other hand, whether, as a result of the payment of the debt guaranteed by the three board members, the three guarantors should be ordered to compensate to the estate the value of the released guarantee on the basis of avoidance rules.

Offence of favouring a creditor

Under the Penal Code, if a debtor, knowing that he or she is unable to meet his or her liabilities, in order to favour a certain creditor at the expense of other creditors

- (i) repays a debt before its maturity in circumstances where the repayment is irregular;
- (ii) gives to a creditor collateral that had not been agreed upon at the time the debt arose;
- (iii) uses an unusual means of payment to meet a liability in circumstances under which the payment cannot be deemed regular; or
- (iv) undertakes another similar arrangement that improves the position of the creditor

he or she will be sentenced for favouring a creditor to a fine or to imprisonment for at most two years.

Unusual method of payment

After finding that the company had at the relevant time been unable to meet its obligations and that the managing director had been aware of such state of affairs, the Supreme Court held that the sale of fixed assets to the company's creditors against setting off its debts constituted an unusual means of payment referred to in the Penal Code. Noting further that it was irrelevant that the managing director had at the relevant time thought it possible to repay all of the company's debts, the Supreme Court found the managing director guilty of favouring a creditor on the basis of the sale transactions and sentenced him to a fine.

Selective payment

As regards the selective payment in full of certain of the company's debts due (including the debt guaranteed by the board members) by using money as means of payment, the Court considered that such action could potentially only fall under sub-section (iv) of the above-mentioned criminal statute concerning favouring a creditor.

The Supreme Court held that in determining whether the debtor had "undertaken another similar arrangement that improves the position of the creditor" within the meaning of the Penal Code, it is not sufficient that the debtor merely pays its debts selectively. To constitute an offence, it is additionally required that the payment or arrangement differs from what is customary or from what had been originally agreed.

Principle of legality

Emphasising the principle of legality in criminal law, the majority of the Supreme Court therefore held, contrary to lower courts, that the selective payment of due debts by using money as consideration did not constitute a criminal offence. According to the Court, in assessing criminal liability, it was irrelevant whether the relevant payment was recoverable under avoidance rules.

The minority of the Court would have imposed criminal liability on the basis of selective payment of due debts because the payments were intended to favour parties closely connected to the insolvent debtor.

Avoidance

In the avoidance case arising from the same circumstances, the bankruptcy estate claimed that, as a result of the payment by the company of the debt guaranteed by the board members, the guarantors, whose guarantee liability had been extinguished, should be obliged to compensate to the estate the value of the guarantee in accordance with the Finnish Act on Recovery to a Bankruptcy Estate (the "Recovery Act").

The estate had earlier dropped the recovery claim against the creditor whose receivable had been paid.

General recovery rule

Pursuant to the general rule of the Recovery Act, a contract or other act will be reversed if it has been concluded to favour a creditor to the detriment of other creditors. Prerequisites for recovery are that the debtor was insolvent or became insolvent due to the contract or act concerned and that the other party knew or should have known of the insolvency and of the implications of the contract or act.

The Recovery Act also contains specific rules on actions against guarantors, which rules, however, were held not to be applicable in this case.

Favouring of guarantors

The majority of the Supreme Court found that the payment of the debt was made in order to release the guarantors from their guarantee and hence to prevent the guarantors from becoming creditors in the bankruptcy. According to the Court, the guarantors were thereby favoured at the expense of other creditors.

The Court considered that it was irrelevant whether the creditor whose receivable had been paid was favoured by such payment or whether such payment could be recovered from the creditor. The Court further held that the general rule of the Recovery Act, which only refers to a "creditor" of the insolvent, could also be applied to a guarantor and, consequently, ordered the guarantors to compensate the value of the guarantee liability to the bankruptcy estate.

The two judgments of the Supreme Court demonstrate, on the one hand, a relatively restrictive interpretation of provisions concerning debtor's offences; this can be considered to comply with the criminal law principle of legality according to which criminal statutes cannot be interpreted expansively to the detriment of the accused. On the other hand, the Supreme Court also shows a willingness to interpret civil law avoidance rules in a purposive manner in deviation from the strict letter of the law.



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DISPUTE RESOLUTION

> ECJ RULES ON ENFORCEMENT OF DECISION REGARDING RETENTION OF TITLE

by Eva Storskrubb

European Regulations

Within the European Union the so called Brussels I Regulation (EC) No 44/2001 following its predecessor the Brussels Convention of 1968 deals with questions of jurisdiction as well as recognition and enforcement in civil and commercial matters. However, bankruptcy proceedings are specifically excluded from the scope of the Regulation together with certain other matters. In contrast, the so called Insolvency Regulation (EC) No 1346/2000 has since its entry into force on 31 May 2002 dealt with certain cross-border insolvency questions in the EU.

In a recent ruling in case C-292/08 of 10 September 2009 the European Court of Justice ("ECJ") was faced with a question relating to the respective scope these two instruments in the context of the enforcement of a decision regarding retention of title in a cross-border insolvency situation.

Facts of the Case

The questions that the ECJ was asked to deal with in the matter arose in proceedings between a German company and the liquidator of a Dutch company. The German company had sold machines to the Dutch company, the agreement for which contained a reservation of title clause in favour of the seller.

In 2006, the Dutch company was placed in involuntary liquidation. At the time of commencement of insolvency the machines sold under the relevant sales agreement were located in the Netherlands. Later in 2006 a German court nevertheless granted the application made by the German company for the adoption of protective measures with regard to a certain number of the machines based on the reservation of title clause in the sales agreement.

Subsequently a judge in the Netherlands declared the German decision enforceable. However, the liquidator lodged an appeal against that decision. The appeal was successful, which led the German party to lodge a further appeal against the decision that revoked the enforceability of the German decision. The Supreme Court of the Netherlands in this context referred certain questions to the ECJ for guidance on the interpretation of the relevant EU provisions.

Protection of retention of title

Article 7 of the Insolvency Regulation provides that the opening of insolvency proceedings against the purchaser of an asset shall not affect the seller's rights based on a reservation of title where at the time of the opening of proceedings the asset is situated within the territory of a Member State other than the State of opening of proceedings.

In the case at hand the provision could not as the ECJ noted help the German company because the assets were at the time of opening of proceedings already situated in the Netherlands. The issue was therefore whether the decision of the German court was enforceable in the Netherlands.

Provisions on enforceability

The enforceability of judgments relating to insolvency proceedings is governed by Articles 25 to 26 of the Insolvency Regulation. According to Article 25(1) certain specific judgments such as the decision to open insolvency proceedings, judgments which are closely linked with insolvency proceedings and judgments relating to certain preservation measures shall be recognised without formalities in all other Member States and are enforceable in accordance with the technical enforcement provisions of the Brussels I Regulation.

However, as for other judgments not mentioned in Article 25(1) enforcement shall according to Article 25(2) of the Insolvency Regulation follow the Brussels I Regulation if they can be held to fall within the scope of application of the Brussels I Regulation. In the case at hand the issue was whether the German decision could be enforceable based on the provisions in Article 25(2) concerning "other judgments".

Decision of retention of title was enforceable

The ECJ found in answering the questions of the Dutch Court that in applying Article 25(2) the court responsible for enforcing a decision on this basis must determine whether that judgment is within the scope of application of the Brussels I Regulation. In the case law of the ECJ the scope of application of the Brussels I Regulation has been interpreted broadly.

As such actions related to bankruptcy are excluded from the scope of the Brussels I Regulation. Matters related to bankruptcy are matters that derive directly from bankruptcy and are closely linked to proceedings for realising the assets or judicial supervision. The German proceedings however did not have a sufficiently direct or close link to bankruptcy to exclude the application of the Brussels I Regulation.

The seller had requested the recovery of assets owned by itself. The question before the German court related to the ownership of certain machines and the answer to that question was according to the ECJ independent of the opening of insolvency proceedings. Hence, the German action concerning the reservation of title clause constituted an independent claim. In addition, the fact that the liquidator was a party to the proceedings was not sufficient to classify the proceedings as ones deriving directly from the insolvency and being closely linked to proceedings for realising assets.

Finally, according to the ECJ, the application of the Brussels I Regulation in the matter was not affected by Article 4(2)(b) of the Insolvency Regulation which provides that the assets which form part of the estate and the treatment of assets acquired by or devolving on the debtor after the opening of the insolvency proceedings shall be determined in accordance with the law of the State of the opening of proceedings.

The decision provides helpful guidance on the relationship between the two regulations in relation to enforceability of judgments and protects the possibility in certain circumstances of enforcement of a judgment regarding a contractual retention of title clause regardless of insolvency proceedings.



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CORPORATE & COMMERCIAL

> REFORM OF LEGAL REMEDIES IN PUBLIC PROCUREMENT

by Eeva Pohja

The Finnish Act on Public Contracts (the "Act") will be amended due to Directive 2007/66/EC, which relates to improving the effectiveness of review procedures concerning the award of public contracts (the "Directive"). A working group appointed by the Ministry of Justice together with the Ministry of Employment and the Economy gave a report on the amendments of the Act in May 2009. The Government Bill is expected to be issued in October 2009 and the amended Act is intended to come into force by the end of the year in accordance with the Directive.

The main amendments include new legal remedies which are briefly described below. The new remedies will apply to public contracts exceeding the EU thresholds, excluding the correction of contract, which will apply to all contracts. Another Government Bill will be issued in the near future to harmonize remedies and other issues concerning national contracts below the EU thresholds.

Ineffectiveness of contract

Ineffectiveness of contract means that a contract will be terminated by the Market Court and the future contractual obligations of the parties involved will not be fulfilled. The purpose of this sanction is to open the contract to competition and arrange a new tender.

The Market Court may declare a contract ineffective, if

- (i) a contracting authority has signed a direct contract that does not fulfill the prerequisites set by the Act and has not published a prior contract notice;
- (ii) a contracting authority has signed a contract during the standstill period (a 14-day appeal period from the receipt of the contract decision during which implementation of contract is prohibited). In addition, the contracting authority must have proceeded incorrectly in the tender, which has affected an applicant's chances to win the contract; or
- (iii) a contracting authority has signed a contract even though the matter has been brought to the attention of the Market Court and, in addition, the contracting authority must have proceeded incorrectly in the tender, which has affected an applicant's chances to win the contract.

Imposition of fines and shortening of contract duration

The Market Court may order the contract to remain in force due to compelling general interest reasons. Economic interests will usually not be accepted as compelling reasons, unless the ineffectiveness of contract leads to unreasonable consequences to the parties involved.

Fines (maximum 10 % of the value of the contract) can be imposed on the contracting authority as an additional sanction to ineffectiveness of contract. If the parties have already fulfilled most of their contractual obligations, ineffectiveness may no longer be an adequate sanction as such. Fines may also be imposed as an alternative sanction. The Market Court may also shorten the duration of the contract, either in addition to fines or as an alternative to fines in case ineffectiveness cannot be applied.

The imposed sanctions should not lead to unreasonable consequences on the contracting authority or its contracting party. The Market Court may take into account the allocation and the combined effect of the imposed sanctions either on demand or on its own initiative.

Transparency of direct awards

It is proposed that contracting authorities could voluntarily publish a contract notice on direct awards in the Official Journal of the European Union prior to signing the contract. In case a contracting authority publishes a contract notice and complies with the standstill period (the 14-day appeal period mentioned above), ineffectiveness of contract cannot be imposed by the Market Court even if there would not have been grounds for using a direct award.

Transparency of direct awards and ineffectiveness of contract are, in fact, alternatives to each other. It might be advisable for contracting authorities to publish a notice and comply with the standstill period and thereby avoid the possibility of the contract being considered ineffective. Furthermore, any appeal on the direct award would also have to be submitted during the standstill period.

Correction of contract

There are currently a number of different remedies available in public procurement. In order to simplify the use of remedies, it is proposed that other remedies than those which can be imposed by the Market Court will be abandoned. This means that so-called municipal remedies, *i.e.*, a claim for correction and municipal appeal, will be abolished.

Instead, a new remedy to correct procurement infringements will be introduced. Correction of contract can be used to correct infringements in procurement procedures either before the matter is taken to Market Court or during Market Court proceedings. It can also be used for contracts that are below the national thresholds. The contracting authority may correct an infringement on its own initiative or on demand.

Other amendments

The amended Act will include a new provision on interim commitment of contracting authority, which means that contracting authorities have a possibility to voluntarily refrain from implementing the contract decision while the matter is being handled by the Market Court. Voluntary interim commitments have already been widely used in practice instead of formal interim prohibitions imposed by the Market Court.

Another novelty is a restriction of appeal to the Supreme Administrative Court. It will no longer be possible to appeal a Market Court decision that concerns the suspension, prohibition or allowing of contract implementation. Furthermore, in matters concerning contracts based on a framework agreement, leave to appeal will be required to the Supreme Administrative Court in case the Market Court has refused to take up the matter.



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D&I EVENTS

LAUNCH OF RESTRUCTURING AND INSOLVENCY TEAM

- > In July 2009 D&I established a restructuring and insolvency team of lawyers to assist and guide lenders, borrowers and businesses in managing legal risks related to corporate insolvency and distressed financing. The team draws on the experience of both the firm's Finance & Capital Markets and Corporate & Commercial practice areas.

110 YEAR ANNIVERSARY CELEBRATIONS

- > On 28 August 2009 D&I celebrated its 110 years with the entire staff of the firm. This day-long event marked the start of the 110 year celebrations of the firm. Other events including the publication of an anniversary book and a seminar series are scheduled for the autumn.

Dittmar & Indrenius is an independent law firm, established in 1899, focused on the quality of its services within four practice areas: Mergers & Acquisitions, Finance & Capital Markets, Dispute Resolution and Corporate & Commercial. Our aim is to be the best long-term law firm partner in Finland for our clients. We also strive to provide the best legal services in complicated transactions and demanding dispute resolution in our jurisdiction.

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