

Restructuring of Distressed Companies in Finland

Innovative Ways to Manage Risk and Value

D&I Focus

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- How to deal with a company in financial crisis
- Why are private workouts beneficial
- Basics of corporate restructuring
- Hold-outs and pre-packaged deals
- DIP financing in restructuring
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> EXECUTIVE SUMMARY

> VOLUNTARY WORKOUTS

During the last few years, Finnish privately arranged restructuring procedures have become easier to carry out. There are two reasons for this. The first is a more widespread use of Loan Market Association (LMA) style loan documentation and intercreditor agreements, which provide structure and a standstill period for the negotiations. The second reason are recent changes to the Finnish corporate restructuring rules that make it easier to approve pre-negotiated deals.

> BINDING THE HOLD-OUT CREDITORS

To the extent there are no intercreditor agreements binding the creditors of a borrower, the Finnish corporate restructuring process can be used as a means of binding hold-out creditors to ensure adoption of a feasible restructuring plan. There is also an expedited pre-packaged plan approval process that, although not commonly used in the markets, can be used in practice to cram down dissenting creditors.

> NEW FINANCING

There are some possibilities for arranging new super-priority financing for a company that is either close to insolvency or in corporate restructuring. In corporate restructuring, which is in essence a DIP (debtor in possession) process, a court may approve super-priority secured financing even for property already covered by an existing creditor's security interest. In a private workout, the parties are entitled to arrange for the new financing priority in any manner they wish. In addition, Finnish law is favourable to set-off, and debt subordination can be carried out effectively.

> LIABILITY ISSUES

Although directors of a financially distressed company may incur damages liability by failing to file for insolvency, delaying filing and causing additional costs for the creditors through other actions deepening the insolvency, the risk of director liability can be managed with careful planning and weighing of the risks and rewards associated with the restructuring.

Lender liability issues are not pressing in Finland, but as only the board of directors can represent the company, creditor control requires usually some

type of equity participation and protections implemented through a shareholders agreement and the articles of association.

> AVOIDANCE OF TRANSACTIONS

Finnish law on avoidance of transactions is extensive and imposes several material boundaries on restructuring transactions. These risks need to be understood fully because avoidance rules can be used by a hold-out creditor or an administrator against the restructuring parties. The most important avoidance rules are avoidance of certain payments and set-off, security for 'old debt', and the general preference rule.

> HOW TO DEAL WITH A COMPANY IN FINANCIAL DISTRESS?

In a threatening insolvency of a debtor company, privately arranged restructuring ('private workout') often leads to a better overall result than the formal procedures, *i.e.* corporate bankruptcy and full-scale statutory corporate restructuring. The current credit crisis requires innovative measures which allow an effective utilisation of the benefits of such private workouts.

The best possible solution sought by most parties is the recovery of the company's business and financial standing to a level that is financially sustainable. The Finnish formal insolvency procedures, *i.e.* corporate bankruptcy and corporate restructuring (unless carried out as a pre-agreed plan), are often inapt to achieve this objective. Furthermore, the traditional creditors' remedies, such as realisation of security interests, often do not lead to a satisfactory outcome as they deplete the corporate assets, which makes the continuation of business difficult or impossible.

How should a creditor then handle a situation where the debtor company is in breach of its financial covenants and its loan agreements contain cross-default clauses eventually leading to loan accelerations?

Due to the diversity and complexity of financial instruments used in modern corporate finance, single-creditor led restructuring procedures and direct negotiations with the corporate management and shareholders do not necessarily yield sufficient results. One reason for this is the inherent difficulty in controlling the actions of other creditors, *e.g.* preferential creditors, trade creditors and distressed investors.

Expectations of the distressed investors may not necessarily run contrary to the objectives of the company

At least from the point of view of an investor in distressed securities or loans, there appear to be four distinct alternatives: expecting that a performing loan will stay that way also in the future, carrying out small reorganisations, participating in large reorganisations and making capital infusions into troubled companies. Therefore, the expectations of distressed investors may not necessarily run contrary to the objectives of the company, often quite the opposite – especially if the distressed investor is able to rely on the rigour and integrity of the restructuring process.

The real risk imposed by other creditors is their right to file for bankruptcy, *i.e.* to act as a hold-out creditor opposing the reorganisation plan. Why then not to opt for bankruptcy?

> DISADVANTAGES OF A FORMAL BANKRUPTCY

Some of the disadvantages of a Finnish corporate bankruptcy procedure are:

1. Good business relationships are generally lost.
2. Benefits, subsidies and development loan facilities are often lost.
3. Creditors often settle for the security realisation value as bankruptcy does not lead to recovery. Rights of a secured creditor are extensive in Finland.
4. *E.g.* lessors are entitled to terminate contracts and creditors protected by retention clauses are often entitled to repossess their assets.
5. Any expected earnings of the company are lost.

Suppliers and lessors often have a strong financial position due to their right to terminate contracts and enforce retention of title clauses. Therefore, and depending on the amount of their claims, it is often prudent to leave these creditors outside the private workout.

In the following, we will first discuss some pros and cons of private workouts compared to the full scale formal procedures and then proceed to the basics of Finnish corporate restructurings.

> WHY ARE PRIVATE WORKOUTS BENEFICIAL?

Financial arrangements are often so complex that there are no general rules which would apply in all situations. However, the pros and cons of Finnish private workouts can generally be listed as follows:

| PROS | CONS |
|---|--|
| Standstill for facilitating recovery | Refinancing plan may be inadequate to facilitate recovery (total debt versus earnings development) |
| No restrictions on business present <i>e.g.</i> in Finnish corporate restructuring | Negotiations are especially demanding |
| Major creditors can effectively control the process (however, see below 'Assuming Control') | Certain creditors may use the threat of insolvency to influence the arrangement |
| Credibility towards business partners, employees and customers | Lender liability risk as the creditors take over |
| Avoidance of bad publicity and loss of intangible value | Divestitures close to insolvency are risky as Finnish avoidance rules are extensive |
| Any court involvement is minimised | It may be hard to replace the management as it is statutorily possible only in bankruptcy |
| First stages of the arrangement can often be carried out confidentially | |

Perhaps the most important benefit of a private workout is that it may be financially more advantageous than a formal procedure

Perhaps the most important benefit of a private workout is that it may be financially more advantageous than a formal procedure. In a private workout, the prospect of the company's recovery and the position of its various interest groups (employees, shareholders, management, creditors, contract parties, etc.) can prove to be much better than in bankruptcy or corporate reorganisation. This, however, depends entirely on whether the private workout leads to a more sound financial structure of the company. If the procedure fails, the creditors assume a greater risk than in a formal procedure. Usually, however, the risk premium and enhanced control of the creditors should compensate for the risk taking.

> ASSUMING CONTROL

Assuming control in a private workout or corporate restructuring requires careful planning. A corporate restructuring is fundamentally a DIP process. Secondly, in Finland, there is no legal institution such as English administrative receivership, which in practice has made (and still makes, although nowadays only to a limited extent) it possible for the holder of a qualified floating charge to assume the control of the debtor company relatively quickly. In Finland, bypassing the management by resorting to an extensive security package is not generally possible outside formal insolvency procedures. This is one of the reasons why privately arranged recovery procedures have not been utilised as much as in England.

Under Finnish law, there are no straight-forward means for taking control of a company. This is only possible if a creditor holds equity in the company

and there is a shareholder agreement entitling it to use control in the debtor upon occurrence of certain events or if there are similar provisions in the articles of association.

> BASICS OF STATUTORY CORPORATE RESTRUCTURING

> OBJECTIVE

The main objective of the statutory corporate restructuring is to make it possible for an insolvent debtor and its creditors to rehabilitate and restructure the debtor's business, rearrange its debts and, with these means, avoid bankruptcy. It is a debtor in possession (DIP) procedure much like the US Chapter 11 procedure. This means that the debtor retains the control of its assets even after the commencement of corporate restructuring. However, the actions of the company's management are substantially restricted in order to make sure the assets are not unduly depleted and that the restructuring plan can be prepared and negotiated.

> STATUTORY FREEZES

In order to facilitate the above objectives, commencement of corporate restructuring leads always to the statutory freezes to:

1. make payments or to grant security for a reorganisation debt;
2. carry out debt collection measures (including e.g. enforcement of security);
3. continue official debt enforcement measures or other enforcement measures; and
4. seek interim injunctions.

> THE RESTRUCTURING PLAN

The structure of the reorganisation plan is in practice determined by the estate administrator, together with the creditors and the debtor. Although there are strict procedural requirements for a plan, the substantive measures needed to effect the rescue are not in practice regulated. However, the administrator can only present a plan to the court that can realistically be expected to be approved by the creditors.

In practice, the plan consists of the debtor statement and the reorganisation measures. The first lists the assets and liabilities, explains what the debtor's situation would be without implementation of the plan compared to the approved plan, and contains a proposal on dividing the creditors into different creditor groups. The latter part of the plan describes on one hand the debt composition measures and on the other hand the corporate restructuring measures.

The creditors vote on accepting the restructuring plan within their respective creditor groups. As a main rule, the acceptance requires that more than half of the creditors, which represent more than half of the group's claims, approve the plan.

The terms of the restructuring debts are replaced by the terms stated in the restructuring plan. Also all secured debts are subject to the restructuring plan, but it should be noted that the composition of debts cannot be applied to the capital amount of secured debts.

Corporate restructuring measures need to be effected through separate contractual commitments

The obligation to follow the restructuring plan rests with the debtor company. A court may order the restructuring plan to lapse if the debtor fails to carry out measures required in the plan. However, as only the debt restructuring part of the plan is specifically enforceable against the debtor, the debtor's restructuring obligations often need to be reinforced through separate contractual commitments, changes to the articles of association of the debtor, management participation, the creditors' veto rights and other such measures to make sure the debtor actually follows the plan. This can be achieved by making creditor approval of the debt restructuring conditional on entering into these detailed corporate restructuring measures (divestments, debt for equity swaps, share issues, and the like).

> PRE-PACKAGED DEALS

> BINDING THE HOLD-OUT CREDITORS

As discussed above, it is possible to cram down dissenting creditors in corporate restructurings with a majority approval in each creditor group, and the court may discard certain lower priority groups for this purpose altogether. There are certain detailed rules for a court to 'cram down' dissenting creditors even if the majority vote is not reached. This is possible *e.g.* when the 'crammed down' creditors would not be entitled to a distribution under the plan. However, similar creditors will have to be treated *pari passu*.

It is possible to carry out a pre-packaged transaction either by means of normal approval of the reorganisation plan, or by means of an expedited pre-negotiated deal

It is possible to carry out the restructuring either by means of normal approval of the reorganisation plan, nomination of the administrator and other statutory measures, or by means of an expedited pre-negotiated deal.

There is no restriction for preparing the reorganisation plan also prior to the commencement of the reorganisation. As a matter of fact, the reorganisation application must even contain a draft reorganisation plan.

However, as of June 2007 it has become much easier to carry out an expedited reorganisation procedure. According to the new rules:

1. There is no need to nominate an administrator if the creditors or the debtor have not applied for the nomination and the court does not deem it necessary.
2. The public announcement concerning the reorganisation need not be made if the debtor and known creditors give their consent. Notably creditors that are unaware of the commencement are not bound by the plan.
3. The reorganisation plan may be approved in an expedited procedure if the debtor and creditors representing at least 80% of the claims and any creditor representing at least 5% of all claims have given their written approval for this process.

Expedited procedure means in essence a right to carry out a pre-packaged reorganisation procedure without:

1. hearing of various parties concerning the reorganisation plan proposal;
2. the parties having the right to dispute or state claims concerning the restructuring claims;
3. carrying out division of the creditors into creditor groups; or
4. implementing any voting procedures or control.

Because the expedited procedure saves considerable amount of time, it also creates substantial pressure to prepare the pre-packaged plan with diligence. The fact that it is in fact the debtor or the main creditor who is obligated to show to the court that the required creditor communications and approvals have been conducted and sought properly means also that the process of managing the pre-packaged plan concurrently with other restructuring measures has to be robust and well-managed.

The way the pre-packaged plan is linked generally to the private workout process as a means of binding hold-out creditors and achieving structure for the transaction is discussed below in '**Example of a Private Workout Process**'.

> DIP FINANCING

The debtor is entitled to incur indebtedness in the ordinary course of business even after the commencement of a corporate restructuring. The debtor is also able to grant security over its assets to the extent the debt is incurred in the ordinary course of business.

DIP financing is not generally considered to be within the ordinary course of business, and any such new debt requires the estate administrator's consent. The same applies to granting security for new indebtedness. A court may on the estate administrator's application permit super-priority new financing. The court may establish that such new financing has same or better priority to the debtor's assets than existing secured debt.

The condition for the above court order is that the arrangement must not considerably increase the risk of the secured creditors who hold the existing security interest. If possible, it is advisable, in order to ensure the priority of new DIP financing, to submit to the court consents from the creditors affected by the order.

> EXAMPLE OF A PRIVATE WORKOUT PROCESS

> STRUCTURE OF A PRIVATE WORKOUT

The structure of a private workout depends fundamentally on the details of each particular company and situation. Even though the legal questions concerning such arrangements require careful planning, understanding their basic features makes it easier to control the situation.

The first condition for a successful private workout is that a sufficiently large portion of the creditors understands and accepts the following facts:

1. In a privately arranged restructuring procedure, the parties must respect the priority order that would apply under the general insolvency laws. Otherwise, a creditor that has a lower priority in a contractual arrangement than in a formal procedure can block the procedure.
2. In a privately arranged debt restructuring, the question is primarily about to what extent each creditor participates in the sharing of financial losses and only as a secondary matter about who gets the benefits of a successful restructuring.

The structure of a private workout depends on the particular company, its financing structure, the needs of its creditors and of various other stakeholders such as owners and contract parties. Even though the best solution is always achieved by structuring the workout on a case-by-case

basis, the following structure sets out in general terms the various phases that a Finnish private workout might consist of.

Example Structure of a Private Workout

1. Entering into a standstill agreement:
 - banks, other creditors and the debtor agree that debts will not be accelerated during a certain period of time; and
 - no enforcement measures concerning the debts or the security will be taken.
2. The auditors or investment bankers prepare a feasibility study concerning the recovery prospects with the assistance of the management.
3. The banks and the most important creditors form a creditor committee and nominate a person or persons to administer the arrangement.
4. The creditors enter into loss-sharing agreements.
5. The parties prepare a restructuring plan concerning the company and the group.
6. The restructuring plan is approved in an expedited corporate restructuring proceedings as a pre-packaged restructuring plan (see '**Pre-packaged Deals**').
7. The banks grant new secured financing in accordance with the plan.
8. A part of the existing debt is converted into equity to restore the solvency of the company or the group.
9. The parties start implementing the restructuring actions.

The above-stages are usually a result of difficult negotiations and require determination and strong will from all parties. In practice, the arrangement is often led by a bank. In the planning stage, the preliminary review of the company's financial and operative situation, creditors and prospects have a central role. For this purpose, the banks should co-operate with the auditors and the legal advisors early on in the process.

It should be noted that certain transactions which have no commercial rationale for the debtor company may be void under company legislation. Private workouts have generally a genuine commercial motive and, therefore, a financially sound and carefully evaluated transaction will most likely not be caught by any ultra vires provisions.

> MANAGEMENT LIABILITY IN RESTRUCTURING

> TRANSACTIONS WITH THE COMPANY CLOSE TO INSOLVENCY

Management liability materialises in practice either if a company is declared bankrupt or is subject to corporate restructuring or when there is a dissenting minority the rights of which have allegedly been breached. This means that a private workout is an exceptionally difficult situation for any manager. If the restructuring does not lead to the desired result, the parties and other stakeholders may well launch damages claims also against the management.

> CERTAIN COMPANY LAW DUTIES OF THE MANAGEMENT

The management of the company must perform its duties diligently and in the best interests of the company. The members of the management are liable for damages caused to the company deliberately or negligently by a violation of their duty of care.

In addition, the board members and the managing director will also be liable for damages caused to the company, a shareholder or a third party by deliberate or negligent breach of the explicit provisions of the Finnish Companies Act or the company's articles of association. In such cases, the burden of proof is reversed. The reversed burden of proof applies also in the case of damage caused by an affiliated party transaction. Furthermore, *e.g.* breach of the requirement of corporate benefit may mean that the transaction is voidable under company law. Therefore, it is important to review the debtor's financial position and the commercial rationale of the transaction.

Liability in connection with continuing to trade while the company is in financial difficulties has often arisen based on breach of duty of care or failure to file for insolvency. However, if the decisions of the management are based on careful evaluation of the alternatives and diligent review of the particular situation, the management will not generally be liable for breach of duty of care.

It is also important to bear in mind that the management's decisions may not cause undue benefit to a shareholder or another person at the expense of the company or another shareholder. Furthermore, the company cannot make any distribution if it is known or should be known at the time of

making the decision on distribution that the company is insolvent or will become insolvent due to the distribution.

Liability for damages is likely to arise if the company enters into credit transactions while its ability to make the repayments can be seriously doubted or when there is no commercial rationale to continue the financing. Failure to take action when the grounds of insolvency are apparent increases the monetary liability of the management.

Even if the members of the management were released from liability by the shareholders' meeting for the past financial year, the insolvency estate is not bound by such decision if the administrator sues the management within two years of the relevant action or negligence. Finnish law does not contain case law on 'shadow directors'. However, almost similar damages liability rules that apply to the management of the company apply also to the actions of the company's shareholders.

> RISKS WITH AVOIDANCE OF TRANSACTIONS

Transactions concluded with a company that is close to insolvency may be voidable.

The most common grounds for avoidance of transactions are: (i) payments of debt that are premature, considerable or made with uncommon consideration, (ii) granting of security interests, and (iii) the general preference rule.

The suspect period for the general preference rule is five years in the case of transactions concluded with parties not affiliated with the insolvent. There is no time limit for avoiding transactions with affiliated parties. The suspect period for any other ground for avoidance is two years for transactions concluded with affiliated parties and three months for everyone else.

Payments

A payment is considered having been made with uncommon consideration if the consideration is something else than money, unless such payment has been agreed on when making the initial agreement.

A payment is usually deemed considerable if it exceeds 15% of the assets of the insolvency estate. Payments that are made in the ordinary course of business or based on long-term practice are considered common and are not voidable. The avoidance rules applicable to payments apply also to set-off, but only if set-off would not have been available in bankruptcy. In corporate restructuring, the best way to avoid this risk is to ensure either that

the company is able to continue on a going concern basis or that the arrangements are recorded in the reorganisation plan approved by the parties.

Security interests

Granting of security interests may be set aside if the perfection of the security has not taken place without undue delay after the parties had agreed on the security, or if the parties had not agreed on security when the debt was incurred. This risk is usually avoided in restructurings if granting of security is a precondition for the new financing. In certain cases it may also be advisable to resort to the procedures described above under '**DIP Financing**' on page 9.

General grounds for avoidance

A transaction may be avoided under the general preference rule if it: (i) inappropriately prefers a creditor, (ii) results in transfer of property outside the reach of the creditors, or (iii) increases debts at the other creditors' expense.

This rule may not be invoked unless the debtor was insolvent at the time of the transaction or became insolvent due to the transaction. The rule may apply also if the transaction is based on pressure exerted by a creditor. However, a duly structured reorganisation plan or a workout arrangement that respects the statutory priorities of the creditors and treats similar creditors *pari passu* is unlikely to be caught by this provision.



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