Restructuring in Estonia – 5 years of practice

By Veikko Toomere, partner MAQS Law Firm in Estonia

On 26 December 2013, the Estonian Restructuring Act[1] celebrates its 5th anniversary in Estonia. Since restructuring may be regarded as the only alternative to a bankruptcy, it is quite surprising that such an important institution was introduced only 17 years after Estonia regained its independence in 1991.[2] Thus, the institution of restructuring in a relatively young and considerable judicial practice is still undeveloped. Some conclusions can, however, already be made.

In this article, the author presents some of the difficulties in implementation of the Restructuring Act as well as describes some of the more important practical aspects of restructuring in Estonia including the so far most common problem that have arisen, the conflicting interests between the different groups involved in the restructuring proceedings. The article is not intended to go into details but to give the reader a good overview.

Drafting of the law and initial implementation problems

As we all know, the main purpose of restructuring is to provide businesses with an alternative to bankruptcy, which would give a company that has ended up in financial difficulties a fair chance to restore is finances to be able to maintain its business activities. The Restructuring Act creates a legal framework which provides for temporary protection of creditors' claims, and thus allows the company to stay alive while restructuring. The procedure must give protection to both the company as well as its creditors and the result should be to satisfy the claims of its creditors at least to the same level as would bankruptcy proceedings.

The Estonian legislator used the following four states' regulations of restructuring as inspiration:

- the German Federal Law on Insolvency ("*Insolvenzordnung*");
- the Law of the Swiss Confederation for Recovery of Claims and of Bankruptcy ("*Bundesgesetz über Schuldbetreibung und Konkurs*");
- the Republic of Finland's the Companies' Restructuring Act ("*Laki yrityksen saneerauksesta*");
- the Republic of Austria's, the Companies' Restructuring Act ("*Unternehmensreorganisationsgesetz*")

In addition, they studied the U.S.A.'s Chapter 11 and the corresponding regulations in force in France.

The working group drafting the act predicted that after the act had entered into force some five to ten cases of restructuring would come before the courts each year for the first three years and there after some 10 to 20 cases per year.

In retrospect you may say they were quite modest in the prediction. Only two months after the act came into force (26 December 2008) the courts had already dozens and dozens of applications at hand. The reason being, of course, that the act came into force at the same time as the financial crisis hit Europe and the World. Many investors saw the Restructuring Act as a lifeline to save their investments.

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[1] In Estonian "*Saneerimisseadus"* (Passed 4 December 2008, RT I 2008, 53, 296, entry into force 26 December 2008). The official translation into English is "Reorganisation Act", however, the author of this article prefers to call it Restructuring Act as this better describes the content of the act.

[2] The Restructuring Act only takes into account restructuring of legal persons. The act allowing for restructuring of debts of private individuals (Debt Restructuring and Debt Protection Act) entered into force as late as in the beginning of 2011.

The courts were all taken by surprise and the judges lacked at that time experience in this field. Most of the applications were granted. Unfortunately, at this time the companies had by the time they applied for restructuring already used up all their assets and a vast majority of the restructurings ended in failure.

In March 2013 a study ordered by the Estonian State Chancellery and made by the auditing firm PriceWaterhouseCoopers was published. The study aimed at determining the Estonian bankruptcy and restructuring statistical key indicators. It also summarized the main problems in these proceedings. The study showed that the Estonian courts in the first three years of the Restructuring Act there were in total 153 restructuring proceedings started. Out of these, in 20 cases the restructuring plan was approved by the creditors, and a further nine cases, the court had confirmed a restructuring plan without approval of the creditors.

This means that only some 13-19% of all restructuring proceedings will get to the point where there is a set restructuring plan. *Nota bene*, that a confirmed restructuring plan is not the same as a successful restructuring. The undersigned has no official sources but makes a qualified guess that in reality only some 5% of the initiated restructuring proceedings end up with a successful restructuring.

The results of the study clearly show that according to the courts and the practitioners the Restructuring Act has not justified itself. It is said that the application for restructuring is often used to postpone a bankruptcy and during the restructuring assets of the company are disappearing. In addition that one of the more common reasons why a restructuring fails is that the owners and management files the application to court too late. Among business people, many see an application for restructuring as equal to an application for bankruptcy and once made, the business will worsen.

The undersigned agrees with the conclusion that one reason for failure is that the application is filed too late when in reality all resources that are needed for a successful restructuring have already been exhausted. But the undersigned cannot agree with the assessment that restructuring is used to be able to take out assets from the company prior to a bankruptcy. In all restructuring cases where the undersigned has been involved there has been an honest company wanting to upkeep and restore its business through the restructuring procedure. No abuse of this legal measure has been noticed.

A brief overview of the Estonian Restructuring Act

It would be wrong to state that the Estonian Restructuring Act is one of high quality. Important details were left unregulated and allow different interpretations. Partly consciously and partly unconsciously have many things been handed over from the legislator to the courts interpret and develop. This has in its turn let to a situation where the companies and their creditors cannot be guaranteed their protection.

The undersigned has in his practice twice experienced that a restructuring plan has been confirmed in the court of first instance as well as in the Court of Appeal but when appealed by one creditor to the Supreme Court, the decisions have been revoked.

A restructuring starts with a court ruling for restructuring. In the ruling the court determines the restructuring advisor and when the advisor shall submit its plan to the court. The restructuring advisor would normally be a lawyer (member of the Bar Association), a bankruptcy trustee or an auditor. The term for submitting the plan should be 60 days as a maximum. Within this time must fit to coordinate between the different creditors, to draft a plan, to present the draft plan to the creditors, voting procedures and submitting the plan to the court. As the law foresees certain time for the creditors to

review the plan, there is in reality only some 25 days left for the advisor to actually draft the restructuring plan.

During the restructuring proceedings the creditor-lender relationships are frozen. With the restructuring plan new terms and conditions are set for the claims that will be fulfilled according to the plan. The former claims will continue their life as frozen in parallel with the new terms and conditions and if and when the creditor manages to fulfil its obligations under the terms and conditions set in the plan, both the new and the old frozen one will seize upon fulfilment of the new. In case the restructured company is not able to fulfil the restructuring plan, the new terms and conditions are terminated and the former ones will be restated. The restated claim will be credited with the payments made but the creditor can claim interest for late payment *etc.* under the original terms and conditions.

Almost any kind of obligation can get new terms and conditions through a restructuring plan in Estonia. The only obligations that cannot be altered are the ones arising from employment relationships and pledges securing claims. This means that in practise what is being restructured are monetary claims from creditors. Different ways of restructuring the terms and conditions of a monetary claim could be to prolong the term of the loan, to reduce the loan or to replace the obligations of the creditor with for example shares in the company being restructured.

Although it is not regulated in the law, the Supreme Court has given clear instructions to make a "bankruptcy test" as part of the restructuring proceedings. The test should show how much of the creditors' claims will be satisfied in case there was a bankruptcy filed instead. According to the Supreme Court, a restructuring is justified in case the creditors' claims can be satisfied to the extent that they are not significantly lower than in case of bankruptcy proceedings.

A restructuring plan is approved through a voting procedure. All creditors' whose claims will get new terms and conditions are eligible for voting and the votes are distributed according to the size of the claims. The creditors may be divided into groups for voting.

For a plan to be accepted at least 50% of the creditors must vote in favour and they need to represent at least 2/3 of all votes. In case the voting has been divided into groups, the same percentage must be reached in each group of creditors.

To minimize the risk of one or two dominating creditors, the legislator has provided the company with an emergency exit. In case half of the creditors have in deed voted for the plan, but these do not represent two thirds of the votes, the company can turn to court and ask the court to rule for an acceptance of the restructuring plan.

In case also the restructuring advisor supports the petition, the court may in addition include at least two experts to evaluate the restructuring plan. The experts will get up to 60 days to give their evaluation on whether the plan is likely to be successful or not.

In case all the experts' evaluations show that it is not likely for the plan to be successful, the court would as a rule terminate the restructuring proceedings. But if the experts (or only one expert) find/s it likely that the plan will be successful, and in case the court also finds that the plan is consistent with the law and that all parties are reasonably protected, the court may confirm the plan.

Practise show that this situation where it has not been possible to get two thirds of the votes for the plan although half of the creditors are in favour, the most resistant players are the banks. As a rule, the banks are the largest creditors and their claims are usually secured with pledges or the like. In most cases the largest debt of the companies are to the banks. As the banks want to safeguard their dominative position in decision making during the life cycle of companies, the banks often take their position based on emotions rather than from a financial standpoint.

The emotional opposition of the banks comes from the simple fact that in case of restructuring the banks are forced to accept longer terms or other worsened conditions with having the final say as they are used to.

The author has experienced repeatedly that even when it is clear that a bank's claim will be satisfied to a much smaller extent through a bankruptcy proceeding, they are still voting against the restructuring plan. By dismissing restructuring plans that result in bankruptcies where the bank will lose even more money, some Estonian commercial banks have clearly showed that for them the most important thing is not the financial gain but the right to dictate the terms and conditions of the businesses.

One important principle in the Estonian restructuring act is the socio-economical aspect. This is particularly apparent from the fact that for approval of a restructuring plan the Act sets one condition, that the company must be a "significant undertaking " and "substantial employer". What this means in reality has been left to court practice to tell and again, this creates an insecurity for the businesses.

During one restructuring proceeding, one of the largest restructuring in claims in Estonian history, where the undersigned was the appointed advisor, the company lacked employees at the time but as a result of an approved restructuring plan, over a hundred persons would have been employed. The courts of the first and second instance approved the plan. One of the largest banks appealed against the decision and the Supreme Court ruled that the company could not be considered a "significant undertaking" or a "substantial employer". Fortunately, the Supreme Court did not terminate the proceedings but sent the case back to the first instance asking the court to analyse some additional aspects. At the time of writing this article, there is still no final decision on the restructuring plan.

The future of Estonian restructuring

As described above a sharp opposition has surfaced between the companies in need of restructuring and the banks in the first five years of restructuring in Estonia. As a rule, banks' claims constitute the larger part of the obligations and are usually secured with pledges and the like. Despite this, the banks seem to be keen on strengthening their already dominant position in the restructuring proceedings.

Currently the Estonian Ministry of Justice is preparing amendments to the Restructuring Act. Surprisingly enough the draft is being prepared by one of the lawyers of the largest commercial bank in Estonia. This fact leaves no doubt about in which direction the suggested amendments will be made. According to rumours one amendment would be an obligation to from a special voting group for all creditors with secured claims.

As part of the legislative process different interest groups will be given an opportunity to comment on the ready draft amendments to the act. The author of this article plans to be active in this part. However, the undersigned identifies a real risk that the amendments will reinforce the dominant

position of the banks in the restructuring proceedings in Estonia. And if so, the efficiency in restructuring in Estonia will be lost.

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About the author:

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Veikko Toomere graduated from Concordia International University in Estonia in 2001. After 4 years practice in his own law firm A Dato Partners Law Firm he and his colleagues established MAQS Law Firm in Estonia in 2005.

Veikko Toomere's main practice areas are corporate law, mergers & acquisitions (including international transactions), restructuring and finance law

Veikko Toomere is head of corporate law and M&A groups in MAQS Estonia.

Among his colleagues in Estonia, Veikko Toomere is highly valued as qualified expert in the field of international transactions, M&A and especially as one of the best lawyers in the field of restructuring law in Estonia.

Veikko Toomere is constantly mentioned by Chambers & Partners and Legal 500.

In October 2013 Veikko Toomere was selected for inclusion in the Fourth Edition of **Best Lawyers** in Estonia in the practice area of Insolvency and Reorganization (Restructuring) Law.

Best Lawyers has been publishing the world's premier guide for the legal profession for over thirty years. The selection of attorneys to **Best Lawyers** is based on an exhaustive and rigorous peer-review survey comprising more than three million confidential evaluations by top attorneys. Therefore, being listed in *Best Lawyers* is considered a singular honor.

During the past four years Mr. Toomere has been an advisor to large scale restructuring cases in Estonia, of which several of them have been reviewed by the Supreme Court of Estonia. One of his latest restructuring cases, restructuring of the large dairy farm in Estonia (Väätsa Agro AS) was already finished successfully last spring.

Veikko Toomere is fluent in English and Russian. His native language is Estonian.

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* MAQS Law Firm in Estonia is member of Eurojuris since 2010