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Finnish Corporate Insolvency and Protection of the Interests of Creditors

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Introduction

The Purpose of the Memorandum

Insolvency strikes big and small alike. Usually it can be avoided by means of continuous restructuring of a company, one-time reorganisation or just by waiting for better times. However, in practice and irrespective of the course of action, the quicker and the more structured the actions, the better the results.

We have discussed in this document a hypothetical situation where a trading partner of a company is threatening to become insolvent. Based on this scenario, the managing director of the solvent company sets forth various practical questions on how to protect the solvent company's interests if the trading partner is actually declared bankrupt or if it enters into corporate restructuring. We have also discussed issues and actions that a creditor can take prior to the commencement of the actual insolvency.

We will not address a situation where a company itself is threatening to become insolvent. If a company itself is close to insolvency or liquidity crisis, we advise to have a look at our publication "Private Workouts – Restructuring of Distressed Companies". That document provides practical ways to take charge of a looming insolvency situation and to get out of it on a going concern basis.

How to Deal with an Insolvent Company

There is no one way of dealing with the threat of insolvency. Any measure chosen depends on the importance of the continuance of the trading partner's business, the possibility to replace the vendor or the supplier with another party, the financial exposure that the company has against the purchaser or the supplier and the legal remedies as well as the relative priority of the company's claims in the purchaser's or the supplier's insolvency.

If the parties are unable to reach a contractual or other commercial solution to the problem, which is in most cases the best alternative, only then will the formal measures of insolvency be relevant. It should be noted that because a purchaser or a supplier often has various creditors and contractual parties, a creditor needs to take into consideration their interests and actions as well. If they opt for insolvency, there is often no other choice but to proceed in the manner described in this document.

Example Situations

There are many scenarios where a trading partner's threatening insolvency will be detrimental to the solvent party. We have discussed below two such examples.

Purchaser's threatening insolvency
One situation that has arisen more and more recently is where a product manufacturer's main

customer defaults on its contractual payments. Such financial problems would typically have arisen as a result of tighter credit conditions or deterioration of demand in its main geographic market.

Therefore, the purchaser will have to do something about its debts, enter into insolvency or carry out a voluntary restructuring to survive the crises. Loss of a main customer would naturally be a difficult situation and would also result in immediate financial problems for the manufacturing company as well. The alternatives are: to grant more time for payment of the customer's debts and discuss how the purchaser will solve its problems, file for insolvency or wait for someone else to do that.

Supplier's threatening insolvency

Another increasingly seen situation is where one of the suppliers of the company has been having problems with its product deliveries due to increasing commercial problems in its own supply chain and tightening of its debt financing. The supplier itself often has several bank lenders and almost all assets of the company are used as security for the loans granted by these banks. The purchaser company does not usually have a large amount of receivables from the supplier, rather vice versa. The purchaser company is usually indebted to the supplier but there are likely to be potential cross- claims based on long-term purchase agreements. One option might be for the purchaser company to terminate these long-term agreements and set-off the resulting claims against debts owed to the supplier. Alternatively the purchaser company might consider trying to financially assist the supplier because of the parties' good long-term business relationship.

What Insolvency Procedures are There

There are two main types of formal insolvency procedures in Finland, corporate bankruptcy and corporate restructuring. In practice, debt execution procedure is also a very common way of enforcing a debt, but as it is not a collective insolvency procedure, it is not discussed here. The selection of the appropriate procedure is made on a case by case basis.

How Can I Determine whether the Company is Insolvent

The general test for insolvency in corporate bankruptcy and in corporate restructuring is whether the company is unable to pay its debts as they fall due otherwise than on a temporary basis. In corporate bankruptcy, the company will also be considered insolvent if its assets are insufficient to cover its indebtedness. The definition of insolvency is essential and it comes up later on in several sections.

Protections and Risks before the Actual Insolvency

What are the General Limits of Our Actions?

In some occasions it is crucial to be able to act before a debtor company's dire financial situation turns into insolvency. There are two main risks in enforcing one's rights before an actual insolvency materialises.

First, Finnish law on voidable transactions (preferences, transactions at an undervalue and artificial transactions) is extensive. Secondly, a transaction may be considered a divestiture of the debtor's assets, i.e. circumvention of the mandatory insolvency distribution regime or an artificial transaction.

It should be noted, however, that Finnish law does not generally restrict genuine commercial transactions or normal debt enforcement or debt collection measures even if the company is close to being insolvent.

A second point to note is that certain transactions which have no commercial rationale for the debtor company may be void under company legislation. Furthermore, e.g. breach of requirements of corporate benefit may make the relevant transactions voidable. When dealing with a company close to insolvency, it is important to review the company's financial position and the commercial rationale of the transaction. Otherwise the creditor may run a risk that a particular transaction is declared ineffective under company law.

Can We Terminate Our Contracts

Contracts can be terminated before actual insolvency if the termination is possible according to the terms of the contract.

If the parties have not included termination clauses in the particular agreement, termination is generally possible if the other party is in material breach of the agreement. This criterion is fulfilled if a business partner has been afforded additional time for fulfilling the agreement but it has not complied within the new time limit. Such a time limit has to be reasonable. The agreement can be terminated before such expiration if the trading partner informs that it will not fulfil its obligations.

It should be noted that a termination clause triggered by bankruptcy is generally ineffective. See "What happens to our agreements" on page 18 on how such situations are dealt with in practice. Termination clauses triggered by corporate restructuring are effective.

Can We Enforce Security Interests

Enforcement of security interests is generally allowed if neither one of the formal insolvency procedures has commenced. However, enforcement is possible only to the extent there is an event of default entitling the creditor to resort to enforcement measures.

It should be noted that in order to be valid, the security interests will have to be duly perfected and the security assets will have to be in existence. Although granting security interests is outside the scope of this paper, you should note the following basic rules for creating security under Finnish law.

Security interests

Finnish law recognises three basic forms of security interests: pledge, business mortgage and real estate mortgage. All forms of consensual security require entering into a pledge/security agreement and perfection of the security interest.

Perfection of security

Perfection of a pledge of receivables and bank accounts is carried out by notice to the debtor or the bank. Pledge of movable assets is perfected by transfer of possession of the pledged asset to the secured creditor or an independent third party. Pledge of dematerialised securities is perfected by registration of the pledge on a respective book-entry account. Pledges of certain intellectual property rights are perfected by notifying the registration authority.

Real estate mortgage and business mortgage are registered in the Land Register or Business Mortgage Register after which the relevant registry delivers the mortgage deeds or promissory notes either to the owner or to the secured creditor. The perfection requires delivery of the mortgage deed or the promissory note to the secured lender.

Can We Set Off Cross-Claims Before Insolvency

In most situations it is possible to set off any cross claims between two solvent parties. Finnish law has two categories of solvent set-off - so called "legal set-off" and contractual set-off. Contractual set-off can be carried out in any manner agreed by the parties. The same applies to close-out netting and other forms of netting1, provided that the relevant contracts and the resulting cross- claim are set off before commencement of insolvency. The requirements for legal set-off are the following:

1. the cross-claims must be due and payable;
2. the cross-claims must be commensurable (that is, only equivalent claims may be set-off - money for money and coffee for coffee); and
3. the cross-claims must be mutual.

There are certain set-off and netting restrictions when a debtor company is close to insolvency. First, set-off or netting may be voidable as a preference (see next page). Secondly, contractual netting may be considered circumvention of the statutory insolvency framework, i.e. divestiture of the insolvent's assets.

The general rule is that set-off is in no circumstances voidable if set- off would have been available in insolvency. For a discussion on voidable transactions, please see "What if the company becomes insolvent shortly afterwards?" below. After the commencement of insolvency the other forms of set-off and netting are replaced by the statutory insolvency set-off and statutory netting exemptions.

Can We Exercise More Stringent Debt Enforcement Measures?

In principle, there are no restrictions on exercising more stringent debt enforcement measures taking place before the actual insolvency. However, under certain circumstances, such payments may be recovered to the insolvency estate if the transaction is deemed voidable. See for the allowed limits in "What if a company becomes insolvent shortly afterwards?" below.

What If the Company Becomes Insolvent Shortly Afterwards?

One of the risks associated with dealing with a company that is close to insolvency is that transactions concluded with such a company may be voidable.

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

The suspect period for the general preference rule is five years for 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.

Furthermore, an artificial transaction may be re-characterised under Finnish law if the right of a third party is based on a financial arrangement the form of which does not correspond to the facts and the intention has been to avoid debt execution proceedings or to keep assets outside the reach of its creditors.

Payments

A payment is considered having been made with uncommon consideration if the consideration is something else than money. Payment with inventory, movable or fixed assets may be

considered common if such payment has been agreed on when making the initial agreement. A payment is usually considered considerable if it exceeds 15% of the assets of the bankruptcy estate. Payments that are made in due course of business or which are based on long-term practice are considered common and not voidable. The avoidance rules applicable to payments apply also to set-off (See "Set-off" on pages 22 through 23). After a company learns about its business partner's financial difficulties, it is usually advisable to take more strict debt enforcement measures.

Security interests

Granting of security interests may be avoided, 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. Notably, a security is not considered as having been granted on an 'old debt' if the company is refinanced and granting the security is a precondition for the new financing.

General grounds for avoidance

Transaction may be avoided under the general preference rule, if the transaction:

1. inappropriately prefers a creditor,
2. results in transfer of property outside the reach of the creditors, or
3. increases debts on the expense of the other creditors.

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 the pressure by a creditor. However, normal credit collection measures do not, as such, mean that the transaction would be voidable as a preference. The party seeking avoidance will have to show that the recipient was either aware or should have been aware both of the insolvency and the inappropriateness of the transaction.

Bankruptcy

What is the Purpose of Bankruptcy?

The purpose of bankruptcy proceedings is to liquidate the assets of the debtor and distribute the proceeds of the liquidation to its creditors. Bankruptcy is not intended to lead to corporate recovery but winding down of the company's operations in a collective and orderly manner. As a consequence, it is not possible to 'cram down' dissenting creditors and scale down the amount of debt capital of the debtor company.
Bankruptcy proceedings can last a fairly long time. Certain major bankruptcies during the last economic recession lasted over a decade. However, the winding down of the operations is heavily dependent on the structure and size of the business. Furthermore, litigations concerning the scope of the estate's assets and voidable transactions tend to prolong winding-up of an insolvent company.

Who Can Petition for Bankruptcy and What Happens After That?

Either the debtor company or its creditors can apply for commencement of bankruptcy. A company is declared bankrupt by an order of the court. If the creditor applies for bankruptcy, the debtor is notified of the application and it will have a possibility to give a written statement by the date set by the bankruptcy court. The other creditors are not heard in that case. If the debtor applies for its own bankruptcy, there is no hearing of the creditors.

A creditor may apply for commencement of the debtor's bankruptcy if its receivable or other claim from the debtor is so clear that its validity cannot justifiably be doubted. This cannot be done, however, if the particular creditor holds sufficient collateral given by the debtor or a third party for the repayment of a claim that has fallen due.

Who Controls the Debtor Company?

The debtor loses the control of the assets upon commencement of the bankruptcy. The administrators and the creditors replace the directors and shareholders in the management of the company. Several administrators may be appointed if the bankruptcy estate is large enough.

Creditors

As a group, the creditors exercise control in the bankruptcy estate and may decide how and when the assets are liquidated. Therefore, the creditors ultimately control the bankruptcy estate, except when a particular matter falls under the administrator's statutory obligations. In practice, the administrator controls the day-to-day management of the estate.

Creditors' meeting

Creditors who have lodged a claim against the debtor or whose claim is otherwise taken into consideration have the right to participate and vote in the creditors' meeting convened by the estate administrator. In the creditors' meeting decisions are made by a simple majority and each creditor holds the number of votes equal to its claim. The estate administrator and the debtor are entitled to express their views in the meeting.

Creditors' committee

If the bankruptcy estate is extensive, there will often also be a creditors' committee. The committee assists the estate administrator, supervises his activities and discharges the duties assigned to it by the creditors' meeting. The creditors' committee has at least three members and all the main creditor groups need to be represented. Decisions in the committee are made by simple majority voting.

What are the Grounds for Applying for Bankruptcy?

A company can be declared bankrupt if it is insolvent (see "How can I determine whether a company is insolvent" on page 6). It is assumed that a company is insolvent if:

1. the debtor has stopped making its payments;

2. the debtor's assets have, during the last six months, been subject to an unsuccessful debt enforcement process; or

3. the debtor has not paid the creditor's clear and matured receivable within one week from having received a payment notice from the creditor.

If a creditor is adequately protected by a security interest or a guarantee, the debtor cannot be declared bankrupt based on an application of such a creditor. Also a right of set-off may be used to discharge creditor's clear and matured receivable.

What Are the Priorities in Bankruptcy?

In summary, the priorities in a corporate bankruptcy are:

1. claims of the pledgees and mortgagees (these are paid from the security assets),
2. certain debts incurred during a corporate restructuring preceding the bankruptcy,
3. creditors secured by business mortgage (50% of the enforcement proceeds is distributed to the mortgagee and the remainder is divided between unsecured creditors),
4. unsecured creditors, such as trade creditors and tax authorities, and
5. creditors who have pre-agreed to subordination of their claims to all other debts and certain other last priority creditors.

Bankruptcy expenses are deducted before payment of the claims according to the above priorities.

What if There Are Pending Legal Proceedings against the Debtor?

In case there are legal proceedings pending at the time the company is declared bankrupt, the estate is given an opportunity to take over the proceedings in its own name. The debtor is given a possibility to continue such proceedings if the estate does wish to carry out the process on its own behalf.

What Happens to the RIght to Resort to Enforcement Measures?

All actions for enforcement of debts and other such measures against the bankruptcy estate, incurred before the commencement of the bankruptcy, are barred as of the time of the bankruptcy order. However, a creditor who has a security interest may bring an action in order to collect its claim from the security assets.

Brief Outline of the Procedure

The petition and commencement of bankruptcy
A petition for bankruptcy is filed with the district court under whose jurisdiction the effective management of the debtor is located. If the petition is accepted, the bankruptcy will commence at the exact time when the court issues a bankruptcy order. The debtor loses simultaneously its authority over the assets of the bankruptcy estate. The court will instead appoint an estate administrator who takes possession of the assets of the estate and takes over the management of the estate, i.e. the debtor company.

How to prove a claim?

A creditor must prove its claim by submitting to the administrator a relatively straight-forward document. The administrator sets the deadline for proving of claims. A creditor has, regardless of its nationality, residence or domicile, a right to lodge its claim and exercise the other rights of a creditor.

A creditor needs to submit a proof of its bankruptcy claim to the estate administrator no later than on the lodgement date. This does not apply e.g. to certain undisputed claims, which can be taken into account without proving.

How are the decisions made?

Any creditors' decision requires a majority of votes in the creditors' meeting. The amount of votes that a creditor has is the monetary amount of its claim. Naturally, no decision can be made to circumvent the statutory distribution regime or other mandatory insolvency rules.

What about estate inventory and other documents?

Within two months of the beginning of bankruptcy the estate administrator prepares an inventory of the assets and liabilities of the debtor

(estate inventory) which is certified by the debtor company. The estate administrator also prepares a description of the debtor and the pre-bankruptcy operations of the debtor (debtor statement). Furthermore, he will also set a date on which, at the latest, the creditors need to prove their claims (lodgement date).

After the estate administrator has given the creditors a chance to be heard, he draws up a distribution list and submits it to the court for approval. The court will hear on possible disputes and other disagreements relating to claims before approving the distribution list.

What kind of information do I receive?

The court will post a statement of the commencement of the bankruptcy in the Official Gazette. The administrator posts notices in newspapers and informs the authorities. Information about the estate inventory, debtor statement and the lodgement date are published in the Official Gazette and notified to the debtor and the creditors. First call to the creditors' meeting is sent at least two weeks before the final lodgement date for proof of claims.
How are the assets liquidated?

The bankruptcy estate liquidates the assets of the estate in the manner most advantageous to the estate. Secured creditors are generally able to sell the security assets irrespective of the insolvency.

After the costs of sale and enforcement have been paid, the bankruptcy estate is entitled to compensation for the costs of the management and sale of the assets.

If a secured creditor has been entrusted with the management of collateral constituting part of the estate, such creditor has a similar right to compensation.

When do we get our money back?

In principle the creditors receive their shares after the estate's final account has been approved, although, in practice claims are often paid out in advance. Claims can be paid out in advance if they are small or if payment in advance is otherwise appropriate. The estate administrator may require that creditors provide security for their advance distribution.

The final phase of bankruptcy

After the assets of the bankruptcy estate have been sold or otherwise disposed of, the proceeds will be distributed in accordance with the statutory priority ranking of the creditors and others (see "What are the priorities in bankruptcy?" on page 13). The distribution list is approved by the bankruptcy court. It is possible for the estate administrator to make advance distributions to the creditors if it is deemed expedient in the particular case.

After the obligations, receivables and other matters of the bankruptcy estate have been settled, and the assets have been converted into cash, the administrator prepares a final settlement of accounts, which needs to be approved by the creditors' meeting. Bankruptcy ends upon the approval given by the creditors' meeting. After that the administrator notifies the Register of the Ministry of Justice of the approval and the end of bankruptcy.

The structure of a bankruptcy procedure can be seen in the following figure.

Agreements, Security over Assets and Set-Off in Bankruptcy

What Happens to the Agreements?

Bankruptcy as such does not affect the continuance of the debtor's agreements. If the debtor has not fulfilled its contractual obligations before commencement of the bankruptcy, the other party must inquire whether the estate will commit itself to the agreement. If the estate commits itself to the agreement and gives an acceptable security for the fulfilment of its obligations, the agreement cannot be terminated even if there is a bankruptcy termination clause. There are some limited exceptions to this rule. If the bankruptcy estate repudiates the agreement, the resulting claim (e.g. damages) is considered a provable claim in bankruptcy. Bankruptcy estate is entitled to terminate all of the company's agreements.

Should We Now Only Deal with the Estate?

Yes. The debtor loses its authority over the assets of the bankruptcy estate when the court issues a bankruptcy order. After this time it is advisable to be in contact only with the estate administrator who manages the estate.

If there are pending legal proceedings at the commencement of bankruptcy between the debtor and a third party concerning assets of the bankruptcy estate, and the estate does wish to continue the proceedings, the debtor may take over the proceedings -- still taking an active part in any disputes.

Can We Continue Our Agreement with the Debtor?

Yes. In case of a trading partner's bankruptcy the most feasible solution is often to continue the contractual relationship even though it might not seem as the obvious choice.

Can the Estate Pay the Debtor's Outstanding Debts and Continue the Agreement?

Yes. After a request regarding whether or not the bankruptcy estate wishes to continue with the agreement it must within reasonable time (usually a few weeks but not more than one month) notify the solvent party whether it intends to fulfil or terminate the agreement. If the bankruptcy estate chooses to assume the agreement it has to provide adequate security for its obligations. The bankruptcy estate must also be given reasonable time (a longer period of time than for the above notification) for providing the solvent party with security. The creditor will be in a preferential position compared to other bankruptcy creditors as the purchase is considered to be a debt of the bankruptcy estate, not that of the debtor.

Does the Bankruptcy Estate Have to Return Products Delivered to It?

If the buyer has not paid but has possession of the products the seller has the right to demand that the buyer or the bankruptcy estate returns them if they have been delivered after the buyer has been declared bankrupt. However, if payment is not due yet the buyer is entitled to keep the products if the estate either pays for them immediately or gives an adequate security to secure payment. If the products have been delivered and there is no retention of title, they cannot be recovered and the creditor will have to prove its receivable in the bankruptcy.

What if We Have Retention of TItle over Certain Assets?

If the seller has retention of title and the buyer is declared bankrupt, the estate may also choose whether to continue with the agreement or not. Because the retention of title acts as security, the bankruptcy estate does not have to provide any counter-security, if it assumes the agreement. Assets for which a creditor has retention of title can be repossessed by the creditor if all of the following conditions are fulfilled:

1. Retention of title has been agreed on before the debtor has been declared bankrupt.

2. The debtor must not have the right to dispose of the products as an owner would, e.g. transfer the products or attach them to other property.
3. The estate is contractually entitled to choose to pay for such products at any time.

We have already Paid but No Delivery Has Been Made

You should inquire from the estate whether it wishes to continue with the agreement. If the estate chooses not to do so the payment is part of the assets of the bankruptcy estate. Set-off may be a good remedy in this case.

What about Employment Contracts

The liquidator may terminate the employment contracts without normal restrictions on termination due to the insolvency. The termination period is 14 days.

What if We Have Security over Assets

Introduction

Secured creditors are generally free to enforce their rights in bankruptcy. Despite the secured creditors' preferential position, the overall interests of the bankruptcy estate need to be taken into account in any liquidation of security interests.

How do we enforce the security interests?

If a creditor holds security for its claim and wants payment out of the security assets, it will first need to submit to the estate administrator information concerning its claim and the security assets by the date set by the estate administrator. If the security assets are located in another EU member state, a creditor is not obliged to give such notice. Secondly, a creditor must notify the estate administrator, well in advance of the sale of the security assets, of the manner of the sale and its planned date, time and location. After the sale has been carried out, the creditor should provide the estate with an account of the sale and of the sale price, as well as hand over any surplus over to the estate. It should also be noted that the creditor should reimburse the estate of the loss if the assets are sold under fair market value.
Can the administrator sell the security assets?
In some cases, the administrator is entitled to sell the security assets even when a creditor has a security interest over the assets. The bankruptcy estate may sell such assets if:

1. the secured creditor gives its consent for the sale; or;
2. the assets will be sold in accordance with the Finnish Enforcement Code (such a request may be filed no sooner than three years after the commencement of the bankruptcy); or
3. there is a court order concerning the sale.

All, including the subordinated pledgees, should give their consent to the sale. It is possible to impose conditions for the sale e.g. set a minimum price for the sale. The above-mentioned court order may be granted, if:

1. the estate has received an offer for the purchase of the assets;
2. the offer exceeds the likely auction price of the collateral; and
3. the creditor does not show that it is likely that a better result can be achieved by other means.

The permission to sell the collateral cannot be granted for sale of assets located in another EU member state. The objective of the administrator's right to sell the assets concerns mainly situations where it is likely that a combined sale of the business assets produces the best financial result for all creditors.

Can the administrator prohibit the sale?

The estate administrator is entitled to prohibit a secured creditor, in order to protect interests of the bankruptcy estate, from taking measures for liquidation of the security assets. Such a restriction is imposed by the court for up to two months and the order can apply to all or part of the security assets. The bankruptcy estate may waive in advance its right to apply for such selling restrictions.

It should be noted that a court or an estate administrator cannot prohibit sale of assets located in another EU-member state.

Can we enforce a pledge?

Subject to the above, a creditor is entitled to sell the object as agreed in the security agreement and collect on its claim out of the sale price irrespective of the pledgor's insolvency.
Can we enforce a real estate mortgage?

Subject to the above, a creditor is entitled to sell the real estate by means of a special execution procedure and collect on its claim out of the sale price.

Can we enforce share pledge?

Subject to the above, a creditor is entitled to sell the shares as agreed in the security agreement and collect on its claim out of the sale price.

Can we enforce a business mortgage?

A creditor secured by business mortgage is entitled to fifty percent of the value of the assets secured by the mortgage. The remaining fifty percent is then paid pari passu to the unsecured creditors. The realisation of the business mortgage is carries out by the estate administrator.

Can we enforce listed securities?

Listed securities, cash and debt instruments are covered by the Finnish Financial Collateral Act, their enforcement and manner of sale is not in practice restricted at all. Furthermore, almost all of the rules on voidable transactions are excluded with such assets. However, this requires that such secured transactions are concluded between financial institutions or between a financial institution and a company.

Set-Off

Finnish law is favourable to insolvency set-off. Although set-off is not automatic or mandatory, all types of cross-claims (e.g. conditional, uncertain and prospective) may be set off. However, in case of uncertain and contingent claims, the liquidator is entitled to value the claims to their likely financial value. A creditor is entitled to use a claim in bankruptcy for set-off against a debt owed to the debtor at the commencement of bankruptcy. A creditor has a right of set-off even if the cross-claims had not otherwise fallen due at the commencement of the bankruptcy.

If a creditor wants to resort to set-off, it must provide the administrator similar information as when proving of debt. Netting is not generally allowed unless carried out in markets subject to the Netting Act or under the Financial Collateral Act.

Set-off restrictions

There are four types of insolvency set-off restrictions. First, set-off cannot be carried out with respect to claims contractually subordinated to all other creditors. This restriction does not, however, apply to claims subordinated to some, but not all, creditors.

Secondly, set-off cannot be carried out with respect to claims created in circumstances where such an arrangement would also have been recoverable as a preference. This limitation applies, for example, to a purchase of goods on credit from the debtor within the suspect period in order to be able to set-off the debt against the amount owed to the debtor.

Thirdly, set-off is restricted with respect to claims acquired less than three months before the filing of the bankruptcy application. This restriction applies only if the creditor was at the time of the acquisition indebted to the debtor. The same also applies to a claim acquired earlier than three months before the cut-off date if the creditor had justified grounds to believe that the debtor was insolvent at that time.

Fourthly, there is special restriction preventing credit institutions from setting off funds in an account of the insolvent company held by the credit institution. This restricts set-off in corporate finance and any measure designed to circumvent it is rather difficult to implement. Even if the account has been pledged to the credit institution, such a pledge agreement is not

binding on the bankruptcy estate if it can be established that the account was pledged for the purpose of circumventing this restriction.

Can the set-off be a voidable transaction?

Yes, set-off can under certain circumstances be considered a voidable transaction and the administrator may apply to the court to set aside such a set-off. Please see "What if the company becomes insolvent shortly afterwards?" on pages 10 through 11.

Corporate Restructuring

What is the Purpose of Corporate Restructuring

The main objective of corporate restructuring is to make it possible for an insolvent debtor to rehabilitate its business, structure its debts and, therefore, avoid bankruptcy. Corporate restructuring is divided into two phases. The first is (i) the starting phase restructuring proceedings during which the financial situation of the debtor company is evaluated and the restructuring plan prepared; and (ii) the execution phase of the court-approved restructuring plan.
An important consequence of the application is that the debtor cannot be declared bankrupt while the application for restructuring is pending.

Who Can Petition for Corporate Restructuring?

Either the debtor company or its creditors can apply for commencement of corporate restructuring. The formal proceedings commence by an order of the court.

If the debtor and its creditors file a joint application, no hearing of the other creditors is usually needed. If the debtor files the application, the court will notify all known creditors of the company and they will be entitled to give written statements concerning the application. If a creditor files the application, the debtor will always be entitled to be heard. The court may and should in most cases give the other creditors a possibility to be heard in the matter.

Who Controls the Debtor Company?

The debtor retains the control of its assets even after the commencement of corporate restructuring. In practice, the debtor is able to continue in the ordinary course of business. Therefore, the directors or the shareholders are not replaced in the company's management but their actions are restricted to a substantial degree to facilitate preparation of the restructuring plan.

Conditions for Corporate Restructuring

A company can be placed into corporate restructuring if:

1. at least two creditors, unaffiliated with the debtor, representing at least one fifth of the debts file a joint application with the debtor or notify the court that they will support the debtor's application;
2. the debtor is threatening to become insolvent (it is required that the procedure is necessary to secure the applicant's considerable financial interest);
3. the debtor is insolvent and none of the restrictions below apply:

    - the procedure would only have a temporary effect;
    - the debtor's assets are insufficient to cover the costs of the procedure;
    - the debtor will be unable to service its debts incurred after commencement of the procedure;
    - there are valid grounds to expect that the purpose of the application is to invalidate creditors' rights or there is no possibility for adoption of the restructuring plan; or
    - the accounts of the debtor are substantially deficient or false.

A corporate restructuring application will generally have to be dismissed if the debtor is suspected of having committed or sentenced for certain types of debtor's criminal offences or the debtor is subject to a disqualification order.

Priorities in Corporate Restructuring

An essential part of a corporate restructuring is a restructuring plan, which sets forth, among other things, changes to the terms and conditions of the restructuring debts, e.g. reductions of the amount of capital. A notable exception to this is the restriction to cut the amount of capital of the secured debts.

The priority of creditors follows the rules that would be applied between solvent parties e.g. subordinated creditors are subordinated

also for the purposes of the plan. The creditors belonging to various creditor groups will have to be treated on a pari passu basis. Interest accruing to other debts than secured debts is statutorily subordinated. Creditors holding only minor claims may be paid before other creditors. In addition, a credit received from the debtor company's own pension fund can be wholly repaid in the restructuring plan.

What if There Are Pending Legal Disputes?

Corporate restructuring does not as such affect pending legal proceedings against the company. However, the statutory freezes discussed below after this question restrict almost all types of enforcement measures initiated against the company.

What Happens to the Right to Take Actions?

The commencement of the restructuring proceedings means that the debtor's debts are divided into restructuring debts (incurred before the proceedings) and new debts (arising during the corporate restructuring). One of the most important effects of the commencement of the restructuring is that it results in certain statutory freezes on actions against the company. These protect the debtor against most creditor actions. The statutory freezes are the prohibitions to:

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

There are exceptions to the above concerning e.g. payments on secured debts, wages and minor debts set-off in certain cases. In addition, an already existing payment account with overdraft facility may be maintained and payment to the account may be deemed as partial payment to the bank. Furthermore, secured creditors are entitled to receive post-commencement interest and other credit expenses.

In some cases where security assets are not needed in the debtor's business, the court may grant an exemption from the enforcement freeze. It is also possible to apply for an interim freeze.

Who Pays for the Procedure?

The costs of the administrator are paid by the debtor. Cost and compensation of the participants of the creditors' committee are paid by the relevant group of creditors. A party that wishes to present its own restructuring plan must prepare the plan at its own cost. The parties bear their own costs incurred during the procedure.

Debts incurred during corporate restructuring procedure are not subject to the restructuring plan and they will have to be paid as they mature. These debts have priority if the company is declared bankrupt following the corporate restructuring.

Brief Outline of the Procedure

Application

The most significant creditors are usually informed by the court of the restructuring application after it has been filed.
If the application is approved, the court issues an order to commence restructuring and appoints an administrator and, in some cases also, a committee of creditors to supervise the creditors' interests.
What kind of information do I receive?
The court will post a statement of the commencement of the corporate restructuring in the Official Gazette. The administrator posts notices in newspapers and usually informs also the authorities. The administrator prepares a proposal for a restructuring plan within four months. During that time the administrator is in contact with the creditors. After the reorganisation proposal has been submitted to the court, the administrator notifies the creditors of their right to give written statements about the plan.

Proving a claim

A creditor is not obligated to prove its claim in corporate restructuring. The debts are taken into consideration by the administrator without any

need to prove the debts. However, if a particular claim is not included in the estate inventory, a creditor is obligated to notify the administrator of its claim within a time period set by the court.

How are the decisions made?

Unless the creditors are unanimous on the contents and the approval of the restructuring plan, the creditors will vote in different creditor groups (secured creditors, creditors with business mortgage, general creditors, etc.). Approval of the restructuring plan requires majority approval (number of creditors and amount of claims) in each creditor group. There are certain statutory exceptions to this rule, such as expedited procedures which are subject to different voting threshold.

The restructuring plan

The administrator prepares a proposal for a restructuring plan which is submitted to the court. The court approves the proposal if the statutory conditions are fulfilled.

The restructuring plan divides the creditors into groups primarily based on the ranking of claims as secured debts, ordinary debts and last priority debts. The creditors can vote on accepting the restructuring plan. If one or more unsecured creditors claim they would receive more in a bankruptcy compared to the compensation they receive as a result of the restructuring, the plan cannot be approved without such creditor's consent. Each category of creditors needs to be treated pari passu in the plan.

After the restructuring plan has been approved, the terms of the restructuring debts are replaced by the terms stated in the restructuring plan. It is therefore advisable for the creditors to exert influence on the contents of the restructuring plan at an early stage.

The plan contains changes to maturity and terms of repayment of the restructuring debt and composition of the debts. 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.

It is the debtor's responsibility to comply with the restructuring plan and there is a specific prohibition to distribute assets contrary to the plan. New debts that arise during the restructuring procedure must be paid as they fall due. Such debts are paid after payment of interest and credit costs for secured debts but in priority to other restructuring debts.

Although the debt restructuring part of a restructuring plan receives usually the most attention, it is possible and often advisable to agree on a more extensive reorganisation package in the plan itself. The manner of corporate, operational and strategic reorganisation should therefore be included in the plan and simultaneously with entering into the plan draw up all required corporate documents and contracts needed to effect the reorganisation. The approval of the restructuring plan marks the end of the official corporate restructuring procedure. After that time the parties will follow the restructuring plan. Fulfilment of the plan is usually supervised by a specifically appointed supervisor. The operational period of the plan may last for years. The basic structure of a corporate restructuring procedure is outlined in the following figure.

Agreements, Security over Assets and Set-Off in Corporate Restructuring

Agreements

Corporate restructuring as such has no effect on the continuance of contracts. There are two main exceptions to this rule. First, a lease or a credit-lease agreement where the debtor is the lessee may be terminated by the debtor to end two months after the notice of the termination. Secondly, the debtor company is in practice able to cancel contracts that are 'unusual' from the perspective of the debtor. In such case, the administrator must on request of the other party inform whether or not the debtor will fulfil its part of the contract. If the answer is no, the other party has the right to terminate.

However, it is common that corporate restructuring is mentioned in commercial agreements as a ground for termination. There is in general no restriction for using such a provision, although there are certain limited exceptions to the rule.

What Happens to Our Receivables?

In a restructuring plan, claims may be adjusted by:

1. altering the schedule of payments;
2. deeming payments, first, as amortisations of capital and, only secondly, as payment of interest or other credit expenses;
3. cutting the agreed credit expenses, including interest rates; and
4. cutting the amount of the unsecured debt capital.

Therefore, creditor influence before the approval of the plan is of great importance from the creditor's perspective.

Minor debts may be fully paid if it is considered necessary for the proceedings. Interest and credit costs on other debts than secured debts have the lowest priority, but followed by debts that would have the last priority in bankruptcy.

If there would be no distribution to unsecured creditors under the plan, corporate restructuring will not be carried out.

We Have a Retention of Title over Certain Assets

The same enforcement rules apply to retention of title clauses as to security interests. There is a statutory freeze, but the creditor is relatively well protected, see "What happens to our right to take actions" on pages 26 through 27.

What about Employment Contracts?

Corporate restructuring does not automatically affect the employees of the insolvent company. Effects on the employment arrangements will have to be included in the restructuring plan. Termination before adoption of the restructuring plan differs from termination during the operation of the restructuring plan. In the first case, termination can be carried out if it is required to avoid bankruptcy and the work has actually diminished. In the latter case, termination can be effected if it is required by the measures included in the restructuring plan. Termination cannot be carried out if the employer is able to offer other work to the employee. The maximum notice period is two months.

What if We Have Security over Assets?

Corporate restructuring results, among other things, in a freeze on enforcement of security interests. A court may grant an exception from the enforcement freeze if the assets are not required from the perspective of the restructuring. In some cases, a court may grant to a new money provider similar or priority right to a security interests held by a secured creditor if that is necessary for financing during the procedure and does not significantly increase the risk of the existing secured lenders.

Under certain circumstances, the court may upon application of a secured creditor give the creditor the right to collect his receivable. Further, the creditor may irrespective of the corporate restructuring collect his claim from a third party

who has given a guarantee or from collateral granted by a third party.

Secured debts enjoy a privileged position in the restructuring plan. The amount of a secured debt may not be reduced in the debt restructuring process and secured debts may only be altered by extending the payment period or by reducing the interest.

Set-Off

The same set-off rules apply in corporate restructuring as in bankruptcy. However, as debts do not mature automatically, a receivable may not be due and payable at the commencement of the reorganisation. In this case, the creditor can withhold the prospective set-off amount corresponding to the debtor's receivable until the debt becomes due and payable.

Some Special Cases

Can We Make Claims against the Management?

Transactions with the company close to insolvency
Claims against the management by the creditors are generally not possible while the company is solvent. If a creditor notices before commencement of insolvency that the management either acts inappropriately or does not promote the interests of the debtor company, a creditor may later on during the insolvency sue the management for damages.

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 deliberately or negligently:

1. to the company by a violation of the duty of care.

2. to the company, a shareholder or a third party for breaches of the provisions of the Finnish Companies Act or the articles of association, unless the particular director proves that he or she has acted with due care.

The reversed burden of proof applies also to the damage caused by an affiliated party transaction.

Liability in connection with continuing to trade while the company is in financial difficulties often arises based on breach of duty of care or failure to file for insolvency. However, the risk is alleviated by the business judgment rule and provided the decisions of the management are based on careful evaluation of the alternatives and diligent review of the particular situation. Management's decisions may not cause undue benefit to a shareholder or another person at the expense of the company or another shareholder.

Furthermore, a 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 incurs additional debt when its ability to make the repayments can be seriously doubted or when there is no commercial rationale to seek financing. Furthermore, 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.

International Insolvency

What happens if the company is facing insolvency in another EU state?

Proceedings opened in an EU Member State under the EC Regulation on Insolvency Proceedings are recognised without any formality in Finland. Such recognition requires that the centre of main interests of the company is in the particular EU Member State. In that case it may be possible to commence a secondary insolvency process in Finland.

How about insolvency proceedings in other countries?

If the centre of the main interests of the debtor is not in an EU Member State, Finnish courts have jurisdiction if the debtor has business premises in Finland or holds such assets in Finland that it can be deemed expedient to have a Finnish bankruptcy procedure. In this case, recognising a procedure started in another jurisdiction depends on the Finnish court's discretion and international comity. However, the Finnish courts have no jurisdiction if the debtor has been declared bankrupt in Iceland, Norway or Denmark and the debtor company's domicile is in one of these countries.

Although there are no statutory rules concerning recognition of foreign proceedings (except within the EU) in relation to corporate restructuring or

other rescue statuses, the above rules should apply also to such proceedings.

It should also be noted that international creditors are always entitled to exercise the same rights as Finnish creditors regardless of their nationality, residence or domicile.

What if our trading partner is not registered in Finland?

Finnish insolvency proceedings can be initiated in Finland even though the debtor is not a Finnish registered company if the (i) debtor's centre of the main interest, (ii) debtor's business premises or (iii) debtor's "significant assets" are located in Finland. Otherwise the Finnish creditor has to resort to a foreign insolvency procedure.
How can we get access to foreign assets?
Debtor's assets, whether located in Finland or abroad, are considered part of the assets of Finnish bankruptcy estate. However, despite of the formally international character of Finnish bankruptcy, enforcement measures concerning assets located abroad may cause practical difficulties.

Can we file for bankruptcy or corporate restructuring abroad?

The right to file for bankruptcy or corporate restructuring abroad (outside European Union and the Nordic countries) depends on national legislation of the country of the insolvency proceedings.

Voluntary Corporate Recovery Procedures

Is it common to opt for a voluntary procedure?

Single-bank led restructurings have been common in the past but there is no extensive experience on voluntary multi-creditor restructuring processes because there are no established structures for carrying out restructuring outside the formal procedures. The only statutory method for binding hold-out creditors can be achieved through corporate restructuring. For this purpose, it is possible to use e.g. an expedited corporate restructuring procedure. A successful restructuring requires in practice ca. 80-90% of creditor approval to prepay hold-out creditors.
Is it possible to restructure a debtor?
Restructuring of the debtor is not possible in bankruptcy but in corporate restructuring such arrangements can be carried out as a part of the restructuring plan.

Restructuring of debtors can also be carried out through a privately arranged restructuring. However, creditors cannot e.g. take control of the company merely based on an extensive security package. In order to make sure the creditors have control of the management of the debtor, an equity participation in the debtor is often required.

Finnish law is rather favourable in terms of facilitating privately arranged restructurings – the management liability can be controlled, debt conversions are relatively easy to carry out, divestments and creditor control can be arranged through contractual arrangements and lender liability risk is not very high.

Is it possible to arrange a pre-packaged transaction?

Pre-packaged transactions are possible but not used too often. Although Finnish reorganisations have concentrated on debt restructuring, there are no legal restrictions to effect various operational and structural reforms through the plan. A fast-track restructuring can be carried out by a pre-packaged restructuring plan approved by a supermajority of the creditors and the court.

M.J.L.

The views expressed in this memorandum are of general nature and should not be considered legal advice or relied upon in a specific situation.

Any actual situations should be evaluated legally on a case-by-case basis.