First year of Reorganisation Act and problems regarding its applicability and efficiency

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Until the adoption of Reorganisation Act Estonian legislation did not provide efficient regulation for companies which were in temporary financial difficulties, but could be "rescued" via certain turn-around proceedings to overcome the economically difficult period.

Estonian legislation regarding insolvency was concentrated solely on bankruptcy proceedings and liquidation. However, that should be the last resource to satisfy the creditors' claims and before turning to bankruptcy and liquidation, other methods should be tried to satisfy the claims with funds gained from economic activities. To serve these purposes the Reorganisation Act was adopted and hastily entered into force on the verge of financial crisis on the 26th of December 2008.

The Reorganisation Act has now been in force for over a year, but unfortunately it has not proven to be as efficient as was predicted.

The opportunity of submitting the reorganisation petition and commencement of reorganisation proceedings has been widely misused by companies in financial difficulties in order to postpone the generally inevitable commencement of bankruptcy proceedings as well as in order to gain other privileges that a company under reorganisation is entitled to, *i.e.* suspension of enforcement proceedings and suspension of commencement of bankruptcy proceedings on the basis of a claim filed by the obligee.

A significant indicator regarding the insufficiency of the regulation and its misuse is the number of commenced reorganisation proceedings.

In the case, when the courts have refused the commencement of reorganisation proceedings the courts have pointed out, that the applicants have not motivated the necessity of reorganisation nor the existence of all noted prerequisites. The courts of first instance have pointed out, that the purpose of reorganisation is not just postponing the fulfilment of one's financial obligations and waiting for the improvement of the market. Several applications for reorganisation have been filed regardless of the fact, that the enterprise has already reached insolvency, however reorganisation is only possible if insolvency is likely in the future.

The courts have pointed out that if based on realistic prognosis the financial difficulties are not of the temporary manner the courts will not commence reorganisation proceedings and that it is impossible to reorganise a company which is already insolvent.

Several problems have also arisen regarding different aspects of reorganisation in case a company has been entitled to reorganisation proceedings.

In its decision of 18th of November 2009 no 3-2-1-122-09 the Civil Chamber of the Supreme Court handled a case regarding reorganisation proceedings of private limited company and *inter alia* stated its approach towards transformation of the Tax and Customs Board's (hereinafter the Tax Board) claims. The court has given clear instructions regarding interpretation of the matter of transformation of tax arrears.

According to the Reorganisation Act § 22 section 1, transformation of claims includes, but is not limited to extension of terms for the performance of obligations, fulfilment of a financial claim in instalments, reduction of the amount of debt and replacement of an obligation with the holding or shares of a legal person.

The reorganisation adviser of the company requesting reorganisation suggested that all claims, including the claim of the Tax Board be transformed so, that up to 15 000 EEK of each claim will be satisfied within 10 months of the approval of the reorganisation plan, the rest will be paid in instalments until 31st of December 2025 and the part of the claim exceeding 150 000 EEK will be reduced by 50%.

The Tax Board argued that the tax arrears cannot be transformed during the reorganisation proceedings as it is a public obligation. The calculation of interest does not stop for the time of the reorganisation proceedings, the Tax Board is not be considered an obligee, as the tax arrears are formed irrespective of the actions of the Tax Board and the Tax Board is not authorised to conclude any agreements regarding minimising or omitting payment of taxes. Should the transformation of such claims be allowed, the equal treatment of tax-payers and principle of equal taxation will be jeopardised. The Tax Board also pointed out, that the tax arrears can written off or forgiven only for the purpose of making a compromise in case of bankruptcy proceedings or based on the reasoned written request of the taxable person, if recovery of the tax arrears is hopeless or would be unfair (Taxation Act, § 114).

The Supreme Court stated, the Reorganisation Act states a non-exhaustive list of transformation methods and only claims which have arisen on the basis of an employment contract, are excluded from transformation according to § 22 section 2 of the Reorganisation Act. Thus the law is comprehensive regarding the claims that cannot be transformed.

The Supreme Court also pointed out, that in a previous ruling of the Constitutional Review Chamber no 3-4-1-15-09 concluded that if a wording of a regulation is clear and unambiguous, then the regulation is to be applied, as it warrants the legal clarity, productiveness of legal consequences and legal certainty. The norm may not be interpreted in conflict with its wording and as a result that be left unapplied.

Therefore the Supreme Court concluded that as tax arrears are not *expressis verbis* excluded from the transformable claims, thus the tax arrears can be transformed and the Tax Board is to be considered an obligee in the reorganisation proceedings.

The Court also explained, the Bankruptcy Act that entered into force 1st of January 2004 eliminated the prerogative approach to tax arrears in comparison to other claims without security. The court pointed out that there are no objective grounds for different treatment of the Tax Board. The situation, in which in order to "save" a company it would be possible to minimize the tax arrears in order to make a compromise within the bankruptcy proceedings, but it would not be possible to transform tax arrears within reorganisation proceedings, would be unjustified.

The Supreme Court pointed out, that even though there is no regulation in the Taxation Act regarding transformation of tax arrears, the transformation on tax arrears is not impossible. The Reorganisation Act is both *lex specialis* and *lex posterior* in regard to the Taxation Act, thus the former is to be applied. Also, should it be forbidden to transform tax arrears, the principal of equal treatment of obligees could no longer be observed.

The purpose of the Reorganisation Act is to provide better protection for the interests of creditors as compared to bankruptcy proceedings. Should the Reorganisation Act be interpreted as the Tax Board suggested, the fulfilment of the purposes of the act would be obstructed. The companies facing financial difficulties very often also have tax arrears, thus the prohibition of transformation of tax arrears would make it virtually impossible to successfully conduct any of the reorganisation proceedings. In such a case the "healing" of the company via reorganisation would be impossible and commencement of bankruptcy proceedings will be inevitable.

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