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The Swedish Company Reorganization Act

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Introduction

In Sweden, businesses facing financial difficulties can be reorganized in a number of ways. The main alternatives are:

- a composition by voluntary arrangement with the creditors;
- a company reorganization (Sw. *företagsrekonstruktion*), with or without a compulsory composition;
- bankruptcy; and
- liquidation.

Voluntary arrangements are not governed by any specific legislation and therefore do not include any element of compulsion vis-à-vis the creditors.

Bankruptcy proceedings are probably the most commonly used vehicle for reorganization of a business in Sweden. The bankruptcy proceedings are governed by the Bankruptcy Act 1987. In bankruptcy proceedings, the court appoints a receiver to wind up the company. The receiver controls the debtor's estate fully and assumes all the powers of the board of the debtor. It is the receiver who decides whether the debtor's assets shall be sold as a going concern or piecemeal.

Liquidation is a less frequently used vehicle for reorganizing a business. This is because it involves the payment of all known creditors of the company in full.

The fourth main alternative is *company reorganization* under the Company Reorganization Act 1996. This is the subject of this article.

The Company Reorganization Act

Rationale behind the Company Reorganization Act

In the early 1990s the number of corporate insolvencies in Sweden reached unprecedented levels. Political pressure led the Swedish Government to make a policy statement to the effect that more *companies* should be reorganized.[1] In line with this ambition, the Swedish Parliament introduced the Company Reorganization Act in 1996. Its underlying purpose is to facilitate the reorganization of companies in financial difficulties without resorting to bankruptcy or liquidation. The intention was that companies that have a potentially viable business should primarily be reorganized, leaving bankruptcy proceedings to be used only to wind up companies with unviable businesses. The Government hoped that the new legislation would enable early reorganizations in order to avoid deterioration of asset values. Another objective was to provide statutory rules that were more flexible than the bankruptcy rules and the compulsory composition rules previously in force.

Eligible entities

Any legal entity conducting business that is domiciled in Sweden can be the subject of company reorganization under the Company Reorganization Act, except certain businesses in the financial and public sectors, e.g. banking companies, insurance companies and debtors controlled by the State.

Applicants

An application for company reorganization may be made either by the debtor itself or by a creditor (unsecured as well as secured). If a creditor is the applicant, the debtor has to consent to the reorganization. The application is filed with a Swedish district court having jurisdiction over the debtor and must include a preliminary plan for the reorganization.

Substantive tests

The company reorganization will only start if the court makes a corresponding order. There are two basic substantive tests that need to be met for the district court to make such order, namely that:

(a) it can be assumed that the debtor is unable to pay its debts as they fall due or that such inability will arise shortly; and
(b) it is reasonable to assume that the purpose of the company reorganization can be achieved.

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1 Government Bill, 1995/96:5, p. 54 et seq.

The first of these tests is a test of illiquidity, or assumed illiquidity. This differs from the relevant test for declaring a company bankrupt under the Bankruptcy Act, where the test is insolvency (i.e. an inability to pay the debts as they fall due which is not temporary).

The second of these tests means that the court must be able to forecast that there is some level of probability, so that the end result of the reorganization can be that the company is reorganized and would thereafter be capable of surviving. The burden of proof is low, but it should be stressed that the court will deny the application if the reorganization plan is impossible to fulfil or the plan does not in fact aim at reorganization. Thus, in principle, a court should deny an application that only aims at affording the debtor the temporary protection of the moratorium rules in the Company Reorganization Act.

Whether the second test is met is continuously monitored during the reorganization proceedings.

The administrator

If the court approves the application, it simultaneously appoints an administrator. Normally the court appoints a lawyer with the experience of serving as a bankruptcy receiver.

Within one week following commencement of the reorganization proceedings, the administrator will notify all the debtor's known creditors. The notice includes a preliminary list of the debtor's assets and liabilities. It also includes information regarding the causes for the debtor's financial difficulties and the manner in which the business may be reorganized.

The administrator is under a general duty to protect the interests of the creditors. His first and primary task is to investigate whether and, if so, how the purpose of the reorganization can be achieved. His conclusions will be laid down in a reorganization plan that is submitted to the court and the creditors. The reorganization plan is not subject to any approval by the court and will be amended and supplemented as the reorganization progresses. While there are no detailed requirements as to the contents of the reorganization plan, it will usually include information about the nature of the company's financial difficulties, the causes of the difficulties, the proposed measures to be taken, the financing of these measures and a time plan. It would also normally include information whether a financial agreement with the creditors (a composition) is contemplated.

The reorganization plan is presented at a creditors meeting held in court within three weeks of the court order. At this meeting the creditors will have the opportunity to express their opinions on the plan and whether the proceedings should continue. If requested by a creditor, the court will appoint a creditors' committee consisting of not more than three members, which the administrator must consult on all significant issues.

Timing

As a main rule the reorganization proceedings must be completed within three months, but this period may be extended up to one year. If compulsory composition proceedings have been initiated before the end of the one year period, the proceedings may however be extended for as long as it is necessary to complete such composition. The reorganization proceedings may be terminated by a decision of the court if:

(a) the applicable time limit has expired;
(b) the debtor has been declared bankrupt;
(c) the debtor so requests and compulsory composition proceedings have not started;
(d) the administrator or a creditor so requests and it can be assumed that the purpose of the reorganization proceedings will not be achieved; or
(e) there are 'special reasons' for terminating the proceedings.

Costs

The costs of the administrator's work are always borne by the debtor.

Debtor-in-possession

During the company reorganization the debtor's board and other representatives do retain their power to represent and bind the debtor. The debtor is on the other hand prohibited from taking certain actions and some actions may only be taken with the consent of the administrator. Furthermore, the debtor must comply with the administrator's instructions regarding the manner in which the business shall be conducted. Actions taken by the debtor in contravention to these rules do not, however, affect the validity thereof. This applies regardless of whether the other party had knowledge of the lack of consent or failure to abide by the administrator's instructions. Such behaviour from the debtor may however lead to the cancellation of the reorganization proceedings.

Moratorium

A cornerstone of the reorganization proceedings is the moratorium that comes into effect upon the approval by the court of the application for reorganization. The moratorium prevents, in different degrees of efficiency, the following actions:

(a) discharge of pre-application debt;
(b) assumption of new obligations;
(c) disposal or encumbrance of assets;
(d) enforcement actions; and
(e) bankruptcy declarations.

Discharge of pre-application debt

The debtor may not discharge any debts that arose prior to the commencement of the company reorganization or provide security for such debts. The administrator may consent to payment of pre-application debts, but only if special reasons exist. Arguably, the prohibition does not cover the fulfilment of pre-existing obligations for performance in specie.

Assumption of new obligations

During the reorganization the debtor is also prohibited from assuming new obligations without the administrator's consent. The prohibition covers, e.g., the entering into of new agreements, employment of staff and leasing of new premises. In order to allow the debtor's business to function properly during the reorganization, a special preferential status in a future bankruptcy is afforded to creditors that enter into new agreements with the debtor during the company reorganization provided that the administrator has consented thereto. Such creditors will rank ahead of all general unsecured claims and most unsecured preferential claims.

Disposals

Transfers, assignments and pledges of assets as well as any other encumbrances of assets are prohibited, without the administrator's consent, if the asset in question is material to the business of the company.

Enforcement

The company reorganization results in a general prohibition on individual enforcement actions by the creditors. Thus, the creditors are, among other things, prevented from repossessing property in which the creditors have retained title, enforcing floating charges and real estate mortgages and attaching property to satisfy debts. A creditor holding a valid possessory pledge may however freely enforce the pledge and sell the pledged assets. In addition, the creditor is in principle able to set off its claim against debts owed to the debtor. The right of set off is very extensive insofar as it allows the creditor to set off its claim regardless of whether the claim is due and payable.

Bankruptcy petitions

During the company reorganization a petition by a creditor to declare the debtor bankrupt will be stayed by the court, unless there are special reasons to assume that the debtor will jeopardize the rights of the creditors. If the company reorganization is terminated, the stay is lifted. It is not possible to commence company reorganization proceedings once a debtor has been declared bankrupt.

Effects on the debtor's existing contracts

General principles

The commencement of company reorganization affects the debtor's contracts only to a limited extent. The debtor and the other party to the contract remain under an obligation to perform their respective obligations. This does not mean however that provisions in the parties' contract or in the applicable proper law of the contract to the effect that a party may withhold its performance (which in Sweden would be called *stoppningsrätt*) if the other party does not perform its corresponding obligations or the other party becomes subject to certain insolvency proceedings are unenforceable. Such provisions remain unaffected.

Unlike similar statutes in other jurisdictions, the Company Reorganization Act does not extend the rights of the debtor to terminate contracts beyond what the contract itself provides. It has however been argued that it is, or at least should be, possible for the debtor to stop performing its contractual obligations (primarily under unfavorable contracts), turn the creditor's right to receive performance into a monetary claim for damages and then include the damages claim in a future compulsory composition. It is, however, submitted here that this is not possible under the current wording of the Company Reorganization Act.

Protection against termination for cause

The Company Reorganization Act does however under certain limited circumstances afford the debtor protection against the creditor terminating the contract with reference to the debtor's delay in performing. The preconditions for the application of these protective rules are that:

(a) the contract is not an employment agreement;
(b) the contract was entered into prior to the date the company reorganization commenced;
(c) the debtor had not performed the relevant obligation prior to the commencement of the company reorganization;
(d) the debtor is either in delay or such delay can be anticipated;
(e) on account of such delay or anticipated delay, the other party has become entitled to terminate the contract; and
(f) the other party has not already utilized the right to terminate the contract.

If these preconditions are fulfilled the debtor may, with the consent of the administrator, within a reasonable time demand that the agreement shall be

performed. In order to be protected from termination of the contract, the debtor must then either perform its corresponding obligations under the contract, if they are due for performance, or, if the obligations are not due for performance, provide security for the performance.

It follows from the rules that the debtor is not protected against termination if the breach by the debtor is anything but performance delay (e.g. defective performance).

The rules are mandatory. Provisions in the parties' contract to the effect that the commencement of insolvency proceedings against a party entitles the other party to terminate the contract are therefore without effect in this situation.

Compulsory composition

Introduction

The Company Reorganization Act presupposes that an administrator should primarily endeavour to achieve a voluntary composition between the creditors and the debtor. There are however no particular rules laid down in the Company Reorganization Act regarding voluntary compositions. As a consequence, there is no voting on, or particular consent requirement with respect to, voluntary compositions. Evidently, however, the creditors whose rights are to be affected by a voluntary arrangement need to be bound as a matter of contract law. Thus, a voluntary composition cannot bind an entire class of creditors unless each such creditor agrees (directly or by proxy) to be bound by the arrangement. If it is impossible to achieve a voluntary composition, the debtor may apply to the court for a compulsory composition.

Claims affected by a compulsory composition

All claims that arise prior to the application for reorganization are capable of being subject to a compulsory composition. The creditors holding such claims are therefore entitled to take part in the composition proceedings. This is the case irrespective of whether their claims are due and payable or merely contingent. A claim which is fully secured, either because of sufficient security (including by virtue of the right to repossess property under a title retention clause) or a right of set-off or would have preferential status in bankruptcy, can not be subject to compulsory composition. Consequently, the creditor of the claim does not have any right to participate in the proceedings. If a claim is merely partially secured, the unsecured part participates in the composition. Recent amendments to the rules regarding floating charges have led to the result that a floating charge can never secure more than 55% of the par value of the underlying debt. As a consequence, a lender having only a floating charge security is unsecured for 45% of its claim and would therefore participate in the composition with the unsecured part of its claim (i.e. 45%).

Subordinated claims present particular problems in compulsory compositions in Sweden. Recent case law suggests that if the subordination clause does not specifically state that the subordination shall apply also to a composition, the subordinated claim will be included in the composition and survive the composition with the applicable reduction.[2] Arguably, this is not what the draftsmen had intended.[3]

Based on the wording of the Company Reorganization Act, it is submitted that the compulsory composition only covers strictly monetary debts and not claims for performance in specie, whether or not such claims are for fungible property.

It is settled that the fact that a claim under a contract can be reduced in a compulsory composition regardless of the fact that the creditor has an unperformed and corresponding performance obligation under the same contract. This can be illustrated by an example. If the creditor has sold goods, he cannot, following the composition, claim 100% of the price but merely the applicable composition dividend. Normally, however, under substantive contract law (at least under Swedish contract law) the creditor would not be required to deliver the goods other than against payment of 100% of the purchase price, irrespective of the composition.[4]

Particularly difficult issues arise with respect to convertible debentures. One view is that the right to convert the debenture into equity remains entirely unaffected by the composition of the underlying debenture, so that 100% of the original par value of the debenture can be converted into equity irrespective of the fact that only a fraction of the debenture remains outstanding following the composition.[5]

The composition is binding on all creditors, both known and unknown, who were entitled to participate in the composition proceedings. The composition does not as such limit the right of the creditor to claim in full against guarantors or other parties who are

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2 Judgment by the Supreme Court, [2003] *Nytt Juridiskt Arkiv*, p. 128 et seq.

3 Cf. S. Lindskog, 'Efterställda fordringar' [2003–2004] *Juridisk Tidskrift*, p. 114 et seq.

4 Judgment by the Supreme Court, [1994] *Nytt Juridiskt Arkiv*, p. 292 et seq.

5 I. Arnesdotter, 'Om konvertibla skuldebrev och kvittning vid ackord' [1995–1995] *Juridisk Tidskrift,* p. 8 et seq.

liable under the composed claim in addition to the debtor. Whether the composition has effects on a guarantee or security provided by a third party is therefore a question to be resolved by the provisions of the guarantee and the security agreement and the proper law of the guarantee or the security.

Contents of the composition

A composition usually takes the form of a *pro rata* reduction of the par value of the outstanding unsecured and unsubordinated monetary debts. However, the Company Reorganization Act also allows deferment of payments and 'other special concessions'. According to the preparatory works, the latter provides the ability to 'change the manner in which payments shall be made'.[6] There is no precedent regarding what this could entail. In particular, it is not settled whether it would be possible to change the very content of the performance, e.g. from money to some other commodity. Thus, it is unclear whether the compulsory composition allows for debt for equity swaps. In any event, however, there is no mechanism in the Company Reorganization Act for compelling the debtor to issue shares. A composition involving a debt for equity swap would therefore require cooperation from the debtor as well as its current shareholders.

A composition will in principle provide all creditors covered by the composition with equal rights. Thus, it is not possible to reduce only the claims of a particular class of unsecured, unsubordinated creditors unless each creditor in such class consents thereto. It is however possible, under certain conditions, to provide that the affected creditors shall receive full payment up to a certain specified amount and that only the surplus amount of their claims shall be reduced. This rule facilitates compositions involving several small creditors, since such creditors will lose their voting rights if their claims are less than the specified amount (i.e. such claims are treated as preferred).

A compulsory composition must be approved by the court and will be voted upon by the creditors in a meeting held no later than five weeks after the commencement of the composition proceedings.

Dividend and voting requirements

The minimum dividend is 25% of the par value of the claims. A lower dividend is allowed if the dividend is approved by all known creditors who would be covered by the composition or where there are special reasons for a lower dividend. A dividend of 50% or more of the par value requires the consent of 60% of the voting creditors representing at least 60% of the aggregate par value of the affected claims. If the dividend is less than 50%, the required majority is 75% of the voting creditors representing at least 75% of the aggregate par value of the affected claims.

Following the composition, the debtor must pay the minimum dividend (25%) within one year unless all affected creditors consent to a deferred payment. If the dividend is higher, the surplus (above 25%) may be paid later. There is no requirement that the debtor must provide security for the payment of the dividend, but it is often necessary to include such security as part of the composition package in order to achieve the required majority.

Recovery in connection with a compulsory composition

An interesting feature of the Company Reorganization Act is that company reorganization can lead to the avoidance of pre-application transactions that prejudice the creditors. As a general principle, the rules in the Bankruptcy Act regarding avoidance of preferential transactions apply equally in reorganization proceedings provided that a compulsory composition is approved. The administrator or a creditor whose claim would be covered by a composition may apply for recovery of the preferential transaction. The recovery petition must be filed prior to the creditors' meeting where the composition is voted upon and can not be finally determined until the composition is final.

The future of the Company Reorganization Act

It is safe to say that the political ambition underlying the Company Reorganization Act has largely been unfulfilled. While in a normal year there are some 5000–10 000 bankruptcy proceedings, there are less than 50 company reorganizations pursuant to the Company Reorganization Act. Furthermore, a study has shown that less than 25% of the companies that have applied for company reorganization have actually survived.[7]

There are probably several different reasons for this failure. One reason may be the unwarranted emphasis that the legislator has placed on the survival of the *legal entity* as opposed to the survival of the *business*. The consequence of this is that the shareholders of the debtor (directly or indirectly through the board of the debtor) have a very strong position under the Company Reorganization Act. This often adversely affects

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6 The Government Bill, 1970:136, p. 95.

7 A. H. Persson, M. Tuula, 'Är lagen om företagsrekonstruktion en papperstiger?', [2001–2002] *Juridisk Tidskrift*, p. 81.

the prospects for reorganization. Among the rules that reflect this strong position is the requirement for the debtor's consent to even start reorganization proceedings, the debtor's retained control of the business and the lack of effective mechanisms to convert debt into equity. As a consequence, the reorganization plans seldom reflect the economic reality that the shareholders are economically wiped out at the time of the reorganization. Instead, the equity interest remains unaffected unless the shareholders voluntarily agree otherwise. Generally, creditors are less inclined to accept a substantial haircut if the possible up-side remains entirely with the shareholders.

As a result of this policy argument, it has been proposed by some that creditors should be able to force a reorganization even against the will of the debtor, that the debtor-in-possession principle should be abandoned or at least curtailed and that it should be analysed whether a compulsory issue of shares in satisfaction of debt could be introduced in the Company Reorganization Act.

Another criticism that has been levelled against the Company Reorganization Act is that it is rarely possible to determine at the outset of the reorganization proceedings whether the particular company is one that ought to be reorganized or which ought to be declared bankrupt. It has therefore been proposed that there should be a single coherent insolvency proceeding with one entry but different exit possibilities.

Other concerns of a more technical nature include the lack of ability for the debtor to terminate unfavourable contracts, the uncertainty surrounding the status of non-monetary creditors and the length and cost of the proceedings.

The discussions have prompted the Government to appoint a committee to analyse the need for a reformation of the Company Reorganization Act and a single all-inclusive insolvency act. The Ministry of Justice is currently preparing instructions to the committee. The legislation process is consequently still at a preliminary stage. History shows that amendments to Swedish insolvency laws tend to be surprisingly politically charged. It is therefore too early to predict the outcome of the legislative process.