International Corporate Rescue

ChaseCambria

3-4 SOUTH SQUARE
BARRISTERS

UCL
UCL LAW FACULTY
CENTRE FOR COMMERCIAL LAW

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2008 (6 issues)
Print or electronic access:
EUR 665.00 / USD 799.00 / GBP 465.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 114 255 9040 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

ARTICLE

Improving Contracts Through Insolvency Proceedings: A Swedish Case Study

Marcus Johansson, Partner, Gernandt & Danielsson, Stockholm, Sweden[1]

The restructuring of the Swedish district heating group, Energisystem, in 2004-2006 was a good example of what can and cannot be accomplished in terms of restructuring using different Swedish insolvency proceedings. It also highlights the importance of creativity in the field of restructuring. The present article discusses some of the features in the restructuring, in particular how insolvency proceedings can be used to amend existing unfavourable long-term customer contracts.

Background

Landshypotek AB (publ) is a Swedish credit institution focused on providing mortgages to farms and forest businesses.

At the end of the 1990s Landshypotek's subsidiary, Lantbrukskredit, started lending to a newly formed group specialising in producing and selling district heating based on renewable fuel. Following a rapid expansion, the financial situation of the borrowing group became extremely dire in the autumn of 2001 and Lantbrukskredit stopped further lending. As part of a restructuring of the group, the owners sold the business to a US and a Swiss company some months thereafter. The new owners injected new capital and the group was refinanced by Lantbrukskredit. The group then consisted of a number of holding companies controlling several local operating companies, each of which had one production facility supplying heating to one particular district. Its main customers were larger landlords owned by local municipalities. Lantbrukskredit then held security over virtually all of the assets of the borrowing group including mortgages over the production facilities (which constituted the predominant value in the group). It also held security over the businesses by way of floating charges and pledges over the shares.

The problematic customer contracts

One of the main reasons for the difficulties of the borrowers was the fact that the group had entered into long-term contracts with its major customers with insufficient indexation of the tariffs. Spiralling raw material costs meant that the yield from the contracts did not suffice to cover salaries, maintenance costs and interest costs. The new owners did try to renegotiate the existing contracts. Politically, however, it was difficult for the municipalities to voluntarily agree new tariffs. A certain lack of understanding of local politics on the part of the Swiss and US owners and a good deal of political posturing and economic irrationality on the part of local politicians aggravated the problem. Consequently, negotiations failed.

Attempted variation of the contracts through company reorganisation

The owners now sought to use formal company reorganisation proceedings to deal with the contract problem. They caused the operating companies to apply for company reorganisation under the Swedish Companies Reorganisation Act (the 'Act') proposing that the administrator would renegotiate the contracts, failing which the customers' (and other creditors') claims would be subject to composition.

An issue that arose almost immediately with respect to the composition element was that the claims of the customers were for the delivery of heating not for the payment of money. It was however argued by the operating companies that the proposed composition could and should affect not only monetary claims but also their customers' claims for performance of the operating company obligation to deliver heating.

The argument raised by the operating companies occurs time and time again in legal literature but has so far never been put to the test in the higher courts. The proponents of the argument maintain that if the debtor

Notes

1 Gernandt & Danielsson acted for Landshypotek AB (publ) and Lantbrukskredit AB in the second restructuring.

declares that it will not perform its non-monetary obligation, the creditor from that point only has, or for the purposes of the proceedings should be deemed to only have, a monetary claim for damages. This claim, or so the argument goes, can be composed just like any other monetary claim. The argument, although frequently repeated in legal literature, is somewhat difficult to sustain. Under general principles of Swedish law, a party to a contract is not required to terminate an agreement which is repudiated by the other party. It may continue to demand performance. Thus, in order to transform the specific claim for performance of the delivery obligation into a monetary claim, one would need to invent a special rule for converting non-monetary claims against the will of the innocent party. Such a rule has no direct support in the legislation or under general principles of Swedish law.

Even if the argument would be valid, the practical value of such a composition of non-monetary claims is limited. What the debtor can achieve is merely to terminate the contract and reduce the resulting damages claim by applying the dividend percentage. It can never achieve a new contract with the customers on more favourable terms. Thus, the debtor must be relatively certain that the customers would enter into new contracts with the debtor after the composition. Equally importantly, the debtor must pay up the entire contract to the applicable composition dividend. This may of course be difficult to finance, especially given the fact the customers will not be bound by any contract after the composition, so future revenue streams may be uncertain.

In fact, the operating companies had a better argument which they did not raise. It has been argued in legal literature that an obligation to deliver fungible property (e.g. heated water) may *as such* be composed. The argument runs as follows. The relevant section, chapter 3 section 2 of the Act, states that the objects of the composition are 'claims' (*fordringar*) that arose before the application for reorganisation was made. Linguistically, the Swedish term does not exclude non-monetary claims. The Act clearly covers money, which is a fungible property. Therefore, or so the argument goes, deliveries of other fungible property, such as heated water, should be equated with 'deliveries' of money. Such deliveries should therefore be capable of being immediately reduced using the relevant dividend percentage.

This argumentation is not universally accepted however. Doubters point to the fact that the Act would not be coherent if non-monetary claims could be composed. Under the Act the debtor is prohibited from 'paying' its 'debts' during the reorganisation (which is logical if the debts are to be composed). *E contrario*, the debtor may continue performing any obligation which does not amount to 'paying debts', i.e. any non-monetary obligation. This difference between monetary and non-monetary claims cannot be reconciled with composition of fungible non-monetary claims. Quite simply, if the debtor may freely perform a certain obligation during company reorganisation such obligation should not be capable of being composed and *vice versa*.

In addition, even if claims for performance of the fungible, non-monetary obligations could be composed, it does not follow that the innocent party must accept to pay the full price against partial performance by the debtor. The innocent party's right to withhold his performance (*detentionsrätt*) if the debtor fails to perform to 100% remains unaffected by the composition. Thus, the operating companies could not have forced the customers to accept *future* deliveries on improved terms with this technique either. Had such a composition been implemented it would have resulted in a peculiar stalemate. The debtor would no longer have been obliged to deliver 100% of the heating against the tariff. On the other hand the customers would not have been obliged to pay the tariff other than against receipt of 100% of the heating.

However, for another reason the selected approach may not have mattered. An insurmountable problem for the debtor in this particular case was the fact that many creditors, including the lender, opposed the composition. In particular, even if some customers may have been prepared to accept *some* price increases the vast majority were not prepared to accept the significant increases proposed. Unfortunately for the development of Swedish insolvency laws, the courts therefore ultimately did not have to rule on these questions of law. One of the applications was dismissed following opposition from the creditors and the remainder were withdrawn by the respective operating company.

Default

Soon after the collapse of the reorganisation proceedings, the borrowing group defaulted yet again, this time in the most unexpected fashion. The first owner of the district heating group had for a number of years claimed to have certain claims against the group. In particular, it asserted that it had the right to an additional purchase price from the parent company of the group (a purchaser in the 2002 transaction). The former owner applied for bankruptcy of the parent company of the group. Unexpectedly, he managed to persuade the Stockholm District Court that this claim was 'due and clear' and had not been paid despite notices in writing. This triggered an insolvency presumption under chapter 2 section 9 of the Swedish Bankruptcy Act, which the debtor failed to rebut. Consequently, the parent company of the group was declared bankrupt. At the end of the day, the decision was overturned by the Supreme Court, NJA 2004 p. 345. By that time, however, the lender had already

accelerated the debt and was preparing for an enforcement sale. The owners and the lenders consequently agreed that the lenders would take over the group.

A new management was introduced who sought to renegotiate the long term contracts with the customers. However, the political climate and certain public vows by local politicians not to accept any significant raise to the tariffs rendered negotiations virtually impossible. The lender therefore implemented a new strategy for achieving improved contracts for the group.

Variation of the contracts through bankruptcy

Strategy

All operating companies except two were put into bankruptcy. The lender, being by far the biggest creditor in each bankruptcy, demanded that the trustee should continue providing the heating to the customers despite the bankruptcy. It also provided the estate with certain intermediate credit facilities to enable the estate to continue the service.

As a matter of law, the estate is not bound by the terms of the debtor's contracts should he continue the debtor's business although the trustee may in certain cases have the option to assume the debtor's contract. In this case the trustee immediately declared that the estate would not assume the debtor's contracts. The bankruptcy therefore meant that there was a contractual vacuum where no contract for the service existed between the trustee and the customers. As a result of the agreement between the lender and the trustee, the estate therefore sent letters to all previous customers of the production companies enclosing the new terms and conditions for the supply of heating, including, of course, significantly higher tariffs. The contracts were also assignable to a new owner of the production facilities.

The customers were then given a certain period of time during which they were asked to decide whether they accepted deliveries on such new terms and conditions or whether they declined. If they declined they were asked to turn off the heating centrally at each customer's premises. (For technical reasons it was impossible to turn off the heating for individual customers at the production facilities.) The customers were then informed that if they continued to use the heating after the deadline they would, irrespective of whether they accepted the new terms and conditions, be bound by the enclosed terms by their conduct. Customers who did not respond were provided with a new letter in which the trustee warned that a representative of his would come and visit the customers facilities and ask for permission to turn off the heating. Invariably, the customers then responded in writing or by conduct that they did not accept to have the heating turned off.

Not surprisingly, the letters were not met with any great enthusiasm among customers and even less so among local politicians. Ultimately, however, virtually all customers accepted the new tariffs.

The trustee then declared an interim bankruptcy dividend to the lender and the lender purchased the assets of the bankruptcy debtors from the estate. The purchase price was paid by the lender by setting off its right to the interim dividend.

Benefits of the strategy

One can readily see that the bankruptcy route was clearly favourable to the composition which the operating companies initially tried to implement or threatened to implement. In comparison with the composition, the customers did not receive any pay off on their existing contracts, not even a composed one. Thus, the bankruptcy was significantly 'cheaper' than the proposed composition. Thus, for the customers the business decision was merely to continue purchasing the heating at a higher price than before, or switch to oil or electricity, which would be even more expensive. This tipped the scales in favour of continuing to purchase from the existing source at higher tariffs. In addition, the bankruptcy route did not require any particular acceptance among customer creditors as any composition would.

Legal analysis

It is submitted that the strategy, although admittedly aggressive and innovative, is based on well established principles of Swedish law. First of all, it is trite law in Sweden that the estate is not bound by the terms of the debtor's contracts if the trustee continues the debtor's business. Thus, the bankruptcy led to a state of contractual vacuum although the service continued. The fact that the debtor (and subsequently the estate) was the only possible provider of heating through the heating pipes could be argued to mean that it had a *de facto* monopoly on the local market for providing heating. In addition, facilities such as heating, electricity, water, etc., are necessary facilities for the customers. These two considerations may mean, although the legal position is not clear, that the owner of the facility is obliged under general principles of law to offer to enter into contracts with the previous customers (*kontraheringsplikt*). This mandatory contracting obligation is not absolute however. The owner of the facility may refuse to enter into a new contract if there are 'valid reasons' to refuse. Luckily, it was never put to the test whether a bankruptcy trustee could successfully claim that the estate is not under an obligation to offer new contracts, either by virtue of its very capacity as bankruptcy estate or by virtue of the fact that continuation of business *in casu* is not compatible with the obligation of the trustee

under the Bankruptcy Act to liquidate the debtor's assets as quickly and favourably as possible. In the actual case all parties wanted the service to continue but they had different views as regards the terms of the offer.

Even if there is a mandatory obligation to contract, the only requirement as regards the terms and conditions to be offered is that they must be 'reasonable'. In the present case, a market analysis was made which showed that the offered tariffs where admittedly on the higher end of the scale but by no means the highest. The offer could therefore never be in breach of the mandatory obligation to offer a new contract on reasonable terms.

Furthermore, it is a principle of Swedish contract law that a party which consumes another party's offered products in knowledge of the terms under which that other party offers the products becomes bound by such terms by his conduct (*realhandlande*). That is so even if he does not accept the *terms* as such. (A simple example would be that one cannot go into a shop, consume a bar of chocolate and then argue that one should pay less than the price displayed because one did not accept the price as such.) The customers who refused to turn off the heating (and, even more obviously, those who refused to let the trustee's representative turn it off) therefore became bound by the estate's terms and conditions.

Obviously, with a product such as heating it will be necessary to allow the customer the necessary time for replacing the service, should he wish to do so or allow the customer a fairly liberal right to terminate the contract for convenience. If not, the customer may be deemed to have been bound without having had a reasonable chance to purchase the product elsewhere or replacing it with another type of product (in this case electricity or oil). In such case, the terms and conditions could be regarded as 'unconscionable' and thus be amended or struck down by the court under section 36 of the Swedish Contracts Act. In the present case there was however ample time for customers to replace the existing heating system and also a right to terminate the contract upon short notice. The fact was that they did not want to.

Post scriptum

In the end, Lantbrukskredit successfully divested the heating business on the back of the new and improved tariffs.

During the course of the reorganisation, the Swedish Government, directly referring to the bankruptcies, appointed a committee to analyse whether the protection for customers upon the bankruptcy of a district heating company should be strengthened. It was proposed that all district heating companies should contribute to a fund intended to finance the continued operations of a bankrupted district heating business, see *Statens Offentliga Utredningar* (2005: 63). To date, no new legislation has been implemented.

International Corporate Rescue

International Corporate Rescue addresses the most relevant issues in the topical area of insolvency and corporate rescue law and practice. The journal encompasses within its scope banking and financial services, company and insolvency law from an international perspective. It is broad enough to cover industry perspectives, yet specialized enough to provide in-depth analysis to practitioners facing these issues on a day-to-day basis. The coverage and analysis published in the journal is truly international and reaches the key jurisdictions where there is corporate rescue activity within core regions of North and South America, UK, Europe Austral Asia and Asia.

Alongside its regular features – Editorial, The US Corner, Economists' Outlook and Case Review section – each issue of *International Corporate Rescue* brings superbly authoritative articles on the most pertinent international business issues written by the leading experts in the field.

International Corporate Rescue has been relied on by practitioners and lawyers throughout the world and is designed to help:

- Better understanding of the practical implications of insolvency and business failure – and the risk of operating in certain markets.
- Keeping the reader up to date with relevant developments in international business and trade, legislation, regulation and litigation.
- Identify and assess potential problems and avoid costly mistakes.

For more information about *International Corporate Rescue*, please visit www.chasecambria.com