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Let's talk

PREVENTIVE RESTRUC-TURING IN PRACTICE

The concept of restructuring is associated with the process of recovering the company, with the aim that the company survives and the creditors of the company, although partially satisfied, benefit from trading with the "saved" debtor. The restructuring according to insolvency act no. 7/2005 Coll. was used minimally after the Lex Váhostav amendment.

On July 17, 2022, a new Act No. 111/2022 Coll. on resolution of impending bankruptcy (hereinafter referred to as the "Act") entered into force. It introduces two new types of restructuring. The aim of the Act is to address the situation of entrepreneurs who are at risk of bankruptcy due to insolvency, so that they avoid bankruptcy. It should be noted that the regulation applies only to legal persons.

According to PWC's analysis, up to 83% of Slovak companies were already at risk of bankruptcy three years before the restructuring was permitted under the Insolvency Act. Statistics testify to the dysfunction of restructuring under the Insolvency Act. Only 20% of companies carry out their business activities five years after the end of the restructuring. In 2021 only 22 restructurings took place. These figures are alarming if we consider that restructuring is the preferred method of dealing with bankruptcy. Considering the current bad economic situation, it can be assumed that the demands to deal with the impending bankruptcy will grow.

The term 'impending bankruptcy' is defined by the Insolvency Act as a situation where, considering all the circumstances, it can be assumed that the debtor will be insolvent within 12 months, i.e the debtor will not be able to repay at least two monetary liabilities to more than one creditor 90 days after the due date or it will not be possible to enforce the monetary claim against the debtor by execution.

The Act envisages the solution of impending bankruptcy with new tools, namely (i) public preventive restructuring and (ii) non-public preventive restructuring. Restructuring according to the Insolvency Act remains in place to resolve the debtor's bankruptcy. All forms of restructuring essentially mean the renegotiation of contracts between the debtor and the creditor.

The fundamental difference lies in the fact that non-public preventive restructuring is a matter of agreement between the debtor and regulated creditors (e.g. banks). The debtor does not have to use the services of an advisor. Creditors who are not part of a non-public preventive restructuring plan are not affected by this, until they express their written consent to it. The court can reject a non-public plan for one reason only, namely that it may harm the property interests of creditors who are not parties to it. If the court does not reject the non-public preventive restructuring plan, the fiction of its confirmation applies. A creditor who has provided financing to a debtor under a confirmed plan is not considered to be a related creditor, even though he or she would otherwise be (e.g. a shareholder of the debtor). The use of public preventive restructuring is a right of the debtor and can only start at the request of the debtor, subject to supervision by the court, advisor, and administrator. The advantage of this process is temporary protection for a maximum of six months, which protects the debtor from the declaration of bankruptcy of the debtor's property, from the initiation of execution, from the unilateral termination of contracts due to the debtor's delay, before the early maturity of the loan due to the fact that the debtor does not comply with the agreed covenants, etc.

Neither form of preventive restructuring is mandatory. It is an option for the debtor. On the other hand, the liability of the debtor's statutory representatives, who are obliged to file for bankruptcy even in the event of insolvency, is being tightened under the threat of a fine of EUR 12,500.

A novelty of the Act is the condition that if the debtor requests that the court replaces the consent of the group of creditors with a public preventive restructuring plan, then the ultimate beneficial owners of the debtor must leave their shares to creditors without compensation or must replenish the debtor's equity in the amount of 20% of the creditors' forgiven claims. The replenished equity must be used by the debtor exclusively to pay the claims of the creditors concerned.

The Act, in contrast to the Insolvency Act, brings a wide range of unaffected creditors. These include in particular:

- employees of the debtor,
- a small creditor with a claim of no more than EUR 500,
- a small creditor with less than 10 employees, annual sales and assets of less than EUR 2mil. and a claim of up to EUR 5,000,
- a disputed creditor who is not related to the debtor,
- a creditor with a non-monetary claim,
- the tax administrator, and
- customs authority.

It can be assumed that the preventive restructuring plan will mainly affect institutional creditors (e.g. banks), creditors related to the debtor (e.g. shareholders).

In the case of restructuring under the Insolvency Act, the forgiven claim represents the creditor's tax expense, and from the debtor's point of view, the debt forgiveness is exempt from income tax. In addition, the creditor can create corrective items for claims against the debtor in proceedings under the Insolvency Act. The legal regulation according to the Act is not yet reflected in the tax regulations at all. An interdepartmental comment procedure is currently underway (September 2022), the result of which should be the consideration of preventive restructuring in tax regulations from 1 January 2023. According to the working material, the write-off of the claim as well as the corrective items to the claims against the debtor will be a tax expense of the creditor. On the debtor's side, the forgiven liability will increase the tax base and thus will have to be taxed. We believe that the tax rules set up in this way will discourage creditors from using these new legal instruments. The debtor's obligation to pay income tax from the forgiven debt will indirectly harm all creditors, as the package of the debtor's financial resources, which he could otherwise use to pay creditors' claims, will be reduced.

In conclusion, preventive restructuring theoretically expands the range of possibilities for legal entities that are balancing on the verge of bankruptcy. The practical use will depend on the connection of the Act and the relevant tax regulations.