Out-of-court debt restructuring: Implementation of INSOL Principles in Austria

How Austria deals with the lack of a legal framework for out-of-court restructurings

SUSANNE FRUHSTORFER
Head of Restructuring & Corporate Recovery CEE, TaylorWessing, Austria

Like some other jurisdictions Austrian law does not provide a concrete legal framework for an out-of-court debt restructuring.

However, the law does not prohibit the management of a company for extra-judicial restructuring; on the contrary, it grants 60 days for extra-judicial restructuring efforts if there is a reason for insolvency (inability to pay, over-indebtedness without a positive prognosis).

Obligation to file for insolvency

On the one hand, 60 days is a relatively short period of time; on the other hand, these 60 days can only be fully exhausted if the restructuring attempt appears promising and feasible. The 60-day period can also be used for the preparation of judicial restructuring proceedings, with or without debtor in possession.

The problem is that few entrepreneurs are willing to admit that a reason to file for insolvency proceedings exists. Most insolvency applications are made after the end of the 60-day time period.

Preventive restructuring proceedings

In 1997, the Austrian legislator tried to prompt companies experiencing financial difficulties to act as soon as possible by creating the Company Reorganisation Act (*Unternehmensreorganisationsgesetz*, URG). A reorganisation proceedings is a judicial proceedings with a court-appointed reorganisation auditor, which can, however, only be installed under the condition that no grounds for insolvency already exist. The proceedings are not public and therefore not published in the public internet insolvency gazette as all other insolvency proceedings are.

Disadvantages of the proceedings are the lack of a stay of enforcement actions and the non-involvement of creditors. The reorganisation proceedings pursuant to the URG (therefore) proved to be a flop. The applications filed in the euphoric period shortly after the law entered into force in 1998 were dismissed as the applicants were already insolvent. Supposedly, proceedings pursuant to the URG were opened only once in all of Austria since the law entered into force. More details are not known because, as already mentioned, the proceedings are not public.

Notwithstanding its failure in practice, the URG is still in force. One positive result of the URG was the legal definition of certain key figures, which were viewed as suitable to identify looming financial difficulties. This is the equity capital ratio figure, which should not fall below 8%, and the notional debt repayment period which should not exceed 15 years.

If these figures are not met, the members of the management board of companies which must be audited are liable for up to €100,000 per person in case of subsequent insolvency proceedings.

Importance of out-of-court restructuring

Regardless of the lack of a legal framework, out-of-court debt restructurings are very popular in practice. There is still a certain stigma attached to judicial insolvency proceedings despite the latest amendment of the Insolvency Law in 2010, in which it was once again attempted to help companies to overcome their fear of the Insolvency Court.

According to the most recent study of the University of Linz, the success rate of out-of-court debt restructurings is around 50%, whereby it is lowest in the case of small businesses with an

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average annual turnover of under €10 million.

Guidelines for restructuring

Due to the lack of a legal framework for out-of-court debt restructurings, three Austrian banks – Raiffeisen Bank International, Erste Group and UniCredit Bank Austria – together with the law firm *Schönherr Rechtsanwälte*, translated the INSOL Principles[1] (*Statement of Principles for a Global Approach to Multi-creditor Workouts, published in 2000*) into German and added explanations and comments with regard to Austrian conditions and specifics.

The eight INSOL Principles were supplemented each with an annex for trade credit insurers and leasing companies. A special section for trade credit insurers was added as the business model of trade credit insurers differs from that of banks. Trade credit insurers have no direct legal relationship with the debtor. If trade credit insurers refuse the further assumption of the risk, suppliers will no longer take the debtor's orders. It is therefore necessary to promptly include trade credit insurers in the process of the out-of-court debt restructuring. The risk position of leasing companies, as owners of the financed leasing objects, is different than that of banks. Leasing companies should be included in a timely manner, and should not take any measures which could lead to additional liquidity burdens during the stay.

The *Guidelines for Restructuring in Austria* are purely voluntary, but have been recognised by most banks since they were first presented in April 2013. They deal with the first phase of an out-of-court debt restructuring in which the possibility for reorganisation of a debtor has to be examined.

It only makes sense to apply the guidelines in cases where at least three banks are involved and liabilities exceed the total amount of €30 million. An initiative of the European Bank for Reconstruction and Development has the aim of making the Austrian form of the INSOL Principles as the standard for restructuring proceedings in the entire CEE-region.

Previous experience shows that only 10% of the cases in which the Austrian form of the INSOL Principles were applied lead to a subsequent insolvency. One must however keep in mind that the test period has only been going on for one and a half years.

As welcome as the initiative of the three Austrian banks with regard to the INSOL Principles (which have already been used in many other jurisdictions) is, problems arise when the debtor is already insolvent. Normally companies only apply to the workout-departments of banks when the 60-day period for the application of insolvency proceedings has already begun.

Especially for large companies the 60-day period is too short for the preparation of a restructuring plan. The duration for the first standstill period is set at one till three months in the explanatory notes to Principle 1.

If there is no positive prognosis for the company's continued existence in the case of over-indebtedness, a bank or another involved creditor group risks avoidance in a subsequent insolvency even if no new credit was granted.

An avoidance risk exists if the potential insolvency estate is diminished (quota impairment) between the point in time where insolvency should have been filed for and the point in time where the proceedings where actually opened.

The danger of liability for this so-called quota impairment has lessened since the 2010 insolvency law amendment as it must be shown that the reorganisation concept was clearly unsuitable.

However, the questions of whether a positive prognosis for the company's continued existence was given and the question of whether the reorganisation concept was suitable, are usually judged subsequently in court proceedings through an expert report. Court appointed experts generally have more information available in hindsight as well as more time than the debtor and his creditors at the time of the crisis.

Reorganisation financing, which is referred to as "super senior" in the explanatory notes to Principle 8, can only be obtained by a court-appointed administrator if it was granted within the framework of reorganization proceedings pursuant to the Company Reorganization Act. Such proceedings do not, however, as mentioned above, ever take place in practice. In subsequent insolvency proceedings, reorganisation financing is not only in danger of not being granted, but is also on the same level as all other insolvency claims.

In the explanatory notes to Principle 3 it is stressed that the agreement for a stay does not release the debtor from his responsibility to file for insolvency, if it is given. The debtor alone has the responsibility to file for insolvency in a timely manner. Evidently, this note is meant to highlight that the banks involved shall not be viewed as de facto management and thus be jointly responsible for a delay in filing for insolvency.

Future developments

As a result of the Recommendation of the Commission dated 12.03.2014 on a new approach to business failure and insolvency, there have been efforts in the Austrian Ministry of Justice to reform the Company Reorganisation Act in such a manner that the restructuring proceedings correspond to the recommendations of the Commission. In the course of this reform a legal framework should be built which supports out-of-court debt restructurings with appropriate involvement of the courts. ■

Footnotes:

1 The INSOL Principles are international standards for a global approach to Multi-creditor Workouts. They are called "*Statement of Principles for a Global Approach to Multi-creditor Workouts*" and were published in 2000.

> **FEW ENTREPRENEURS ARE WILLING TO ADMIT THAT A REASON TO FILE FOR INSOLVENCY PROCEEDINGS EXISTS**