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The Importance of the Structure of the Insolvency System for Facilitation of Business Operators' Reorganisation

1. Introduction

The United Nations Commission on International Trade Law¹, The World Bank², and the International Monetary Fund³ have all recommended that states create, via legislation, options for the reorganisation of business operators. Although procedural alternative allowing the reorganisation of a business operator may be found in the insolvency laws of nearly all states today, countries vary in the thresholds that have to be met for initiation of reorganisation proceedings and in how reorganisation proceedings are positioned *vis-à-vis* bankruptcy proceedings structurally. The insolvency system's ability to promote reorganisation via legislation is another area in which states vary significantly.

The purpose of this article is to give an answer as to whether the structure of the insolvency system may help to promote the reorganisation of business operators in those situations wherein reorganisation should be preferred to liquidation. Also discussed is whether enabling the reorganisation of insolvent business operators may help to prevent the liquidation of viable business operators whose sustainable management after reorganisation would be possible in those kinds of insolvency systems whose structure does not promote reorganisation in appropriate cases.

2. The position of reorganisation in the system of objectives for insolvency law

In the structuring of their insolvency systems, states are—or at least should be—guided by the objectives of their insolvency law. Differences amongst states in terms of insolvency law range from the fundamental facts of their legal philosophy, specifically the key issue of whether the law is directed primarily at the pro-

¹ Legislative Guide on Insolvency Law. United Nations Commission on International Trade Law. New York 2005, p. 11. Available at http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (most recently accessed on 7.4.2012).

² Principles and Guidelines for Effective Insolvency and Creditor Rights Systems. The World Bank 2001, p. 6. Available at <http://www.worldbank.org/ifa/FINAL-ICRPrinciples-March2009.pdf> (most recently accessed on 7.4.2012).

³ Orderly & Effective Insolvency Procedures: Key Issues. International Monetary Fund 1999. Available at <http://www.imf.org/external/pubs/ft/orderly/index.htm> (most recently accessed on 7.4.2012).

tection of the debtor or creditor, to issues of how proceedings are initiated and the content of the procedural rules.^{*4} Given the rather short history of insolvency law, the world's legal systems have developed no uniform traditions for channelling reorganisation proceedings.^{*5} However, providing the option of reorganisation as an alternative in the insolvency law of a state always points to the objective of allowing a business operator subject to bankruptcy proceedings to continue operating under certain circumstances instead of being liquidated.

One way of classifying insolvency systems is their bifurcation into debtor- and creditor-centric systems. A debtor-centric system is directed primarily at the protection of turnover, and its key objective is to minimise the adverse impact of insolvent business operators on the economy overall. The key objective of the creditor-centric system is to protect the rights of creditors and ensure fairness (equal treatment of creditors) in settlement of claims.^{*6} Although it has been claimed that the manner of expression of the objective of protecting the interests of the debtor and its creditors in the insolvency regulations of states is that the main emphasis in a creditor-centric system is normally on bankruptcy proceedings aimed at liquidation, with reorganisation proceedings established as an ancillary option^{*7}, the priority of reorganisation proceedings need not automatically imply limited protection for the interests of creditors. In certain instances, it is precisely by means of reorganisation that creditors may be able to have their claims settled on a larger scale than under bankruptcy proceedings, where the likelihood of settlement of the claims of creditors with unsecured claims is fairly low to nil.^{*8} Hence, an insolvency system that attaches significance to extensive protection of the creditor's rights does not necessarily presuppose, *per se*, an emphasis on bankruptcy proceedings directed toward liquidation.^{*9}

In view of the above, encouragement of reorganisation does not imply regulation of insolvency law proceeding from the fact that the objective of the insolvency system is mainly the protection of the debtor's interests. A more appropriate formulation is whether the objective of the relevant state's insolvency law is to encourage reorganisation at all costs or only in those instances wherein it secures optimal utilisation of the debtor's assets (and, thereby, also the best protection of the creditors' interests).

Therefore, for example, under French insolvency law, the continuation of the debtor's operations by means of reorganisation is always seen as having priority over liquidation of the business operator by means of bankruptcy proceedings.^{*10} In states following the German legal tradition, the emphasis is, instead, on the protection of the creditors^{*11}, as a result of which it is held in Germany, for instance, that if reorganisation is in the interests of the creditors and allows the value of the debtor's assets to be maximised, procedural rules should be no obstacle to reorganisation.^{*12} The Supreme Court of Estonia too has upheld reorganisation in instances in which better protection is secured for the creditors thereby than bankruptcy proceedings would provide.^{*13}

Both in instances wherein the objective of insolvency is to encourage reorganisation by all means and in those insolvency systems where reorganisation is given priority only if it allows more effective utilisation

⁴ I.F. Fletcher. *Insolvency in Private International Law: National and International Approaches*, 1st ed. US: Clarendon Press 1999, p. 4.

⁵ W.W. McBryde, A. Flessner, S.C.J.J. Kortmann (eds). *Principles of European Insolvency Law*, Vol. 4 in the Law of Business and Finance series. The Netherlands: Kluwer Legal Publishers 2003, p. 67.

⁶ P. Manavald. *Likvideeriva pankrotimenetluse alternatiivid maksejõuetuse tingimustes (Alternatives to Bankruptcy Proceedings Directed at Liquidation in the Event of Insolvency)*. – *Juridica* 2005/2, p. 125 (in Estonian).

⁷ *Ibid.*

⁸ The fact that larger proportions of creditors' claims are settled under a reorganisation plan than under bankruptcy proceedings has been analysed empirically in the context of Finnish reorganisation law: S. Sundgren. *Does a reorganization law improve the efficiency of the insolvency law? The Finnish experience*. – *European Journal of Law and Economics* 1998 (6)/2, p. 186. This position has been expressed also by D. Milman, C. Durrant. *Corporate Insolvency: Law and Practice*, 2nd ed. London: Sweet & Maxwell 1994, p. 125.

⁹ J. Israël. *European Cross-Border Insolvency Regulation*. Antwerp & Oxford: Intersentia 2005, p. 165.

¹⁰ See C. Jungmann, J. Thiessen. *Discussion report: Restructuring insolvent companies in the UK and in the US*. – *European Company and Financial Law Review* 2008, p. 190; S.A. Davydenko, J.R. Franks. *Do bankruptcy codes matter? A study of defaults in France, Germany, and the U.K.* – *The Journal of Finance* 2008 (63)/2, p. 566; Israël (see Note 9), p. 25.

¹¹ R. Blazy, B. Chopard, B. Fimayer. *Bankruptcy law: A mechanism of governance for financially distressed firms*. – *European Journal of Law and Economics* 2008 (25)/3, p. 265.

¹² M. Balz. *Market conformity of insolvency proceedings: Policy issues of the German insolvency law*. – *Brooklyn Journal of International Law* 1997 (23)/1, p. 168.

¹³ Supreme Court Civil Chamber ruling of 18.11.2009, 3-2-1-122-09, paragraph 17. – RT III 2009, 53, 395 (in Estonian).

of the debtor's assets, it is important for the insolvency system to ensure, by virtue of the structure of the insolvency system, that in situations in which the reorganisation of the debtor is warranted instead of bankruptcy proceedings, insolvency law should also be able to meet this objective. Hence, in all procedural systems that include an alternative to reorganisation proceedings, the legislation in effect should be impelled by the objective of ensuring a structure of proceedings that allow a choice to be made effectively with respect to the appropriate procedural alternative.^{*14}

3. The impact of the insolvency system's structure on the initiation of reorganisation proceedings

3.1. Problems arising from separation of bankruptcy and reorganisation proceedings

In terms of approaches to proceedings under the insolvency law of a state, a distinction is made between systems featuring uniformity of bankruptcy and reorganisation proceedings and the direction of procedural regulation in decision between liquidation and reorganisation proceedings under the proceedings initiated and, on the other hand, systems wherein the reorganisation and liquidation proceedings are detached from each other, with their initiation possible on a variety of bases.^{*15}

The entry into force of the Estonian Reorganisation Act^{*16} (ERA) on 26 December 2008, which for a business operator faced with solvency problems includes the option of overcoming the financial difficulties and continuing to operate by restoring liquidity, has not, in terms of its application in practice, brought with it the anticipated results, and reorganisation proceedings for business operators are conducted at a fraction of the rate seen with bankruptcy proceedings.^{*17} Although the regulation of insolvency law as a uniform type of proceedings has been considered a trend of contemporary legislation^{*18}, the establishment of Estonia's ERA was not guided by this principle. Since the word 'bankruptcy' sends a signal to society that a company is distressed, one reason for keeping the proceedings detached from each other was the legislator's desire to keep the negative meaning of bankruptcy from discouraging debtors from filing for reorganisation and creditors from accepting the reorganisation plan.^{*19} Considering bankruptcy as a result of preventable failures (in contrast to the US view, according to which it is recognised that failure need not rule out future suc-

¹⁴ Balz (see Note 12), p. 170.

¹⁵ Legislative Guide on Insolvency Law (see Note 1), p. 17.

¹⁶ Saneerimisseadus. – RT I 2008, 53, 296; RT I 2010, 2, 3 (in Estonian). English text available via <http://www.legaltext.ee/> (most recently accessed on 7.4.2012).

¹⁷ In 2009, 93 applications for reorganisation were filed with courts of the first instance, whereas applications filed for bankruptcy of legal entities numbered 1,562. Reorganisation petitions were satisfied with respect to only six of the 93 business operators that had filed for reorganisation (see: I ja II astme kohtute statistilised menetlusandmed. 2009. aasta kokkuvõte (Procedural Information from Courts of the First and Second Instances: 2009 Summary). Ministry of Justice 2010, p. 7 (in Estonian)). In 2010, 51 applications for reorganisation were filed in Estonia. By contrast, applications filed for the bankruptcy of legal entities numbered 1,345 (see: I ja II astme kohtute statistilised menetlusandmed. 2010. aasta kokkuvõte (Procedural Information from Courts of the First and Second Instances: 2010 Summary). Ministry of Justice 2011, p. 7 (in Estonian)). In the first half of 2011, 18 applications for reorganisation were filed with courts of the first instance. In contrast, applications filed for the initiation of bankruptcy proceedings for legal entities numbered 573 (see: I ja II astme kohtute statistilised menetlusandmed. 2011.a I poolaasta kokkuvõte (Procedural Information from Courts of the First and Second Instances: 2011 First-Half Summary). Ministry of Justice 2011, p. 7 (in Estonian)). The statistics do not provide information about the number of instances in which reorganisation proceedings reached the approval of a reorganisation plan or on the proportion of the applications filed that saw successful reorganisation proceedings. By comparison, it may be noted that in 2008, when there was no procedural alternative in the Estonian legal system to allow the initiation of reorganisation proceedings, 1,186 applications in all for bankruptcy of legal entities were filed with courts of the first instance (see: I ja II astme kohtute statistilised menetlusandmed. 2008. aasta kokkuvõte (Statistical Procedural Information from Courts of the First and Second Instances: 2008 Summary. Ministry of Justice 2009, p. 16 (in Estonian)). Even though the years following 2008 were also characterised by a decline in the economy due to the recession more generally, the above makes it possible nonetheless to infer that the adoption of the ERA did not significantly reduce the filing of applications for bankruptcy and that the proportion of instances of recourse to procedural alternatives directed toward reorganisation and the resolution of solvency problems remained lower than expected in comparison to bankruptcy proceedings.

¹⁸ McBryde *et al.* (see Note 5), p. 17.

¹⁹ Saneerimise kontseptsioon (The Concept of Reorganisation). Ministry of Justice of Estonia, Tallinn 2007, p. 22 (in Estonian)—copy in possession of author.

cess of incumbent management) is characteristic of other EU countries also.^{*20} The justification for making that kind of procedural choice may also be seen in the need to not encumber insolvency law that functions well for bankruptcy proceedings with profound legal changes.

On the other hand, precisely that strict separation of reorganisation and bankruptcy proceedings—in other words, the lack of integration in Estonian insolvency law more generally—may be why reorganisation proceedings are pursued so rarely in practice.

In order to understand the issues related to the structure of insolvency law in Estonia, one has to begin with explication of the regulation in effect under the Bankruptcy Act^{*21} (BA). Namely, before the ERA was passed, the BA already contained regulation allowing the business operator faced with solvency problems to undergo rehabilitation. This procedural alternative, essentially directed at allowing the business operator to continue operating, may be resorted to only in bankruptcy proceedings. In practice, the rehabilitation regulation under the BA has failed to gain extensive application. The reason may be that, following regulation under the BA, rehabilitation can be decided upon only after bankruptcy has been declared (§129 (3) of BA), or even later if composition is negotiated during rehabilitation, as under bankruptcy proceedings a decision on composition can be made only after claims have been defended (§180 (2) of BA). A decision for composition, however, is mandatory if, for instance, the goal of the rehabilitation is to reduce the creditors' claims, because under §178 (1) of the BA, repayment of debts may be agreed upon only by means of composition. To ensure successful rehabilitation, however, rehabilitation measures that include transformation of claims and working out a plan for sustainable management of the business operator should usually be implemented without the excessive delay that is characteristic of the BA, under which rehabilitation measures are to be applied only in the second stage of bankruptcy proceedings. In a situation of financial crisis, such a temporal gap could destroy the chances of rehabilitation of the business operator, creating a scenario wherein the financial situation of the business operator may become impaired irreversibly by the time rehabilitation is considered, with no actual possibility for successful rehabilitation.^{*22} The negative background of bankruptcy proceedings too may be seen as a reason creditors do not favour rehabilitation being carried out once bankruptcy has been declared. The rehabilitation taking place under bankruptcy proceedings may also have a negative effect on the debtor's willingness to apply rehabilitation. Hence, regulation of rehabilitation under bankruptcy proceedings in Estonia may be considered a failure, as in actual fact the conducting of the rehabilitation of the debtor is not encouraged by regulation under the BA.

Given the deficiencies in the regulation of rehabilitation conducted under bankruptcy proceedings, the ERA was established for a type of proceedings entirely detached from and independent of bankruptcy proceedings. The main effect of the strict separation of these proceedings is that once the bankruptcy petition is filed, a court cannot on its own initiative convert the proceedings into reorganisation if that appears to be more appropriate in the given circumstances. Hence, the initiation of reorganisation proceedings depends entirely on the debtor's ability to evaluate the financial state of the business operator and to understand the legal opportunities to overcome its solvency problems. As was mentioned above, reorganisation, however, need not be only to protect the interests of debtors, which is why the insolvency system has to ensure by its structure that application of reorganisation is considered in appropriate cases. Consequently, an insolvency system with strictly separated proceedings does not encourage the consideration of an alternative that allows the reorganisation of the business operator; instead, it imposes on the business operator the choice of whether to file for reorganisation when solvency problems appear or wait until insolvency comes to pass, when filing for bankruptcy is the only lawful way to proceed.

²⁰ M. Brouwer. Reorganization in US and European bankruptcy law. – *European Journal of Law and Economics* 2006 (22)/1, p. 9.

²¹ Pankrotiseadus. – RT I 2003, 17, 95; RT I, 29.6.2011, 1 (in Estonian). English text available via <http://www.legaltext.ee/> (most recently accessed on 7.4.2012).

²² U. Tross. Saneerimine kui alternatiiv ettevõtte likvideerimisele pankrotimenetluses (Reorganisation As an Alternative to the Liquidation of a Business Operator under Bankruptcy Proceedings). Master's thesis. Tartu 2003, p. 41 (in Estonian).

3.2. Methods for unification of the insolvency system

It has been pointed out that, to ensure the effectiveness of insolvency law, switching proceedings smoothly should be allowed by procedural rules.^{*23} For that, however, reorganisation and bankruptcy proceeding must be seen not as two strictly separated measures for resolving solvency issues but as alternative and closely linked parts of a single system that aims to allow the liquidation of business operators only if reorganisation is not an adequate means in the given solvency situation.

Unlike in the system of procedural regulation in effect in Estonia, under uniform insolvency proceedings the financial situation of the business operator is evaluated within a certain time after an application has been filed for the initiation of proceedings, and then a decision is made as to reorganisation or liquidation.

French insolvency law, for instance, by virtue of its structure, is always directed at the consideration of options for reorganisation before bankruptcy is declared. French insolvency regulation under the Commercial Code (*Code de commerce*^{*24}, CC) is in its structure directed at ruling out all options that allow reorganisation before liquidation occurs. Under any proceedings directed at resolving insolvency, this is made possible, in the initial phase, by the designation of an observation period, during which the prospects for reorganisation are established.^{*25} Hence, French insolvency law is directed at the consideration of alternatives to reorganisation before liquidation proceedings are initiated, precisely by virtue of the fact that the possibility of the reorganisation of the business operator is established during the observation period that is the first phase of the proceedings. That rules out liquidation occurring with respect to a business operator with positive prospects for reorganisation.

Under the Swiss Debt Enforcement and Bankruptcy Law^{*26} (*Bundesgesetz über Schuldbetreibung und Konkurs*, SchKG), objectives similar to that of the observation period applicable under French insolvency law are served by the designation of a moratorium upon initiation of proceedings (§§ 293–304 of SchKG).^{*27} For the duration of the moratorium, the court may appoint an administrator whose activity is aimed at establishing the options for the reorganisation of the debtor (§293 (3) of SchKG). Nevertheless, a court is not required to do so. Thus Swiss law entitles a court to initiate reorganisation proceedings in a situation wherein, under bankruptcy proceedings, reorganisation appears to be more expedient. In such an event, there is no need to wait for an application from the debtor or creditor before initiation of reorganisation proceedings; instead, a court can initiate proceedings at its own initiative^{*28}, regardless of whether reorganisation or liquidation proceedings have been initiated on the basis of an application to begin the relevant proceedings.

In such forms of insolvency systems, the reorganisation possibilities are considered and reorganisation measures are implemented betimes, enabling minimisation of the risk of the business operator becoming irreversibly insolvent during the time of the proceedings on account of the delay before reorganisation can be applied. However, as is clear from, for instance, the lack of implementation of the rehabilitation institution in Estonia (which, at least formally, in combination with bankruptcy proceedings forms a kind of unity of proceedings in which the time gap before the possibility to apply rehabilitation measures rules out the opportunity for the successful implementation of the rehabilitation institution), merely formal uniformity of the insolvency system cannot ensure that reorganisation is conducted when it is suitable. It is apparent that uniformity of the insolvency system alone cannot ensure that reorganisation is conducted if the procedural provisions themselves do not enable the reorganisation to be carried out—as, for example, if the reorganisations measures are to be applied by the time at which insolvency may have become irreversible.

For instance, in Germany, reorganisation proceedings quite similar to Estonian rehabilitation proceedings under the BA have been enforced. In Germany, when an application is filed, the proceedings initiated are always bankruptcy proceedings. In bankruptcy proceedings, however, a court may also approve

²³ Principles and Guidelines for Effective Insolvency and Creditor Rights Systems (see Note 2), p. 28.

²⁴ Code de Commerce, as entering force on 1.1.2006. English text available via <http://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations> (most recently accessed on 7.4.2012).

²⁵ J. Marshall (ed.). *European Cross Border Insolvency*, Vol. 1. London: Sweet & Maxwell 2007, pp. 10–6, 10–8.

²⁶ *Bundesgesetz über Schuldbetreibung und Konkurs*, as entering force on 11.4. German text available via http://www.admin.ch/ch/d/sr/c281_1.html (most recently accessed on 3.6.2012).

²⁷ S.V. Berti. *Swiss Debt Enforcement and Bankruptcy Law*. Zürich: Schulthess Polygraphischer Verlag 1997, p. XVII.

²⁸ The Concept of Reorganisation (see Note 19), p. 28.

a reorganisation plan, according to §217 of the German Insolvency Act²⁹ (*Insolvenzordnung*, InsO). As in Estonian rehabilitation proceedings under the BA, the debtor may seek the initiation of bankruptcy proceedings also by submitting a reorganisation plan (§218 (1) of InsO). In the event of the initiation of proceedings upon an application being filed by the debtor or creditor, in Germany the decision as to the approval of the reorganisation plan can be made on the basis of the reorganisation plan submitted by the bankruptcy administrator, if the bankruptcy administrator has determined that reorganisation might meet with success (§156 (1) of InsO) and if the committee of creditors has tasked the administrator with the preparation of this kind of plan (§157 of InsO). Hence, analogously to what occurs in Estonian rehabilitation proceedings, under German insolvency law the reorganisation measures, at least in theory, are applied with inappropriate delay that may render successful reorganisation impossible. It has been pointed out that reorganisations occur infrequently in Germany, as they do in Estonia, regardless of uniformity of insolvency law of this sort.³⁰

As appears evident from the above, the uniformity of proceedings characteristic of insolvency systems such as the French or Swiss system, by virtue of its structure, rules out the problem related to a switch of proceedings, as it allows selection of the proceedings that are most appropriate in light of the facts of the business operator's solvency problems in the first phase of the proceedings. It appears thus that the procedural structure of the insolvency system may have an important role in ensuring that options for reorganisation are assessed before the bankruptcy of the business operator is declared. It is the uniform structure of an insolvency system that brings about flexibility in terms of the decision between alternative proceedings, contributing to the reaching of the objective of liquidating only those business operators whose reorganisation is not possible.

Proceedings upon whose initiation a decision has to be made as to whether to apply for reorganisation or file a bankruptcy petition, and during which the possibilities for reorganisation are not considered in the first phase of the proceedings, if at all, do not make it possible to facilitate the reorganisation of viable business operators via the structure of the insolvency system. Additionally, it has been correctly pointed out that excessive separation between the proceedings may, in the final instance, cause delay, increase the expenses incurred in the proceedings, and be ineffective.³¹

It cannot be ignored, however that uniform insolvency systems too have imperfections. One reason for dysfunction of Estonian rehabilitation proceedings could be the negative connotations of bankruptcy that accompany rehabilitation taking place as a part of bankruptcy proceedings—the question arises of whether uniformity of the insolvency law might have, due to the connectedness of reorganisation and bankruptcy proceedings, influence on a debtor's desire to file for any proceedings at all since the final outcome, in terms of the type of the proceedings that are to be conducted, cannot be foreseen at the initiation phase of the proceedings. However, the duty of filing a petition to initiate proceedings in the case of insolvency should prevent the debtor's complete lack of concern for obligations deriving from insolvency provisions. The main reason for preferring a uniform insolvency system regardless of its flaws is that a uniform insolvency system guarantees at least the consideration of the possibility of reorganisation, which has been ruled out in the case of the insolvency system of strictly separated proceedings since the reorganisation proceedings can only be initiated if the debtor has applied it and no conversion from bankruptcy to reorganisation can be done once the bankruptcy petition has filed. Thus, uniformity of the insolvency system helps to minimise the risk of initiating the inappropriate proceedings for the nature of business operator's solvency problems.

²⁹ *Insolvenzordnung*, as entering into force on 1.1.1999. German text available at <http://www.gesetze-im-internet.de/inso/> (most recently accessed on 3.6.2012).

³⁰ D. Smith, P. Strömberg. *Systemic Financial Crises: Containment and Resolution*. – P. Honohan, L. Laeven (eds). USA: Cambridge University Press 2005, p. 233.

³¹ Legislative Guide on Insolvency Law (see Note 1), p. 18.

4. Insolvency as a prerequisite for the initiation of reorganisation proceedings

Under Estonian insolvency law, the prerequisites for the initiation of bankruptcy and reorganisation proceedings diverge: the general standard is that bankruptcy proceedings may be initiated only with respect to an insolvent business operator^{*32} (§31 (1) of BA) and it is the responsibility of the business operator to file for bankruptcy with a court in the event of permanent insolvency. The duty to file for bankruptcy arises under §36 of the General Part of the Civil Code Act^{*33} (for a private limited company, for instance, more specifically under §180 (5¹) of the Commercial Code^{*34} (ComC) and for a public limited company under §306 (3¹) of the ComC). In contrast, reorganisation proceedings may be initiated only if the business operator faces financial difficulties that might result in insolvency coming about later (§8 (1) of ERA). Accordingly, in cases of permanent insolvency of the business operator, applying the petition for initiation of bankruptcy proceedings is obligatory even if sustainable management of the business operator after reorganisation would likely be possible despite insolvency.

Threshold requirements for the initiation of reorganisation proceedings differ from one state to the next. In this respect, there are states that view insolvency as the prerequisite for the initiation of proceedings and those where mere impending insolvency is sufficient. These differences are fundamental with respect to the insolvency system overall.^{*35}

Where reorganisation is involved, however, the issue of insolvency is actually secondary. It is more important to ask whether the business operator has potential to resume successful operations. Hence, under certain circumstances, reorganisation of an already insolvent business operator should be permitted, as this allows for the objective of insolvency law—liquidation of only irreversibly non-viable business operators—to be met. Consequently, an insolvency system that rules out reorganisation of an insolvent business operator need not allow the desired implementation of the institution of reorganisation.

Whether it is possible via insolvency law to encourage the reorganisation of business operators or whether that would result in inappropriate use of the insolvency system depends in part precisely on the system's structure. For example, under French insolvency law, the initiation of one type of the alternative proceedings directed at reorganisation—*redressement judiciaire*—is possible also in a situation wherein the business operator is insolvent.^{*36} In the context of the structure of the French insolvency system, under which the appropriateness of reorganisation is decided upon during the observation period designated at the beginning of proceedings, allowing reorganisation of insolvent business operators makes it possible to reach insolvency law's objective of conducting reorganisation if it is, in comparison to liquidation, an appropriate solution to the case-specific solvency issues.

Allowing reorganisation of insolvent business operators in insolvency systems with detached proceedings such as that in Estonia, however, could bring the risk of reorganisation being used only as the preliminary phase of bankruptcy proceedings, in order to defer bankruptcy.^{*37} With the separation of the alternative proceedings, the structure of the Estonian insolvency system creates a situation wherein allowing reorganisation with respect to insolvent business operators would enable a business operator acting in bad faith to use reorganisation proceedings to the end of deferring bankruptcy. Although a business operator has to establish, upon filing for reorganisation, that its sustainable management will be likely after its reorganisation (§8 (1) 3) of ERA), said prerequisite does not entirely eliminate the risk of reorganisation proceedings nonetheless being initiated to the benefit of an irreversibly insolvent business operator whose intention is only to defer bankruptcy.

³² Under §31 (3) of the BA, it is nevertheless possible, upon the debtor filing for bankruptcy, to declare bankruptcy even if insolvency is likely to occur in the future.

³³ Tsiviilseadusliku üldosa seadus. – RT I 2002, 35, 216; RT I, 6.12.2010, 1 (in Estonian). English text available via <http://www.legaltext.ee/> (most recently accessed on 7.4.2012).

³⁴ Äriseadustik. – RT I 1995, 26, 355; RT I, 28.12.2011, 1 (in Estonian). English text available via <http://www.legaltext.ee/> (most recently accessed on 7.4.2012).

³⁵ J. Omar. *International Insolvency Law: Themes and Perspectives*. United Kingdom: Ashgate Publishing Press 2008, p. 87.

³⁶ R. Cork, M. Santoi. *France: Restructuring and Insolvency Procedures*. Available at <http://www.iflr.com/Article/2166556/France-Restructuring-and-insolvency-procedures.html> (most recently accessed on 3.6.2012).

³⁷ The ineffectiveness of the Reorganisation Act as a means to defer bankruptcy and the resulting insolvency has been pointed out by Prit Manavald. See P. Manavald. *Economic Crises and the Effectiveness of Insolvency Regulation*. – *Juridica International* 2010 (XVI), p. 214.

A unitary insolvency system, in which the choice of appropriate proceedings is made during the first phase of the proceedings initiated, unlike the Estonian insolvency system, rules out the potential risks attendant to the legalisation of reorganisation of an insolvent business operator, as the appropriateness of reorganisation is identified immediately after the commencement of the proceedings. Thus uniformity in an insolvency system helps to prevent the filing of applications for reorganisations that are impelled by the objective of deferral. However, in, for instance, French insolvency law, an extra guarantee to prevent proceedings from becoming drawn out and the associated cost in situations wherein proceedings have been initiated with respect to a business operator who is clearly irreversibly insolvent has been granted by regulations that designate no observation period if, by the time the application is filed, the business operator has ceased operations or if reorganisation is, for some other reason, clearly impossible.³⁸ In systems that allow the reorganisation of an insolvent business operator, complementary conditions that help to prevent unnecessary spending of time on consideration of the reorganisation options are certainly relevant.

Those insolvency systems with detached proceedings, such as the Estonian one, have to implement other means to prevent abuse of the reorganisation regulation. One solution for the problem might be sanctions for failure of a member of a business operator's management board to fulfil the obligation of submitting a bankruptcy petition in cases wherein the business operator is irreversibly insolvent and applies for reorganisation only so as to defer bankruptcy. However, evidence of intent to abuse reorganisation regulations is probably difficult to produce.

By virtue of its structure and prerequisite of initiated reorganisation proceedings, the Estonian insolvency system, insofar as a business operator that has become insolvent is required to file for bankruptcy, creates a situation wherein options for reorganisation are not considered even with respect to those insolvent business operators whose successful operations could, in fact, resume. However, in insolvency systems wherein the alternative sets of proceedings are detached from each other, the possibility of reorganising insolvent business operators with potential to resume successful operations might compensate for the system's lack of ability to support reorganisation on the appropriate occasions.

5. Conclusions

The issue of the procedural structure of insolvency law has not only formal significance, since the flexibility characteristic of uniform insolvency systems with a phase providing recognised chances to reorganise the business operator makes it possible to encourage the reorganisation of business operators in situations wherein this would be a more appropriate solution than liquidation. This kind of insolvency system also enables prevention of drawn-out, cumbersome, and costly proceedings that in no way can contribute to the reaching of insolvency law's objectives.

Although the structure of a procedural system alone cannot ensure effectiveness of the practical implementation of the institution of reorganisation, its role as a guarantee of reorganisation of viable business operators cannot be overlooked.

Insolvency systems with proceedings strictly separated from each other, permitting initiation of either reorganisation or liquidation proceedings on the basis of distinct applications and imposing different threshold requirements for the two types of proceedings, do not support consideration of the option to reorganise a viable business operator. On the contrary, the system might push a business operator into applying for reorganisation only when its solvency problem has become irreversible and liquidation is the only option left, or preclude reorganisation of a viable business operator whose bankruptcy petition has been filed. This adds to the ineffectiveness of insolvency law overall. Hence, the procedural structure of the insolvency system is of significant importance in ensuring that the options for reorganisation are assessed before the liquidation of a business operator.

However, the disadvantages of those insolvency systems with detached reorganisation and liquidation proceedings can be, at least partly, compensated for by allowing reorganisation of the insolvent business operators who have potential to resume successful operations.

³⁸ Israël (see Note 9), p. 25.