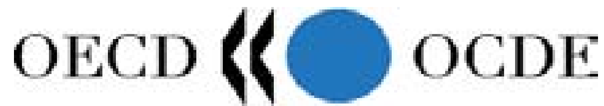

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Lessons from out-of-Court Debt Restructurings in Post-Crisis Asia:
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Lessons from Out-of-Court Debt Restructurings in Post-Crisis Asia?

By Timothy B. DeSieno[1/]

Since the onset of the Asian currency crisis in 1997, many Asian countries have focused political and commercial energy on the development and/or improvement of their corporate debt restructuring systems. These efforts have included a wide variety of steps, ranging from revised insolvency laws to new courts and judicial training to governmental asset management companies (AMCs) to enhanced systems for out-of-court restructurings. In this work, countries in the region have built on their own history and culture, and each has accordingly mixed the various elements in a unique way. On the other hand, many of the issues faced in all countries undergoing a currency, or other financial crisis are similar, and it may therefore be useful to compare experiences.

This paper is designed as an introduction to a panel discussion at the OECD's Second Forum for Asian Insolvency Reform (FAIR) taking place in Bangkok 16-17 December 2002. The panel discussion is to review and evaluate the successes and failures of the implementation of out-of-court restructuring systems in post-crisis Asia. Below is a list of questions that the author believes are most critical to the evaluation of any out-of-court system in transition.

First, however, the goals of an out-of-court system must be determined. Fundamentally, any system should be judged by how well it serves the goals of its creators and beneficiaries. The most apparent goal of an out-of-court debt restructuring system would be to promote more cost-effective debt restructurings than could be accomplished in the context of court-supervised proceedings. That goal is in turn a subset of a larger goal to resolve the troubles of companies that are over-indebted by de-leveraging them and encouraging improved business planning. That goal is, again in turn, a subset of a still larger goal of returning an economy to financial health and productivity.

Many market participants are concerned, however, that these goals may not in fact be the primary motivators in some countries' recent decisions to establish or strengthen corporate debt restructuring systems. Some investors posit that many revisions may have been imposed through official sector funding sources (e.g., other countries or multilateral organizations) to the countries in question, or otherwise, and the countries in question would not necessarily have made the changes otherwise. This sort of possibility could be particularly strong in countries where companies have a high proportion of offshore creditors, and where it is politically difficult to be seen as transferring stakes in companies to those creditors at discounted prices.

If these were the facts in any given country, then the goal of the new or newly strengthened system might not necessarily be to de-lever companies as part of a plan to return an economy to financial health. Instead, the goal could well be to create sufficient apparent de-leveraging effort so that the official sector funding sources are satisfied. To the extent that those funding sources do not cease

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providing funds to the country in question, then the revised system would have served a useful, if short-term purpose. There may of course be other internal or external reasons, unrelated to corporate de-leveraging itself, that make effort toward enhanced insolvency/restructuring systems a useful idea.

Many market participants believe that this sort of possibility is sufficiently real that emerging markets and their investors (whether they are official or private sector investors) ought to examine each of the following questions very carefully. The answers to the questions below will help indicate which goals a given country may have for its out-of-court system and the likelihood of success in achieving those goals.

1. ***Is there a political will that is truly supportive of resolving a corporate debt overhang?*** If the goal of an emerging market's out-of-court system is to resolve a private debt overhang, then the system's success will be dependent on the prevailing political will to ensure that it succeeds. If there is no political will, or inadequate political power to achieve success, experience shows that it will not happen. In gauging such political will, there is no substitute for results. That is, if the necessary political will is present, investors will know it because debtors and creditors will agree and implement commercial restructurings. Aside from results, and particularly important early on during a transition, there are at least two factors that help predict whether a system will become effective.

    - ***Is the country reliant on private capital inflows in the short- and medium-term future?*** If the country in question is significantly dependent on private capital inflows (funding from private offshore sources provided to private local companies, as opposed to funding from the official sector provided to the local government), the country will be much more inclined to encourage its out-of-court system to de-lever companies in a manner that is consistent with international, market-driven restructuring standards – standards that have proven effective around the world. This result is because private offshore funding sources will be less inclined to invest in a country where the debt resructuring system is thought to be inconsistent with such standards. On the other hand, if the country in question receives adequate funding for its economy from the official sector (or from internal sources), then the country will be much less motivated to ensure that its out-of-court system will work consistently with proven international standards.

    - ***Is there a credible social safety net in place to protect against social dislocation caused by large-scale debt restructurings?*** Another important factor in predicting how well the out-of-court system will work is the strength of the social safety net. If the government does not provide adequate protection for dislocated employees of failed businesses, investors tend to believe that the debt restructuring system in place will be less likely to function well. In many instances, debt restructuring exercises lead to increased unemployment, and without an adequate unemployment protection, the short-term dislocation of a large scale restructuring effort may pose a cost to the country that appears too expensive. Concern about that expense may tend to prevent successful restructurings, in- or out-of-court. On the other hand, a strong social safety net tends to indicate that the restructuring system is more likely to succeed.

2. ***Is there a clear and enforceable legal alternative to the out-of-court restructuring system?*** Unless creditors have access to a professional, speedy, and predictable legal system in which to enforce their claims, shareholders of financially troubled companies are unlikely to engage in serious out-of-court debt restructuring efforts. Shareholders are naturally reluctant to part with their ownership, and unless creditors have a realistic ability to threaten that ownership or otherwise exert leverage against the shareholders, the shareholders may have little incentive to

negotiate sensible restructuring terms. Especially once shareholders begin to enjoy the cash flow benefit of ceasing interest payments to their creditors, their reluctance to negotiate restructurings is enhanced.

For the legal system to be effective, it is most important that the judges be experienced in commercial matters and that their decisions be predictable and transparent. So long as the rules are known and consistently applied, almost regardless of what the rules actually are, creditors will be able to evaluate what kinds of restructurings to expect in court, and therefore, what is sensible to agree to out of court.

The author suggests that, in this regard, many countries have focused too little attention on liquidation procedures, preferring instead to focus on restructuring/rehabilitation procedures. At bottom, the success of an out-of-court restructuring system is dependent on the predictability and effectiveness of the in-court restructuring system. The success of any in-court restructuring system, however, is critically dependent on the predictability and effectiveness of the liquidation system. As such, liquidation procedures are the core of creditors' rights on default. Due to the rather shareholder-unfriendly result of a transparent liquidation system, however, it is often not politically helpful to focus on its improvement particularly intently. It appears to the author that weak and non-transparent liquidation procedures, have been among the most fundamental problems preventing more wide-scale success in recent out-of-court restructurings in Asia.

3. ***Does the out-of-court restructuring system adequately include governmental creditors?*** As part of the debt resolution system, many countries have established governmental assets management companies (AMCs). AMCs are designed to acquire non-performing assets from local financial institutions, and often then to coordinate the related restructuring efforts. In most places, AMCs have been both helpful and harmful to the out-of-court restructuring effort.

    - ***Do those governmental creditors have extraordinary powers that are useful?*** Ordinarily, when establishing an AMC, a country will grant it extraordinary powers in order to accelerate restructurings. These powers can include the ability to obtain guarantees from the shareholders of troubled companies, the ability to take control of the debtor's assets without resorting to the judicial system, and other powers and regulatory abilities. In countries where the AMC has a clear and politically-supported mandate, these powers tend to enhance the willingness of reluctant shareholders to come to the out-of-court negotiating table more rapidly and more commercially than they otherwise might. These powers can therefore be helpful in getting restructuring negotiations underway.

    - ***Are those powers adequately constrained, or do they create an inherent conflict of interest?*** On the other hand, if the AMC's powers are too great, especially if the judicial system is relatively weak, a strong conflict of interest arises. An AMC is usually tasked with maximizing value for itself, as any rational creditor would be. And, the extraordinary powers of the AMC are ordinarily more valuable to the AMC's own recoveries if they are exercised for the exclusive benefit of the AMC, rather than for the collective benefit of the creditor body. If these powers and incentives are counter-balanced by an effective judicial process for the creditors' collective benefit, then creditors have meaningful recourse if the AMC is seen to be prejudicing the other creditors. If the remaining creditor body has no meaningful recourse to a capable and powerful collective process, however, then the AMC's processes effectively supplant a judicial system – the AMC's processes may well be the only rules to which the debtor will adhere. This dynamic puts the AMC in the role of creditor as well as insolvency judge. Experience has demonstrated that this conflict is not easily resolvable in a manner that

instills confidence in the international investor community. All countries are accordingly well-served to find a credible balance among the competing interests.

4. ***Are there meaningful incentives for debtors to participate in the out-of-court restructuring process?*** In addition to the incentives caused by effective insolvency laws and court systems, experience has shown that out-of-court restructurings proceed most effectively in countries where there are positive incentives as well. The most customary example is the provision of tax incentives to companies who restructure. Other possibilities include specialized listing or accounting provisions that provide helpful relief for defined periods.

5. ***Are there meaningful incentives for local financial institutions to participate?*** Regulations that govern local financial institutions have been another critical stumbling block in achieving commercial restructurings. Often, regulations have permitted local financial institutions to value non-performing assets on their books at (what the market would likely consider to be) artificially high levels. Then, once that institution makes the concessions necessary to achieve a commercial restructuring, some regulations require the institution to reduce the value of the asset on its books, often quite markedly. When aggregated, these "write-downs" can threaten the capital adequacy of a financial institution. In order to avoid this threat, local institutions are often reluctant to participate in restructurings at all. In order to reduce this effect, some countries have considered adjusting the regulatory requirements, either by phasing in a general requirement that over-valued, non-performing assets be written down or by reducing or deferring the effect of the write downs associated with restructuring deals.

6. ***Is there well-trained financial restructuring professional talent in the country?*** International experience indicates that debt restructuring is a highly-specialized skill, and restructuring work proceeds most efficiently when it is led by trained experts. These experts are not only trained in designing complex financial solutions, but also in helping to manage the cultural and interpersonal tensions that often accompany restructuring efforts. In most countries, there is a body of experienced restructuring professionals who can serve as advisors to creditors and debtors. International experience indicates that the out-of-court restructuring system will be most successful in those countries where there is a culture of engaging such professionals to help drive the effort.

7. ***Is there a strong secondary market in distressed debt instruments?*** In addition to negotiated restructurings, a strong secondary market in distressed debt securities presents another option for creditors (offshore and local) to remove non-performing assets from their books. In addition, purchasers of distressed debt ordinarily bring with them significant experience in international and complex debt restructuring. As a result, these purchasers can play a helpful role in accelerating commercial restructuring deals. For each of these reasons, a country will be well-served if its laws and regulations encourage, and do not inordinately constrain, trade in distressed debt instruments.

8. ***Does the system effectively require that debtors disclose detailed financial information on a regular basis?*** All successful restructuring efforts are heavily dependent on creditors obtaining detailed and accurate information about their debtor. The gathering of such information has been among the most troublesome and time-consuming aspects in recent Asian debt restructurings. If the legal and regulatory environment in a given country requires companies to prepare and provide regular, detailed, and accurate financial reports, then a necessary information base, and the company resources to provide additional detail in the restructuring context, will be present. Given the fundamental importance of financial information sharing in restructuring, these items will vastly accelerate commercial restructuring deals and make them more viable.