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*Informal Workouts – Out of Court Restructuring:  
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## **INFORMAL WORKOUTS – OUT-OF-COURT RESTRUCTURING**

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### **DEFINITION**

The phrase “informal workout” has almost assumed international currency, is used sufficiently frequently that it seems not to need definition, and regularly appears in all manner of learned papers and legal publications. Before entering in to a discussion on techniques and mechanisms, and the problems associated with this system, it would probably be best just to pause and reflect upon what exactly is meant by the term itself.

In fact, the term is used to cover a myriad of practices, and in examining further how best to achieve a successful workout, one perhaps needs to be more definitive, and indeed narrow, in deciding what exactly comprises recovery/workout and restructuring. The only common denominator between the many types is the fact that they are “informal” or out-of-court, they are by mutual arrangement between a debtor company and its various creditors. Once the company enters into the legal process, then the word informal drops away, and it becomes a formal insolvency in one shape or another.

The following is just a selection of the different practices that have all fallen under the heading of “informal workouts”

- A realisation of sufficient assets by a company to pay off its main financial creditors, the creditors having given time for this process to take place.
- Rescheduling of the debt – the financial creditors extending their loans over a longer period of time, often with a more lenient repayment structure in the earlier years.
- An agreement whereby the main financial creditors forgive some of their debt, and/or waive interest, in exchange for formal security over the balance.
- An agreement whereby the main financial creditors forgive some of their debt, in exchange for equity, or equity based instruments.

There are various others, but this indicates the variety of practices that are called “informal workouts”. Some may, depending upon the laws of the country concerned, ultimately require a formal court approval, but if that is merely the last step, then the phrase “informal” is still valid. However, all of these options may just be based around achieving recovery for the lenders, there may be little change within the company itself.

## RESTRUCTURING

Most of the examples above are geared around the recovery of money for lenders. However, increasingly, the terms “turnaround” and “restructuring” are being used to describe rather more than merely the recovery of money. It is the basis of this paper that one really should be looking at full out-of-court “restructuring” rather than merely “workout”. This is a much more positive approach, looking not just at recovery for lenders, but also saving businesses, including both the preservation of present economic value and the maximisation of future value.

The real benefit of the out-of-court process is the opportunity that it gives to make the many significant changes that will be necessary in a business that is in difficulty, without the full glare of publicity, formal mechanisms, delays and costs that tend to accompany a full court process. As one simple example, consumers may be less ready to buy product from a company that is known to be in a formal insolvency process, than from a company that is still trading. Too often, the adverse publicity, that is attendant upon the formal process, destroys business value before a turnaround can be achieved. The informal process provides time for the restructuring to be done outside court, with the intention of creating much greater value for the future from a business that has successfully turned its fortunes around. “Turnaround” would be a word much preferable to “workout”. Clearly, this can only work where a business is inherently capable of being turned around from distress to a viable entity.

There is another phrase that needs clarification. The word “restructuring” is much used, but the same word is used to cover a number of different situations. Too often it is used only to describe the financial restructuring. This paper argues that for the most effective overall restructuring to take place, there have to be two integral elements. These are corporate restructuring and financial restructuring.

Whilst occasionally the financial difficulties of a company in trouble may be the result of purely external forces, the cause more usually lies with its own internal shortcomings, often its management. If there is to be a successful turnaround or restructuring, these internal issues will need to be addressed. It matters not whether it is the company’s product quality, production capability, marketing strategy, acquisition strategy, or whatever, the likelihood is that there is usually something wrong, other than bad luck, which has led the company into difficulty. The fact is, that unless these issues are addressed and appropriate changes take place, then the company will continue not to be competitive or successful in its market place. There therefore needs to be some form of internal change or corporate restructuring for the company once more to become fully viable and regain market position. This may range from management change, to the sale of divisions or subsidiaries or even overall change in policy and strategy.

The second part is the financial restructuring. With the corporate restructuring issues properly addressed, the financial restructuring helps to re-position the company’s finances so as to enable the benefits of the corporate restructuring to be achieved. This can include lenders agreeing to rearrange their facilities, write off debt and accept debt equity swaps amongst other options.

All too often, what is called a restructuring is in fact only a financial restructuring and little change actually takes place within the debtor company itself. This is often the case with pure rescheduling, which usually only involves loans being extended over longer periods and repayment programmes being softened. This is questionably termed a restructuring. Very often, nothing changes within the business, all that happens is that the problems have been put back another year or two. However, a successful restructuring requires all parties to “bite the bullet” in respect of what they each need to do to create sufficient change that the company can re-establish viability.

Even where there is a financial restructuring, it often does not actually achieve the intended result in due course. If a company is to go forward into the future and compete successfully, it needs to have an appropriate balance sheet, appropriate level of debt and appropriate capital structure so that it can compete equally in the market place with its other challengers. As just one example, it needs to be able to obtain supplies on the same terms as its competition, or better. Too many supposed financial restructurings merely do the minimum that the lenders can get away with, still leave the company with too much debt, too much interest burden and with a balance sheet that still looks weak, and therefore leave the company in an uncompetitive situation when compared to its rivals. Realistically, how does this help that company to stride forward and thrive in the future?

For the purposes of the remainder of this paper, “out-of-court restructuring” will refer to full restructuring, including both elements, and “informal workout” will be interpreted this way.

## THE INSOL GLOBAL PRINCIPLES

Formal insolvency systems differ dramatically around the world. Whilst increasingly there is some conformity, there is huge variation, not only in laws themselves, but in their interpretation and application, and indeed their overall efficiency. The situation is even worse with out-of-court restructuring, where there are usually no rules or guidelines at all, and in many countries no experience or background in this process. The Insol Global Principles for out-of-court restructuring (which were developed alongside a World Bank initiative on formal insolvency systems), seek to address this, but it is acknowledged that they will take considerable time to achieve worldwide acceptance. They were devised following consultation with no less than 150 bodies worldwide and thus represent a broad spectrum of views and practice. They are very much based upon the principles of equity and sound common sense between the various parties. Designed to facilitate the rescue of viable businesses, with a particular aim to achieve preservation of economic value, they provide a set of guidelines to assist those wishing to do informal or out-of-court restructuring. They do, however, acknowledge that not all businesses can be saved.

## BASIC REQUIREMENTS

In looking at countries where these principles may work, there has to be regard to three different background requirements:-

- a. A set of formal insolvency laws that is reliable, predictable and efficient.
- b. Some form of policing, not as strong as enforcement, which encourages the participants to play by the rules.
- c. A fallback formal court option, for use when the out-of-court system is working, but is about to fail because of the actions of one or two individual players. The informal process needs to be able to move swiftly in to this and have a rapid outcome.

Examining these in more detail, (a) is crucial, as without this, there is really no pressure upon a debtor company to come to the table. The fact that creditor rights are acknowledged and upheld, that the creditors have power to take action and this action will be enforced by the courts, is a very powerful persuasion to debtor companies and their directors to come to the table and negotiate. If there is no reliable, formal system, or it is either extremely protracted, as is so often the case, or ineffectively enforced (if at all), then the directors of the debtor company are able to delay or even ignore the need to negotiate solutions with the creditors.

With regard to (b) and (c), it is increasingly important that at least one of these is available, alongside (a), to support the process. The need for such support always comes in to conversation when the possible adoption of the Insol Global Principles is under discussion.

For (b), in England, the Bank of England played a pivotal role in the success of the London Approach. In times of difficulty, their quiet intervention was usually able to help break deadlock, and achieve successful resolution of seemingly impossible positions. One can see other institutions worldwide which are held in similar respect, and which can usefully play a similar role, one thinks of the HK Monetary Authority in Hong Kong.

As to (c), it is extremely useful to have a fallback in to a quick formal legal system where a process is moving forward positively, but where it is necessary to deal with small dissident minorities. Because the out-of-court process is consensual, and, at the end of the day, needs to achieve 100% support, it is always open to minority players to grandstand and hold the deal to ransom. The term “green mailing” has been used to describe this. In the US, there is a very effective “pre-pack” system using Chapter 11, where most of the work can be done outside the legal process, and then the deal is taken through the legal process to achieve a binding solution, including members who would seek to spoil the deal. Interestingly, the existence of this option, since it is known to all the players, creates the result that players who are effectively holding a deal to ransom will often moderate their behaviour towards the end of a negotiation, knowing that if they go too far, they will end up in a formal proceeding in which they will be “crammed down”.

## SUCCESSFUL RESTRUCTURING

There are a number of factors that will lead to a successful out-of-court restructuring. Firstly, there must be trust by the debtor company that it can actually talk openly and freely with its financial creditors. If there is suspicion that, immediately there is known to be a problem, certain financial creditors will rush in, grab assets and head for the hills, then a debtor company is unlikely to be willing to initiate any discussions. There has therefore to be an environment created by the financial creditor group within which the company feels encouraged to discuss issues and problems. Secondly, the financial creditors themselves must be prepared on occasion to moderate their own views, in order to achieve consensus for the greater good. Clearly, that is much easier said than done.

The primary condition is that there must be a belief within all parties that there is a viable business that can be preserved. If there is no belief that this is the case, then an out-of-court restructuring is very unlikely to work. If there is a belief that there is something worth rescuing, then it requires the financial creditors to be prepared to standstill for a period of time, whilst the position is properly examined and reported upon. This in its turn requires the debtor company to be prepared to make available all the information necessary to facilitate this process. The doubts, suspicions, and background culture in so many parts of the world make this an extremely difficult issue.

The real reason that financial creditors will be prepared to go forward in a support programme is enlightened self interest. It is all about the preservation, and hopefully the maximization, of economic value. If financial creditors can be persuaded that there is a better value return to them in being supportive and helping a struggling business to recover and stride forward rather than merely realising the present assets, then there is a big pressure upon those creditors to act sensibly. The whole key to this issue is the assessment of where economic value lies, whether in fact it can be preserved, and how it can be maximised. There are no prizes for lenders who support "dead ducks", but equally there are significant rewards to those lenders who are prepared to support a turnaround operation which ultimately delivers very good value. This perhaps illustrates one of the major problems in cross-border or international restructurings, namely the alignment of the interests of the debtor company with those of the creditor group. On a purely internal basis, this is usually more easily achievable, although again more so in some countries than others. However, on a cross-border basis, with the international differences in culture, laws, background experience and practice, this can be extremely difficult.

## PROBLEMS

There are no doubt problems going forward. Globalisation expands, even medium sized companies now have international connections, whether it be through customers, suppliers, international divisions, subsidiaries/associates, or foreign lenders.

From the lenders' perspective, there are increasingly different levels of players. Not so many years ago, there was a fairly simple split between equity funders and banks. That has changed, the range and variety of lending levels becomes evermore complex, not only with mezzanine

funding, but including high yield funding, private placements, bonds, subordinated and senior bank lending. As companies grow evermore global, they become subject to increasing numbers and varieties of laws in the various jurisdictions in which they operate – the recent European Union insolvency directive is illustrative of how complex these matters can become. Whilst the Insol Global Principles endeavour to bridge the problems of distrust between international funders, protectionism is still an issue and what is acceptable practice in some countries is culturally quite unacceptable in others.

## CREDIT DEFAULT INSTRUMENTS

Even more problematic for the future is the increasing use of derivatives. A particular problem within this is credit default derivatives, or credit insurance. As international lenders seek to diversify their portfolios, known as portfolio management, so the risks are spread wider and involve more people. Put simply, if bank A has a risk of £50 million to a company, it may well take out a credit default contract, for a premium, which effectively swaps away all or part of that risk in a default situation. When the particular company concerned then moves in to a problem situation, if the lenders are called together to find a solution, this creates a number of issues for bank A. If it now wishes to exit this situation, then contrary to helping find a working solution, it may suit bank A for a formal default to be declared, so that it may claim on its insurance contract and be repaid.

The insurance contract itself may be “silent”, in other words it may not be publicly declared. If so, the behaviour of bank A, which will be driven by the terms of its contract, (unknown to the rest of the lender group that may be endeavouring to achieve a turnaround), may seem quite illogical to the other players. This can create some very interesting and difficult, behavioural dynamics. If a requirement of the rescue plan is that lenders put forward further cash to help the business, bank A may not be minded to do this, bearing in mind that it is currently not on risk – why should it take on further risk? Furthermore, in supporting a rescue plan, it may be in breach of its contract, and therefore jeopardize its cover. Pity the poor negotiator or bank endeavouring to achieve a consensus within this group, when any number of the players may be in a similar situation. This is just one example of the complexities facing lender groups.

Conversely, at a time when out-of-court restructuring is achieving a higher profile internationally than has ever been the case, and when there is increasingly more wide acceptance of the values of this practice, so the problems in achieving such resolutions are themselves becoming more complex, and indeed, in the larger cases, less easy of achievement. Perhaps it echoes the old adage that advancement does not necessarily equate to progress.

## THE FUTURE

There are however good reasons to be optimistic as well as pessimistic. More and more countries are interested in fostering out-of-court restructuring. The increasing size of major corporates, and the money involved, means that failure can have dramatic effects on a country's economy, the ramifications can be massive and widespread. Once a company moves into formal insolvency proceedings, its chances of recovery reduce, and actual “business value”

diminishes. There is an increasing acceptance that value is best preserved through a consensual process where everyone is working together to achieve a turnaround. The number of invitations to Insol from countries to discuss the Global Principles evidences the growing interest in this process.

What is certain, is that out-of-court restructuring has a major future in many countries and economies where it currently is not practice. Balanced against that, especially in the very large cases, must be the fact that the hurdles to a successful achievement will increase.

It is up to each country to examine the case for out-of-court restructuring, to consider whether it will be beneficial to the overall economy to preserve potentially viable businesses, production and employment, and then to adopt processes that will enable this to work. If they do this successfully, then it will be possible to save a good many troubled businesses, combat the problems that are bound to arise, and thus enable a much greater preservation of economic value than currently happens.

Terry E Bond.

The views expressed in the above are the personal views of the author and should not be taken to represent the official views of either Barclays Bank PLC or Insol.

Insol is the International Federation of Insolvency Professionals, details of the Insol Global Principles can be accessed on [www.insol.org](http://www.insol.org), enquiries email: [claireb@insol.ision.co.uk](mailto:claireb@insol.ision.co.uk).