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*Techniques used in informal workouts:  
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## **Techniques used in informal workouts to facilitate financial and operational restructuring and the practices that have developed.**

In Thailand the informal workout process established in the late 1990's was titled CDRAC - Corporate Debt Restructuring Advisory Committee, which put in place a "formal approach" to informal workouts outside of the court system. CDRAC was established in June 1998 as an unincorporated body consisting of the Board of Trade, the Thai Federation of Industries and the Bank of Thailand ("BoT").

CDRAC commenced with 351 cases and established a framework for the efficient restructuring of corporate debts of viable entities, to benefit creditors, debtors, employees, shareholders and the Thai economy. The rules governing CDRAC replicated some of the practices which had been established in informal workouts in the West.

Creditors who agreed to be part of the CDRAC process agreed to be bound by the processes and schedule of corporate debt restructuring with individual debtors, who must have executed a Debtor Accession in accordance with CDRAC requirements, thereby binding all parties to the CDRAC process.

At the time of implementing the CDRAC process, the Thai government indicated that it wanted a process which would enable creditors to reach consensus, as efficiently as possible, on the approval or disapproval of proposed plans for the restructuring of outstanding debt, and to prevent any deterioration of the debtor's assets.

Two major agreements form the backbone of CDRAC as follows:

- (i) The Inter-Creditor Agreement ("ICA"), effective March 1999; and
- (ii) The Debtor - Creditor Agreement ("DCA").

The ICA is signed only by financial institutions, whilst the DCA, is entered into between a debtor and its financial creditors wishing to take part in the CDRAC process.

The ICA and DCA set out certain procedural guidelines for debt restructuring which were similar to those in the rehabilitation process under the Bankruptcy Act, with respect to approval of debt restructuring plans.

Under CDRAC corporate debtors were eligible to be restructured under CDRAC if the debtor was listed on the BoT's "watch list". After signing the Debtor Accession to the DCA, creditors were bound to commence restructuring procedures pursuant to the DCA with the debtor.

The execution of the Accession marks the commencement of the suspension of payments of default interest, which will be waived during the time period taken for the proposed plan to be approved by the creditors. If the proposed plan is not approved, only then will the suspended default interest become due and payable.

The process under CDRAC can be commenced by a creditor, CDRAC or the debtor itself. The process under the initiation of a creditor or CDRAC is the same, in that these parties give written notice to the debtor for the first meeting of creditors. The debtor then has 5

business days to provide a list of creditors together with outstanding debts and a copy of the Debtor Accession. Within 15 business days, the first meeting of creditors is held. From this point onwards, the process is the same, whether it was commenced by CDRAC, the creditor or the debtor.

If the debtor initiates the process, it does so by executing the Debtor Accession and notifying each creditor of the time and place of the first meeting of creditors. At least 10 business days' notice must be given but, the first meeting must be within 15 days of the execution of the Debtor Accession.

The first meeting of creditors has two purposes as follows:

- (i) The election of the Lead Institute and the Steering Committee; and
- (ii) To set out the schedule for the workout-action plan and timeframe.

### **Lead Institute**

All creditors attending the first meeting must vote to elect the Lead Institute. As a prerequisite, the Lead Institute must have restructuring experience, a significant exposure to the debtor, and a professional working relationship with the Senior Management of the debtor.

It is the responsibility of the Lead Institute to establish goals and schedules for the workout plan, facilitate inter-creditor discussions, liaise with financial and legal advisors and resolve disputes between parties. As the title implies, it is the Lead Institute's responsibility to lead negotiations with the debtor and to ensure all relevant information is cascaded to all creditors. Also, the Lead Institute must calculate the creditors' voting rights based on the outstanding debt.

The costs associated with undertaking the Lead Institute role are borne by the debtor and taken into account in any approved restructuring plan. The Lead Institute must distribute, within 10 business days, details of action plans and the timeframe for the restructuring plan submission.

### **Steering Committee**

Membership of the Steering Committee must comprise at least 3 creditors, including the Lead Institute, which will chair the Committee. The role of the Steering Committee is one of coordinator, and not agent of the debtor. The Steering Committee has the power to retain professional advisors, if necessary, at the expense of the debtor.

### **Provision of Information**

At the conclusion of the first meeting of creditors, a time clock is commenced for the submission of relevant information and the appointment of professional advisors. This is designed to ensure transparency between parties and such relevant information is to be shared amongst creditors, the debtor and other concerned parties.

The critical pieces of information/actions to be provided/undertaken are as follows:

- Lead Institute or debtor must notify creditors, debtor or CDRAC of its appointment within 5 business days of first meeting.
- Debtor must submit preliminary information within 7 business days of first meeting. (Note: Appendix V of DCA details what preliminary information is to be made available).
- Appointment of independent accountant/expert within 7 business days of first meeting. Note: This appointment is at the request of the Lead Institute, as nominated by creditors. The debtor is required to fully cooperate with the independent expert by promptly providing all information requested.
- Creditors to submit claims in writing, to the Steering Committee within 15 business days of first meeting. The debt must be denominated in Thai Baht.

Until the submission of a plan creditors are free to sell their debt to a third party including an affiliate of the debtor. However, the third party must have executed an Accession to be bound by the terms of the DCA.

The debtor has two months within which to submit a proposed plan and other information requested. This period may be extended by CDRAC for a period of up to one month.

During this period covenants are in place that prohibit the debtor, without the consent of all creditors, from undertaking the following key actions:

- (i) Creating or assuming additional debt;
- (ii) Incurring expenses outside the ordinary course of business;
- (iii) Disposing of assets outside the ordinary course of business;
- (iv) Entering into any transaction with a related party other than in the ordinary course of business;
- (v) Creating any additional security interests on the debtor's assets; and
- (vi) Making preferential payments i.e. repaying debt.

The above covenants help to achieve a standstill arrangement between the financial creditors. This allows the company to only undertake business-as-usual decisions, ensuring on-going operations are continued.

During this period creditors also suspend charging default interest as discussed earlier.

While the first draft of the plan has to be circulated within 3 months, the plan does not have to be ready for voting for 5 months after the first meeting. This is because a two month extension may be granted with CDRAC approval.

If the debtor fails to submit the proposed plan within the stipulated timeframe CDRAC will appoint a qualified financial advisor to submit a plan within 30 calendar days, at the debtor's expense.

The plan must meet the following criteria:

- (i) The restructuring value (not defined in either ICA or DCA) must exceed the liquidation value of the debtor;
- (ii) All creditors must be treated reasonably and fairly taking into consideration the ranking of creditors under the Bankruptcy Act; and
- (iii) The plan must substantially be in compliance with the set of guidelines issued by the BOT in respect of the provision of information, fair treatment of creditors etc., in restructurings.

Creditors have 10 business days to propose amendments to the plan. Such amendments must be in writing. The Lead Institute, together with CDRAC, must then convene a meeting to vote on the proposed plan within 15 days after receiving all proposed amendments.

### **Voting on the Proposed Plan**

The decision of the eligibility of a party to vote on a proposed plan is generally resolved between the Steering Committee and CDRAC on a case by case basis. In certain cases, only those financial institutions that are parties to both the ICA and DCA have been permitted to vote. In other situations, financial institutions who are not party to the ICA but accede to the DCA, with respect to a particular debtor, have been allowed to vote on the proposed plan. Also other cases have arisen where all financial institution creditors of the debtor have been permitted to vote.

In order for the proposed plan to be passed and thereby adopted, a Special Resolution by the majority of the voting creditors must be attained. A Special Resolution is defined as at least 75% of the total value of the debts of the voting creditors.

Note that the above is only the first vote and creditors who vote against the plan may propose amendments as they see fit. The creditors must then re-convene to vote on the amended plan or reconsider the original plan if no amendments were proposed, within 10 business days after the date on which the proposed plan was first considered.

However, a significant difference at the second meeting is that if the plan receives either of the following number of votes then the plan can be referred to the Executive Decision Panel (“EDP”):

- (i) Not less than 50% of the total amount owing to voting creditors; or
- (ii) Not less than 50% of the number of voting creditors by number.

That is to say the decision to approve the plan, despite not obtaining a Special Resolution but only an ordinary majority, be it either by value or number, is vested with the EDP.

In the event the plan does not achieve simple majority, by either number or value of debt, the creditors shall immediately file a joint petition with the court for the reorganisation or liquidation of the debtor.

## **Executive Decision Panel**

The EDP comprises of 3 members appointed from 3 separate lists of executives proposed by the Thai Banker's Association, Foreign Banker's Association and Association of Finance Companies. The decision to be binding must be unanimous and the EDP has the power to appoint any financial, legal or other advisor or expert as it sees fit, at the debtor's expense.

The EDP's decision is only on an "as is" basis, in other words, it has no power to amend either a modified or proposed plan. Section 6 of the DCA covers in depth the procedures governing the EDP including issues such as independence, appointment and resignation. Critically, the EDP has 33 business days after receipt of all documentation, which includes any submission by creditors to CDRAC of their position on disputed issues, to hand down a decision on the plan. This timeframe can be extended by the EDP and CDRAC.

The decision of the EDP is final and binding. However, where the plan has been rejected by the EDP, creditors holding more than 26% of the debt may submit an alternate plan to all creditors. Similarly, the debtor can also submit an alternate plan. This alternate plan will be adopted if a Special Resolution is passed. If the plan does not obtain a Special Resolution it can be referred back to the EDP.

Once the process is completed and an approved restructuring plan is in place no further amendments can be made. All creditors party to the DCA are compelled to vote in favour of the plan at any subsequent creditors' meeting or court proceedings, if rehabilitation is entered into.

The above is a very convoluted process which at best can be achieved within 5 months but closer to 9 months if the EDP is involved.

The other technique for informal workouts is to apply London Rules, which in effect is to enter into a standstill agreement between the financial creditors and the debtor. Such a standstill relies on trust and experience, and adopts similar principles detailed in CDRAC, but avoids some of the bureaucracy associated with CDRAC, and also avoids the potential for minor creditors to be at the sufferance of the major creditors.

The principles underlying the standstill agreement that achieve the optimal results are similar to the covenants placed on the debtor and creditors under CDRAC, and are founded on the willingness of both parties to achieve a win/win result. The strength of this mechanism in the West is predicated on a strong legal system which is efficient and effective in its dealings and judgements. Unfortunately, these are attributes which are not considered as strong in Thailand.

I do not propose to go into depth on the informal negotiations process which takes effect in Thailand outside of CDRAC as that is not the purpose of this paper.

## **Environment you need to make workouts successful**

A critical feature of a successful environment for workouts is a strong legal system, which is efficient, effective and transparent.

The legal system provides the backbone to the insolvency environment, as it is critical for parties (creditors and debtors) to know and fully understand the “last resort” in workout situations. A strong legal system in which parties are confident, will enable parties to pursue open and forceful but fair discussions. The legal system should be sufficiently fair to protect both creditors and debtors and as a result, provide a “carrot and stick” to the parties assisted with informal workouts to motivate them to achieve satisfactory settlement or resolution. However, at the same time, the legal system cannot be seen as a deterrent to making the difficult decision of not achieving resolution in an informal workout.

Implicit in any strong legal system, is clear and user-friendly insolvency legislation, which contains formal processes for debt recovery/restructuring.

In Thailand the lack of insolvency experience and skills in the market at the start of the crisis, plus the lack of clear insolvency legislation, resulted in CDRAC being developed to enable parties to adopt a standardised approach to workouts. This at least allowed for a consistent approach across the country and endeavoured to eliminate any perception of favouritism to larger and/or more “influential” debtors. Notwithstanding the flaws in the CDRAC process, it at least set out a process which could be followed by debtors and creditors, the majority of which had not had any extensive experience in dealing with insolvent companies.

A strong legal system must be all encompassing, in that at every step of the process legislation allows for the efficient and effective management of insolvent companies. It is not enough to simply have good rehabilitation law which allows for the resuscitation of companies but also laws which appropriately deal with the liquidation of security expeditiously and cost effectively. If the legal system does not adequately protect the creditor in respect of dealing with its security, the entire system is compromised, meaning that informal workouts will favour debtors, as creditors will fear relying on a legal system which does not suitably reward good commercial business practice. The legal process in dealing with security is a major dynamic in the workout process because as indicated earlier this in the eyes of the creditor is generally the last resort, and setting aside vindictive motives, creditors are loathe to take such steps as enforcing security through court action when such action may take a number of years to achieve a result. The “carrot and stick” therefore are not sufficiently balanced, as enforcing security or taking legal action as a means to an end, often is a veiled threat, which debtors are confident creditors will not exercise due to weaknesses in the legal system.

Each workout is unique. The facts and situation in any two cases are never the same. Therefore some workouts are relatively straight forward, whereas others are not. Flexibility in the process and the minds of the debtors and creditors is essential to achieving success.

Having a regimented process which is dictated by guidelines is not always optimal and this can be a significant hindrance, particularly for large companies. The deadlines can be a hindrance but similarly, may equally be a stimulus to achieving a result. However, the deadline and more importantly, the consequences of missing imposed deadlines can at times compromise the quality of the workout because it is based on flawed information.

Overall I am not in favour of defined timeframes however, in many cases this structured approach has enforced discipline that was otherwise missing, so this is a benefit.

Dealing now with the individual groups - debtors and creditors - I wish to highlight a number of critical issues these respective parties look for in a workout environment:

## **Debtors**

- Knowledgeable and experienced creditors who have realistic targets and expectations.
- Transparency in dealings – it is critical that creditors remain faithful to decisions made, unless circumstances or situations precipitate a necessary deviation.
- A fair trial – by this I mean that after the initial reaction to hearing of the financial problems facing the debtor, the emotional aspect is taken out of the equation. To achieve this it is critical that creditors focus on the future and not the past.
- Reputable independent accounting and legal advisors who can maintain an appropriate level of impartiality when dealing with the relevant stakeholders. This is critical in the initial workout period as trust is being built and developed between the parties. Keeping promises at the early stages is essential to building up credibility in the eyes of all parties concerned.
- Strong Lead Institute, which understands the problems and can clearly communicate to the creditors. A good open relationship with the Lead Institute can pave the way for a successful workout.

## **Creditors**

- Committed debtor, who is prepared to give a little to get a little. In all workout negotiations “quid pro quo” is a necessary part for the simple reason that creditors need to be seen as achieving some wins along the marathon of a workout, which inevitably will entail some pain at some stage. Hence, the sentiment of the guarantor releasing additional unencumbered property for the creditors or, injection of funds, sends a strong message that the debtor is committed to resolving the situation to everyone’s acceptable level of satisfaction.
- A viable underlying business with strong management. Without this there is no point of having an informal workout. Liquidation is the appropriate action when the business is clearly non-viable and, liquidation based on detailed analytical reviews and valuations provides a higher return.
- Following on from the point above and from the debtor requirements, reputable independent accountants and legal advisors.
- Co-operative debtor and creditor group. The co-operation of the debtor is obviously essential but it is equally important that as a group the creditors remain co-operative with each other and share the same goal of minimising the downside of the negotiations. This will be enhanced by having experienced creditors on the Steering Committee (if one is formed) or in the group generally, who can focus on

the relevant issues and avoid being derailed by irrelevant issues which add no value to the workout process.

- Reliable information from the debtor; this relates to the point about independent accountants. Reliable information, which can be independently verified is a critical element in building a conducive workout environment.

### **Incentives which assist in facilitating informal workouts**

If the legal system is efficient and allows for the wresting of control from the incumbent debtor's owners into the hands of its creditors with relative ease, then the debtor will be motivated to workout its financial problems on an informal basis. Thailand has a system which does not allow this to readily happen and therefore it can be difficult for the creditor to enforce a workout either formally or informally.

Ultimately, the key incentive which drives the debtor to the workout table is the need for cash, which not surprisingly creditors are not willing to continue providing unless certain terms and conditions are imposed. It is the need for cash and the desire to retain control of its own destiny that pushes the debtor to the negotiation table, while clearly it is protection of its capital that motivates a creditor to achieve a resolution to the financial difficulty the debtor is facing.

Having a formalised approach to workouts as set down by CDRAC can have a converse effect on the workout process. The timeframe establishes deadlines to which parties must work towards and this in itself will facilitate the process towards achieving a result of some kind. Conversely, however, the timeframes can be tight in larger cases, as previously mentioned, thereby inhibiting the workout process or, at the very least, compromising the quality of the workout.

Respective parties can abuse the deadlines to push decisions through and thus there is a solid argument for not having a timeframe in place. Overall, however, in countries where there is a lack of discipline in complying with regulations and financial prudence, together with a lack of general insolvency experience, the adoption of a CDRAC-type structure makes commercial sense.

Dealing with the two respective groups, major incentives or triggers in facilitating informal workouts are as follows:

#### **Debtors**

- Ability to retain control of the company which, after making the difficult decisions usually associated in a workout, is generally in much better shape.
- The opportunity to reduce debt through interest waivers/debt forgiveness is generally the major incentive to the debtor. Usually the debtor will reach the point it cannot continue operating as it is insolvent. Trading while insolvent rules and preferential payment rules evident in Australia and the UK are non-existent or are not practically enforced in Thailand. Such legislation acts to incentivise the meeting of the debtor with its creditors. However, often the workout process in Thailand commences very late in the loan lifecycle, so that a default has already

occurred (usually a missed interest payment). This default, together with the realisation that the cash has dried up forces the parties to meet and is generally addressed by financial restructuring (or in many cases rescheduling), and not by operational restructuring addressing the fundamental underlying problems.

- The transparency of the workout process is also a critical factor for the debtor. The behaviour and the willingness to compromise by the creditors sends a strong message to the debtor and it is one of the better requirements in CDRAC, that creditors must indicate why they oppose the proposed plan and/or submit amendments. Such action at least facilitates open communication and clearly establishes the parameters of what is considered negotiable or not negotiable.

## **Creditors**

- Transparency as indicated above, together with a genuine willingness to resolve the financial restructuring on an equitable basis are powerful incentives to a creditor. If creditors do not perceive that the debtor is making a genuine attempt to restructure the debt but instead is “loading the votes” to bulldoze a debtor-favoured plan, then not only do creditors become disincentivised, but the whole process is compromised and the quality of the restructuring becomes questionable.
- Equality of classes of creditors. Creditors seek fair and reasonable treatment between the different classes of creditors. This principle is essential to any workout and any inequality between creditors is a major deterrent. Similarly, related party transactions and how they are dealt with are often a major bone of contention with creditors. The forgiveness of intercompany loans and/or shareholder loans are seen as significant gestures by the debtor evidencing a genuine willingness to achieve the best result for creditors. The stacking of votes in the CDRAC process with related party debtors is a bane on the process.
- During the workout process, creditors naturally maintain a healthy degree of scepticism concerning the debtor’s incumbent management’s capabilities and its honesty. This is natural given it is the same management that has led the debtor to the financial difficulties it is in. A key incentive for the creditor group is to ensure that there is no further dissipation of cash and/or assets out of the company, while the debtor and creditors work through a solution. The ability to control this by freezing its facilities can be achieved readily enough, but it does not necessarily mean that the debtor will not seek or obtain additional debt from a third party. Similarly, the payment of some creditors in preference to others also puts at risk the possibility of a satisfactory resolution. These issues are addressed in CDRAC, with the covenants stipulated in the DCA. However, often the monitoring of these covenants is difficult unless there is an independent third party, such as an accounting firm, appointed to take control. A strong incentive to creditors in a workout is the ability to take greater control of the debtor’s purse strings, and place it in the hands of a reputable, independent professional.

## **Benefits informal workouts have produced**

The primary benefit of informal workouts is that they allow the debtor to survive and, in many cases prosper by giving the debtor the necessary breathing room it needs to get its house in

order. If the process is commenced early enough the options available to the debtor and its creditors are significantly varied and, the debtor's chances of surviving the financial strain are significantly increased.

The informal workout also ensures that the standstill, which is the cornerstone of the true informal workouts in the West, is effectively in place through the DCA covenants. This essentially enables the company to operate on a business-as-usual basis, but protects creditors from the fear of assets being dissipated, or preferential payments taking effect.

The informal workout process also ensures that all debtors are ostensibly treated equally under the CDRAC process, in that even if the creditor was unaware of the debtor facing financial difficulty, it would be protected if it was a party to the CDRAC process. This process can therefore reward creditors with weak monitoring controls in place, while equally penalising those creditors who are ahead of the pack.

The CDRAC process being as detailed as it was institutionalised the practices for debtors and creditors to follow and, given the lack of insolvency experience in the country at the time of the crisis, this has been a major benefit at least at the initial stages. However, as indicated earlier such a regimented process does have drawbacks, but at the time a regimented process was required to provide direction and discipline to the parties.

The CDRAC process has also allowed the country to work through non-performing loans without having to clog up the court system. This allows for a quicker process than formal channels, which invariably take longer and require court approval. The cost differential is questionable.

### **The dangers of informal workouts - have they been abused?**

Debtor integrity is a major concern in this region, and the informal workout process is only as strong as the integrity of the debtor involved in the process. The major danger is obviously abuse of the system by debtors to pass through plans that do not address the fundamental underlying problem, which caused the debtor to face the financial problems it is experiencing. This situation can be exacerbated in the scenario where no independent advisor has been appointed to review the financial and business operations of the debtor, and the creditors are stacked with related parties thereby pushing through a debtor proposed scheme which is not favourable to creditors.

Has this happened – yes. Will it continue to happen – yes, but how can it be resolved? If there is one major weakness it is that the CDRAC process still leaves a significant level of control in the hands of the debtor, thereby allowing manipulation through the appointment of biased advisors or avoiding the appointment of an independent party.

In Australia the voluntary administrative process can also get abused in a similar way, but creditors can vote out an administrator. One major amendment would be to allow only creditors to elect the independent advisor, an appointment which must be compulsory from the time the CDRAC process is commenced. This independent party would have full control of the finances of the debtor.

In informal workouts outside of the CDRAC process, control of the company generally remains with the company. However, the appointment of an independent advisor is generally

a pre-requisite to continuing negotiations and this appointment is usually at the behest of the financial creditors, and it is “their” appointment. Also, stronger insolvency laws concerning trading whilst insolvent provide for significant penalties to act as a deterrent. The lack of such legislation means it is difficult to apply implicit pressure on the company to give implicit control to creditors.

The structured timeframe approach of CDRAC has ingrained disciplines which were necessary, as mentioned. However, as also discussed, the timeframe can be counterproductive and can compromise the workout process and the ultimate solution. Many workouts have been nothing more than rescheduling of debts, not ground-breaking restructures which take into account the underlying business operations of the debtor. Cashflow analysis and asset valuations have often been accepted without sufficient critical analysis, as banks seek to maximise recoveries, without any heed to business reality. It is not unusual to see proposed plans with full recovery of principal and interest based on a proposition of a three year principal grace period with reduced interest rate, followed by three years or more of minimal principal repayments at commercial rates with a balloon repayment in year ten. Such restructurings are a blight to the process and a significant cost to the economy. Banks, however, readily accept such proposals as their balance sheets will reflect that the debtor is a performing loan and the matter, for all intents and purposes, is swept under the rug for ten years when default is likely.

Such “restructurings” as detailed above are based on the perception that the crisis was an aberration, normal GDP annual growth of 8 – 10% will return, and things in general will return to normal in a few years time. Accepting the paradigm shift has been difficult and is still difficult to accept for some in the business world. This is not to say that the CDRAC process is solely to blame for such abuse, but clearly it does facilitate the acceptance of such practices given its pro-debtor slant on passing plans. The fact that the debtor has so many opportunities to have a plan approved means that inefficient insolvent companies continue to survive, draining bank resources and capital on assets which are returning below market expectations. This is an area which needs significant review and cannot be simply addressed without undertaking substantial financial and legal reform.