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THE DYNAMIC BETWEEN THE ROLE OF COURT AND INFORMAL WORKOUTS

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In light of the limited time available today, I would like to make the following brief points which will touch on a number of areas in the hope of stimulating discussion.

There is an inherent relationship between the courts and informal workouts which take place out of court. However, the relationship operates differently in different countries. The way in which the courts recognise various debtor-creditor rights and enforce insolvency and other laws directly affects the way in which out of court workouts operate. Indeed, the way in which the courts treat insolvency cases affects the entire dynamics of informal workout negotiations.

At its extreme, an efficient court which applies, in a predictable fashion, an effective insolvency law may do so with the consequence of eliminating the need for informal workouts. This will only occur in economies which have a highly developed understanding of insolvency and rehabilitation laws and where, as a result, the stigma associated with entering a formal process has been extinguished by a history of beneficial results for creditors and debtors through the formal process.

Some examples of the interaction are worth considering. In Australia, the way in which the courts have applied the laws in relation to unfair preferences has meant that informal workouts are rare and, at times, non-existent. Creditors realise that if one creditor does not get paid there is an efficient court process under which the company could be placed in liquidation or some other insolvency process. Secured creditors' rights are respected by the court and the ability to appoint a receiver can be exercised quickly and through a simple process entirely out of court with the secured creditor commonly needing to do little more than sign a demand followed by a deed of appointment to appoint a receiver to take control of the debtor's assets. The ease with which a secured creditor can enforce its security and the ability of any creditor to place the company into liquidation combined with the ease with which a company can appoint a voluntary administrator to initiate a voluntary formal rehabilitation mean that creditors are reluctant to enter into informal workout agreements, especially when not all creditors are covered by the out of court workout. Creditors know that payments that they would receive under the workout plan are quite likely to be recovered as preferences if the company enters a formal insolvency process. Add to this the growth, with the court's approval, of insurance schemes to fund actions by liquidators to recover preferences and the result is that out of court workouts have become rare.

Since the Asian economic crisis began in 1997, a number of Asian countries have introduced frameworks for informal workouts. Some of these frameworks have developed, in Thailand for example, into binding agreements which set out the procedures for out of court workouts. In cooperative workouts conducted in accordance with these out of court frameworks, the court rehabilitation process has been used to put prepackaged plans into effect and bind all creditors to the workout plan.

Some Asian countries have been faced with the reality of inefficient and at times unpredictable courts. Thailand's new Central Bankruptcy Court has made a significant difference in the way out of court debt restructuring is progressing. The court has been fairly predictable in interpretation its of Thailand's rehabilitation law. This has armed creditors with the ability to threaten debtors with rehabilitation if debtors do not co-operate in the debt restructuring negotiations. This is material because historically in Thailand debtors have not been overly concerned that a creditor will commence ordinary debt recovery

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civil actions against then due to the inefficiencies involved in those actions. The Central Bankruptcy Court's application of the rehabilitation law has created a real "stick" for creditors at the restructuring negotiating table.

Debtors have carefully watched the way in which the courts have treated applications by creditors to place recalcitrant debtors involuntarily into formal insolvency or rehabilitation proceedings and have adjusted their positions in debt restructuring negotiations accordingly. Where the creditor's threat of placing the debtor into a formal process is not a threat which the debtor takes seriously as a result of the way the courts deal with aggressive rehabilitation petitions brought by creditors, creditors have little to negotiate with in countries where other debt recovery legal processes are not effective.

Similarly, debtors who wish to frustrate formal proceedings watch carefully the way courts deal with applications by debtors, or creditors who are in reality merely stooges for the debtor, which are aimed at challenging the rehabilitation process sponsored by the creditors.

In countries where independent parties (called trustees, receivers, administrators, planners etc.) can be appointed to take control of a company's assets and formulate rehabilitation plans, the degree of protection extended to these independent parties by the courts is crucial in determining whether creditors can use the threat of formal proceedings to make a debtor act reasonably in out of court workout negotiations. If debtors know that the courts will not come to the aid of these independent parties, debtors can stand bold in workout negotiations as they know that they could frustrate an aggressive involuntary rehabilitation commenced by the creditors by civil and criminal attacks at the independent party. The degree of protection extended by the courts to these independent parties, for example, by dismissing spurious claims brought against them by the debtor or stooge creditors which are in reality attempts by the debtor to frustrate the rehabilitation process, affects the willingness of talented restructuring experts to make themselves available to take on these important roles. If the talent pool is significantly reduced as a result of poor protection from the courts, the quality of restructuring is almost certain to decline and economic recoveries will be delayed.

On the other hand, in countries which allow the debtor or its related parties to be the planner or rehabilitation administrator, the court's role in ensuring that creditor interests are protected becomes crucial. In Thailand some debtors have viewed the formal rehabilitation process, under which the courts have allowed the debtor to act as its own planner on occasion, as a useful tool for delay. By putting themselves forward as planner and then submitting unworkable and unacceptable plans, they achieve numerous months of delay, force the creditors through an expensive proof of debt process and whittle down the endurance of the creditors. If the plan is not approved, the law allows the company to be returned to its original status as the court can only order bankruptcy if a bankruptcy petition was pending at the time the rehabilitation petition was filed.

One of the greatest risks facing Asia at present is that many restructuring plans are not feasible. They are fictions with unrealistic debt repayment plans which few, if any, involved in the restructuring expect that the debtor will be able to comply with. Many restructurings in Thailand are nothing more that reschedulings of debts. The restructuring plans do not truly focus on the viability of the business; rather, they are simply a rescheduling of debts with no real expectation that the debtor will be able to comply with the rescheduled debt reduction program - in particular, the significant balloon payment which is a common feature of many restructurings. In the desire to restructure non-performing loans quickly, if is fair to say that some countries have only recently begun to focus on the quality of the restructuring. When these prepackaged workout plans are taken to the court to be formalised by a court process which will bind all creditors and/or enable aspects of the plan to be implemented which would otherwise not be possible (for example, debt to equity swaps in Thailand), the degree to which the courts scrutinise a deal approved by a majority of creditors is crucial if the courts are not to be tools used to perpetuate fictional restructurings.

As discussed above, plans are being submitted to courts for approval which involve repayment plans over many years with a significant and often unrealistic balloon payment in the final year. As many countries have maximum time periods prescribed by law for formal rehabilitations, many plans provide for the company to be subject to the formal process during the first 5 or 7 years of the plan and then outside the

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formal process for the balance of the term of the workout plan. It is important that the court, in approving the plan and approving the company's exit from the formal process, considers whether it is allowing an insolvent company to reenter the world of business. Surely, any rehabilitation process under court supervision must prevent this circumstance. The aim must be to rehabilitate the company under the formal process and only allow companies which have reattained solvency to reemerge from the formal process. The reality is that many rehabilitations do not result in the debtor's business being rehabilitated and it continuing in existence with a fresh start, solvent and free of unsustainable debt.

Many insolvency laws require that any rehabilitation plan approved by the court must satisfy some criteria. Commonly there are very few criteria but most insolvency regimes require that the plan provide for creditors to receive more than they would in liquidation. This nebulous concept which requires a degree of guesswork by the court really imposes on the court a duty to ensure that if a workout plan is brought to court as a prepackaged plan to be put through a formal rehabilitation process the result must be beneficial to all creditors.

Another danger facing restructuring in Asia is the fact that the informal workouts can take place without creditors having the opportunity to make fully informed decisions about the feasibility of the restructuring plans. Increasingly it seems creditors are not being allowed full access and disclosure of information about the company's position and prospects. In some cases cost constraints or reluctant debtors prevent the creditors having an independent investigative accountant investigate the companies' affairs and advise on the plans proposed by the debtor. In these cases the danger arises if the plans are then submitted to the court as prepackaged plans which the court approves without too much review. Parties could abuse court process by having plans which conceal fraud or unfairly discriminatory transactions sanctioned by the court through the formal insolvency process. Whilst the majority of creditors might approve the plan, the court is really the bastion of protection for each and every creditor, particularly those who are unfairly discriminated against or from whom important information is concealed.

Out of court workouts are by their nature flexible; they are limited only by the creativity of the parties and their advisers and the limits of the law as identified by the participating advisers. When these workout plans are then submitted to the court to obtain the benefits of the court process (for example, a cramdown or tax waivers) the court's identification of unworkable or illegal aspects of the plan is a crucial quality control aspect of allowing debtors and creditors to utilise the court process to implement pre-agreed workouts.

Bankruptcy or liquidation is the backbone of an insolvency law. To the extent that a court or its agencies are responsible for the administration of bankruptcies, the degree to which creditors are able to obtain a prompt and efficient liquidation of the debtor's assets and payment of distributions through the bankruptcy process affects the entire dynamic of out of courts workouts. If the court or its agencies are responsible for administrating bankruptcy cases allow bankruptcy to be an inefficient or unworkable process, debtors will not fear the threat of bankruptcy, as they will realise that creditors do not consider it a realistic option. If at a practical level creditors are likely to have to wait years to receive any distribution in a bankruptcy, creditors will always prefer any deal in an out of court workout (or formal rehabilitation if the process exists in the country) which involves real money to bankruptcy. This can mean that insolvent companies with businesses that are not viable will be allowed to continue in existence.

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