A Toolkit For Out-of-Court Workouts

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Foreword

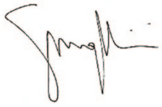
Since the global financial crisis of 2008, countries around the world have looked to develop policy responses to the challenge of an increasing number of nonperforming loans. What has become evident in the years since the crisis is that there is no single, "silver-bullet" policy response to address this challenge. Instead, a wide array of tools needs to be made available to businesses and lenders to resolve situations of corporate distress in a manner that yields the maximum value available to stakeholders, while promoting certainty and transparency. In particular, countries have begun to recognize the need to have a diverse set of tools that promote corporate restructuring and rehabilitation. Indeed, the stakes could not be higher. When the right tools are available, they can aid in the preservation of jobs, the retention of supply chains, and the preservation of asset value. Conversely, the risks of not doing so have become all too clear in the many corporate failures of the last few years.

Many elements need to be present to effectively restructure businesses. Businesses will need to be viable or capable of being reorganized, related laws will have to facilitate both financial and operational restructuring, and participation of the various stakeholders is critical. Most importantly, a country needs a transparent legal framework or regulatory principles that provide an enabling environment for fair and good-faith restructuring negotiations. Once the framework is in place, it needs to be applied consistently to ensure that the economic benefits of these restructuring tools are achieved. It is therefore vital that stakeholders learn how to effectively use such tools.

We have created this Toolkit to help policy makers develop a corporate restructuring framework and culture in their country and to help stakeholders implement informal, corporate restructuring principles in order to successfully rescue failing enterprises. Accordingly, this guidance is primarily aimed at policy makers, financial institutions, insolvency representatives, and businesses. It fo-cuses primarily on out-of-court restructurings and hybrid workouts that can sometimes involve the court, but that are fundamentally different than court-supervised restructurings. We seek to explain the necessary practicalities and standard approach to achieving a successful restructuring. We also highlight different restructuring models that countries have adopted in the understanding that there is no 'one size fits all' approach.

This work also arises from the World Bank Group's mandate as a joint standard-setter with the United Nations Commission on International Trade Law (UNCITRAL) for the Insolvency and Creditor/Debtor Rights Standard (ICR Standard) in insolvency law and practice. Specifically, the ICR Standard is recognized by the Financial Stability Board as one of the key standards for sound financial systems. The ICR Standard is based on the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes and the UNCITRAL Legislative Guide on Insolvency Law. These two complementary texts represent the international consensus on best practices and set forth a unified standard for evaluating and strengthening ICR systems.

As the world of finance continues to evolve at a remarkable pace, businesses are able to avail themselves of newer sources of capital that go beyond traditional commercial banks. When a period of distress arises for the business, having a framework under which all of the various providers of capital can negotiate, increases the likelihood of maximizing value for all stakeholders in that business.



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Acknowledgments

A Toolkit for Out-of-Court Workouts is a collaborative effort of the World Bank Group Finance & Markets MENA, and the Finance & Markets Insolvency and Debt Resolution teams.

The Toolkit was led by Antonia Menezes and prepared under the overall guidance of Mahesh Uttamchandani. Specific advice and leadership on issues relating to the MENA region were provided by Rolf Behrndt and Carol Khouzami.

The primary technical content of the Toolkit was developed by Rodrigo Olivares-Caminal (Professor in Banking and Finance at the Centre for Commercial Law Studies [CCLS], Queen Mary, University of London) and Arnoud Griffioen (Turnaround Specialist and Lecturer, AG Financial Management & Turnaround Management). The team was supported by Oleksandra Svyryba and Nicholas Avis.

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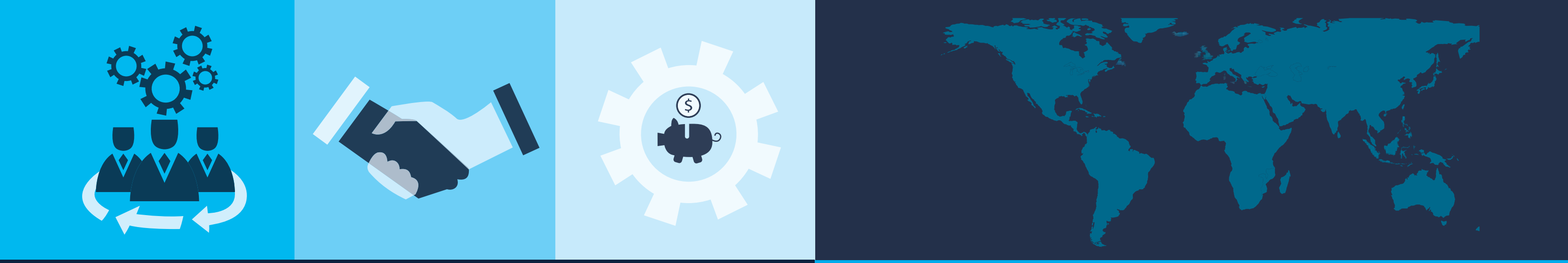
This Toolkit complements the foundational World Bank Group 2012 study on *Out-of-Court Debt Restructuring,* and should be read as a companion to that work. The team would therefore like to acknowledge Dr. José Maria Garrido, primary author of the study, for the instructive framing of many of these issues. In further amplifying the 2012 study, the Toolkit draws on the experience of the World Bank Group's Insolvency and Debt Resolution Technical Assistance Program, focusing on the practicalities of creating out-of-court restructuring platforms that seek to achieve restructuring agreements with no or limited court involvement.

Acronyms and Abbreviations

ABJ	Association of Banks of Jordan
ABL	Association of Banks of Lebanon
BdL	Banque du Liban (Central Bank of Lebanon)
CAPEX	Capital Expenditure
CBJ	Central Bank of Jordan
CDR	Corporate Debt Restructuring
CDRG	Corporate Debt Restructuring Guidelines
COMI	Center of Main Interests
EBITDA	Earnings before Interest, Taxes, Depreciation, and Amortization
EC	European Commission
GDP	Gross Domestic Product
ICR	Insolvency and Creditor Rights
ICR Standard	Insolvency and Creditor Rights Standard
INSOL	The International Association of Restructuring, Insolvency, and Bankruptcy Professionals
INSOL Principles	INSOL Statement of Principles for a Global Approach to Multicreditor Workouts
MENA	Middle East and North Africa
NPL	Nonperforming Loan
OCW	Out-of-Court Workout
SME	Small- and Medium-Sized Enterprises
UNCITRAL	United Nations Commission on International Trade Law
Legislative Guide	UNCITRAL Legislative Guide on Insolvency Law
WB-ICR Principles	World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes



1 Introduction to the Toolkit

1.1 Background

Financial distress may be described as both a symptom and a cause of economic weakness, and in a globalized world, corporate distress often results in a domino effect across financial markets. The collapse of Italian dairy enterprise Parmalat illustrates this point—36,000 jobs across 30 countries were imperiled when it filed for Europe's largest insolvency proceeding in 2003.[1] Canadian telecommunications enterprise Nortel had a similar global impact when it filed for Canada's largest insolvency in 2009, resulting in 30,200 lost jobs in global operations,[2] followed by years of litigation by creditors in Canada, the United States, Europe, and Asia.[3] Today, the Spanish utility enterprise Abengoa faces a comparable fate, with 26,600 jobs and crucial water, electricity, and solar energy projects on five continents at risk[4] as the enterprise grapples with over €14.6 billion of debt.[5]

Such insolvencies emphasize the need to resolve corporate distress quickly, and to the extent possible, retain the value of the enterprise as a going concern and reassure creditors that the value of their claim will not be overly diminished. Moreover, as with the cases cited, corporate distress on a wide scale can impact the broader financial stability of a country. Financial crises are usually characterized by a large number of enterprises unable to meet their obligations, leading to high levels of nonperforming loans (NPLs) on banks' books. Addressing the problem of NPLs requires looking for sustainable solutions that tackle the real roots of corporate distress and the potential for long-term business profitability, liquidity, and solvency. The recent financial crisis has prompted many countries to reevaluate the effectiveness of their corporate restructuring mechanisms and focus on preventing severe corporate distress in a timely and effective manner.

Nonetheless, corporate distress is unavoidable and, to a certain extent, a desired outcome of strong market economies. It can be seen as a self-cleansing, market-efficiency process that promotes the "survival of the fittest" enterprises. While the least capable and nonviable enterprises should leave the marketplace to make resources available for other entities, their exit should be guided by a clear and pre-established mechanism that deals with distress and firm closure. Other distressed but viable enterprises should be provided with a method of becoming more efficient and better organized in order to maintain profitability and improve business operations. This is the role of restructuring processes. They should seek to provide an orderly procedure to save businesses that are still viable and capable of revival and growth, and allow nonviable entities to liquidate in an orderly fashion. As discussed later in this Toolkit, restructuring procedures may be formal and involve the courts, or may be less formal and conducted by parties with minor or no institutional involvement or supervision.

Although the goal of an effective corporate restructuring mechanism is an intervention aimed at avoiding the failure of an enterprise, insolvency laws are primarily focused on maximizing creditor returns. An effective restructuring plan recognizes the available options for creditors to collect their debts (or parts of them) while simultaneously facilitating the rescue of the enterprise.[6] A properly structured corporate restructuring process will achieve these twin goals: (1) obtaining debt sustainability by reducing the debt burden of the enterprise in an orderly manner while (2) protecting the value of the assets and the rights of the creditors in order to avoid litigation. These goals need to be achieved over a short period of time to preserve value in the enterprise, prevent possible disruptions in business activities, and regain access to financing options.

The restructuring process also has to ensure a balance between protecting the debtor and the creditors. A debtor may enter into negotiations with its creditors to reach a restructuring agreement, which might imply less beneficial economic and financial terms for the creditors, although it could be preferable to liquidation—with little or no prospect of recovery. However, if it is too unreasonable, creditors always have the option of pursuing remedies against the debtor in a court of law, trying to collect the full face value of the debt. It is therefore in the interest of both parties to maintain a balanced approach that can successfully lead to an agreement.

1.2 Purpose of the Toolkit

A Toolkit for Out-of-Court Workouts was created to achieve two objectives: (1) to provide policy makers with tools to develop a corporate restructuring framework and culture in their country; and (2) to help stakeholders implement informal corporate restructuring principles to try to rescue failing enterprises. It is accordingly aimed primarily at policy makers, financial institutions, and insolvency representatives, as well as enterprises.

The Toolkit generally examines different models for restructuring, in the understanding that there is no such thing as a "one size fits all" approach, and countries have the ability to develop flexible and varied solutions to meet their specific financial sector needs. Specifically, the focus of the Toolkit is on workouts, which for the purposes of this publication is taken to mean two types of restructuring models: (1) those that involve no judicial involvement (i.e., that are purely out-of-court mechanisms [OCWs]); and (2) those that involve some institutional or judicial involvement (hybrid procedures). Focusing on these models is designed to provide stakeholders with a broader understanding of restructuring and the varied models that different countries are implementing.

Included in the Toolkit are sample documents typically used in a workout. *These are included only to illustrate certain practicalities and considerations in conducting a workout, and should not be used without legal advice in the jurisdiction of their intended use.* Complex restructurings often require much more elaborate documents of many different types, which are beyond the scope and objectives of this Toolkit.

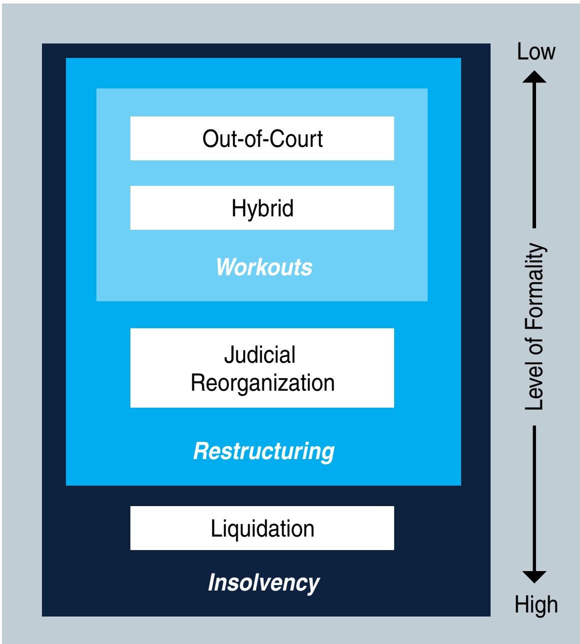
The publication also touches on more formal, court-supervised methods of reorganization for completeness, as well as on formal liquidation

Note on Terminology

The terms *reorganization, workout,* and *restructuring* may sometimes be used interchangeably in common parlance; however, this Toolkit assigns them unique technical definitions that are found in the Glossary.

In this publication, *reorganization* is used in the sense of judicial reorganization, meaning a court-supervised restructuring. A *workout* is an out-of-court restructuring, which includes both fully out-of-court workouts (OCWs) and workouts that are conducted mostly out of court ("hybrid procedures"). *Restructuring* refers to business rescue procedures in general, and includes reorganization, OCWs, and hybrid procedures (see Diagram 1).

Diagram 1: Level of Formality of Insolvency Proceedings



processes to explain what happens when an enterprise is no longer viable. The relationship between these different processes is shown in Diagram 1.

1.3 Structure of the Toolkit

The remainder of Chapter 1 describes different types of frameworks for effective restructuring, the link between informal and formal mechanics, why such frameworks are economically beneficial, and the relevant World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes (WB-ICR Principles).

Chapter 2 sets out some of the preconditions and practical steps that help ensure productive workouts. It presents the different stakeholders involved, describes the tools needed to conduct an effective workout, and explains some of the elements of an enabling legal framework that facilitate successful workouts.

Chapters 3 and 4 delve deeper into the OCW and hybrid restructuring models, including "real world" instructive examples and success stories about various workout frameworks. These illustrate how different countries develop a framework that suits their culture, local laws, and financial sector realities.

Chapter 5 examines a sample OCW case study and shows associated model agreements and forms that relate to specific steps in the OCW. They are provided as guiding tools to help stakeholders understand how to conduct an informal OCW in a practical manner.

Chapter 6 concludes the Toolkit with a discussion of lessons learned and recommendations, and is followed by references used in the text.

1.4 The Different Restructuring Models

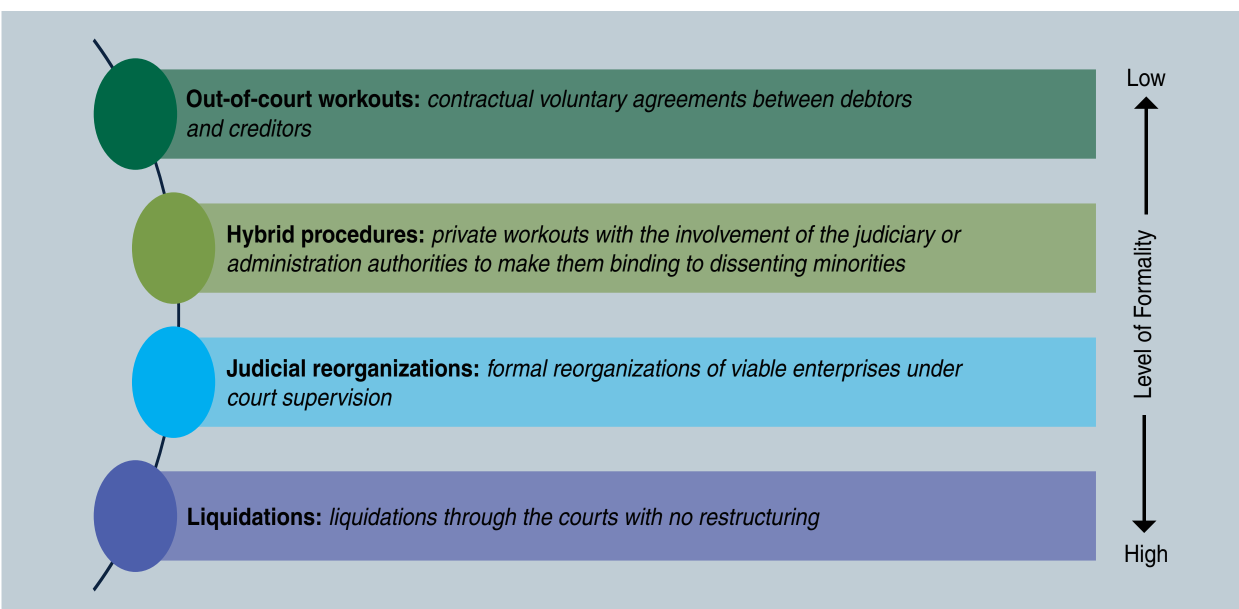
Restructuring frameworks can take many different forms. They are adaptable to the specific needs of the country's financial and real sectors.

Restructuring frameworks range from informal to formal procedures. The typologies below are classified based on the level of court involvement and their degree of formality.[7] Moreover, as illustrated in Diagram 2, at some point it will be realized that the enterprise cannot realistically be restored to profitability and is no longer viable: there is no longer a prospect of successful enterprise rescue, and the enterprise should exit the restructuring framework and enter a formal, court liquidation process to try to preserve as much of the respective creditors' claims as possible. In practice, this point is typically reached toward the start of the analytical process, as it will be apparent that no restructuring is feasible.

- **OCWs** are nonjudicial, private contractual arrangements between the debtor and its creditors (all or just some of the creditors). OCWs workouts are not typically provided for in insolvency legislation, but are instead the result of consensual negotiations, which is why many workouts are considered "informal." In OCWs, parties are free to negotiate the terms of their restructuring agreement without involving the court. This typically means that workouts are flexible, fast, and less expensive than litigation. Generally, the only formal requirement of OCWs is that the negotiations must ultimately result in a valid, binding contract. The major drawback of OCWs is that they are only binding among the parties to the agreement, lacking the cram-down[8] feature of a court-supervised sanctioned reorganization.

- **Hybrid procedures** as the name suggests, combine informal out-of-court restructuring arrangements (that is, privately negotiated restructuring contracts) with elements of formal court or institutional procedures and supervision.[9] The importance of the hybrid procedure is that it benefits from the most salient features of both OCWs and reorganization processes: it is a fast and flexible procedure that can enhance the efficiency of an otherwise lengthy formal process and can also be binding on other creditors. Moreover, it might be used before the enterprise is actually in insolvency to stave off further corporate distress.
- **Reorganizations** are formal proceedings supervised by a court.[10] The role of the court-supervised reorganization processes is to facilitate the survival of the enterprise and its business as a going concern to preserve the source of the debtor's income, the value of its assets, and its employees' jobs while maximizing the potential recovery value for creditors. Often, a country's insolvency laws require that a majority of creditors and/or the creditors holding a certain threshold of the debt agree to a reorganization plan. Typically, the court then approves the plan and, in certain jurisdictions, makes the reorganization binding on all creditors that were subject to such process regardless of whether they have accepted the terms of the plan or not (a cram-down).[11] These types of procedures are usually characterized by two features: (1) the proceedings are lengthier due to the court's involvement, since all parties involved are required to follow a pre-established procedure and adhere to set time intervals; and (2) the proceedings are public and often require that certain financial and commercial information be disclosed, which might deter certain enterprises

Diagram 2: Spectrum of Processes from Informal OCWs to Formal Insolvency Proceedings



from undergoing such proceedings. This Toolkit is focused less on the establishment and implementation of these procedures, although they are included for comprehensiveness.

- **Liquidation proceedings** do not incorporate elements of restructuring, and are not addressed by the Toolkit. Liquidation is a court-supervised, orderly process in order to close the nonviable enterprise and pay outstanding claims.

Diagram 2 illustrates the spectrum of processes from informal OCWs to formal insolvency proceedings.

In many cases, countries choose to have several of these procedures in their insolvency law to provide stakeholders with a variety of options from which to choose. Which option is selected depends on the level of financial distress of each enterprise and the stage at which recourse is sought.

1.5 The Economic Impact of Restructuring Frameworks

A well-functioning insolvency law seeks to sort viable, but financially distressed, enterprises from nonviable enterprises. It seeks to offer mechanisms whereby the first category of enterprise may be rehabilitated in the marketplace—whether through a restructuring of its capital structure or a sale of the business as a going concern—and at the same time to ensure that the second category of firm is closed and liquidated as quickly as possible. However, under a poorly functioning insolvency regime, viable but financially distressed enterprises may have no option but to enter liquidation and close.[12]

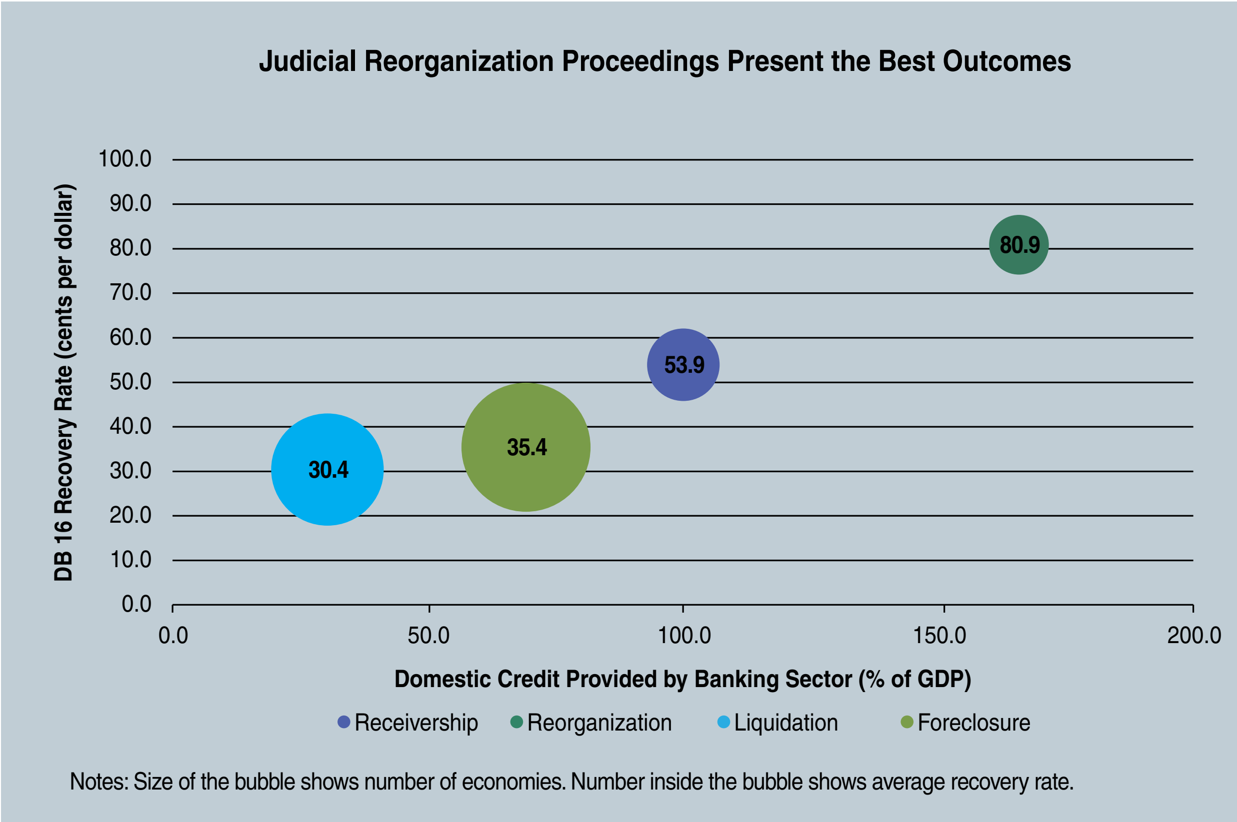
Restructuring frameworks therefore help encourage domestic and foreign lending by giving lenders and investors assurance that, if a borrowing enterprise runs into financial difficulty, a framework is in place that will both protect creditor rights and allow a viable enterprise to resolve its indebtedness as quickly and inexpensively as possible. Restructuring also preserves the value of the enterprise, enables its continuous operation, and ensures higher repayment rates to creditors.

As many workouts are confidential, it is difficult to get empirical data on the success of these restructuring regimes, particularly those that take place with no court involvement. Nonetheless, more general studies show that effective insolvency regimes, which include both judicial reorganization and more informal restructuring tools, preserve jobs by facilitating the survival of distressed but viable enterprises, reduce credit risk, and help strengthen access to credit at a lower price.[13] Some of these studies follow.

Following the revised corporate reorganization code that Colombia enacted in 1999, which dramatically improved the efficiency of reorganization proceedings, the duration of reorganization proceedings fell from an average of 34 months to 12 months. This in turn reduced the burden on the judiciary and other parties to the reorganization, and strengthened overall creditor rights.[14] A 2007 study analyzed Mexico's newly enacted corporate insolvency law, which changed the structure, venue, and length of proceedings, and also strengthened the role of professional administrators. These changes increased the average recovery rate for secured creditors from 19 cents on the dollar to 32 cents on the dollar, and shortened the duration of proceedings from an average of 7.8 years to 2.3 years.[15] In the United Kingdom, comparative studies have been conducted between formal receivership and administration procedures in the insolvency law vis-à-vis more informal hybrid restructuring tools known as restructuring plans (discussed in Chapter 4). These studies showed that of all the sales of businesses as going concerns during receivership or administration proceedings, 65 percent of cases resulted in the new owner's preserving the entire workforce. In more informal pre-pack solutions, the owners preserved the entire workforce in 92 percent of cases.[16]

The impact of reorganization proceedings on the economy is demonstrated in Diagram 3, which

Diagram 3: Judicial Reorganization Proceedings Present the Best Outcomes



highlights cross-country data from the World Bank's *Doing Business 2016* report.[17] Diagram 3 indicates a causal link between the design and operation of insolvency procedures on one hand and recoveries in insolvency on the other. The data illustrates that reorganization proceedings yield higher recovery rates than foreclosure, receivership, or liquidation. Moreover, reorganization proceedings are positively correlated with greater amounts of domestic credit provided by the financial sector; in other words, there is a correlation between restructuring and accessing higher levels of credit in an economy.

1.6 Workouts in the World Bank Group Principles for Effective Insolvency and Creditor/Debtor Regimes

The WB-ICR Principles[18] were developed in 2001 in response to a request from the international community in the wake of the financial crisis of the late 1990s. At that time, the WB-ICR Principles constituted the first internationally recognized benchmarks that could be used to evaluate the effectiveness of domestic creditor/debtor rights and insolvency systems. The WB-ICR Principles, together with the UNCITRAL Legislative Guide on Insolvency Law (Legislative Guide), form the Insolvency and Creditor Rights Standard (ICR Standard) in insolvency law and practice. The ICR Standard is recognized by the Financial Stability Board as one of the key standards for sound financial systems, and represents the international consensus on best practices for evaluating and strengthening insolvency regimes.[21]

The WB-ICR Principles, as they relate to developing workout and corporate debt restructuring frameworks, are discussed in detail in the 2012 World Bank Study.[22] Sections B3, B4, and B5 of the Principles form the best-practice guidance for corporate workouts and restructurings. These are

BOX 1: The Impact of Pre-Insolvency Restructuring in the European Union

The European Commission (EC) published a 2015[19] report based on data from its member states that demonstrates that efficient pre-insolvency frameworks can (1) spur entrepreneurship, (2) mitigate the impact that deleveraging has on GDP growth, and (3) improve financial stability by quickening the normalization of nonperforming loans in an economy. Pre-insolvency frameworks are commonly based on a hybrid model of restructuring, meaning they incorporate limited court involvement typically at the beginning and/or end of the proceedings, in addition to informal creditor negotiations (see Chapter 4 for more discussion on the EC's discussion of pre-insolvency frameworks). The EC's study approached pre-insolvency frameworks from a general perspective without focusing specifically on hybrid frameworks.

Entrepreneurship

Efficient pre-insolvency frameworks are shown to be particularly beneficial to entrepreneurs because they lessen the level of risk that entrepreneurs would assume should their venture fail. Further, the frameworks facilitate an entrepreneur's rapid reentry into the economy following an enterprise failure. Using self-employment as a proxy for entrepreneurship, this EC study measured the efficiency of member states' pre-insolvency structure by applying a grading scheme to 12 indicators that it considered characteristic of an efficient, preventative restructuring framework. When the efficiency of a member state's pre-insolvency framework increased by one percentage point, self-employment increased by an average of 0.75 percent.[20] This positive relationship suggests that the more efficient a country's pre-insolvency framework is, the better it is at fostering entrepreneurship and its economic benefits.

Nonperforming Loans

Rising NPLs mean debtors are less capable of servicing their debts. As a result, the supply of credit is lessened. By giving debtors the opportunity to restructure their debts at an early stage through pre-insolvency frameworks, they can react more quickly to changing economic conditions. Accordingly, there appears to be a relationship between efficient pre-insolvency frameworks and the speed at which NPLs return to normal levels following negative economic conditions.

Corporate Deleveraging

Corporate deleveraging lowers corporate expenditure and slows economic growth, which results in enterprises implementing cost-cutting measures. However, in jurisdictions with efficient pre-insolvency frameworks, the negative consequences of deleveraging are softened. For each one percentage point reduction in debt-to-financial assets, the GDP growth is lowered by only 0.23 percentage points, compared to 0.36 percentage points in jurisdictions with less efficient insolvency frameworks. Thus, efficient early insolvency frameworks make an economy less sensitive to changes in corporate indebtedness.

set out here, accompanied by summaries of each relevant principle.

1.6.1 Principle B3: Enabling Legislative Framework

Summary

Principle B3 contains the core criteria for establishing an enabling legislative framework in a country—one that is conducive to conducting negotiations and undertaking analysis to preserve viable businesses in the economy. Such a framework should include:

- The availability of accurate and reliable information;
- Incentives to invest in or recapitalize viable, financially distressed enterprises;
- A range of restructuring tools that the stakeholders can use to achieve their goals;
- Appropriate tax treatment in associated laws that enable debt restructurings;
- Effective debt enforcement and insolvency procedures;
- In addition, regulatory impediments in associated laws should be removed.

B3 Enabling Legislative Framework

Corporate workouts and restructurings should be supported by an enabling environment, one that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An environment that enables debt and enterprise restructuring includes laws and procedures that:

B3.1 Require disclosure of or ensure access to timely, reliable, and accurate financial information on the distressed enterprise;

B3.2 Encourage lending to, investment in, or recapitalization of viable financially distressed enterprises;

B3.3 Flexibly accommodate a broad range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt reschedulings, debt and enterprise restructurings, and exchange offerings (debt-to-debt and debt-to-equity exchanges);

B3.4 Provide favorable or neutral tax treatment with respect to losses or write-offs that are necessary to achieve a debt restructuring based on the real market value of the assets subject to the transaction;

B3.5 Address regulatory impediments that may affect enterprise restructurings; and

B3.6 Give creditors reliable recourse to enforcement, as outlined in Section A, and to liquidation and/or reorganization proceedings, as outlined in Section C.

1.6.2 Principle B4: Informal Workout Procedures

Summary

As discussed throughout this Toolkit, informal restructurings or workout procedures take place in the "shadow of the law"—that is, they do not typically follow a legislative or regulatory framework because they are private, contractual arrangements that occur outside of the courts (Chapter 2 covers these restructurings in detail). However, the WB-ICR Principle B4 encourages the use of voluntary dispute resolution tools to help facilitate such negotiations. As discussed in Chapter 3, several countries have adopted pre-insolvency procedures that make use of such tools, as well as "hybrid" measures that allow the conversion of informal instruments to formal, court-sanctioned ones.

B4 Informal Workout Procedures

B4.1 An informal workout process may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation, or informal dispute resolution. While a reliable method for timely resolution of inter-creditor differences is important, the financial supervisor should play a facilitating role consistent with its regulatory duties as opposed to actively participating in the resolution of inter-creditor differences.

B4.2 Where the informal procedure relies on a formal reorganization, the formal proceeding should be able to quickly process the informal, pre-negotiated agreement.

B4.3 In the context of a systemic crisis, or where levels of corporate insolvency have reached systemic levels, informal rules and procedures may need to be supplemented by interim framework enhancement measures in order to address the special needs and circumstances encountered with a view to encouraging restructuring. Such interim measures are typically designed to cover the crisis and resolution period without undermining the conventional proceedings and systems.

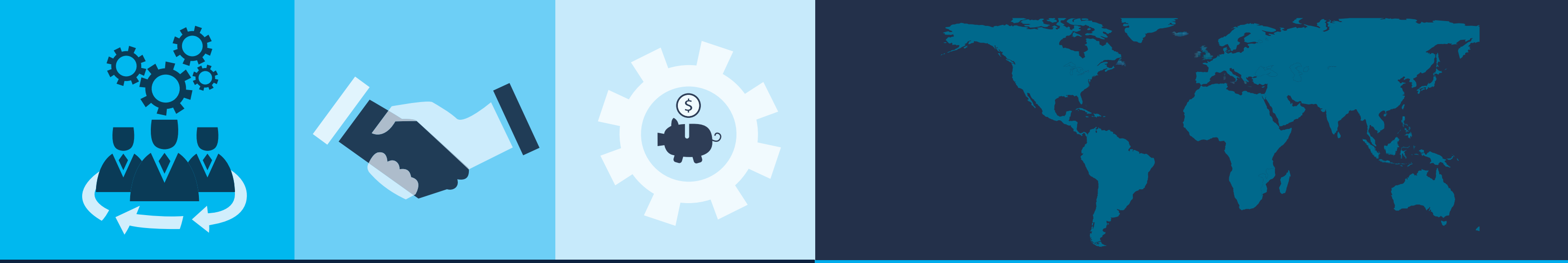
1.6.3 Principle B5: Regulation of Workout and Risk Management Practices

Summary

WB-ICR Principle B5 emphasizes the importance of having financial sector authorities and regulators promote any guidelines or code of conduct on how to conduct informal workouts. Having strong leadership from the banking community helps ensure implementation of workouts on the ground, and will start developing a fair and effective negotiation culture in the country. Some countries have initiated Memoranda of Understanding between the central bank and the bankers' association to ensure that there is strong promotion of principles among the key financial sector players. Other countries have adopted more mandatory, hybrid models, discussed further in Chapter 4.

B5 Regulation of Workout and Risk Management Practices	
B5.1	A country's financial sector (possibly with the informal endorsement and assistance of the central bank, finance ministry, or bankers' association) should promote the development of a code of conduct on a voluntary, consensual procedure for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure, especially in markets where corporate insolvency has reached systemic levels.
B5.2	In addition, good risk-management practices should be encouraged by regulators of financial institutions and supported by norms that facilitate effective internal procedures and practices supporting the prompt and efficient recovery and resolution of nonperforming loans and distressed assets.


Contract



2 Cross-Cutting Practicalities of Conducting a Workout

Chapter 2 highlights practical considerations for two types of workouts: those with no court involvement (OCWs), and those with some court or institutional involvement (hybrid procedures). OCWs and hybrid procedures have many overlapping elements because the latter often includes an informal, out-of-court negotiation phase as part of the process. This chapter focuses solely on elements that are mutually relevant to both types of workouts. In-depth discussions of OCWs and hybrid procedures appear in Chapters 3 and 4, respectively.

This chapter is designed to highlight issues as they would arise in a workout process, namely:

1. The considerations that the debtor must address prior to engaging in a workout;
2. The relevant stakeholders of a workout and how these stakeholders may change due to debt trading;
3. The types of agreements they might consider putting in place from the outset, such as a standstill agreement;
4. The standstill period;
5. The importance of protecting confidential information;
6. The valuation of the debtor's assets;
7. The debt restructuring tools that might be relied upon in a restructuring plan;
8. The procedural elements of conducting workout negotiations;
9. Establishing intangible elements of a successful framework;
10. The ranking of creditors' claims;
11. New financing during a workout;
12. Potential impediments in other laws;
13. The classification of claims; and
14. The possible role of the mediator.

2.1 Preparing for a Workout: A Checklist of Debtor Considerations

Prior to entering workout negotiations with creditors, the debtor in financial difficulties must prepare for these negotiations. Preparation is the crucial first step to a successful workout. When preparing for creditor negotiations, the debtor should have a view to achieving a business restructuring and gaining financing so that the enterprise can continue operations. The following Box is a general checklist of considerations that the debtor should address prior to engaging in negotiations. By following this checklist, debtors will be well prepared to negotiate a restructuring plan.

Checklist for Debtor before Workout Negotiations

The checklist was designed to apply to a corporate debtor that is part of a group of companies. Nevertheless, although not all of the questions raised will be relevant in all circumstances, it is hoped that financially troubled debtors of all types, including single corporates, partnerships, and sole proprietorships or merchants, will benefit from using it on a selective basis. The aim is to help debtors be well prepared for discussions, and to assist them in developing a credible plan which will win the support of creditors and, if need be, the court.

1. Group Structure

1.1 Prepare the current group structure chart.

1.2 List the place of incorporation of each company.

1.3 Verify all shareholdings within the group.

1.4 Establish whether or not any companies in the group are publicly listed (and if so, where).

1.5 Establish the identity of any controlling shareholders, or of identifiable groups of shareholders (e.g., family members).

1.6 Establish if there are any associated or related companies or individuals under local law and consider the consequences of this for any future restructuring process.

1.7 Obtain up-to-date search information from all public registers.

1.8 Obtain copies of the constitutions of all the companies.

2. Business and Assets

2.1 Identify business activities of the group and draft a description of these.

2.2 Establish which companies in the group carry on which business.

2.3 Establish the level of interdependence of members of the group, such as: common services or facilities, intragroup trading, cross-ownership of assets.

2.4 Establish which companies own the operating and other assets of the group.

2.5 Establish the recent trading history of the group, including major changes in the business, acquisitions, or disposals.

2.6 List assets that are owned outright, and list separately all assets that are charged, leased, hired, licensed, held on trust or subject to retention of title or otherwise not subject to the claims of creditors.

2.7 Obtain copies of any property, plant, or other asset registers of title.

2.8 Consider obtaining independent valuations of key assets likely to be essential to enable the business to continue or likely to need to be sold to raise finances.

3. Management

3.1 Identify current directors and secretaries of all group companies.

3.2 Identify key managers and employees who are not directors.

3.3 Identify connections, if any, between management and shareholders, including family connections.

3.4 If remuneration of management is linked to performance, set out the details of the arrangement.

4. Financial Information and Confidentiality

4.1 Obtain copies of the latest management accounts.

4.2 Obtain copies of recently audited accounts.

4.3 Identify auditors of each company.

4.4 Obtain, if necessary, individual accounts as well as consolidated accounts.

4.5 Obtain/produce up-to-date cashflow statements and forecasts.

4.6 Obtain/produce budgets, forecasts, and other future financial planning information.

4.7 Consider the need for confidentiality agreement for recipients of commercially sensitive information and form of any such agreement.

5. Cash Flows

5.1 Identify all bank accounts of every company in the group, including bank, location, currency, purpose, and current balances.

5.2 Describe cash flow patterns: which company receives and pays, how much it receives and pays, in which currency, and when.

5.3 Identify all intragroup payments/payment patterns.

5.4 Identify any intragroup loans and their terms.

5.5 Identify key cash flow dates, such as: paying wages, rent, and other periodic mandatory payments.

6. Key Contracts Review

6.1 Locate all key contracts. If they are not in writing, then draft a description of their terms.

6.2 Establish whether valuable contracts may be terminated by a counterparty or might automatically be terminated on an "insolvency." Determine whether "insolvency" includes "restructuring" and if so, whether it might make a difference if the "restructuring" is completely informal or involves the court.

6.3 Establish the consequences of termination by the debtor of key contracts: damages or contingent liabilities.

6.4 Examine contracts with customers and suppliers, service providers, IT and IP licenses, property and other operating leases, and assess the consequences of a restructuring on these.

7. Financing

7.1 Identify all sources of financing used by the group, including intragroup loans (see above).

7.2 Obtain copies of all bank loan documentation and identify, where applicable:

- Agent and Security Trustee;
- All current participants in the loan;
- Amount and type of facility;
- Current level of drawdown;
- Repayment profile;
- Currencies involved;
- Interest rates and margins, both normal and default;
- Fees and expenses;
- Events of default and potential events of default;
- Termination rights, including acceleration;
- Financial and other covenants;
- Negative pledges;
- Assignment provisions;
- Majority bank voting percentages;
- Pro-rata sharing provisions;
- Confidentiality provisions; and
- Governing law.

7.3 Establish if there are any existing defaults. Have any default notices been served or rights reserved? Are there any letters extending or varying facilities?

7.4 Obtain copies of documents relating to all other bank facilities, such as:

- Overdrafts;
- Letters of credit;
- Bonding;
- Acceptance credits;

(*continued*)

Checklist for Debtor before Workout Negotiations—Continued

- Bills of Exchange; and
- Currency facilities.

7.5 Identify any foreign exchange contracts, swaps, options, or other derivative contracts, and obtain copies of relevant ISDA Master Agreements and Schedules. Establish termination provisions, close-out exposures and current mark-to-market values.

7.6 Identify all bonds, notes, and other debt instruments issued by the company, and obtain copies. Review these documents as loans.

7.7 Identify all finance leases and obtain copies. Review as loans.

8. Security and Guarantees

8.1 Identify all guarantees given by or to members of the group and note the following in each case:

- Identity of guarantor;
- Beneficiary of guarantee;
- Persons/entities guaranteed;
- Liabilities guaranteed;
- Date of guarantee;
- Purpose/benefit to guarantor in providing the guarantee;
- Consider the enforceability of the guarantee under its governing law; and
- Assess the risk that payment under the guarantee will be required.

8.2 Identify all security given, by which company to which lender, including the following:

- Mortgages on land;
- Debentures;
- Charges or pledges over shares;
- Charges by deposit of title deeds;
- Charges on bank accounts;
- Charges over movable/personal property, e.g., ships, aircraft;
- Cash held as collateral, and where;
- Other collateral, type and location.

8.3 Identify all creditors who may be able to assert liens, retention of title claims, trusts, or other proprietary (*in rem*) or security rights.

8.4 Check that all security requiring to be registered has been registered and assess the consequences of failing to do so.

9. Litigation and Litigation Risk

9.1 Obtain details of all material litigation against the company, including:

- Parties;
- Nature and amount of claim;
- Lawyers acting;
- Stage reached in the proceedings;
- Advice received on likely outcome;
- Insurance coverage; and
- Settlement prospects.

9.2 Obtain details of any claims or threats of litigation.

9.3 Establish if any significant arrears are owed to suppliers, tax or government creditors. Has any enforcement action been threatened or commenced?

10. Regulation

10.1 Are the activities of the group subject to regulation in any way? If so, by whom?

10.2 Does the group hold licenses that permit its activities? Could these licenses be affected by a restructuring or insolvency?

10.3 Are there obligations to disclose restructuring or insolvency events to regulators? Consider how this obligation is to be discharged, and when this must/should be done;

10.4 Are any public announcements required, e.g., through a stock exchange?

11. Advisers

11.1 Identify and list contact details for:

- Legal advisers in local jurisdiction;
- Legal advisers in other jurisdictions;
- Auditors;
- Financial advisers;
- Valuations experts; and
- Any relevant technical advisers.

11.2 Identify and list contact details for the legal, financial, and other advisers to the financial creditors.

2.2 Relevant Stakeholders

The main and obvious participants in any restructuring scenario are the debtor enterprise and its creditors. As noted by the Legislative Guide, an important aspect of a workout is to have a balance between the different interests of these stakeholders, as well as between the broader social, political, and policy considerations that impact insolvency proceedings in general.[23] However, when the debtor is facing a liquidity crisis or a situation of financial distress, there are a number of other stakeholders (not necessarily participants in the negotiations) that may be interested in the development and success of the workout process. Stakeholders might include:

Promoters of the overall restructuring framework in a country (not typically parties to the negotiations):

- *The central bank*, as the guardian of the financial stability in the country;
- *Bankers' associations*, as coordinators of creditor banks.

Creditors (parties to the negotiations):

- *Leading domestic and international banks*, as creditors and new finance providers;
- *Microfinance institutions* (including peer-to-peer lenders), as creditors;
- *Tax authority*, as creditor, but often one that benefits from a priority to be paid ahead of certain creditors;
- *Labor authority or trade unions*, as representatives of the employees of the enterprise in distress, who are creditors regarding unpaid wages;
- *Insurance enterprises*, as potentially affected parties in the event that any policy is linked to a default or nonperformance of obligations;
- *Trade creditors*, as sellers who deliver goods to a buyer and do not require payment for a certain period of time.

Economic stakeholders (not typically parties to the negotiations):

- *Chambers of Commerce*, as parties interested in the sound functioning of the business environment in the country and in preserving enterprises as a growing concern;
- *Stock exchange*, as listing authority of the enterprise in distress;
- *Credit default swap providers,* as protection providers in an event of default, which can put them at risk.

Potential facilitators of the negotiations:

- *Insolvency representative associations* (if any), as safeguards to the integrity of the restructuring processes;
- *Alternative dispute resolution professionals* (that is, mediators, conciliators), as facilitators of party negotiations.

The composition of the stakeholders in any given case may vary depending on the type and size of the borrower (for example, a large incorporated enterprise; a small- or medium-sized enterprise [SME]; or an entrepreneur who has taken on a personal loan for an enterprise).

2.2.1 The Issue of Debt Trading

Debt trading is one of the many issues that need to be considered in identifying the central stakeholders in the context of debt workouts and in determining the possibility of success because it changes who is a relevant stakeholder at the time of the workout. Debt trading is the transfer of a creditor's claim to another party, resulting in the party that assumes the claim becoming the new creditor. Original creditors may engage in debt trading for a number of reasons, resulting in them no longer being creditors during workout negotiations. They may, for example, have their own liquidity problems and be willing to sell their claim in an attempt to get cash. Other creditors, such as banks and pension funds, may be subject to regulatory constraints and only be permitted to hold certain levels of distressed claims. On the other hand, some parties are interested in acquiring such claims, either because they specialize in debt collection (for instance, the so-called "vulture funds") or for other reasons relating to debt restructuring, such as the desire to acquire a stake in the debtor enterprise. Debt trading is best facilitated through active secondary markets for distressed debt and when there are few regulatory or tax impediments.

Generally, debt trading can have both positive as well as negative implications for the success of a workout. For instance, a liquid market in secondary debt may complicate the negotiation process and cause difficulty in identifying the relevant parties. Furthermore, creditors who specialize in distressed debt may have very different incentives from original creditors, and may therefore be more willing to block a comprehensive restructuring and seek concessions from the debtor without regard to the interests of other creditors or the survival of the debtor's business. Alternatively, it is possible for debt trading to increase the possibility of a successful workout and improve corporate governance in debtor firms. Debt trading can encourage the concentration of debt in fewer creditors, which in turn reduces the transaction costs of restructuring. The presence of creditors that specialize in distressed debt may also lower the fixed cost of enforcement and help discipline the debtor's management in times of distress.[24]

2.3 Standstill Agreement

Creating a standstill agreement is one of the first steps involved in a workout once the creditors have convened. It is an agreement between the debtor and relevant creditors that the creditors will grant a specific standstill period during which they will not enforce their rights against the debtor for any default. Depending on the standstill agreement, it may also provide that creditors must keep open any existing lines of credit to the debtor, or postpone any capital or interest payments due. Furthermore, since insolvent debtors do not default on all loans at the same time—but rather on the facility whose payment comes due just as the debtor's financial situation becomes so acute that it cannot make the next payment—the burden of default falls disproportionately on one creditor. As a result, creditors often agree to share the losses from any debtor default.

It should be emphasized that with certain hybrid procedures, the court might impose a formal stay or moratorium to prevent enforcement actions by creditors. However, with more informal negotiations, a standstill agreement will have to be negotiated contractually by the respective parties. In either case, a successful workout generally requires the involvement of the debtor's major bank lenders and their agreement not to enforce their debts, since it is their cooperation that is needed to restructure the enterprise's obligations. Typically, trade creditors continue to be paid and often may not even be aware that the borrowing enterprise is attempting to restructure its debt. If the number of bank lenders is great enough to make coordination difficult, the standstill agreement may designate a bank to oversee the loan restructuring and represent all lenders in negotiations with the debtor and any professional advisors (lead bank). In particularly complex cases, lenders may find it appropriate to form a committee of creditors that oversees the restructuring on behalf of all creditors (steering committee).

In some cases, the lead bank may have a conflict of interest between its position as an individual lender and its role representing other creditors. While the lead bank would generally be required to disclose any conflict of interest, the other bank lenders could decide that it is appropriate for the lead bank to continue representing them, notwithstanding the conflict.

2.4 Standstill Period

The standstill period grants the debtor a reprieve from enforcement actions. In return, the debtor agrees to use this time to:

- Draft a restructuring plan;
- Provide creditors with relevant information on the enterprise and its financial position, so that creditors can assess the viability of the restructuring plan. The creditors may hire professional accountants to prepare a report detailing the enterprise's financial situation and prospects for rescue.

The length of the standstill period varies, but typically will not exceed two months, at least initially. The standstill agreement can be extended if the parties concur.

2.5 The Importance of Confidentiality

Confidentiality is an essential element of workouts. However, with certain hybrid procedures, this might not be possible in light of the court's involvement. For instance, a formal stay imposed on creditors to prevent enforcement action would necessarily mean that all creditors receive notice and the court proceedings will be public knowledge. On a general level, the management of a struggling enterprise may not wish to make it known that the enterprise is insolvent, or negotiating with its creditors to avoid insolvency, for fear that customers would shun the enterprise or that suppliers might break off their relationships with it. In the specific context of the workout negotiations, the debtor would be concerned about how creditors will treat the information it provides so that the latter can assess the debtor's financial situation and assess the chances of a successful restructuring. Much of this information is often commercially sensitive and, in the wrong hands, could be used against the debtor. As a result, debtors and creditors often incorporate confidentiality agreements into the workout.

2.6 Valuation of the Debtor's Assets

Properly valuing a distressed debtor's assets is crucial to a successful operational and financial restructuring. A workout must be based on the assumption that the debtor's financial situation has been accurately described and that there are no hidden losses or overvalued assets. Creditors will need to compare the enterprise's current value against the value that a proposed restructuring will generate and make an informed decision on whether to agree to the measures proposed by the debtor and accept a restructuring plan. However, the debtor and the creditors often have conflicting views of the value of the debtor's assets; on the one hand, creditors will tend to overstate the debtor's financial woes, while the debtor will emphasize the economic prospects of the enterprise as foreseen by the reorganization plan.

Where debtor and creditors cannot reach an agreement on the valuation of certain assets or losses, the parties to the restructuring may benefit from engaging independent third-party advisors and experts who can undertake due diligence. Advisors and experts should address the general suspicions that creditors have regarding the debtor's previous business conduct and its ability to produce a successful business plan, as well as helping to gather the necessary information to get a clear picture of the debtor's situation and its viability according to a new business plan. They may also study the causes of the enterprise's problems and prepare or review a business plan that would put the enterprise back in a healthy economic situation. Advisors and experts may be drawn from a variety of disciplines, such as accounting, finance, law, business reorganization, and marketing.

2.7 The Restructuring Plan

The debtor's main responsibility is to prepare and present to its creditors a plan for restructuring its debt and/or operations. The restructuring plan also specifies how and when creditors are to be repaid. There is no format for how a restructuring plan should look. The details of the plan depend mainly on the needs of the business and the willingness of creditors to make concessions to avoid a liquidation of the debtor and the risk of even lower recoveries.

When undertaking a workout, both the procedural and substantial aspects need to be considered. The procedural aspect focuses on the way in which the restructuring should be performed (for example, OCW, hybrid procedure, extent of court intervention, etc.), whereas the substantial aspect involves the actual restructuring of debt. The substantial aspect can occur pre-emptively in an attempt to prevent actual default (debt rescheduling) or after the default has taken place. The substantive aspect can take the form of an array of options that may, for instance, consist of:

- *Debt write-down*: a face-value reduction on the claim;
- *Extension of maturities*: by extending maturities, the debtor benefits from a net present value reduction on the claim, and obtains relief from the consequences of what might be a temporary cash-flow problem;
- *Interest holiday*: a temporary suspension of interest payments;
- *Delivery of assets to the creditors*: the creditor is paid in kind;
- *Debt-for-equity swaps*: structuring the enterprise so that the general creditors exchange their debt for shares in the enterprise (or partners in a partnership);
- *Restructuring of the debtor enterprise*: a corporate restructuring that can result in the isolation of the deficit units to protect the revenue-generating parts of the enterprise to guarantee payment;
- *Management of all or part of the enterprise for the creditors' benefit*: to appoint a third, independent party with the required skill sets to run the enterprise for the benefit of all parties, bearing in mind streamlining costs;
- *Issuance of securities or convertible debt instruments*: issue new shares of the enterprise or debt instruments that the creditor can convert into shares in the event the enterprise recovers and performs well;
- *Creation of guarantees on thirty-party assets*: a different party guarantees the claims of creditors (that is, the pool of available assets gets bigger);

- *Assignment of stock in other enterprises*: this is another type of payment in kind, where the debtor assigns the shares it owns in another enterprise to the creditors;
- *Capitalization of claims into shares or in stock ownership programs*: this is mainly an option for employees of the enterprise, whereby the monies owed are paid in shares or future shares of the enterprise.

Note that these options can be combined or arranged in such a way that alternative options can be offered to several types of creditors allocated or categorized in separate classes (for instance, secured creditors in one class versus unsecured creditors in another class). Nonetheless, the proposal should contain equal or equivalent provisions for all creditors in the same class. If this is not done, there may be court challenges to the enforceability of the plan in OCW cases as well as challenges to the approval of the plan in hybrid procedures.

2.8 The Different Steps of the Workout Process[25]

This section discusses the key steps of a typical workout. Whether for an OCW or a hybrid procedure, these steps are likely to be undertaken in the restructuring assessment and ensuing negotiation. Based on research and experience, the prime focus of a restructuring should be on improving the competitive position of the debtor. Consequently, "fixing the business" is the prime focal point. This consists of addressing two matters:

- Operational or business restructuring; and
- Financial restructuring.

The underlying idea is that it is impossible and undesirable to carry through financial restructuring without operational restructuring of the enterprise operations (which is what usually leads to the deteriorated financial situation within the enterprise). The process is also aimed at a restoration of confidence in the enterprise and its management among interested parties.[26]

Operational Restructuring

Operational restructuring is the adjustment of a debtor's liabilities to make the debtor more capable of meeting its obligations. It can be financial, operational, or a combination of both. For ease of analysis, workout process can be divided into the following phases[27]:

1. Stabilizing;
2. Analyzing;
3. Repositioning; and
4. Reinforcing.

In practice, the different phases (and actions to be taken) frequently overlap, as restructuring management is an iterative process.

Phase I. Stabilizing

In the stabilizing phase, the focal point is to identify and react to the distress, which requires immediate action to stabilize the enterprise. The primary concern in this phase is increasing the incoming cash flow, and reducing the outgoing cash flow. In this way, the required "breathing space" can be created to meet critical short-term financial obligations. Some possible actions that can be taken include:

- Reducing the current expenses both in the field of costs and with regard to investments;
- Selling off excessive inventory, as well as reducing the stock;
- Quicker collection of receivables and/or reducing the payment periods; and
- Selling excessive assets (asset stripping).

When stabilizing an enterprise, it is important that management implement new (temporary) internal controls. See Chapter 5 for more detail.

Phase II. Analyzing

In the second phase, it is necessary for the enterprise to look at its long-term prospects. Drawing up a well-founded restructuring plan is of vital importance, particularly to restore confidence of the relevant interested parties. When developing the plan, it is important to adequately set forth the core activities of the enterprise—including the (potential) value that they can create. In addition, consideration must be given to which specific products, services, and customers should be retained and which should be given up. Measures to restore profitability in the long term can be diverse and will depend upon the specific situation.

The restructuring plan must indicate the short- and long-term objectives to halt the insolvency process and to restructure the enterprise, as well as the actions to take to achieve the objectives. It is important that the plan is realistic; interested parties make decisions on this basis. Financiers decide on the basis of the plan whether to maintain the credit facilities granted or make new funding available to finance the workout. Suppliers of products/services decide whether to continue to supply the enterprise (on credit). In addition, shareholders/investors consider whether to make any required capital available. This involves, for instance, the depositing of (informal) capital and/or (subordinated) loans. It is often also necessary to recruit or consult persons such as restructuring and insolvency representatives.

Phase III. Repositioning

In the repositioning phase, management and any consultants initialize the restructuring as outlined in the plan. This is called the "value recovery process," so named because the enterprise has lost value due to its financial distress, but now in the process of reversing that value loss. It is important that means of recovering value are feasible and that management reports to the interested parties in an open and timely manner. This will enable the restructuring plan to restore the confidence of the interested parties in management, and ideally help to rebuild relationships. In many ways, the process of the enterprise's recovery is also the process of restoring confidence among the interested parties. Third-party professionals who specialize in restructuring and insolvency processes may also assist in this regard.

Phase IV. Reinforcing

In addition to initiating the restructuring (during which period the organization tries to regenerate positive cash flows from operations), the enterprise also needs to be "reinforced." This means replacing or enhancing current management and improving the enterprise's balance sheet by lowering the debt-equity ratio. This can be achieved by transferring the enterprise to be restructured to another enterprise, thus guaranteeing future payments.

As stated before, it can help to involve third-party experts in the restructuring process, as it still remains to be seen whether current management will be able to independently complete the operation successfully. During the reinforcing phase, the question is whether current management is able to successfully run the enterprise in the future, and whether the existing organization and management structure fits within the new enterprise. Changing the management structure—including position changes or dismissal of key figures in management—may be required.

Reinforcing the balance sheet, as described in this phase, is interconnected with financial restructuring.

Financial Restructuring

Although the restructuring plan forms a basis for a successful rationalization of the enterprise, some degree of financial restructuring can also often be necessary. The losses from the past have—in most cases—disturbed the balance sheet ratios to such an extent that the obligations toward the assets are excessive; as a result, interest and repayment obligations cannot be or no longer have been met. In addition, high restructuring costs are usually involved, for example, costs for redundancies.

The enterprise is not always able to clear away its debt with its own current cash flows. Therefore, new financing assistance from outside the enterprise (that is, from shareholders and/or creditors) must often be requested, as well as revision of the terms of funding already provided by creditors.

The core of financial restructuring is typically debt rescheduling, namely the deferment or remission of current financial obligations, as well as generating additional liquidity. The partial or complete takeover of an enterprise fits within the financial restructuring framework because the buying enterprise usually acts as guarantor (in part or in whole) of current obligations and/or provides additional financial resources.

2.9 Establishing Intangible Elements of a Successful Framework

Despite the best intentions, stakeholders may fail to reap the benefits of a workout framework if certain intangible elements are not present. Motivating private parties to be fully engaged in negotiation and open discussion requires that certain intangible elements be in place. These include:

- *Good faith* on the part of the borrower and lenders;
- An *understanding* by lenders of the methods and principles for conducting workouts;
- A highly developed *creditor culture,* where creditors possess the initiative and incentive to work with debtors to obtain the best possible outcome;
- An *awareness* on the part of lenders that workouts work in their best interest, compared to either refusing to negotiate or going through a formal proceeding;
- A *willingness* on the part of lenders to proactively encourage borrowers to seek help if they are facing financial difficulty;
- A *setting* in which both parties feel they can engage in open dialogue; and
- A *business culture* where borrowers feel comfortable approaching lenders with financial problems in a timely way, that is, while borrowers' businesses are still viable.

These elements cannot typically be created by any public sector authority.

2.10 The Ranking of Creditors' Claims in a Restructuring Plan

An "order of priorities" means that some creditors have precedence over the others in the distribution of the proceeds of the sale of the debtor's assets, if liquidation were to take place. There is no standardized order of priorities across countries, although there is guidance as to best practices, and modern thinking suggests that to the extent possible, the order of priorities should be based upon commercial bargains and not reflect social and political concerns that have the potential to distort the outcome of insolvency.

A creditor's ranking is often arranged at the time that the creditor lends money to the debtor or it is set by law. The order of priorities is important in the context of an OCW because creditors might agree to change their status or priority in the workout in order to facilitate a restructuring plan. Similarly, creditors might agree to provide new financing to the enterprise to help save it, which might result in a higher ranking in priority.

2.10.1 Subordination

Another method of altering priority is subordination. Subordination is "the act or an instance of moving something (such as the right or claim) to a lower rank, class or position."[28] Creditors voluntarily agree to situations of subordination, and understand that by holding subordinate debt, they have moved lower in the order of priorities (that is, subordinated debt is only recoverable after other debt is satisfied).[29] Creditors mitigate the risk associated with subordinated debt by pricing the debt accordingly and charging higher interest rates or some other kind of benefit.[30]

Subordination is usually agreed upon and governed by means of an inter-creditor agreement, a common feature in transactions where most of the outstanding debt obligations are of a financial nature rather than commercial or trade debts.

2.11 New Financing during a Workout

Since most enterprises undertaking a workout are typically in serious financial straits, they may not be able to continue operating through the OCW or the hybrid procedure without additional financing. Without new financing arrangements, the debtor enterprise may experience liquidity problems and be forced to resort to formal insolvency proceedings. Additional financing may also be necessary to satisfy the claims of smaller creditors so that negotiations may be kept to a manageable number of parties. Therefore, additional funding (sometimes referred to as "new money") is often an important prerequisite of a successful debt restructuring.

An effective way to encourage lending to distressed enterprises is to accord priority status to new funding. Given the importance of such additional financing to the enterprise's survival (and consequently the potential benefit for all creditors), as well as the additional exposure and risk that the lender (often the lead bank) is taking on, many jurisdictions understand the importance of allowing providers of additional financing a super-priority over other, existing creditors. However, obtaining funds during the informal process can be a significant problem because, even though there is some provision under formal proceedings for a type of "super priority" for a debtor's post-commencement financing, that law normally does not extend to such an arrangement under the informal process. Therefore, priority of new money will normally require the prior approval of creditors (or of a committee of creditors).

Another way of attracting post-commencement financing is by providing creditors with additional security over the debtor's assets. The negotiation of new security and the provision of new money for the debtor are also considerably easier under a workout, as important rigidities and requirements of formal processes are avoided. In a number of cases such security may not be granted, either because of the existence of a negative pledge provision in ongoing financing agreements, or because of the lack of available unencumbered assets. In those cases, creditors will again need to reach an agreement in order to ensure that the new money will be accorded priority status. In any case, it is important to review existing legal provisions related to creditor priority in a liquidation to make sure that the grant of super priority is not prohibited by local laws and, importantly, that such a priority will apply even in the event of a subsequent liquidation should the workout attempt fails.

2.12 Potential Impediments in Other Laws

The existence of priorities in other laws, and the priorities that they or prior contracts might confer on creditors, could impact the dynamics of the negotiations. It is therefore important to understand the existence of such legal priorities in the relevant jurisdiction, whether the priorities could survive liquidation, and whether they will ultimately affect bargaining positions.

Tax laws in numerous jurisdictions often give rise to difficulties in implementing workouts, because tax laws may not allow write-offs of the value of the loan. This creates certain inefficiencies because the tax authority is sometimes protected by a super priority and can end up obstructing the success of a restructuring. Other concerns are considered in Box 2.

2.13 The Classification of Claims

A debtor seeking to achieve a workout may have a number of different creditors to whom it owes various sums pursuant to different types of transactions (financial, commercial, etc.) and different legal structures (unsecured, secured, other priorities, etc.). In such a context, achieving debt restructuring without the involvement of the court requires coordinating and motivating these different groups of creditors as well as providing

BOX 2: Tax Considerations in Out-of-Court Workouts

In debt restructuring, tax policy plays a key role in creating adequate incentives for parties to engage in informal agreements. While debt-restructuring transactions that occur within in-court proceedings are usually exempt from taxation, this is not usually the case for identical transactions negotiated out of court. In fact, many restructuring transactions—such as outright write-offs, debt forgiveness, debt-to-equity swaps, and simple sales of assets in exchange for debt—result in a tax obligation for the debtor or the creditor.

Two typical impediments that arise are (1) the tax treatment of debt forgiveness and (2) the deductibility of losses. Both obstacles occur, for instance, when a creditor accepts a partial write-off or a reduction on the principal of the loan in a workout settlement. Under the first impediment, the amount written off is sometimes considered an extraordinary income or "gift" received by the debtor, and is therefore treated as taxable income. This classification creates a significant tax burden on an already cash-strapped debtor, and allows the tax authorities to make a "profit" out of the amounts sacrificed by creditors. The second impediment consists of the impossibility of a creditor to deduct the losses incurred in a restructuring transaction, including the amounts of the claim written off to allow the survival of the debtor. Although these amounts are typically regarded as losses under applicable accounting and regulatory legislation, tax laws may impose additional stringent requirements to allow their deductibility for tax purposes, such as, having exhausted collection efforts. This restrictive interpretation of losses significantly discourages creditors from engaging in restructuring transactions.

Tax rules are designed to protect government revenue, and as such, to accelerate income recognition and minimize deductions. However, these overarching goals may undermine successful restructuring and de facto minimize the tax base during financial crisis: the more businesses liquidated, the lower the tax base will be. For this reason, several countries have introduced exemptions in their tax codes that promote corporate rescue and allow a neutral treatment of out-of-court restructuring.

a mechanism that simplifies voting and ensures an efficient and equal treatment of claims. In order to achieve the above objectives, creditors are usually divided into separate classes for the purpose of treatment of their claims based by the reorganization plan.

The classification of claims in OCWs has a different function than in the context of formal proceedings. More specifically, classification may help the debtor treat similarly situated creditors consistently as well as identify those creditors that are the most significantly affected in the restructuring. On the other hand, classification cannot provide a mechanism to bind holdout creditors through a cram-down mechanism as in the case of formal proceedings (except to the extent that financing agreements provide a majority mechanism for altering the terms of transactions). The only leverage participating creditors have to persuade a holdout to cooperate is market leverage and peer pressure, especially if the participating creditors do other business with the holdout except from the particular restructuring. In general, creditor classification in the context of OCWs may prove a valuable technique for reducing the costs and complexities of restructuring and also ensuring that similarly situated creditors are treated equally.

2.14 The Possible Role of a Mediator

Workouts succeed when there is open dialogue and good-faith negotiations between the debtor and its creditors. At times, these intangible elements may be missing. Mediators or conciliators are a means of support. They can be used in a variety of restructuring models, but are particularly beneficial in workouts.

Mediators assist the parties by operating like intermediaries or referees in that they facilitate the creation of an agreement between disputing parties; however, mediators are not enabled to make binding decisions for the parties. Instead, the goal is to guide the disputing parties to reach their own resolution. Mediators are independent and objective third parties, and they frequently have vast experience in mediation as well as knowledge about the topic being mediated.

Mediation is a growing trend, although it is most often used in common law jurisdictions. The use of a “conciliator” in civil law jurisdictions can be seen in France and Greece or a “mediator” in Belgium, where the insolvency laws expressly include the use of these alternative dispute-resolution mechanisms to overcome differences between the parties. In addition, the *UNCITRAL Practice Guide on Cross Border Insolvency Cooperation* expressly acknowledges the important role that mediation plays in the field of insolvency law.[31]

3 Informal Out-of-Court Workouts

3.1 What Are Out-of-Court Workouts?

As defined in the Glossary, a workout for the purposes of this Toolkit is defined as a nonstatutory agreement between a debtor and creditors with the aim of easing the debtor's debt-servicing burden so that it can maintain its business activities and value. Out-of-court workouts have no judicial involvement. This informal restructuring process is akin to a private reorganization,[32] and involves changing the composition of assets and liabilities of debtors in financial difficulty.[33] As discussed in Chapter 2, OCWs often contemplate a debt rescheduling between the debtor and its creditors, and encompasses a wide array of other possibilities.

An OCW regime is not structured by formal rules and modes of participation. The whole procedure is driven by the players and their needs, outside of the formal court system.[34] All stakeholders who are to be bound by the terms of the restructuring plan need to be persuaded that the plan is in their best commercial interests. If the going concern value of a firm exceeds its liquidation value, most stakeholders will have an incentive to prefer a workout.

3.2 The Advantages of Out-of-Court Workouts

Advantages of an OCW include that they are:

- *Fast,* as there are no procedures with pre-established timeframes to follow. If agreements with creditors are properly conducted, and with the right incentives in place, the process can be relatively quick.
- *Flexible,* because parties are free to agree to the terms of the restructuring in their most convenient way (for example, an agreement does not have to observe the priority rule, and parties can decide what to do with their security interests).
- *Informal,* because the agreement is conducted privately between parties, and is therefore subject only to the formalities of a valid contract under the governing law of the agreement.
- *Confidential,* since the private agreement is not publicly disseminated. OCWs are less prone to unwanted publicity and speculation, and are therefore a good option for preventing reputational damage to the debtor.[35]

3.3 The Challenges of Out-of-Court Workouts

As discussed in Chapter 2, there are several challenges to workouts (such as tax disincentives). Some additional impediments specific to OCWs include:

- *Creditor "hold-out"*: The drawback of OCWs is that due to their contractual nature, they are only binding upon signatories. Unless there is unanimity among the participating creditors, there is a risk of the so-called "holdout creditor" problem occurring.[36] Holdout creditors benefit at the expense of the agreeing creditors because the holdout creditors are not bound to the agreement, and they must therefore be paid in full, to prevent them from commencing a legal claim against the debtor. In some circumstances, holdout creditors are not a concern (for example, it may be understandable to permit a small or special creditor to be excluded from the proposal and collect its debts in full). In other circumstances, a holdout creditor may be viewed as a free rider and prompt other creditors to not agree to postpone or reduce their debts unless all creditors of that class unanimously agree to the agreement. The holdout creditor problem may be avoided with a hybrid model, which gives the court the power to impose the terms of the plan on dissenting creditors.

- *Collective responses*: An OCW is only possible if the enterprise's main creditors are willing to explore it as a viable option. That means it offers the prospect of a higher return than the statutory alternatives. The main creditors will act as a critical mass that can induce other creditors to join (or not). For example, if a major creditor does not agree with the terms of the OCW or holds out to get paid in full (or to force the debtor to make a better offer), the workout will be at risk because others might follow suit (herd behavior[37]).
- *Creditor identification/organization*: The sale of debt in secondary markets and risk hedging tools can make it more difficult to identify and organize creditors aiming at coordinating a negotiation strategy.[38]
- *Coordinating participants*: Negotiations are enhanced when the creditors appoint a leader (and, if need be, a creditors' committee) to facilitate discussion among fragmented participants, and better disseminate competing viewpoints.
- *Aggregation problem*: There are frequently different types of creditors with distinct interests (for example, secured and unsecured), so it may be hard to engage in meaningful negotiation if various classes of creditors are all present. It may make negotiations easier to separate them into homogeneous groups and have multiple OCWs based on types of creditors, or focus only on a select group of creditors.
- *Requirement for good faith*: An OCW agreement can only be successful where there is real commitment to negotiate on the part of the financial creditors—either due to their desire or initiative, or simply by necessity. OCWs should be binding on all creditors, but the contractual nature of such procedures means that every creditor must give its individual consent to the agreement for this to happen. OCWs are different from court-supervised procedures in that there is no statutory stay, and therefore the status quo can be altered at any time by a dissenting creditor rushing to the courthouse. A contractual stay can mitigate this, but again it requires unanimous agreement to be effective. The lack of a formal stay or moratorium on creditor demands while resolving the enterprise's problems represents a weakness of OCW mechanisms. Creditors may simply not consent to delay enforcing their debt while waiting for a private agreement to be reached. Changes to the composition of the syndicate as a result of debt trade can disrupt negotiations as new creditors take time to comprehend the detail, often wishing to reopen negotiating ground that has already been covered.[39]
- *Requirement for cooperation:* A workout entails a substantial degree of cooperation. Each creditor must agree not to press for repayment until the viability of the enterprise has been assessed and a consensus reached on a way forward. In particular, secured creditors must stay from enforcing their rights, although non-secured creditors should also refrain from making demands for repayment. The use of OCWs involves challenges due to the growing complexities of capital structures in a way that each creditor approaches the restructuring. As the European High Yield Association noted in 2008, "Stakeholders approach each restructuring with their own agenda and strategy, often looking for positions of control and influence to gain leverage, not always seeking common ground and consensus."[40]

- *Informality might be too challenging in some jurisdictions*: The absence of a predictable restructuring process (to say nothing of the absence of a predictable liquidation process) may create a level of uncertainty that would mean that OCWs are not attractive to stakeholders, particularly in cases of larger-scale enterprises. In such jurisdictions, it is necessary for the design of OCW guidelines to be as simple as possible, and for expectations of the pace of development of the workout culture to be realistic.
- *Information asymmetry*: Imbalances in the information publicly available and the interrelationship between the debtor and its creditors can create conflicts of interest between creditors and coordination problems.[41] To prevent this, the debtor should provide its creditors with full disclosures of all financial and market information relevant to the decisions being asked of them.
- *Insolvency law*: Typically voidance actions nullify agreements that involve the creation of additional securities or preferences, while the enterprise is on the verge of insolvency. These common provisions, if not mitigated, may create disincentives to achieve workouts because creditors may be reluctant to enter in agreements that can be easily nullified in a liquidation scenario.

3.4 Implementing an Out-of-Court Framework

OCWs, by definition, are *voluntary* informal proceedings. Conducting an OCW does not need to involve establishing specific institutions or mechanisms. Instead, many countries have chosen a consensual approach to OCWs through the issuance and dissemination of nonbinding OCW guidelines for parties to follow when conducting an informal restructuring. The consensual approach is inspired largely by the so-called London Approach, the product of extensive experiences with multiparty OCWs in the United Kingdom.

In the 1980s, the Bank of England consolidated the debt restructuring practices of financial institutions into a set of nonbinding guidelines that the Bank of England then promoted. The London Approach has inspired other debt-resolution models, such as INSOL Statement of Principles for a Global Approach to Multi-Creditor Workouts (the INSOL Principles) (discussed in detail later), as well as a number of country-specific models, including the Bangkok Rules,[42] the Istanbul Approach,[43] and the Jakarta Initiative.[44]

The specific actions required to institute OCW guidelines as the basis for an out-of-court workout system include:

- Understanding the existing insolvency framework (or lack thereof);
- Designing and issuing guidelines; and
- Communicating the insolvency framework to various stakeholders.

3.4.1 Understanding the Existing Framework

The first stage of any implementation program is to review how lenders currently work with borrowers and other lenders to resolve debt situations. This review is key to designing OCW guidelines that conform to local laws, circumstances, and practice. For example, differences in practice or exposure between foreign and domestic lenders may call

Tenets of the London Approach

1. The lenders agree not to pursue enforcement actions against the debtor;
2. The debtor provides relevant information on its financial situation to all lenders, who agree to keep this information confidential;
3. The lenders use this information to evaluate the business's viability and determine whether to continue to support it;
4. The burden of supporting the debtor (e.g., the provision of additional financing) should be shared by all lenders equally.

for a different approach to how losses are shared among creditors; the approach would need to be taken into account in the design and application of OCW guidelines. Similarly, while certain countries may already have a highly developed creditor culture—perhaps aided by the presence of foreign financial institutions that are familiar with multi-party OCW practices in other countries in which they do business—other countries may not have a strong tradition of an independent and proactive creditor culture. There may also be impediments that discourage parties from pursuing OCWs (for example, tax laws or labor laws, as discussed in Chapter 2). It is important to gauge the country's familiarity with workout practices, because this can impact whether a more concerted communications strategy is more appropriate than would otherwise be the case.

To evaluate the existing situation, it is necessary to engage in a fact-finding mission and meet with representatives of the various stakeholder groups, determined based on the case's unique circumstances (common stakeholders can be found in Chapter 2). The fact-gathering process takes about one week. Afterward, the information should be compiled into a research report that clearly outlines the current situation and identifies areas on which to focus the new insolvency framework. The World Bank Group can provide assistance in such evaluations.[45]

3.4.2 Design and Issuance of Guidance

Based on the report, the second step is issuing voluntary OCW guidelines for borrowers and relevant creditors[46] to follow in negotiating OCWs. The OCW guidelines should set out basic tenets for OCWs and provide commentary on how they can be put into practice. Before being issued, these guidelines should be reviewed by different stakeholders (for example, the central bank, regional lawyers, etc.). These guidelines should be as brief as possible, since they are statements of guidelines rather than binding regulation.

The form of the guidelines need not adhere to any particular template. The issuing institution may see fit to send a letter with the guidelines to the stakeholders, or simply to publish them on its website.

3.4.3 Implementation of a Communications Strategy

The OCW guidelines need to be publicized in a manner that educates lenders and borrowers on the utility of OCWs. If lenders and borrowers are not persuaded that alternatives to judicial reorganization will produce the best outcome, the OCW Principles will not achieve their goal of rescuing troubled enterprises and reducing the amount and volume of nonperforming loans in the private sector. A communications strategy needs to be adapted to the local environment. Less intense communications efforts may be needed in countries with more developed insolvency and financial systems, a more developed creditor culture, and greater awareness and cultural acceptance of insolvency as a useful tool for debt resolution and enterprise restructuring. In countries where such conditions do not exist, a targeted, customized communications strategy is needed.

To disseminate the OCW guidelines most efficiently, financial institutions that act as senior lenders in multi-lender situations often guide other lenders and the borrowers through the OCW process. (Since banks typically account for the largest portion of private sector lending, the central bank, as the regulator of banking institutions, is also a natural authority to provide guidance on bank practice. See Chapter 4 for an example of the role the Reserve Bank of India plays in a workout regime.)

Once convinced that OCWs represent their best chance for optimum returns, these lenders could play an important role in advising borrowers of restructuring options. The scope of the communications strategy should not be limited to banks and financial institutions; other bodies, such as chambers of commerce, could be used to disseminate the guidelines. Third-party insolvency representatives can also be integral to communicating restructuring options because they are often client-facing and considered authorities on the subject.

In addition, and at a minimum, it would be appropriate to conduct dissemination workshops for all stakeholders soon after the issuance of the OCW guidelines. Other types of communications efforts that may be appropriate on a case-by-case basis include:

- A series of speeches by government and bank officials promoting OCWs;
- A series of articles to familiarize the lending and business communities with OCW guidelines;
- Roundtable discussions to examine issues that arise during workouts;
- Follow-up seminars on specific topics, such as:
  - Loss-sharing among creditors;
  - Problems faced by lead banks;
  - How to coordinate steering committees;
  - Debt-to-equity swaps;
  - Engaging insolvency representatives;
  - Negotiation techniques;
  - Using unresolved workout negotiations as bases for an expedited proceeding/pre-packaged restructuring;
  - SME debt-resolution issues;
  - Conflict-of-interest issues; and
  - Other topics as appropriate.

3.5 INSOL Principles for Out-of-Court Workouts

The INSOL Principles of the International Association of Restructuring, Insolvency and Bankruptcy Professionals (the INSOL Principles), published in 2000, are a modern version of the London Approach. They are regarded as a set of best practices for private rescue arrangements[47] in all multi-creditor workouts. The INSOL Principles encourage financial creditors to take a collective, coordinated, and cooperative approach to debtors in difficulty and, most important, facilitate the rescue of debtors.

The eight INSOL Principles are listed here and followed by a short commentary on their most salient aspects. Policy makers should consult the principles when establishing guidelines.

FIRST PRINCIPLE: Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to cooperate with each other to give sufficient (though limited) time (a "Standstill Period") to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.[48]

Commentary

1. No enterprise has a "right" to conduct an OCW: the granting of a standstill period is a concession by creditors and not a right of the debtor. The debtor (and, if applicable, the debtor's advisors) therefore needs to assess whether there is a realistic possibility that financial difficulties can be resolved and the enterprise's long-term viability restored. If a possibility does not exist, alternative remedies should be considered, including liquidation of the enterprise through formal bankruptcy proceedings.[49]
2. As explained in Chapter 2, the standstill period allows the debtor time to prepare a restructuring plan. The plan must show that the business is capable of operating profitably and the extent to which the debtor will be able to repay its debts. There is no prescribed minimum requirement to the contents of a restructuring plan, but it is imperative for the debtor to show in the plan that there is a reasonable prospect that the enterprise will be viable within the foreseeable future.
3. The reference to "all relevant creditors" means all creditors whose rights will be affected by the proposed restructuring.
4. The unanimous support of all relevant creditors is essential to the restructuring's success. As a result, the number of creditors being included in

the restructuring should be strategically planned to minimize the complexity of the negotiations. If there is not enough creditor support for granting the debtor a reprieve to find a solution for its financial difficulties, the restructuring cannot proceed because the lack of court intervention means that there is no way to force opposing creditors to come to terms against their will.[50] That said, the way in which the first INSOL Principle is expressed makes it plain that what is hoped to develop, over time, is a willingness of creditors to participate in the process with the understanding that it is not uncommon that enterprises could get into trouble, and that if creditors are informed of the current situation and future prospects, they could be better off by accepting the restructuring.

5. The standstill period should be limited to the time required to produce a restructuring plan, or to establish that such a plan cannot be produced within an acceptable time. It would be unusual for the initial standstill period to be longer than a few weeks, although this will vary from case to case.[51] This is discussed in Chapter 2.
6. During the standstill period, it is essential that creditors receive sufficient current and reliable information to enable them to assess the debtor's financial position, to understand the causes of the financial problems, and to evaluate any solutions proposed. This is discussed in Chapter 2.
7. An ever-present challenge for the debtor is the natural tendency of many creditors to adopt an "each creditor for itself" approach and to pressure the debtor for payment on an individual basis. The effectiveness of such a strategy will depend in part on the provisions of local insolvency law dealing with transactions undertaken on the eve of a debtor's insolvency. For example, in some jurisdictions, the application of such pressure can be a defense to a claim brought by a subsequent liquidator to challenge the validity of the transaction as a preference. The prospects of success of the out-of-court workout are diminished as the commercial significance of such transactions increases.

SECOND PRINCIPLE: During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.[52] Conflicts of interest in the creditor group should be identified early and dealt with appropriately.

Commentary

1. The objective of this principle is to achieve stability and to maintain the pre-standstill status quo among existing relevant creditors.[53]
2. The attractiveness of the workout process can be enhanced by the involvement of qualified professional advisors or government agencies that have the required know how and/or can earn the respect of the creditors.
3. All creditors must be confident that, in deciding not to pursue their individual remedies, they will not be prejudiced vis-à-vis other creditors if a consensual way forward for the restructuring of the debtor could not be found. Each creditor's relative ranking must neither be worsened nor improved during the workout process unless voluntarily agreed.
4. In those cases where there is a written standstill agreement, it will be necessary for the creditors signing up to it to agree, during the standstill period:
   a. Not to try to improve their positions relative to other creditors;
   b. Not to insist on payment of amounts owed to them;
   c. Not to initiate collection, security enforcement, or winding-up proceedings; and
   d. To allow existing credit lines and facilities to be used.
5. A written agreement is not always necessary, as there can be an informal understanding among the most important creditors that they will work together toward a solution.

THIRD PRINCIPLE: During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.[54]

Commentary

1. If the creditors are to expressly or tacitly agree that they shall not take any steps intended to enable one (or one group of them) to gain an advantage over other creditors, it must follow that the debtor must also agree not to undertake any activities or transactions which would be detrimental to the interests of any creditor or class of creditors, or alter their respective priority positions.
2. One important exception to this principle must be the ability of the debtor to continue to make payments in what is commonly referred to as "the ordinary course of business," as otherwise the debtor would not be able to continue to trade while attempts are made to agree to the terms of a workout. What must be avoided, therefore, are transactions that are not for full value, the making of preferential payments, the granting of security for past debts, or incurring new borrowings without creditor consent.

FOURTH PRINCIPLE: The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative coordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.[55]

Commentary

1. All negotiations between the debtor and relevant creditors must be conducted in good faith, in an atmosphere of honesty and frankness, and with the objective of finding a constructive solution. If any parties lose confidence that their counterparts are negotiating in good faith, the negotiations are likely to fail. Consequently, creditors will fall back on their legal remedies and enforcement proceedings and/or insolvency proceedings are likely to begin.
2. Unless the negotiations can be conducted on a bilateral basis, the number of constituencies that could be involved in a corporate workout and their different priority positions in the event of liquidation means that it is often advisable for committees to be formed and for professional advisers to play their part in achieving a consensus. These committees will include different types of creditors or the most representative creditors and are normally used to facilitate the representation of creditors and the communication with and among them.
3. Relevant creditors or any coordination committee may wish to consider appointing one person (for example, the creditor with the greatest exposure or experience managing workout negotiations, or an independent third party) or a small representative group of creditors (usually not more than three, and the creditors with the greatest exposure or a representation of creditors from different classes) to lead negotiations on their behalf with the debtor.
4. If the creditors experience difficulties in reaching an agreement, it is appropriate to consider whether mediation can be used as a workout tool. Any agreement reached between or among certain creditor groups on this basis can be conditioned on an overall workout plan being agreed upon that also includes them.
5. It may be appropriate for the costs of outside advisers (perhaps within specified limits, or "caps") to be paid by the debtor.

FIFTH PRINCIPLE: During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers' reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.[56]

Commentary

1. The integrity of the process depends on creditors being provided quality information regarding their debts. Although time is in most cases of the essence—and indeed the tension of deadlines serves a valuable purpose in reaching agreement—the standstill period must be sufficiently long to enable information gathering, dissemination, and analysis.
2. It is in the debtor's interest to disclose all required information. At the very least, this information will include full particulars of the debtor's assets and liabilities, and of the debtor's future business prospects. Full disclosure may require that the debtor produce forecasts and projections that are more detailed than those it would normally prepare.
3. The creditors must also have sufficient time to consider the details of the workout solution being proposed.

SIXTH PRINCIPLE: Proposals for resolving the financial difficulties to the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.[57]

Commentary

1. Absent special circumstances, creditors will wish to be assured that the debtor will treat like creditors alike both throughout the workout process and in any proposed plan.
2. The provisions of local bankruptcy law should serve as the guide to the relative priority position of creditors. For example, unless local bankruptcy law specifically so provides, it will generally be unacceptable if deferred creditors or shareholders are to benefit to any extent while unsecured or secured creditors are not being paid in full.
3. Creditors will analyze their position under different scenarios (for example, in a liquidation or in a reorganization) in order to decide what their view of any proposed restructuring plan should be. That said, creditors may appreciate that it may be necessary for minor trade creditors to be paid in full to achieve greater consensus and also to permit the debtor's enterprise to continue.

SEVENTH PRINCIPLE: Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.[58]

Commentary

1. All relevant creditors should be provided with the same information, and it should be as detailed as the circumstances of the case require. It must in any event be sufficiently detailed to permit creditors to form their own view of the merits of the proposal being put forward by the debtor.
2. If information is price sensitive or in some way the subject of legitimate confidentiality concerns, then confidentiality agreements may be appropriate before the information is made available.
3. Where the relevant creditors are only the debtor's banks, in most instances they can be relied on to treat any information concerning the debtor in confidence.
4. In very complex cases, the issue of debt trading may arise. This raises complex issues, and special conditions may be needed where creditors intend to trade their debt.

EIGHTH PRINCIPLE: If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.[59]

Commentary

1. The ability of the debtor to continue in business during any period of negotiations is central to the notion of an OCW. While some debtors do not depend on third-party finance to operate, many do. In that event, or if additional funding is required for other justifiable reasons during the workout discussions, the sources are typically the proceeds of sale of noncore assets, new investment from shareholders, or additional lending from existing creditors (including banks).[60]
2. Unless a certain degree of priority is accorded to any additional lending, it is highly unlikely that money will be made available, and the workout may fail to survive long enough to permit a workout plan to be fully developed and considered by creditors.
3. The priority treatment that is generally sought and made available for additional finance provided during a workout is often described as a "super priority," mentioned earlier, because the provider of such finance is entitled to be paid in priority to the claims of pre-existing creditors, even if the workout fails and a formal insolvency follows. Because of this super priority, it is often the case that existing creditors (or new finance providers) are willing to provide this form of finance. They see it as a relatively low-risk way of increasing the chances that their existing obligations will be satisfied, if only in part, in the longer term.[61]
4. There are many ways of achieving the desired priority, including the provision of fresh security of some kind (for example, a first ranking mortgage security over physical assets or receivables) and various forms of statutory priority. Care must be taken to ensure that any security will be considered valid in the event of the debtor's insolvency.
5. Questions of priority often raise acute local sensitivities. It is therefore important to examine existing priority provisions under local law to ascertain what priority can appropriately be given to this form of finance.

3.6 Examples of Guidelines for Out-of-Court Workouts and Case Studies

This section presents examples of OCW guidelines adopted in four jurisdictions (Lebanon, Jordan, Latvia, and Mauritius). Needless to say, these OCW guidelines are not identical, because they are tailored to the country's financial sector and needs on the ground. In addition, some are more detailed and/or their length number of principles differ.

3.6.1 Examples of Guidelines for Out-of-Court Workouts

Examples of Some Recently Adopted OCW Guidelines				
	Lebanon[1]	Jordan[2]	Latvia[3]	Mauritius[4]
Principle 1	The debt restructuring is contingent upon the approval of at least two-thirds of the creditor banks and financial institutions that hold at least 60% of the debtor's total bank debts.	Workouts are a concession and not a right. An out-of-court workout should only be commenced if the circumstance of a financially troubled debtor appears to offer the possibility to resolve the financial difficulties and achieve long-term viability. In any case, and despite the non-mandatory nature of these principles, debtors should be encouraged to approach their creditors to discuss options for the settlement of their debts.	Debt restructuring is a compromise, not a right. Out-of-court debt restructuring must be initiated only if the debtor's financial problems can be solved and their business can continue in the long term. A debtor should turn to the creditors in order to discuss available options.	Where a debtor finds itself in financial distress, all relevant creditors should be prepared to cooperate with each other, and the debtor, to provide sufficient (though limited) time—the "Standstill Period"—for information about the debtor to be obtained and evaluated, and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless in a particular case such a course is inappropriate.
Principle 2	The creditor that holds the largest portion of the debt shall manage and supervise the debt restructuring process, and shall be called hereinafter the "Manager," unless otherwise agreed between it and the other creditors.	Good faith. All negotiations between the debtor and the relevant creditors on one hand, and between the creditors themselves on the other hand, take place in good faith with the objective of finding a constructive solution.	Good faith. Negotiations between the debtor and the relevant creditors must take place in good faith in order to create a constructive solution.	During the standstill period, all relevant creditors should agree not to take any steps to enforce their claims against, or to reduce their exposure to, the debtor (this would exclude the disposal of their debt to a third party). However, creditors are simultaneously entitled to expect that their position relative to other creditors will not be prejudiced during the standstill period.
Principle 3	The "Manager" shall set a detailed preliminary plan to deal with the client's situation, with a new repayment schedule based on the client's cash flows, after having: ▪ Examined the client's financial statements (balance sheet, income statement, cash flows)	Confidentiality of Information. Information relating to the assets, liabilities, business and capacities of the debtor and any proposals for resolving his difficulties should be made available to all relevant creditors or their representatives and should, unless already publicly available, be treated as confidential.	Unified approach. The interests of all parties should be observed if a unified approach is taken to solving the issues. Creditors may facilitate coordination of the issues by forming a coordination work group. In more complex situations, the parties should consider the option of inviting	During the standstill period, the debtor should not take any action that would adversely affect the prospective returns to the relevant creditors on a collective or individual basis, as compared to their position at the commencement of the standstill period.

	Lebanon[1]	Jordan[2]	Latvia[3]	Mauritius[4]
Principle 3—*continued*	■ Taken cognizance of all the facilities granted to the client by the creditor banks and financial institutions and by other creditors. ■ Identified the weaknesses that led to the deterioration of the client's financial situation and the way to address these weaknesses.		professionals who can consult with and advise the parties and the relevant creditors.	
Principle 4	The "Manager" shall notify all the creditor banks and financial institutions as well as the Banking Control Commission that negotiations on the restructuring process have started with the debtor, and that banks and financial institutions approving this negotiation undertake to refrain from taking any new legal proceedings against the debtor during the negotiation period.	Debtor's undertaking to the creditors during standstill. During the standstill period, the debtor and his guarantors undertake in writing not to take any action that might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared to their positions at the Standstill Date.	Negotiation with the debtor. The creditors must appoint one person (usually it is the creditor which has the largest claim against the debtor, with experience in negotiating debt restructuring, or it may be a neutral third party), who will conduct negotiations with the debtor, and will ensure that the relevant creditors receive the information provided by the debtor. It must be taken into account that if necessary, in the event that there is a dispute between the interested parties, they may turn to an arbitration procedure.	In an out-of-court restructuring, the interests of the relevant creditors are best served by coordinating their response to a debtor experiencing financial difficulties. In complex cases coordination of this nature may be facilitated by the formation of one or more representative coordination committees, by the appointment of professional advisors to advise and assist such committees and, where appropriate, the relevant creditors themselves participating in the process as a whole.
Principle 5	All the agreeing banks and financial institutions shall participate in the negotiations in order to set a final restructuring or rescheduling program within a three-month period renewable for another three months, with the consent of all banks and financial institutions involved in the negotiation process.	Full disclosure by the debtor during the standstill. During the standstill period, the debtor should provide relevant creditors and their professional advisors and representatives full access to all relevant information relating to his assets, liabilities, business, and prospects.	Moratorium period. All relevant creditors must be prepared to cooperate with the debtor as well as with each other in order to provide the debtor with enough time (identifying a deadline) in which to prepare options for solving financial problems (hereinafter—moratorium period).	During the standstill period, the debtor should provide all relevant information regarding its assets, liabilities, business, and future prospects. All relevant creditors and/or their professional advisors should be given reasonable and timely access to this information in order

(*continued*)

Examples of Some Recently Adopted OCW Guidelines—Continued				
	Lebanon[1]	Jordan[2]	Latvia[3]	Mauritius[4]
Principle 5—*continued*			Granting this moratorium period is not the right of the debtor, but is a concession granted by the creditors. The beginning date is called the first date of the moratorium period. It is necessary to identify the length of the moratorium period, providing enough time to prepare the plan as mentioned in Principle 11, or to constitute how much time would be necessary to prepare such a plan.	to enable a proper evaluation to be made of its financial position, and for the formulation of any proposals that are to be made to the relevant creditors.
Principle 6	Without prejudice to the right of the creditor banks and financial institutions that agree on the restructuring process on the basis of the guarantees given to them, these creditors shall refrain from taking any individual action to reinforce such guarantees during the restructuring process or to start any judicial or enforcement proceedings that might hinder the restructuring process agreed upon with the complying debtor.	Restructuring plan. The debtor and his advisors must prepare a restructuring proposal based on a business plan that addresses operational and financial issues. The business plan should be supported by reasonable and achievable forecasts which evidence the ability of the debtor to generate the cash flow required, according to the restructuring plan. The aim should not be simply delaying insolvency.	Priority of new resources. If, during the moratorium period, or in accordance with the suggestions put forth as a part of the restructuring process, additional assets are given to the creditor, then the grantor of this loan shall have the option to request security for the loan.	Proposals contained in a restructuring plan for resolving the financial difficulties of the debtor, and, in so far as this is practicable, arrangements between the relevant creditors relating to any standstill period, must comply with both the applicable law as well as reflect the relative positions of the relevant creditors at the commencement of the standstill period.
Principle 7	The restructuring process shall not bind any non-consenting creditors.	Proposals must be in line with the legal rights. Proposals for resolving the debtor's financial difficulties should take into account the legal rights of each creditor, separately, and the creditors' legal positions at the Standstill Date.	Creditors do not take action during the moratorium period. All relevant creditors do not take any actions to submit court claims against the debtor or to reduce their claims against the debtor during the moratorium period.	Any information obtained for the purposes of the restructuring process dealing with the assets, liabilities and business of the debtor, as well as any proposals for resolving its financial difficulties, should be made available to all the relevant creditors and should, unless already in the public domain, be treated as confidential.

	Lebanon[1]	Jordan[2]	Latvia[3]	Mauritius[4]
Principle 8		Standstill period. All relevant creditors should be prepared to cooperate with the debtor and each other to give sufficient (though limited) time for the debtor to prepare proposals for resolving its financial difficulties (a "Standstill Period"). Such a Standstill is a concession and not a right. The commencement is referred to as the Standstill Date. The Standstill should be limited to the time required to produce the plan referred to in Principle 6 or to establish that such a plan cannot be produced within an acceptable time.	Debtor's pledge to the creditors during the moratorium period. During the moratorium period, the debtor promises not to take any actions which may negatively affect the proposed debt repayment to the relevant creditors (to all, or either of them individually) in relation to the state at the beginning of the moratorium period.	If additional funding is provided to the debtor during the standstill period, or as part of any restructuring proposal, the repayment of such additional funding should, in so far as this is practical, be accorded priority status as compared to other indebtedness or claims of the relevant creditors that existed at the time of the commencement of the standstill period.
Principle 9		Creditors refrain from action during standstill. During the standstill period, all the relevant creditors refrain from taking any legal measures to enforce their claims against the debtor or to reduce their exposure to the debtor.	The debtor's complete transparency during the moratorium period. During the moratorium period, the debtor shall provide the relevant creditors and advisors with access to all information regarding assets, liabilities, and business transactions and forecasts.	
Principle 10		Coordinated approach. The interests of all parties are best served by adopting a coordinated approach. The creditors may facilitate coordination by selecting a coordination committee. The appointment of professional advisors to advise and assist	Information confidentiality. Information regarding the debtor's assets, liabilities, and business transactions and forecasts, as well as proposals for solving the problems must be available to the relevant creditors and must be	

(*continued*)

Examples of Some Recently Adopted OCW Guidelines—Continued				
	Lebanon[1]	Jordan[2]	Latvia[3]	Mauritius[4]
Principle 10—*continued*		the committee and the relevant creditors should be considered for more complex cases.	confidential, unless it is publicly available information.	
Principle 11		Leading negotiations with the debtor. Creditors should appoint one person (usually the creditor with the greatest exposure; or one with experience in managing workout negotiations or an independent person) to lead negotiations with the debtor and ensure that the relevant creditors receive the debtor's information. Regard should be given to the timely use of mediation to resolve disputes.	Debt restructuring plan. It is the obligation of the debtor and his advisors to prepare proposals for debt restructuring which are based on a business plan that contains information regarding the necessary steps that need to be taken to solve the debtor's financial problems.[62] The business plan must be based on sound and feasible forecasts, which indicate the debtor's ability to increase cash flow to the point that is necessary to execute the debt restructuring plan (and not delaying the insolvency process).	
Principle 12		Priority of fresh fund. If additional funding is provided during the standstill period or under any rescue or restructuring proposals, the settlement of such additional funding should be accorded priority in accordance with a written agreement among the creditors.	Settlement proposals correspond with the party's rights. When creating proposals for solving the debtor's financial difficulties, the parties must take into account the rights of the creditor and the amount of outstanding obligations at the beginning date of the moratorium period.	

[1] The Governor of Banque du Liban, Basic Circular No 135 addressed to Banks and Financial Institutions, 26 October 2015.
[2] Amman Principles for Out-of-Court Debt Workout.
[3] Guidelines and Debt Restructuring Principles on Out of Court Debt Restructuring in Latvia, issued by the Ministry of Justice in association with the state agency "Insolvency Administration," the Latvian Commercial Bank Association, Latvian Certified Insolvency Process Administrator Association, the Latvian Labor Confederation, the Foreign Investor's Council in Latvia, the Latvian Chamber of Commerce and Industry, and the Latvian Borrower's Association approved on 6 August 2009.
[4] Out-of-Court Restructuring Guidelines for Mauritius, issued by the Insolvency Service and endorsed by the Bank of Mauritius dated 21 January 2013.

3.6.2 Jordan, Lebanon, and Latvia

CASE STUDY 1: Middle East and North Africa (MENA): Introduction of Out-of-Court Debt Restructuring in Jordan and Lebanon

Banks in Jordan and Lebanon have traditionally negotiated with their clients informally when they saw distress warning signs. At times they would even cooperate with other banks to better understand the state of affairs of common clients. However, Jordan and Lebanon only recently implemented a structured and transparent framework for private out-of-court debt restructuring workouts.

The formal insolvency regime in both Jordan and Lebanon is outdated and inefficient, and relies on slow and costly court proceedings that are rarely used in practice. In this context and while also assisting authorities to revise the insolvency sections of the Commercial Code, the World Bank Group helped the respective Governments launch an OCW framework in an effort to strengthen creditor recovery by facilitating out-of-court debt negotiation. The initiative started in October 2013 in both Jordan and Lebanon through a first awareness and consultation workshop held in collaboration with the association of banks in each country. The event was attended mainly by middle and senior management of commercial banks operating in the country, as well as representatives of the central banks and association of banks. The workshop aimed at explaining the OCW rationale, benefits, and functioning, as well as identifying the potential idiosyncratic challenges of introducing OCW, in each country.

Following this first event, an OCW framework consisting of 12 straightforward principles inspired by the INSOL Principles was suggested to the banking authorities in these two countries. After careful consideration, each country opted for the approach that was better aligned with its domestic banking culture. In Jordan, it was decided to further tailor the 12 principles proposed and then launch them as guidelines through a public endorsement by the Central Bank of Jordan (CBJ) and the Association of Banks of Jordan (ABJ), in an event chaired by the Governor of the Central Bank, which was held on October 21, 2015. The Banque du Liban (BdL), Lebanon's central bank, adopted its provisions as Circular No. 135 of October 26, 2015. The BdL included prudential incentives to encourage the use of certain new principle-based rules and procedures (see the table prior to this section of Chapter 3, "Examples of Principles for Out-of-Court Workouts") under the supervision of the Banking Control Commission. Despite differences in how these two countries approached OCW structures, the mechanisms adopted by both countries are fully voluntary and out-of-court—no judiciary supervision or validation is required.

In Jordan, the CBJ made clear from the outset the need for extended consultations to gather bank feedback on the OCW principles, an explanatory note for each principle, until consensus on the final text was ultimately reached. Consequently, in addition to the many awareness-raising events that the World Bank Group team held, there were three rounds of written consultations with all banks, requesting feedback. After each round, the team discussed the comments received from the CBJ and ABJ and agreed on amendments to the text, whenever relevant and acceptable, according to the feedback received. The financial community in Jordan requested the introduction of prudential incentives, similar to those introduced in Lebanon. The CBJ has stated its intention to consider granting them on an ad hoc basis.

In Lebanon, reaching consensus among the Lebanese banks was relatively simple, as the Association of Banks of Lebanon (ABL) was actively involved. This was because of the strong position of the ABL in the banking community and its experience in spearheading new initiatives in close cooperation with the BdL. Thus, the main culture-based resistance that the project team had to face was to make sure the debtor's voice was heard in a region where, traditionally, debtors facing financial difficulties were presumed to be acting in bad faith. Technical assistance was provided to ensure that the draft circular on the OCW prepared by the Lebanese banking authorities embodied the fundamentals of OCW principles. This required seemingly endless written comments on the countless versions of the draft circular, in addition to many meetings with the reform champions and key actors at the BdL to discuss and promote the draft circular.

Shortly after the enactment of the Jordan Guidelines in October 2015, the first restructuring case was initiated, involving a local debtor in financial distress and five leading creditor banks. While there was uncertainty throughout the negotiation phase as to the restructuring process and the legal documentation required, the parties have so far acted in good faith and cooperated with each other in their attempt to create mutually beneficial settlements. These experiences can be beneficial to those countries that are introducing a restructuring culture in the banking sector.

CASE STUDY 2: Corporate Debt Restructuring in Latvia

In Latvia, a World Bank Group team assisted the government in improving the insolvency framework through the implementation of the Latvian Corporate Debt Restructuring Guidelines (CDRGs). This was followed by a public–private sector workshop, which was cohosted by the World Bank Group and the Latvian Government, on how to use this tool in out-of-court debt negotiations. The guidelines are a series of principles promulgated by the Ministry of Justice for improving the effectiveness of informal workouts. The CDGRs were promulgated in the aftermath of a financial crisis that affected Latvia in early 2009. As result of the crisis, Latvia saw a two-digit gross domestic product decline, plummeting real estate property values, and a three-fold increase in nonperforming loans. The communication of the CDRGs in August 2009, shortly after the crisis, was timely. It coincided with the early stages of development of restructuring and corporate recovery divisions in the major commercial financial institutions in the country, as a result of the number of enterprises affected by the crisis.

With limited prior debt restructuring experience in Latvia, the workout team of four banks representing 63 percent of the loan market share (9.5 billion Latvian latu, or $18.8 billion) confirmed that the guidelines played a pivotal role in providing a framework to address widespread debt distress in the corporate sector (the national NPL rate was 18 percent as a percentage of total loans). Coupled with proactive risk management tools and the principles set forth in the guidelines, the largest commercial banks have developed a restructuring culture by applying principles contained in the guidelines to foster the use of informal workouts. This provided viability to enterprises with an opportunity to weather the crisis and continue operating.

Success stories such as the restructuring cases of Valmiermuizas Alus and Sportland International show that early detection, good faith negotiations, and multiparty concessions are key to restoring distressed firms and getting them back on track.

The Case of Sportland International Group

Sportland International Group ("SIG") is a multinational manufacturer and retailer of sporting goods from Estonia and operates in the Baltic region. SIG underwent a multi-creditor workout in Latvia. In 2005 the enterprise was reaping the rewards brought by strong economic growth in the region, but by 2007 it anticipated a burst of the economic bubble and started to take conservative steps to lessen pre-orders for the following season and stop opening new stores. When financial difficulty arrived, discussions with the major secured creditors in Estonia, Latvia, and Lithuania (including DnB in Latvia, a subsidiary of Norway's largest financial services group) started early on and led to a multi-creditor restructuring agreement in early 2010.

Viktors Šeršņovs, former head of the Restructuring Department at DnB in Latvia, confirmed that reaching a restructuring plan with SIG was not easy. Key to reaching a restructuring agreement was SIG's early detection of financial distress, its understanding of the steps it needed to take, its early initiation of discussions with creditors, and its laying out of the benefits of restructuring to creditors. The restructuring plan with SIG took several months to complete and required that SIG refrain from further expansion and expenditures, along with changing its management and consolidating subsidiaries. Although some jobs were cut, the restructuring plan allowed the rescue of the business, which ultimately preserved 986 jobs in 106 stores across four countries.

Stakeholders from Latvia who specialize in restructuring and insolvency confirm that timely action, a realistic restructuring plan, new solutions that do not concentrate solely on cost-cutting, multi-creditor cooperation, concessions, guidance from experienced restructuring specialists, and good faith relations and negotiations are the main ingredients for a successful restructuring.

4 Hybrid Procedures

4.1 What Are Hybrid Procedures?

The circumstances of some restructurings may make it necessary for the debtors to have access to the courts in order to develop and/or implement a restructuring plan. Most commonly, this is the case when the debtor cannot continue to operate without the benefit of a court-imposed stay against creditor action, or where it is necessary (in order to make the business viable in future) for the plan to be legally binding on creditors who may not be willing to vote in favor of its terms. In such cases, the procedure can be called a "hybrid procedure" because it combines elements of both the OCW approach and judicial reorganization.

To fully understand the hybrid procedure, it is necessary to understand both OCWs and judicial reorganization. Chapter 3 discusses OCWs, and the following section briefly outlines judicial reorganization. Judicial reorganization is a formal restructuring process that is usually included in a country's insolvency legislation and takes place under the supervision of a court with the assistance of insolvency experts. The court-supervised procedure aims at reducing the financial burden of the debtor enterprise by means of a reorganization achieved through an agreement reached with the legally required majority of creditors and a consequential order by the court imposing the terms of the agreement on all affected creditors. Judicial reorganization only constitutes a valid option if there is a real possibility of reaching an agreement to restructure the enterprise in distress.

BOX 3: A Generalized Description of Judicial Reorganization

Clearly, every reorganization process will differ, depending on the relevant domestic insolvency legislation in a country. This Box sets out a general description of a judicial reorganization process. The initial step in a court-supervised rescue is the submission of a formal request to a court for the commencement of the process, followed by the creditors establishing that the debt is owed.[63] In the process, the court will require information about the business of the enterprise, including its state of affairs and its financial condition. Based on the information presented to the court, the court may impose a time-bound stay (or standstill) on the enforcement of creditors' claims to assist the debtor in trying to rescue the enterprise. Throughout this process and until the plan or arrangement is fulfilled, the debtor is under the supervision of the court or an insolvency representative.

In some jurisdictions (for example, the U.S.), the stay is imposed automatically, without any intervention or decision by the court or any administrative agency. Instead, the debtor obtains a stay simply by opening an insolvency proceeding, and the stay arises by statute. Stays can be varied or eliminated if the creditors can

(*continued*)

BOX 3: Continued

successfully challenge them or their scope. This approach is not considered suitable for transition economies or jurisdictions where the level of trust and confidence in insolvency debtors or in the capacity of the local courts is weak.

The reorganization plan must lead to the rescue of the enterprise while allowing the enterprise to continue its business activity.[64] Some jurisdictions include what is known as a "best interest test" to ensure that any arrangement is better than alternatives to creditors, and a "feasibility test," whereby the debtor must demonstrate that it can meet its obligations under the proposed plan. The reorganization plan needs to be accepted by a specified majority of creditors, after which the court is often empowered to bind (cram-down) the plan on the dissenting creditors.

The debtor and creditors may be unable to create an agreement on which a sufficient majority of creditors agree. In such circumstances, a judicial reorganization allows for orderly liquidation. This is possible because the enterprise continues running until the last instance and under the supervision of a court to preserve its going concern value.

The success of court-supervised procedures depends on the workability of the process itself (for instance, whether the necessary restructuring agreement can be effectively reached by creditors and enforced), and whether the agreement is recognized in foreign jurisdictions (if necessary). Factors influencing the choice of the judicial reorganization proceedings include:

1. Whether the directors are penalized or are held personally liable if they continue to trade or whether they are obliged to commence formal insolvency proceedings;
2. The ability to bind dissenting creditors; and
3. The violability of security, especially security for preexisting debt.[65]

The court-supervised approach is complex because it forces the debtor to face three interest-balancing dilemmas:

1. The risk-shifting incentives of shareholders/managers in the proximity of insolvency;[66]
2. The desirability of workouts to prevent a time-consuming process in which delays are risky for the survival of the enterprise, and the possibility of not being able to contain the damage resulting from bad publicity; and
3. The benefits of a court imposed stay and the possibility of binding dissenting creditors through a formal process.

4.2 The Advantages of Hybrid Procedures

The hybrid procedure is advantageous because it brings together the benefits of the OCW and judicial reorganization procedures. The following advantages that certain hybrid procedures have are particularly notable:

- *Binding nature.* A private agreement reached with creditors is usually presented to the court or administrative authority to approve and sanction. Having the agreement sanctioned in a court makes it binding on and enforceable by the respective parties, which gives the agreement a strong advantage over informal agreements.
- *Cramming-down the agreement on dissenting creditors.* Due to the agreement's binding nature, if the agreement is sanctioned by a court administrative authority, it can often be forced on minority creditors that abstained from or dissented to the agreement, making a court sanction a powerful tool of persuasion.

- *Fairness.* The restructuring agreement, when brought before the court or administrative authority, will be assessed to help ensure that it meets the formal requirements and minimum thresholds required by law to be binding and enforceable, particularly on dissenting creditors.
- *Certainty.* The involvement of the court or administrative authority affords the sanctioned agreement the "blessing" of an independent, objective, and fair third party. The resulting process provides certainty of the validity and inviolable nature of the agreement.

4.3 The Disadvantages of Hybrid Procedures

Although there are no real disadvantages per se, there are several issues that might be of concern to the parties, depending on the circumstances surrounding the restructuring. These are:

- *Publicity.* The process can lose its confidential nature (in light of the court's role) and can dissuade parties from entering workout discussions for fear of the financial repercussions.
- *Possible challenges.* Since the agreement is presented to the court or administrative authority for sanction, it may be possible for opposing creditors, or those that were not included in the agreement, to challenge the outcome. The outcome of judicial challenges is often unpredictable. Nevertheless, the reasons upon which the agreement can be challenged are usually quite limited.
- *Temporary uncertainty.* The judicial or administrative review built in the sanctioning of the agreement takes time, regardless of whether there are challenges (challenges, when present, increase the level of uncertainty and frequently the length of time). While under review, there is a window of time when the status of the agreement is uncertain. In some jurisdictions, the window is very narrow, yet in others it is longer, and the window can be extended as a result of the number of challenges presented by "unhappy" creditors.

4.4 Implementing a Hybrid Regime

This section discusses considerations that policy makers should bear in mind when considering developing hybrid procedures in their own jurisdiction. Secondly, it highlights different types of hybrid procedures to illustrate that countries have developed numerous ways of handling financial distress to suit their unique domestic legal, administrative, and cultural contexts.

Policy makers should foremost bear in mind the main difference between OCWs and other types of restructurings: OCWs can be started by the debtor at any time and for any reason. On the other hand, the need for the court or an administrative agency to be involved in hybrid procedures and more formal reorganizations almost always requires some statutory trigger or approval to enable the debtor to have access to the process. In other words, to develop new, effective hybrid procedures, some measure of legal reform to the domestic insolvency legislation will normally be necessary, whereas for OCWs, informal guidelines can be published without any legislative act. Accordingly, when policy makers are considering putting a hybrid regime in place, the first task of the informed policy maker is to be absolutely clear on what is currently legally permitted and what legal revisions are needed.

Following on from this, there are many cases where local laws already allow for hybrid procedures, but local practice has not developed. In such jurisdictions, law reform may not be necessary, but rather policy makers should focus on dissemination, training, and promotion.

Hybrid procedures are one of the "last pieces in the puzzle" of evolved bankruptcy regimes. For this reason, hybrid regimes present a unique and delicate challenge to law reformers and policy makers in transition economies. Hybrid regimes have for the most part arisen:

- In a piecemeal fashion, often (but not always) by practice rather than by decree or law;
- Over a period of many years; and
- In ways which suit unique contexts and needs relevant to the cases at hand and the time period (for example, whether the context is a financial crisis or otherwise).

What this means is that no two hybrid regimes are exactly alike.

4.4.1 Steps in Developing Hybrid Procedures

4.4.1.1 Step 1

The first step is for policy makers to consider the state of development of its relevant insolvency regime and its most important characteristics. Once there is clarity on that, then it is possible to assess which of the main shared characteristics of hybrid regimes would stand a good chance of working in that respective jurisdiction.

If the jurisdiction in question does not already have a functioning in-court, formal reorganization process, then it might be more difficult for any hybrid proceeding to work. In such cases, policy makers should consider whether it might be better to adopt some form of OCW guideline (discussed in Chapter 3). There should be pressure on the central bank to assist in this by endorsing the guidelines, and for banks doing business there to improve their practices by participating.

4.4.1.2 Step 2

If the jurisdiction in question does have a functioning reorganization regime, but does not (yet) have a cadre of competent insolvency representatives in whom the public have confidence, then experience suggests that one of the more effective hybrid model to be introduced first should be a U.S.-style pre-pack. The advantages of this are as follows:

- It permits the development of a confidential out of court solution which the court can endorse;
- The debtor will take care to ensure that the voting protections for creditors already provided for in the formal process will be respected when the pre-pack is put to the court for approval;
- Cram-down is possible;
- Such pre-packs are in use in many jurisdictions, both common and civil law based, and this will reassure policy makers locally;
- Importantly, there is no need, in order for this approach to be taken, for there to be a cadre of insolvency representatives in place to assist;
- Legislative change may be needed to permit an application to court for approval of the deal. There may be sensitivities about requiring the opening of a formal "bankruptcy proceeding" for this purpose, but cram-down is a huge advantage.

4.4.1.3 Step 3

If the jurisdiction in question has both a functioning judicial reorganization regime and a cadre of competent insolvency representatives in whom the public have confidence (whether licensed and regulated or not), then this opens other possibilities.

- A U.S. pre-pack approach will of course still be possible;
- Appointment by the court of an independent insolvency representative to assist the debtor develop a plan, followed by a pre-pack, but with no stay;
- Appointment by the court of an independent insolvency representative to assist the debtor, followed by a pre-pack, with a stay.

In latter two cases, other policy decisions and implementing legislation may be needed. These might include determining the following issues:

- What financial condition must the debtor be in to have access to the court to ask for the appointment of the insolvency representative, and should the requirement vary depending on whether a stay is sought as envisioned in the two latter points above?

- What should the insolvency representative be called once appointed, e.g., facilitator or representative?
- What are the tasks of the appointed person, and should this be set out as a statutory list or in court orders?
- What are the necessary time limits?
- How is new financing dealt with, including the priorities allocated (as discussed in Chapter 2)?
- Should it be necessary for the debtor to have opened an insolvency proceeding to benefit from the assistance of the insolvency representative? Or should it only be necessary if the debtor wants the benefit of a stay?
- What should the scope of the stay be?

4.5 Early Intervention Models

Over the past several years, there has been a focus on pre-insolvency and early intervention systems that seek to save businesses that might be experiencing financial distress, but are not yet in a technical state of insolvency. Such measures have been particularly important in Europe, where European Commission analysis showed that about 50 percent of enterprises do not survive the first five years of their life.[67]

The EU adopted Council Regulation (EC) 1346/2000 on Insolvency Proceedings, which became effective on May 31, 2002 (it was revised in 2012, with the revisions to become effective in 2017). The main features of the regulation are: (1) it provides a uniform set of conflict of law rules to determine jurisdiction between member states in relation to insolvency proceedings; (2) it allows domestic courts of any member state to assert jurisdiction over an entity if its center of main interests ("COMI") is located in that jurisdiction; and (3) it regulates significant consequences of that assertion of jurisdiction, notably, applicable law, recognition, and procedural coordination.

The revised regulation that takes effect in 2017 provides for more hybrid, pre-insolvency restructuring proceedings in an attempt to avoid costly insolvency procedures that do not necessarily rescue businesses effectively. Moreover, a 2014 recommendation by the EU Commission[68] encouraged member states to put in place a framework that enables the efficient restructuring of viable enterprises in financial difficulty and give honest entrepreneurs a second chance. This promotes entrepreneurship, investment, and employment and helps reduce the obstacles to the smooth functioning of the internal market.

The following is a discussion of various country examples where pre-insolvency procedures have been introduced or have added more options for early rescue in their legislation. The objective of providing such examples is to emphasize how varied hybrid procedures are and that they can be developed for the local context.

4.5.1 Italy

In Italy, a debtor in financial difficulty may file with the competent court for a pre-insolvency procedure, even when it is only in a crisis situation (*stato di crisi*) and not technically insolvent. The Italian Bankruptcy Law does not define the concept of "crisis," but this situation will generally occur when there are financial difficulties (not necessarily reaching insolvency).[69]

The debtor must file a petition with the competent court, accompanied by a proposed plan certified by an expert opinion confirming its feasibility and the truthfulness of the accounting data. The bankruptcy court does not have the power to examine the expert's opinion on the feasibility of the plan, limiting its activity to check if the procedure has been fulfilled and if the classes of creditors have been formed according to the law. The debtor may ask for authorization to obtain interim financing by granting first priority to the lender offering it.

BOX 4: Summary of the European Commission's Recommendation Regarding Early Intervention

The European Commission published a 2015 report[70] that offered recommendations to its member states about implementing efficient pre-insolvency frameworks. This is discussed in the Introduction above. The EC emphasized the need for its member states to have methods of early intervention to increase the potential for firms to survive financial distress. It outlined 12 "indicators of efficiency of preventive restructuring frameworks."[71] Within each indicator, the EC created a grading scheme with higher values assigned to what it considered best practices. The following is the list of indicators with the associated feature that the EC assigned the most value:

1. Existence of early restructuring possibilities: Early restructuring (as soon as the debtor is in financial difficulties) is preferred. The recommendation is that the procedure should be available before insolvency, when insolvency is imminent or foreseeable, but has not yet happened, or even simply when the debtor is in financial difficulty.
2. Conditions for initiating the early restructuring process: Preferably the debtor is still making payments (not in cash flow insolvency). The rationale for this recommendation is that the easier the test for initiating the procedure, the more accessible it will be for debtors or creditors if they are allowed to initiate reorganization. It is best not to require expert opinions or audits before allowing access to the procedure. In some countries, such as Croatia, the debtor must only have an unsettled obligation in the registry, or be delinquent by 30 days on employee salaries or payroll taxes.
3. Existence of alternative preventive procedures: A variety of options are preferred.
4. Debtor's control of the business operations/administration: Preferably the debtor retains control of the operations and administration of the business (that is, it is not automatically transferred to an insolvency representative). A pre-insolvency procedure is not likely to succeed if the debtor does not continue to operate the enterprise. The rationale behind this recommendation is that the debtor's current management knows the enterprise best, and removing it would interrupt operations and make rehabilitation unlikely.
5. Possibility of a moratorium (that is, a stay of individual enforcement actions by the creditors against the debtor): Preferably debtors have the ability to request a moratorium for protection from individual enforcement (discussed in Chapter 2). The recommendation is that the length of the moratorium should balance debtors' and creditors' interest, and should be long enough to allow a chance at negotiations but not long enough to directly cause additional creditors' losses.
6. Length of the moratorium: Ideally not less than two months.
7. Majority decision on plan approval as opposed to the requirement of full consensus among creditors (cram-down): Majority rather than unanimous consent is preferred.
8. Possibility to obtain new financing in preventive procedures: Preferably new financing that is exempt from avoidance actions.
9. Limited court involvement: Court involvement is ideally limited to appointing the insolvency representative and confirming the plan. The rationale is that the court needs to be available to ensure that creditors' rights are protected, but should not be the driver of the process. The negotiation should be largely driven by the debtor and creditors, with the insolvency administrator overseeing the process. The court should be available to resolve disputes if necessary and ensure that the approved plan is within legal limits and adequately protects all parties' rights.
10. Confidentiality of the proceeding: Confidentiality throughout is recommended. It can encourage debtors to use a pre-insolvency procedure so that the debtor may negotiate with creditors before news of its insolvency is published.
11. Existence of early warning procedures of insolvency: Debtors should be provided five or more tools to help them recognize when they are in financial distress.
12. Debt discharge possibilities following an entrepreneur's bankruptcy: All debt should be discharged within three years and without requiring a repayment threshold.

The grading scheme appears to indicate that the EC favors hybrid forms of pre-insolvency restructuring. (Certain traits of hybrid forms are assigned higher values, for example, some court involvement is preferred to full court involvement, majority approval and cramming-down are preferred to unanimous consent, and the ability to impose a moratorium is preferred to no moratorium). Nevertheless, the EC does not explicitly recommend one form of pre-insolvency restructuring over another, but rather indicates that enterprises should have a variety of options from which to choose.

After the most recent amendments of the bankruptcy law, creditors holding 10 percent of the debt may propose competing plans. After filing for a pre-insolvency procedure, the creditors are subject to a moratorium on enforcement action. Creditors representing a majority of the debt must vote for approval of a pre-bankruptcy settlement agreement. A court will approve the plan if the creditors vote in favor of it. The court may also approve it against the will of a dissenting creditor if it can determine that the creditor receives as much under the plan as it would in liquidation. The proceedings must be concluded within six months from the date of filing the petition, which can be extended by the competent court for an additional two months.

The Debt Restructuring Agreement (*accordo di ristrutturazione*), pursuant to Article 182 of the Italian Bankruptcy Law, is an out-of-court procedure that allows the debtor to negotiate with its creditors, mostly bank creditors. Despite the out-of-court nature, a debtor may file with the competent court for a moratorium during the negotiation period for a Debt Restructuring Agreement. If bank creditors holding 60 percent of the debt approve the plan, it is binding on dissenting creditors. Unlike the pre-bankruptcy settlement agreement in *concordato preventivo*, a Debt Restructuring Agreement only applies to the parties to the agreement. The competent court can grant judicial approval of the agreement once it has ruled on any opposing actions. The court's decree of approval is then published in the Companies' Registry.[72]

4.5.2 Croatia

In Croatia, a filing for pre-insolvency may be done based on the threat of bankruptcy, which is evidenced by an unsatisfied debt registered with the financial agency, representing 20 percent of the debtor's liabilities, or the debtor being 30 days in arrears on employment salaries or employment taxes.[73] The decision to open the proceedings is published on the financial agency's website. The procedure is intended to last approximately four months; this period may be extended by the court. A moratorium on enforcement action goes into effect when the proceeding is opened. A commissioner, who functions much like a bankruptcy trustee, is appointed to help oversee the process. All creditors whose claims are reduced must approve the plan. The first time this procedure was introduced, in 2012, it was a separate act and overseen completely by the financial agency. In 2015 the procedure was incorporated into the bankruptcy law, and is now under the jurisdiction of the commercial court and the financial agency. When the procedure was first enacted under its own law, many enterprises (several thousand) filed under it.

4.5.3 Spain

In Spain, if a debtor informs the court that it is negotiating with its creditors, a limited moratorium on court enforcement actions against assets needed for reorganization enters into force for four months.[74] In practice, it appears that debtors obtain a standstill agreement from their creditors to negotiate effectively. This notification to the court delays an insolvent debtor's obligation to file for bankruptcy, and prevents creditors from filing bankruptcy against the debtor. This notification can be done either while the debtor is in imminent insolvency or actual insolvency. The pre-insolvency stage, if successful, allows the debtor to avoid mandatory insolvency.

4.5.4 France

The French pre-insolvency model has three procedures:

- Special mediation (*mandat ad hoc*), which is requested by a debtor and where a *mandataire* can only be appointed once financial difficulties have materialized, but before cash flow insolvency (*cessation de paiements*).

- Conciliation proceeding (*conciliation*), which can be commenced before the debtor is in cash flow insolvency or is actually in cash flow insolvency for less than 45 days. It has a limited timeframe of just four months plus a one month extension.
- The law for Companies' Safeguard (*loi No. 2005-845 de sauvegarde des entreprises*, dated July 26, 2005) provides a court-supervised restructuring procedure similar to the U.S. Chapter 11 restructuring process to enterprises that are in distress but not yet in cash flow insolvency.

The first two procedures might be considered hybrid models because they are opened and closed in court, but with a long, private negotiation phase for the stakeholders to come to an amicable agreement on the restructuring plan. Overall, the success rate of cases that have preserved enterprises as a going concern, as a result of either the special mediation or the conciliation proceeding, is 60 percent.[75] Moreover, a study by Deloitte and Altares shows that, based on a sample size of 17 courts, the number of *mandat ad hoc* and *conciliation* cases continues to rise on an annual basis. In their sample analysis between 2011 and 2014, the total number of amicable proceedings opened in 2014 in these courts was 948; five percent higher than in 2013.[76]

4.5.4.1 Mandat Ad Hoc

The special mediation procedure—which has existed in practice for many years—was formally introduced into the restructuring and insolvency legislation in July 2005. The management of an enterprise can request that the president of the commercial court appoint a preselected special mediator (the *mandataire ad hoc*), provided that the enterprise is not in cash flow insolvency. The appointment will usually last three months, and can be renewed, as the law does not provide any specific time limit.

The rights and judicial remedies of creditors remain unimpaired, and it is common practice that the *mandataire ad hoc* will request a contractual standstill to be able to work on the understanding that no creditor will enforce their claims and undermine any negotiations. If an agreement is reached, it can be presented to the court for approval (*homologué*) through a conciliation proceeding. Otherwise, upon failure to reach an agreement, there is a serious chance that the enterprise can be put into an insolvency procedure and consequently be liquidated.

4.5.4.2 Conciliation Proceedings

The conciliation proceedings were also introduced in 2005. Similar to special mediation, the purpose of conciliation proceedings is to facilitate an agreement between the enterprise and its main creditors.

The conciliation proceedings are available to any enterprise that faces actual or foreseeable legal, economic, or financial difficulties and has not been in default for more than 45 days.

Upon the commencement of conciliation, the enterprise is required to provide details of its financial, economic, and social situation, including its future financial needs. As in the special mediation, the rights and judicial remedies of creditors remain unimpaired, and a creditor can make a formal claim on its debt during the conciliation proceedings. If that is the case, the debtor can apply to the court for a grace period.

An agreement reached by the debtor and its creditors can be endorsed by the court if the following three conditions are met: (1) the debtor is not in default of the agreement, or the agreement reached resolves the situation; (2) the agreement allows the continuation of the business; and (3) the agreement does not affect the interests of the creditors that did not participate in the agreement.

New debt financing obtained within the framework of the agreement will have priority, although subordinated to court fees and labor claims. This is similar for new services and assets suppliers.

CASE STUDY 3: Saur[77]

Saur is a leading French water utility provider. In early 2012 the enterprise breached a financial obligation and, as a result, petitioned for conciliation proceedings. It applied to the court and was granted a conciliator, so Saur engaged in private pre-insolvency negotiations with its creditors. Using the conciliation method, the involved parties agreed to give the creditors control of the enterprise's shares. The creditors cut the €1.7 billion of debt to a more manageable €900 million and provided an additional €200 million of financing. The proceedings avoided a lengthy court dispute (the court was only involved for the purpose of appointing the conciliator and approving the final arrangement).

4.5.5 Tunisia

Tunisia's newly enacted insolvency law (April 2016) provides for a debtor that is facing financial difficulties, but is not yet insolvent, to request the opening of an amicable settlement proceeding. It is a voluntary process that can be initiated only by the debtor through the court that also validates the agreement. Negotiations between the debtor and its creditors are facilitated by a court-appointed conciliator. The agreement should be reached within a period of three months, renewable for one month (as set out in the law).

Information on the financially troubled enterprise can be requested by the conciliator and the court from the debtor itself, any public administration, any financial institutions, and the *Follow-up Committee on Economic Entities.* The court can also request from the committee a diagnosis of the debtor's situation within one month.

A stay of execution cannot be ordered by the court on a debt recovery proceeding initiated prior to the opening of the amicable settlement proceeding or related to the payment of wages, unless it appears that it could worsen the situation of the business and jeopardize its rescue.

Parties are not subject to any constraint or rules to reach an agreement that could include, but is not limited to, a rescheduling of the debt, a write-down, and suspension of interests.

The settlement agreement is validated by the court if it is agreed on by the creditors holding debt equivalent to two-thirds of the total loans, and the court shall also order the rescheduling of the remaining loans held by other creditors (with the exception of certain small debts) for a period not exceeding the duration of the agreement or alternatively no longer than three years. Creditors bound by the agreement will have to suspend (for the period of the agreement) any debt recovery proceeding.

Fresh money provided in the context of the settlement agreement will be given a super priority ahead of other creditors.

In case the debtor breaches its obligations under the settlement agreement, the agreement can be terminated by the court at the request of any relevant party, and the pre-settlement situation restored unless debt has been reimbursed.

4.6 The Pre-Packaged Restructuring Plan

Pre-packs are generally negotiated as out-of-court workouts. They are characterized by a contractual resolution arrangement agreed prior to the enterprise's formal reorganizing under an insolvency law.[78] In this regard, much of the process is hidden from public scrutiny because a significant portion of the pre-pack takes place in an informal and private process that does not usually involve all creditors. Under the structure of a pre-pack, the enterprise in financial distress can negotiate a solution with a limited amount of its creditors, prepare an action plan on how to reorganize the enterprise, and solicit the acceptance of the plan all in private and prior to filing an insolvency-related petition.[79]

The pre-pack is mostly a market-oriented insolvency procedure that offers the benefits of quickly rescuing an enterprise in distress without the recourse of a judicial order.[80] In practice, when a deal is reached and endorsed by a sufficient majority, it is presented to the court to verify the formality and transparency of the process and subsequently make it binding on all creditors.

The pre-pack procedure originated in the United States under Chapter 11 of the United States Bankruptcy Code,[81] where it is currently regulated under Section 1125(g) of the U.S. Bankruptcy Code.[82] Following the United States example, pre-packs then became popular in the United Kingdom after the introduction of the Enterprise Act 2002, as well as in Canada under the Companies' Creditors Arrangements Act.

The main advantage offered by a pre-pack is the speedy and efficient resolution of an enterprise's distress, as well as the secrecy and flexibility surrounding the negotiation process. This combination of factors maximizes the chances that the enterprise's business will be preserved. However, in some cases pre-packs may succeed at the expense of certain minority creditors that are not involved in the negotiations and that may have different views on the objectives and values that are to be pursued. These differences may only come to light at the time the agreement is filed with a competent judge, since for a pre-pack plan to be able to be implemented, only a significant majority of creditors have to agree to the plan.[83]

Indeed, the interests of unsecured creditors may be inadequately protected during the process if their input into the pre-pack is weak and they are unable to submit early objections to unrealistic options proposed by the secured creditors.[84] The input of unsecured creditors is sometimes sought after a pre-pack agreement had been concluded, that is, once the troubled enterprise has entered reorganization under an arrangement that would be unsuitable for some of the unsecured creditors.

To protect minority creditors from potential abuses, courts have to assess the sufficiency of the disclosure made in the pre-pack process to ensure that all creditors have equal knowledge about the situation of the enterprise and the relevant circumstances. If the agreement is approved by the court, it becomes binding on all creditors affected, even if they have rejected the agreement.

BOX 5: Understanding the Term *Pre-Pack*

There is a significant difference in terminology in various jurisdictions when it comes to the term *pre-pack*. In the United Kingdom, this term makes reference to a procedure whereby the business of the debtor is sold expeditiously after the appointment of an administrator. This would be the equivalent to the sales "free and clear" of charges under Section 363 of the U.S. Bankruptcy Code. In the United States, however, the term *pre-pack* refers to pre-agreed plans filed for confirmation before the Bankruptcy Court where a certain amount of creditors have already agreed on the content of the proposed plan. As a result, the borrower continues operating and there is no sale involved.

4.6.1 Legal Differences between Pre-Packs

■ ***The United Kingdom***

As stated earlier, in the United Kingdom, pre-packaged administrations, or pre-packs, can be used to quickly facilitate the sale of the business and/or to realize the assets of the enterprise. A pre-pack is "an arrangement under which the sale of all or part of an enterprise's business or assets is negotiated with a purchaser prior to the appointment of an Administrator, and the Administrator effects the sale immediately on, or shortly after, his appointment."[85] The enterprise's business and/or assets are typically sold immediately after the administrators are appointed. Administrators can be appointed out of court by certain secured creditors (specifically, those with qualifying floating security interests), the enterprise or its directors, or an order of the court. Out-of-court routes in particular represent a quick entry route into administration to facilitate the delivery of a pre-pack (for example, the requisite forms pursuant to which the appointment of administrators is made can be filed with the court by email or fax outside of court hours).

Major advantages of pre-packs in the United Kingdom include the fact that they minimize the risk of losing material contracts and reduce the costs arising from an administration. In an ordinary case, an announcement that a company is in administration can generate uncertainty for counterparties, employees, and other stakeholders. With a pre-pack, this is more likely to be averted because by the time the administration is made public, a solution will have been agreed to and implemented. Pre-packs can preserve the goodwill, reputation, and confidence the market has in the business, as well as the value of the enterprise and therefore the potential returns available to creditors. Another factor in favor of pre-packs is that they can usually help ensure continuity of employment for the employees of the business.

The length of time it takes from a pre-pack proposal to the sale's effective date can depend on a number of factors, including the size of the business and the industry sector in which it operates, as well as the amount of market testing and/or the number of valuations carried out by or at the instance of the prospective administrators. Since the timeframe can vary so widely, it is difficult to provide estimates of how long the process is likely to take, but, depending on the business in question, it could be anywhere from a matter of days to several weeks to complete the process from start to finish.

In the United Kingdom, there is no requirement for creditors to be consulted or to formally approve the pre-pack proposals (although the prospective administrators may seek the consent of the enterprise's financiers in advance in the interest of minimizing the risks of subsequent challenge) or for any form of court involvement (unless, perhaps, the court is involved in appointing the administrators). Effecting the sale of the business and the amount of the sale price is a matter for the commercial judgment of the administrator, once appointed.

The main criticisms that have been made with respect to pre-packs concern the comparative lack of monitoring and judicial oversight; agreement on the future of the business is reached in principle before the statutory administration process commences and unsecured creditors will normally find out about the pre-pack after the event. However, there are now extensive (albeit ex post facto) reporting requirements with which administrators must comply, which has helped in demonstrating to creditors the steps taken to implement a pre-pack and improve the transparency of the process more generally.

■ *The United States*

In the United States the term "pre-packaged" reorganization (pre-packs) is often confused or used in conjunction with "pre-arranged" or "pre-negotiated" reorganization. While these two procedures are in fact closely related, it is important to distinguish between them on the basis of the different treatment afforded to them by the U.S. Bankruptcy Code as well as non-bankruptcy law.

In a pre-packaged case, unlike regular bankruptcy proceedings under Chapter 11, a debtor files for bankruptcy after having already solicited the acceptance of a reorganization plan by a majority of its creditors. In a typical pre-packaged case, the debtor will negotiate with its creditors (at least its main creditors) and prepare a reorganization plan, which will then be circulated to creditors together with a disclosure statement and a ballot.

After the creditors review the plan and submit their votes, provided that the plan receives sufficient support, the debtor will file for bankruptcy and the court will confirm the plan, usually within three months (sometimes as fast as 30–45 days). This enables a debtor to restructure quickly, it is less costly, there are no significant disruptions to its business operations, and it has the ability to bind dissenting creditors or holdouts. The success of a pre-packaged plan, however, hinges on a number of factors. For example, the court will have to review the sufficiency of disclosure provided by the debtor during the out-of-court negotiations, and determine whether it satisfies the bar of "adequate disclosure" specified in Section 1126 (b) of the Bankruptcy Code. In the event the disclosure is deemed inadequate, the court will require the debtor to repeat the solicitation process. Furthermore, the debtor runs the risk of creditor enforcement actions during the time of negotiations, unless it has managed to successfully conclude a standstill agreement with its creditors. Finally, the law also places some limits on the expediency of the case through rules requiring that creditors are provided with adequate time to review the plan before voting.[86] In any case, the United States pre-packaged bankruptcy is mostly used as a means to reorganize and rescue the enterprise in a quick and cost-efficient manner, and not as a mechanism to sell the enterprise, as is commonly the case in the United Kingdom.

A pre-arranged bankruptcy proceeding has many similarities with a pre-packaged case. Unlike the latter, however, the enterprise and key creditors (or their representatives) in a pre-arranged case agree upon the terms of a restructuring and contractually bind themselves to such terms without yet having engaged in the voting process mandated by Section 1126 of the Bankruptcy Code. Consequently, no disclosure statement is circulated, no solicitation takes place, and creditors are only contractually bound to vote in the manner agreed upon. Following the conclusion of this agreement, the debtor initiates a Chapter 11 case, a disclosure statement is filed and approved by the Court, and the actual solicitation commences. This, however, usually proves to be less time-consuming than a regular bankruptcy case, considering most creditors have already consented to the restructuring. A pre-negotiated plan may be useful in cases where the debtor does not wish to deal or comply with non-bankruptcy rules that may govern pre-packaged plans, such as securities regulations. A pre-arranged

CASE STUDY 4: Blue Bird Body Company (Blue Bird)[87]

Blue Bird is a manufacturer of school buses in the United States that, from start to finish, successfully implemented a pre-pack process in seven days (one of the shortest bankruptcies in U.S. history).

In 2006 Blue Bird found itself in dire financial straits. It considered filing a traditional bankruptcy petition, but changes to the U.S. Bankruptcy Code and the enterprise's unique business model meant that Blue Bird could not survive such a process. Moreover, Blue Bird was under severe time pressures because it needed an immediate cash infusion if the enterprise was to survive.

Blue Bird quickly began an out-of-court restructuring process with its shareholders and creditors. It arranged for $211 million of secured debt to be reduced to $100 million, along with an infusion of $52 million in credit. In exchange, Blue Bird's creditors would be given shares in the restructured enterprise. All the necessary stakeholders less one hedge fund agreed to this arrangement. Accordingly, the out-of-court arrangement failed because the enterprise failed to attain unanimous approval.

Blue Bird then decided to undertake a pre-packaged reorganization plan. By using a pre-pack, the enterprise could take advantage of the U.S. Bankruptcy Code's lower voting threshold so that each class of creditors could be deemed to approve the arrangement if at least one-half of the creditors holding at least two-thirds of the debt voted to support the plan. Blue Bird took four days to renegotiate a similar proposal to its out-of-court agreement, following which it took a vote. Ninety percent of its creditors supported the arrangement, representing 92.6 percent of the relevant debt. That day, Blue Bird filed its petitions in court. Shortly thereafter, the court considered the petition and heard from the dissenting hedge fund. It ruled in favor of Blue Bird, and within 32 hours and 26 minutes of the petition being filed, Blue Bird was formally restructured.

The Blue Bird case demonstrates the speed at which pre-packs can occur. By minimizing the time it takes to reorganize, enterprises incur lower restructuring costs, less publicity, and less operational downtime.[88]

plan may also be a fitting solution when the creditors are "knocking at the door," and the debtor does not have time to negotiate each point of a pre-packaged plan but can only agree on the principal terms of a deal with its major creditors and work out the rest in bankruptcy. As a result, pre-negotiated plans may prove particularly useful in a debtor's effort to achieve a speedy restructuring of its business and involve less stringent requirements than a pre-packaged plan.

■ ***The Netherlands***

Although there is not yet specific legislation in place regarding pre-packs in the Netherlands, in practice, some Dutch courts have adopted pre-packs under the scheme of "silent trustees."[89] A silent trustee scheme is a restructuring transaction negotiated prior to formal insolvency proceedings, but put in place during the formal insolvency. The transaction helps ensure maximum preservation of the value of the enterprise in distress by selling the business on a going concern basis to a new legal entity. The silent trustee is appointed by the court, and in the event of a formal application for a bankruptcy proceeding, will be appointed as trustee.[90] The silent trustee scheme was used in the case of *Schoenenreus* (a chain of shoe stores). A pre-pack restructuring was the only tool that could be used to retain the majority of the employees. The transaction was prepared with the close involvement of a bank that held a pledge over almost all of the enterprise's assets.[91]

The Dutch pre-pack with a silent trustee represents a useful option in situations where the amendment of leases appears to be the only solution for maintaining the enterprise's viability. Currently, a draft proposal to implement a pre-pack proceedings in the legislation is pending in the Dutch Parliament. Some practitioners report that the trade unions in the Netherlands take the view that a pre-pack is contrary to European law. This is because the pre-pack proceeding is not intended to liquidate the business, but is rather aimed at a restructuring, and therefore all the employees should follow the enterprise. Recently, a Dutch Court raised pre-judicial questions with the European Court of Justice in relation to a pre-pack. Pending this decision, the position of the pre-pack in the Netherlands—even if the proposed Dutch legislation is enacted[92]—is not yet clear.[93]

4.6.2 The Pre-Arranged Plan

A pre-arranged or pre-negotiated plan is a restructuring plan negotiated between the debtor and its creditors that requires a formal solicitation of votes. This is done under the auspices of the court or an administrative authority.[94] The approval of any restructuring plan is settled by a procedure established by the court or an administrative authority; it is usually a creditors' meeting summoned by the court or administrative authority that resolves the outcome. This procedure shows strong similarities with the pre-pack, since it combines elements of judicial and non-judicial restructuring schemes. The difference between the pre-pack and the pre-arranged or pre-negotiated plan lies in whether the agreement is pre-voted or post-voted.[95]

The pre-arranged insolvency procedure allows the debtor, before commencing the formal proceedings, to negotiate a restructuring plan and solicit votes on the plan from the number and classes of creditors and of shareholders required for reorganization (or by the representatives of the most significant creditors and shareholders).[96] It is important to highlight that the alleged solicitation of votes will not be formally carried out beforehand since it has to be done under the auspices of the court. However, no debtor will submit a pre-negotiated or pre-arranged plan without having previously secured the necessary votes and having locked them up in some kind of binding arrangement. Otherwise, the outcome would be too uncertain. It is common practice that the debtor and its agreeing creditors (the majority required by law) will enter into a lock-up or plan-support agreement that sets out the main aspects of the restructuring plan that will be put forward when the court summons a creditors' meeting. Creditors would—on the assumption that there are no changes to the originally proposed plan—tender their vote as previously committed.

■ ***Bolivia and Peru***

Pre-arranged insolvency plans are contemplated in Bolivia's Law 2,495 (titled Corporate Voluntary Restructuring Law), which regulates these plans as "transactional agreements" (Article 1). The rule provides that once the debtor negotiates a transactional agreement, it requests the approval of the agreement by the enterprise's supervisory authority (*Superintendencia de Empresas*). The supervisory authority appoints a trustee to oversee the proceedings. The trustee summons a general meeting to decide on the transactional agreement, which needs majority approval to bind the creditors to a newly arranged contract.

In Peru, the insolvency framework is regulated by Law No. 27,809 (*Ley General del Sistema Concursal*). Enterprises undergoing restructuring can choose from two procedures (*concursos*): preventive or ordinary. In either case, only creditors at a creditors' meeting can approve the restructuring plan under both the preventative and ordinary procedures. Accordingly, debtors and creditors often meet before entering the formal proceeding to create a pre-negotiated restructuring plan so that when they enter formal proceedings the process is easier and more predictable (however, pre-negotiated plans are not required nor endorsed by the legislation). The resolution approving the restructuring plans (and their amendments) requires more than 66.6 percent of the recognized credits (in the first call); or more than 66.6 percent of the recognized credits represented in the creditors' meeting (in the second call). Each creditor gets a vote proportionate to its share of the debt—see Art. 53.1, Law 27,809. In cases of preventive restructuring where an automatic stay of protection is requested and if the restructuring agreement lacks the required approval from the enterprise's creditors, INDECOPI ("National Institute of Competition and Protection of Intellectual Property," the administrative authority that oversees insolvency procedures) can start an ordinary restructuring procedure if more than 50 percent of the creditors recognized or present at the creditors' meeting agree so.

INDECOPI is limited to an administration role except in certain exceptional circumstances. It is the sole administrative body that oversees insolvency; Peruvian courts do not participate directly in the insolvency process, though they may at later stages review administrative resolutions that exhaust all available administrative remedies.

4.7 Contractual Workout Schemes

Although a different form of the hybrid procedure, because it might not necessarily involve the courts, some workout schemes have been reinforced by institutional and administrative contractual frameworks. These models still involve a large degree of extra judicial negotiations among stakeholders, but the more formal framework and institutional role of the central bank helps promote restructuring within financial institutions.

The 1999 East Asia Crisis gave rise to a number of workout models in different forms. For instance, Korea adopted a contractual workout approach in July 1998 with encouragement from the Financial Supervisory Commission (FSC). Local financial institutions, 210 in all, signed Corporate Restructuring Accords that provided for one to three months' standstill (depending on due diligence requirements), which could be extended for one month; a creditors committee led by a lead creditor; a 75 percent threshold for creditor approval of any workout plan; and a coordination committee that would provide workout guidelines and arbitrate certain disputes where workout plans were not approved.[97]

CASE STUDY 5: India's Corporate Debt Restructuring Mechanism[98]

India's Corporate Debt Restructuring (CDR) mechanism was initiated in 2001 and is run by the Reserve Bank of India to provide an alternative, voluntary method of restructuring corporate debts without involving the court. Banks and financial institutions that take part in CDR[99] sign an inter-creditor agreement in which they agree that if 75 percent of creditors by value approve of the restructuring package, the other 25 percent are bound. When debtors engage the CDR mechanism, they sign a debtor–creditor agreement that provides a 90–180 day moratorium. The CDR mechanism is comprised of three panels, each composed of representatives from participating banks and financial institutions:

1. The CRD Forum creates policies and guidelines that are used for debt restructuring.
2. The CRD Empowered Group decides which cases are eligible for the CDR mechanism.
    a. Debtors are only eligible to restructure their debts if they can demonstrate the viability of their business to their lead banker and the CDR Cell.
3. The CDR Cell works out the detailed restructuring package in coordination with the referring institution and other experts as need be.

Statistics[100]

- Since inception, 655 cases were referred to the CDR process; 530 were accepted (81 percent acceptance rate).
- Out of the accepted cases, 80 (15 percent) successfully exited the process (none since 2011), 165 (31 percent) were withdrawn on account of package failure, and 285 (54 percent) were ongoing.
- The total debt of the 530 cases accepted was over 4 trillion Indian rupees ($60 billion). About 600 billion Indian rupees ($9 billion) of debt has been successfully resolved.

Impact of CDR

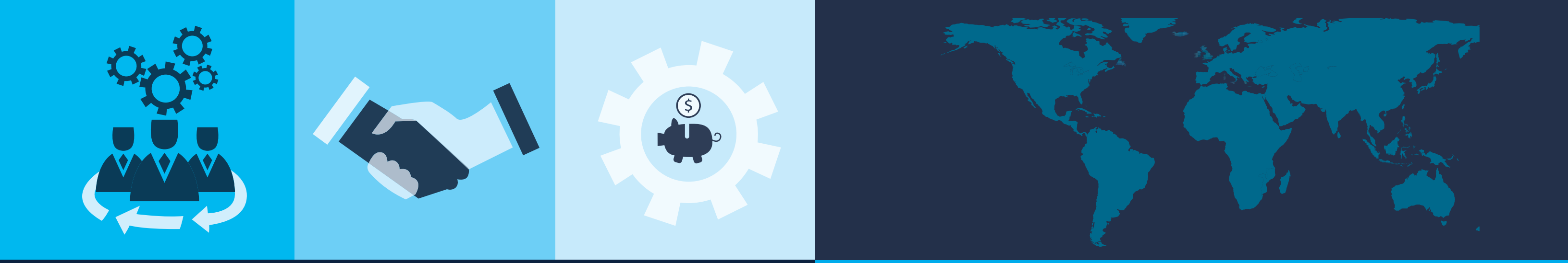
A 2013 study[101] compared enterprises that underwent the CDR process ("treated firms") with a control sample over a five-year period. The treated firms were found to have a lower return on assets vis-à-vis the control sample in each of the five years after restructuring, meaning that treated firms did worse than enterprises that did not engage in CDR. Granted, this study was hindered by the difficulty in choosing accurate control firms, but it nevertheless demonstrates the questionable impact of CDR.

A 2015 report[102] raised similar concerns. The report studied 24 enterprises that were restructured under CDR and found that two years after restructuring the financial performance of these enterprises, there was little improvement (as measured by their interest coverage ratios and debt-to-equity). Moreover, the report claimed the CDR mechanism was distorting the financial stability of India's banks. The Reserve Bank of India requires that banks holding nonperforming loans have loan loss provisions of 15 percent to 100 percent, but for loans undergoing restructuring, the provision threshold is 5 percent. Accordingly, banks are motivated to push enterprises to restructure, even if they are not ideal candidates for restructuring, in an effort to avoid classifying them as NPLs on their balance sheets.

CDR's Success

Essar Steel is one of the CDR mechanism's 80 successful cases. The enterprise agreed with its creditors in 2002 to repay its debt of 28 billion Indian rupees ($417 million) over a 12-year tenure, but the enterprise was instead able to pay it within four. The repayment was funded in part through internal means and loan refinancing, and it was helped by an upturn in economic conditions. The flexible nature of CDR allowed Essar to implement rigorous changes to improve its operations, and it was able to acquire another enterprise to help boost profits (it was paid for with equity, not debt).[103]

Another successful case is Future Financial Services Ltd. (FFSL), a microfinance enterprise that opted for CDR in 2011 when a controversial law barred it and all other microlenders from collecting certain debts in a key market. FFSL had 1.1 billion Indian rupees ($16.5 million) in debt and used CDR as a means of acquiring a moratorium to negotiate lower interest rates and expand to new markets. The breathing room offered by CDR let it pay off its debts within two and a half years.[104]



5 Practical Case Study

5.1 Introduction to the Case[105]

A hotel group (the "Hotel Group") is facing a challenging financial situation. Because of changing market dynamics, the Hotel Group's assets—its three hotels—are losing market share and have started to experience substantial losses. Limited financial resources have prevented the Hotel Group from making the large-scale renovations necessary to compete for customers with new hotels emerging throughout the region. As a result, the Hotel Group is in financial distress and does not have sufficient funds to cover current and future obligations.

5.1.1 The Problem

The Hotel Group currently generates positive earnings before interest, tax, depreciation, and amortization (EBITDA), which represents operational earnings. However, net profits are down, and the Hotel Group remains burdened with a high debt load. Projections show that the Hotel Group will not generate sufficient cash to meet both interest and debt repayment expenses, and its planned capital expenditure (CAPEX). However, an underlying assumption in the projections analysis is that the management team will be able to make headway in reviving the Hotel Group's operational and financial health. As such, the projections show gradual operational improvements in the Hotel Group's performance. Specifically, these estimates assume greater efficiency and profitability in day-to-day hotel operations and a positive impact from the Hotel Group's investment in property renovations.

The enterprise is owned equally by a family of three (father, son, and daughter), who represent the Hotel Group's management.

5.1.2 A Restructuring or Liquidation? That Is the Question . . .

Despite the projected improvements, the Hotel Group is not able to meet its current interest and debt repayment obligations to lenders. Moreover, some of the loans are due to be repaid in full in 2016. These issues mean a prompt workout is necessary so that the Hotel Group has sufficient cash to pay its suppliers and employees and prevent being forced into insolvency proceedings. If the Hotel Group does not take action, some of the secured creditors may start judicial enforcement proceedings to seize secured assets (the hotels) and have them sold piecemeal (whether or not in a going concern sales transaction). In case the company is unable to repay its debts, the directors have the statutory obligation to initiate a formal insolvency proceeding.

5.1.3 Current Debt Structure

The table below shows the current debt structure of the Hotel Group.

Lender A and Lender B have secured senior debt over the same assets. There is an inter-creditor agreement between them to split the proceeds of the collateral pro rata.

5.1.4 Valuation of the Hotel Group's Assets (Three Hotel Properties)

The valuations are based on the assumption that the Hotel Group's properties could be sold relatively quickly to, for example, a strategic or financial investor. The Hotel Group's assets can be sold. The value of the three hotel properties is shown in Tables 1 and 2, which present a high and low valuation of the properties. That would depend on the negotiation skills and business connections of the seller.

Each property has its own license to operate. In the valuation, it is assumed that the licenses will remain; however, this is not 100 percent guaranteed (the license is subject to the discretion of the authorities).

5.1.5 Case Study Analysis Guidance

1. *What are the parties' interests?* All the stakeholders involved have different interests. Some of them are relatively safe (Lender A and Lender B) because they have senior and/or secured debt. In the worst-case scenario, they lose their investment, but there is not as much at stake compared to Lender C and Lender D. The Trade Creditors have a large outstanding amount of debt, and no collateral, but they do have a strong (informal) position.
2. *Is there consensus on a possible solution?* Do all the parties in this case understand that an informal workout is probably the best for all stakeholders in order to maximize recovery?
3. *How should the workout be restructured?* How should the informal workout process be managed and structured to satisfy all stakeholders?

Table 1: Hotel Group's Debt Structure

Stakeholder	Term Loan	Currently Outstanding	Expiration Date	Arrears in Interest Payments	Arrears in Debt Repayment
Secured senior debt Lender A		6.937	Expires in several months	Yes	Yes
Secured senior debt Lender B		5.946	Expires in several months	Yes	Yes
Unsecured subordinated debt (working capital) Lender C		991	Expired		
Unsecured debt Lender D		793	Expires in several years	No	No
Secured debt provided by shareholders		2.000	No expiration date	N/A	N/A
Trade Creditors (unsecured)	N/A	4.851	The Hotel Group currently pays on average after 90 days.	Payment is net 30 days from date of invoice according to contract terms.	
	The two Trade Creditors that are at the negotiation table are crucial for the Hotel Group's operations, as they supply food and beverages (F&B) and daily cleaning and housekeeping services. It is not possible to switch to other suppliers within 30 to 60 days, as the current suppliers (which represent about 50 percent of the current trade debt) are monopolists in the high-end hotel industry. Also, new suppliers probably would demand substantial guarantees or cash-on-delivery.				

Table 2: Valuation of the Hotel Group's Assets: Best-Case Scenario

BEST-CASE SCENARIO	Out-of-Court Workout (going concern scenario)	Reorganization Proceeding (going concern scenario)	Liquidation (going concern scenario)	Liquidation (piecemeal sale of assets)
Total Hotel Group	27.000	21.600	17.550	13.500
Hotel Master	16.546	13.236	10.755	8.273
Hotel Oak	7.560	6.048	4.914	3.780
Hotel Gold	1.123	899	730	562

Table 3: Valuation of the Hotel Group's Assets: Worst-Case Scenario

WORST-CASE SCENARIO	Out-of-Court Workout (going concern scenario)	Reorganization Proceeding (going concern scenario)	Liquidation (going concern scenario)	Liquidation (piecemeal sale of assets)
Total Hotel Group	20.250	16.200	13.163	10.125
Hotel Master	12.409	9.927	8.066	6.205
Hotel Oak	5.670	4.536	3.686	2.835
Hotel Gold	842	674	548	421

5.2 Phases in the Operational Restructuring Process

Chapter 2 discussed the four phases of restructuring in depth. They are

1. Stabilizing
2. Analyzing
3. Repositioning
4. Reinforcing

The Case Study will now put the phases into practice for the Hotel Group. All Forms are set out at the end of Chapter 5.

5.2.1 Phase 1: Stabilizing

This phase focuses on how to stop the cash outflow or reduce it to an acceptable level, and additionally on how to increase the cash flow. Minimizing operational expenses and capital expenditures is necessary. The sale of assets (fixed assets but also Hotel Group enterprises or business units), as well as selling inventory is key.

To effectively minimize expenses, the Hotel Group's management needs to have a clear overview of payments that need to be made in the forthcoming weeks. Management naturally has concerns about its ability to pay employees, tax authorities, and Trade Creditors, and a failure to make these payments could cripple the enterprise. Creditors, in turn, are concerned about the stability of the company since they have limited faith in the reliability of the reporting by the Chief Financial Officer. At this stage, creditors may also focus on what management considers drastic means of generating cash (for example, some creditors may push for the sale of certain assets like artwork or vehicles in order to alleviate some liquidity concerns).

The importance of the stabilizing phase is often underestimated. In practice, parties initiate meetings to try to resolve the financial distress and to protect their own interests as much as possible. However, just like any other project, the OCW will most likely fail if the objectives of the workout are not clearly defined and are not shared among the relevant stakeholders.

In the stabilizing phase, the relevant stakeholders of the Hotel Group are identified and meetings are set up (**Form 1**). The Hotel Group's owners and the lenders and Trade Creditors agree on the OCW process and the communication framework (**Forms 2 and 3**). Next, since there is already a lack of trust toward the Hotel Group's owners, it is important that if there information is disclosed, it is reliable information and that the parties will keep it confidential (**Form 4**). The principles that will be adopted for the workout should be explicitly stated at this point so that they can set the tone for the upcoming negotiations, for example, in the terms of a Standstill Agreement (**Form 5**). Throughout these early stages, deadlines are set and deliverables are determined.

During this phase, information sharing and sharing of financial data is key (**Form 6**), as well as a clear action plan addressing how to stabilize the enterprise to prevent further deterioration and exacerbated financial distress (**Form 7**). In order to ensure that all stakeholders are fully informed, it is important that the Hotel Group's owners will fully disclose their financial data to all relevant stakeholders.

Potential deliverables and agreements in this phase are:

- Identification of all the relevant stakeholders (**Form 1**);
- Adoption of guiding principles of the OCW in letter of intent (**Form 2**);
- Workout planning and communication framework (**Form 3**);
- Confidentiality agreement (**Form 4**);
- Standstill agreement (**Form 5**);
- Financial data (past data and also forecasts of the income statement, balance sheet, and cash flow statements) (**Form 6**); and
- Stabilizing plan (**Form 7**).

5.2.1.1 Identifying Stakeholders

The owners of the Hotel Group should first identify the relevant stakeholders in the OCW, including the lenders and the Trade Creditors (**Form 1**).

In the case of the Hotel Group, the primary stakeholders are:

- Hotel Group management
- Lender A
- Lender B
- Lender C
- Lender D
- A representation of the Trade Creditors

Other possible stakeholders include:

- Tax authorities
- Employees/trade unions

If stakeholders that are not yet involved in the OCW are identified, the owners should contact them and invite them to participate in the process. In order to make the OCW process as efficient as possible, the representatives of the relevant stakeholders (for instance, any creditor committees representing the creditors) should have a mandate in the negotiations.

In the case of the Hotel Group, the Trade Creditors do not seem to be very important given their legal status. However, the continuity of the operations will be at risk if the Trade Creditors decide to stop their supply of services to the Hotel Group. The legal position of Trade Creditors is not strong, but their informal power is enormous. Therefore, management, Lender A, Lender B, Lender C, and Lender D asked the Trade Creditors to join the OCW.

5.2.1.2 Adoption Agreement of Workout Principles

The relevant stakeholders of the Hotel Group should agree (on a voluntary basis) that the workout will be done according to a framework of OCW principles. A letter of intent is drafted to ensure a mutual understanding of the OCW "do's and don'ts" or standards of conduct by all stakeholders (**Form 2**).

Workout Planning and Communication Framework

In order to have a clear overview of the standstill period and the roles, responsibilities, and deliverables, as well as the overall timeframe of the process, a detailed workout plan should be drawn up. An example is set out in **Form 3.** The plan should include a plan to structure communications and meetings with all relevant stakeholders of the Hotel Group. The planning and communication framework should answer the following questions:

- When are important deadlines for the owners, for the lenders and the Trade Creditors?
- What information will be disclosed and at what time, and to which stakeholder?
- What are the tasks and responsibilities of the owner and the other stakeholders?

For the owners of the Hotel Group, it is most important to ensure compliance with the deadlines agreed in the planning. If the Hotel Group fails to comply, trust in the enterprise will be even further deteriorated while, in fact, restoring faith in the enterprise by the lenders and Trade Creditors is necessary for a successful OCW.

Current management of the Hotel Group has not been able to guide the company towards a positive cash-generating company, despite promises towards the creditors in the past. The creditors also have serious doubts about the positive forecasts of the Chief Financial Officer. Restoring the creditors' trust in management of the Hotel Group is important to ensure that management can remain in charge, and therefore the Hotel Group should be compliant in the planning agreed to by both the Hotel Group and its creditors, since otherwise this will erode their trust even more.

5.2.1.3 Short-term Stabilizing Plan

The Hotel Group should prepare a short-term stabilizing plan that includes:

- An analysis of why the enterprise went into a phase of financial distress. This analysis is preliminary, but indicates the causes of decline that need to be addressed in order to effectively stabilize the enterprise.
- An overview of the immediate cash requirements of the Hotel Group.

Subtopics in the short-term stabilizing plan (which is different from the restructuring plan insofar as it focuses on short-term survival) may include:

- An overview of the first analysis of the causes of decline;
- An overview of the immediate cash requirement needs (based on a short-term cash flow overview of six–12 weeks);
- An overview of initiatives that will generate cash flow, for example, the sale of business units, increased collection of accounts payable, postponement of payment of Trade Creditors, reduction of inventory, sale of assets;
- An overview of newly installed controls to gain more control over the cash outflow of the enterprise (for example, payment controls, controls regarding forecasting and reporting, human resources controls);
- Implementation of cash rationing (restrictions on capital expenditures); and
- An overview of the newly formed restructuring management team, including roles and responsibilities and a description of changes in existing management.

5.2.1.4 Confidentiality Agreement

A confidentiality agreement (**Form 4**) should be required of any stakeholder receiving information that is not already publicly available. Information, ideas, concepts, and other thoughts or facts that are shared between the relevant stakeholders within the context of the OCW should be strictly confidential. This will help generate an open, trustworthy relationship between the participants, and this will ultimately lead to a better workout solution.

The owners of the Hotel Group, Lenders A, B, C, and D and the Trade Creditors will provide information to each other, and in order to facilitate a safe environment, the confidentiality agreement should be put in place. In this way, the Trade Creditors are more likely to provide information about their cash flow position that might clarify their formal and informal position in this OCW process (for example, are the Trade Creditors able to pay salaries to their employees and what happens if this is not possible anymore? Will the going concern of the operations of the Hotel Group be at stake?).

5.2.1.5 Standstill Agreement

The stakeholders should agree on the standstill period, which is discussed in Chapter 2. A sample of a standstill agreement is set out in **Form 5.** The timeframe should be enough for the enterprise to create a short-term stabilizing plan, but at the same time the period should not be too long in order to protect the creditors whose money is at stake. A standstill period of several weeks is common, but this may depend on the complexity of the enterprise and the willingness of the individual lenders and Trade Creditors.

The following items should be included in the Hotel Group's standstill agreement (with additional issues set out in **Form 5**):

- The timeframe of the standstill period, including the end date;
- Defining the circumstances in which the company can continue to have access to credit;
- The deliverables that the Hotel Group agrees to disclose to the stakeholders; and
- The intention of the lenders and the Trade Creditors not to enforce their claims against the Hotel Group during the standstill period.

5.2.1.6 Financial Data

Once the standstill period starts, it is necessary for the owners of the Hotel Group to provide financial information to relevant stakeholders. This information may consist of:

- The latest audited financial statement, including a balance sheet, income statement, and cash flow statement with disclosures;
- Management reports per business unit/product/service line/country per month over the past 24 months (including reconciliation to last year's audited financial statements); and
- Forecast cash flow statements and income statements (short-term and long-term).

An example of financial data relevant to the Hotel Group is set out in **Form 6.**

5.2.1.7 Short-term Stabilizing Plan

Preferably before the start of the standstill period, the Hotel Group should commence to prepare a short-term stabilizing plan. An example of this is set out in **Form 7.**

Such a plan is essential in order to enable the Hotel Group to negotiate a standstill, which will help it achieve its primary function of permitting the Hotel Group to trade while developing a restructuring plan. The short-term plan need not be a single formal document (if it is not voted on by creditors). However it is presented though, it must make clear what cash requirements of the Hotel Group need to be met, in order to permit the Hotel Group to carry on with the restructuring. It should be a convincing document, supported by financial and market projections that are credible. The plan should be capable of being presented to groups of creditors at a meeting. In large cases, the involvement of expert financial advisers is an essential part of this exercise, and often such advisers present, explain and/or support the plans at meetings with creditors.

Topics in the short-term stabilization plan may include the following:

- An overview of the first analysis of the causes of decline;
- An overview of the immediate cash requirement needs (based on a short-term cash flow overview of six–12 weeks);
- An overview of initiatives that will generate cash flow, for example, the sale of business units, increased collection of accounts payable, postponement of payment of Trade Creditors, reduction of inventory, sale of assets;
- An overview of newly installed controls to gain more control over the cash outflow of the enterprise (e.g., payment controls, controls regarding forecasting and reporting, human resources controls);
- Implementation of cash rationing (restrictions on capital expenditures); and
- An overview of the newly formed restructuring management team including roles and responsibilities and a description of changes in existing management.

5.2.2 Phase 2: Analyzing

When entering Phase 2 of the OCW process, the focus of the Hotel Group's management and the relevant stakeholders shifts from a short-term to a longer-term perspective. As noted in Chapter 2, there is overlap among the phases. Phase 1 is still in progress when Phase 2 begins, so management is often changing focus—solving short-term issues and trying to stabilize the enterprise while at the same time forecasting what the enterprise should look like in five to ten years. Management should keep in mind that short-term survival is necessary for long-term success.

The deliverable in this phase is the restructuring plan.

5.2.2.1 Restructuring Plan

The best outcome of an OCW is the agreement among owners, lenders, Trade Creditors, and other stakeholders to continue to support the enterprise so it can survive and succeed in the long term. An important basis for this agreement is restoring the trust of the stakeholders in the enterprise and in the possibilities to overcome this difficult period. A restructuring plan is the foundation of restoring trust. **Form 8** sets out an example of issues that might be considered when developing a restructuring plan.

Reasons to write a restructuring plan are:

- It provides a holistic overview of what needs to be done;
- It provides guidance and ensures complete focus on the objectives set in the restructuring plan;
- It provides quantitative and qualitative objectives; and
- It provides trust to the stakeholders and is a way to communicate with them.

In case of the Hotel Group, important aspects for the restructuring plan are:

- A clear definition of the position of the Hotel Group (high end versus budget), including a definition of target groups (leisure, business);
- An analysis of the threat of online competition for hotels (for example, providers like *Airbnb*) and how to deal with this;
- An analysis of the dependency of online travel agents and a solution for how to attract more bookings through the website of the Hotel Group (to reduce commission fees for such online agencies);
- Targets for key performance indicators for the Hotel Group:
  - Decrease of occupancy in combination of an increase of the average room rate;
  - Increase of the Revenue per Available Room;
  - Change in booking channels (less online agencies, more direct bookings).

5.2.2.1.1 The Restructuring Plan Should Contain the Following Topics:

- Detailed enterprise profile, including an analysis of the causes of decline;
- Analysis of the external environment (competition, trends, new forces, and so on);
- Vision on the restructuring (new customers, new branding, new partnerships, new structure, new management, new technology);
- A detailed restructuring strategy (detailed description of the new products/services, including the needs and wants of the customers, positioning of the products/services, focused on sales);
- Operational analysis (detailed overview of the enterprise's strengths and weaknesses, and opportunities and threats to the enterprise);
- Operational action plan (proposed measures in small, clear, and quantifiable steps, segmented to the various parts of the organization in which specific actions should be taken);
- Financial projections (long-term and short-term versions of the balance sheet, income statement, and cash flow statement including worst-case and best-case scenarios);
- Time scheme;
- Risk analysis; and
- Analysis of effects for current lenders/Trade Creditors/owners.

5.2.3 Phase 3: Repositioning

In the third phase, the restructuring plan is implemented. At the start of this phase, it is important that the relevant stakeholders, including the owners/management of the Hotel Group, agree on certain aspects. For example, if one of the lenders of the Hotel Group is willing to invest funds to keep the current Trade Creditors satisfied (to ensure that the supply of goods and services continues), all the stakeholders need to agree on how to deal with the additional funding.

An important option for the Hotel Group, for instance, is a sale-and-leaseback of one or more of the hotel buildings (with a real estate investor). This will generate cash, reducing the cash outflow for investing, but it results in a long-term rental agreement.

An important deliverable in this phase is a post-commencement financing agreement to try and keep the business afloat (see **Form 9** for a sample letter of intent to provide new financing).

Possible other agreements that might be put in place will vary depending upon the particular circumstances of the debt, but might include:

- Contractual post-commencement financing priority;
- Share issuance agreements;
- Waiver of pre-emption rights;
- Hybrid securities agreements;
- Sale and purchase agreements;
- Forms for modifying or cancelling tax debt; and
- Transfer of licenses.

5.2.3.1 New Financing and Letter of Intent to Provide New Financing

As discussed in Chapter 2, the enterprise will most likely need additional funding during the OCW period. For instance, in the case of the Hotel Group, the Trade Creditors need to be at least partially paid to ensure that the Hotel Group can continue to receive key services, such as laundry services, food supplies, staff for housekeeping, transport services, etc.

An example of a letter of intent on the part of the creditors to provide new financing to the Hotel Group is set out in **Form 9.** However, if no agreement can be reached regarding such new financing, for instance, regarding the priority that creditors providing the new financing will have (see Chapter 2), it is unlikely that any lenders will be willing to furnish such funding. To create this opportunity, current relevant stakeholders should be willing to prioritize the additional post-commencement financing in case of insolvency.

The Hotel Group should answer the following questions in their post-commencement financing agreement:

- Who is going to provide additional funding to ensure continuation of supply by the Trade Creditors?
- What are the possibilities of providing this lender a secured loan?
- Do all stakeholders agree that this additional funding should be the most senior debt, even though this means less security for the existing lenders?

5.2.3.2 Set-off Agreement

A set-off agreement is a settlement of mutual debt between a creditor and a debtor through offsetting claims. This allows creditors to collect a greater amount than they usually could under bankruptcy proceedings. **Form 10** provides an example of a set-off agreement.

5.2.4 Phase 4: Reinforcing

During the last phase of the restructuring process, the relevant stakeholders should focus on improving the financial situation of the balance sheet (improving the debt-to-equity ratio, for instance). Part of the improvement of the financial situation will be reaching an agreement among the stakeholders regarding the funding of the Hotel Group.

While in the stabilizing phase, the attention of the Hotel Group was focused on short-term survival; here the owners of Hotel Group and the lenders are focused on how to fund the company for long-term growth. An example is looking for strategic partnerships with other hotel groups, participation of a private equity firm or looking for a franchise partnership with one of the international hotel chains. Also, the sale-and-leaseback of the hotel buildings can be considered to improve the financial position and ratios.

Another part of this phase is strengthening the leadership team of the enterprise. During the stabilizing phase a restructuring team was formed, more or less equivalent to a project team. The main task of this team was to stabilize the company, and to ensure its short-term survival to facilitate a restructuring plan. Part of the long-term survival involves changing the board of directors. In case of the Hotel Group the creditors might consider adding a Chief Marketing Officer to the board or replacing the Chief Financial Officer for a more qualified and independent (not family related) person.

An important deliverable of this phase is a summary by the relevant stakeholders on the restructuring process, including an assessment of the incorporation of restructuring management skills in the enterprise itself.

5.3 Forms

Disclaimer

The sample forms and documents included in this publication are intended to serve as simplified examples solely in the context of the case study in Chapter 5. While they represent a basic example of the type of documentation that might be used in such a case, they are in no way intended to serve as models for actual transactions. Rather, they are intended to give users of this publication an idea of the types of issues that may arise in the context of an OCW and the types of documents that participants in such a workout may need to produce. All documents including contracts, agreements and undertakings in relation to a restructuring should be subject to local legal and financial advice, and nothing in this publication is intended to serve as a substitute for, or supplement to, such advice.

FORM 1

STAKEHOLDER IDENTIFICATION

NAME OF STAKEHOLDER	Family Y
CONTACT PERSON	Enterprise Executive
POSITION	Enterprise Executive
EMAIL	ceo@hotelgroup.com
TYPE OF STAKEHOLDER	Owner
SHORT DESCRIPTION OF THE POSITION	100% owner of the enterprise and management
NAME OF STAKEHOLDER	Lender A
CONTACT PERSON	Mr. X
POSITION	Senior Account Manager, Large Clients
EMAIL	x@lendera.com
TYPE OF STAKEHOLDER	Bank
SHORT DESCRIPTION OF THE POSITION	Senior debt, collateral
NAME OF STAKEHOLDER	Lender B
CONTACT PERSON	Ms. Z.
POSITION	Vice President, Corporate Clients
EMAIL	z@lenderb.com
TYPE OF STAKEHOLDER	Bank
SHORT DESCRIPTION OF THE POSITION	Senior debt, collateral
NAME OF STAKEHOLDER	Lender C
CONTACT PERSON	Mr. A
POSITION	Account Manager, Hospitality
EMAIL	a@lenderc.com
TYPE OF STAKEHOLDER	Bank
SHORT DESCRIPTION OF THE POSITION	Junior debt, no collateral
NAME OF STAKEHOLDER	Lender D
CONTACT PERSON	Mr. F
POSITION	Account Manager, Hospitality
EMAIL	f@lenderd.com
TYPE OF STAKEHOLDER	Bank
SHORT DESCRIPTION OF THE POSITION	Junior debt, no collateral

NAME OF STAKEHOLDER	Trade Creditors
CONTACT PERSON	Mr. R and Ms. T
POSITION	Representatives of Trade Creditors
EMAIL	r@tradecreditor1.com and t@tradecreditor2.com
TYPE OF STAKEHOLDER	Trade Creditors
SHORT DESCRIPTION OF THE POSITION	Important Trade Creditors for going concern, not easy to replace, no formal position, but strong informal position

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FORM 2 Letter of Intent to Adopt Workout Principles

LETTER OF INTENT TO APPLY OUT-OF-COURT WORKOUT PRINCIPLES

Parties to this Agreement:

- Creditors: Lender A, Lender B, Lender C, Lender D, and Trade Creditors
- Debtor: Hotel Group

It is a generally accepted in global principles that restructurings achieved outside of formal insolvency proceedings yield higher stakeholder returns for those involved, as these are more flexible and efficient than court proceedings.

It is generally accepted that OCWs:

- Allow *viable* businesses to continue to operate and to emerge successfully from financial distress;
- Allow creditors generally, but specifically lenders, to reduce losses;
- To a large extent avoid the social and economic impact of major business failures;
- Reduce pressure on the courts;
- Better serve other key stakeholders, such as customers, employees, suppliers, and investors, since businesses subject to out-of-court restructuring proceedings continue to trade;
- Are more efficient and effective than court procedures due to the shorter time frames and higher recovery rates;
- Assist the commercial community in developing confidence in the fairness, transparency, and accountability of insolvency and restructuring proceedings;
- Can apply to any form of business enterprise. The approach taken in these guidelines is that of INSOL International's "Statement of Principles for a Global Approach to Multi-Creditor Workouts." The INSOL principles are highly regarded around the world, and have formed the basis for out-of-court restructuring guidelines in various jurisdictions.

The eight Principles of workout procedures adopted under this agreement are:

FIRST PRINCIPLE

Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to cooperate with each other to give sufficient (though limited) time (a "Standstill Period") to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

Creditors will agree with Debtor a Standstill Period of 1 month. Within this Standstill Period the Debtor should produce (in cooperation with Creditors) a turnaround plan.

SECOND PRINCIPLE

During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced. Conflicts of interest in the creditor group should be identified early and dealt with appropriately.

Creditors acknowledge that their positions are best served by a going concern of Debtor. An interruption of the operations of the hotels would seriously damage the reputation of Debtor and the insolvency issues will become a self-fulfilling prophecy.

THIRD PRINCIPLE

During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.

Payments to all Creditors (including Lender A, Lender B, Lender C, Lender D, and the Trade Creditors) is subject to approval of all parties involved in this deal. Repayment of outstanding loans will not take place during the Standstill Period. Payments to Trade Creditors can take place, however payments of amounts that are currently overdue are not allowed. Payments to a creditor that exceed USD 100,000 in total in the Standstill Period needs explicit approval of Creditors.

Debtor will not take action to file for insolvency procedures without the approval of Creditors.

FOURTH PRINCIPLE

The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty. Such coordination will be facilitated by the selection of one or more representative coordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

The Parties involved have appointed a Coordination Creditors' Committee (Committee) comprising Professor A (mediator), Mr. X (Lender A), and Ms. T (Trade Creditor). The Committee is responsible for managing the process of the OCW and will provide information to all stakeholders. The Committee also schedules meetings (both general meetings between Creditors and Debtor as well as bilateral meetings).

FIFTH PRINCIPLE

During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers' reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

Debtor will create a detailed package of information (to be specified) and will create a data room with access for Parties involved. New information provided by Debtor will only be distributed via the data room so all Creditors will receive that information.

SIXTH PRINCIPLE

Proposals for resolving the financial difficulties to the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill, should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

Since the Debtor is located in jurisdiction ABC, the laws of ABC should be respected. The positions of the Creditors at the Standstill Commencement Date are:

	Term Loan	Currently Outstanding	Expiration Date	Arrears in Interest Payments	Arrears in Debt Repayment
Secured senior debt Lender A		6.937	Expires in several months	Yes	Yes
Secured senior debt Lender B		5.946	Expires in several months	Yes	Yes
Unsecured subordinated debt (working capital) Lender C		991	Expired		
Unsecured debt Lender D		793	Expires in several years	No	No
Secured debt provided by shareholders		2.000	No expiration date	N/A	N/A
Trade Creditors (unsecured)	N/A	4.851	The Hotel Group currently pays on average after 90 days.	Payment is net 30 days from date of invoice according to contract terms.	

SEVENTH PRINCIPLE

Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

All information provided from Debtor to Creditors should be made available through the data room. Proposals from one of the Creditors will be discussed during the meetings between Debtor and Creditors.

EIGHTH PRINCIPLE

If additional funding is provided during the Standstill Period or under any rescue of restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

Both Lender C and Lender D have indicated that they are willing to provide additional funding to the Hotel Group. Debtor needs to provide an overview of the necessary funding for the next 6 months. Lender A, Lender B, and Trade Creditors have indicated that they are willing to discuss a higher priority for repayment of the new financing.

The parties acknowledge that they have read and understand this Letter of Intent and the Out-of-Court Workout Principles and voluntarily accept the duties and obligations set forth herein.

Signed on 24 May 2016 by:

Owners	Lender A	Lender B
Lender C	Lender D	Trade Creditors

FORM 3

Workout Planning and Communication Framework

Workout Planning and Communication Framework	24-May	25-May	26-May	27-May	28-May	29-May	30-May	31-May	1-Jun	2-Jun	3-Jun
Standstill period	Start										
Meetings											
—OCW stakeholder meeting	X		X			X					X
—bilateral meetings (Enterprise—Lenders)		X			X					X	
—bilateral meetings (Enterprise—Trade Creditors)		X			X					X	
—bilateral meetings (Lenders—Trade Creditors)		X			X					X	
Information											
—financial statements		X									
—management information		X									
—cash flow forecast—2 weeks			X								
Deliverables											
—signed letter of adoption of OCW principles	X										
—confidentiality agreement	X										
—standstill agreement—draft	X										
—standstill agreement—final				X		X					
—stabilizing plan											
—turnaround plan											
Other			X								
—new Turnaround Team											

FORM 4

Confidentiality Agreement

CONFIDENTIALITY AGREEMENT OUT-OF-COURT WORKOUT

Parties to this agreement:

- Creditors: Lender A, Lender B, Lender C, Lender D, and Trade Creditors
- Debtor: Hotel Group

It is understood and agreed to that the parties to this Agreement would each like to provide the other with certain information that may be considered confidential. To ensure the protection of such information and in consideration of the Agreement to exchange said information, the parties agree as follows:

1. The confidential information to be disclosed under this Agreement ("Confidential Information") can be described as and includes:

Financial information about the Debtor, financial projections, budgets, forecast, restructuring plan, future business plans, information about customers and suppliers, information about bank loans, and all other information regardless of whether such information is designated as Confidential Information at the time of its disclosure.

In addition to the above, Confidential Information shall also include, and the parties shall have a duty to protect, other confidential and/or sensitive information which is (a) disclosed as such in writing and marked as confidential (or with other similar designation) at the time of disclosure; and/or (b) disclosed by in any other manner and identified as confidential at the time of disclosure and is also summarized and designated as confidential in a written memorandum delivered within thirty (30) days of the disclosure.

2. The parties shall use the Confidential Information only for the purpose of trying to reach an Out-of-Court Workout Agreement.

3. The parties shall limit disclosure of Confidential Information within its own organization to its directors, officers, partners, members, and/or employees having a need to know and shall not disclose Confidential Information to any third party (whether an individual, corporation, or other entity) without prior written consent. The parties shall satisfy its obligations under this paragraph if it takes affirmative measures to ensure compliance with these confidentiality obligations by its employees, agents, consultants, and others who are permitted access to or use of the Confidential Information.

4. This Agreement imposes no obligation upon the parties with respect to any Confidential Information (a) that was possessed before receipt; (b) that is or becomes a matter of public knowledge through no fault of receiving party; (c) that is rightfully received from a third party not owing a duty of confidentiality; (d) that is disclosed without a duty of confidentiality to a third party by, or with the authorization of the disclosing party; or (e) that is independently developed.

5. The parties warrant that they have the right to make the disclosures under this Agreement.

6. This Agreement shall not be construed as creating, conveying, transferring, granting, or conferring upon either party any rights, license, or authority in or to the information exchanged, except the limited right to use Confidential Information specified in paragraph 2. Furthermore and specifically, no license or conveyance of any intellectual property rights is granted or implied by this Agreement.

7. All parties acknowledge and agree that the exchange of information under this Agreement shall not commit or bind either party to any present or future contractual relationship (except as specifically stated herein), nor shall the exchange of information be construed as an inducement to act or not to act in any given manner.

8. Neither party shall be liable to the other in any manner whatsoever for any decisions, obligations, costs or expenses incurred, changes in business practices, plans, organization, products, services, or otherwise, based on either party's decision to use or rely on any information exchanged under this Agreement.

9. If there is a breach or threatened breach of any provision of this Agreement, it is agreed and understood that the non-breaching party shall have no adequate remedy in money or other damages and accordingly shall be entitled to injunctive relief, provided however, no specification in this Agreement of any particular remedy shall be construed as a waiver or prohibition of any other remedies in the event of a breach or threatened breach of this Agreement.

10. This Agreement states the entire agreement between the parties concerning the disclosure of Confidential Information and supersedes any prior agreements, understandings, or representations with respect thereto. Any addition or modification to this Agreement must be made in writing and signed by authorized representatives of both parties. This Agreement is made under and shall be construed according to the laws of country ABC. In the event that this agreement is breached, any and all disputes must be settled in a court of competent jurisdiction in ABC.

11. If any of the provisions of this Agreement are found to be unenforceable, the remainder shall be enforced as fully as possible and the unenforceable provision(s) shall be deemed modified to the limited extent required to permit enforcement of the Agreement as a whole.

Wherefore, the parties acknowledge that they have read and understand this Agreement and voluntarily accept the duties and obligations set forth herein.

Signed on 24 May 2016 by:

Owners	Lender A	Lender B
Lender C	Lender D	Trade Creditors

FORM 5 Standstill Agreement

STANDSTILL AGREEMENT OUT-OF-COURT WORKOUT

Parties to this Agreement:

- Creditors: Lender A, Lender B, Lender C, Lender D, and Trade Creditors
- Debtor: Hotel Group

All parties involved acknowledge that the parties should be provided sufficient time for information about the Debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed.

1. The standstill period is effective as of 24 May 2016 and ends 24 June 2016 12:00 CET.
2. During the standstill period, the Debtor:
   a. Has the obligation to prepare a restructuring plan that will resolve the Debtor's financial difficulties. The restructuring plan must demonstrate that the distressed business is capable of operating profitably, as well as the extent to which it will be able to repay its debts.
   b. Has the obligation to provide all relevant Creditors with adequate reliable information to enable them to assess the debtor's financial position, to understand what has caused the underlying financial problems, and to evaluate any proposed solutions that are put forward.
   c. Should not take any action that would adversely affect the prospective returns on the relevant Creditors on a collective or individual basis, as compared to their position at the commencement of the standstill period.
3. During the standstill period, the Creditors:
   a. Are entitled to expect that their position relative to other creditors will not be prejudiced during the standstill period;
   b. Will not try to improve their positions relative to other creditors;
   c. Will not insist on payment of amounts owing to them;
   d. Will not initiate collection, security enforcement, or liquidation proceedings;
   e. Will allow existing credit lines and facilities to be used; and
   f. Will allow the Debtor to continue to make payments in what is commonly referred to as "the ordinary course of business."
4. The standstill period ends on 24 June 2016 at 12:00 CET. Extension of the standstill period is only possible if all Creditors and the Debtor agree.

Wherefore, the parties acknowledge that they have read and understand this Agreement and voluntarily accept the duties and obligations set forth herein.

Signed on 24 May 2016 by:

Owners	Lender A	Lender B
Lender C	Lender D	Trade Creditors

FORM 6 FINANCIAL DATA

Balance Sheet*

Consolidated Balance Sheet as at 31 December	2017E	2016E	2015A	2014A	2013A
Fixed assets					
Intangible fixed assets	1,386	1,708	1,525	1,540	1,400
Tangible fixed assets	17,198	19,768	15,865	15,950	14,500
Financial fixed assets	1,202	1,365	980	731	683
	19,786	22,841	18,370	18,221	16,583
Current assets					
Inventories	1,100	1,350	967	950	800
Trade receivables	1,750	2,208	1,960	1,980	1,800
Taxes and premiums	1,436	1,650	1,200	1,345	1,255
Other current assets	3,295	4,132	2,614	2,640	2,000
Cash and cash equivalents	147-	211-	113	342	540
	7,434	9,129	6,854	7,257	6,395
	27,220	31,970	25,223	25,478	22,978
Shareholders' equity					
Share capital	18	18	18	18	18
Share premium	—	—	—	—	—
Legal reserve	—	—	—	—	—
Other reserves	2,155-	660-	743	2,006	3,000
Result current year	1,331-	1,495-	1,403-	1,263-	994-
Total equity	**3,468-**	**2,137-**	**642-**	**761**	**2,024**
Provisions					
Deferred taxes	642	975	409	584	900
Long-term liabilities					
Long-term loan	14,000	15,000	12,500	11,016	10,000
Short-term liabilities					
Trade payables	4,300	5,300	4,851	4,250	3,500

Consolidated Balance Sheet as at 31 December	2017E	2016E	2015A	2014A	2013A
Taxes, pensions and premiums	2,000	2,000	1,200	1,800	500
Short-term part of long-term debt	6,745	7,500	4,167	3,667	3,370
Other liabilities and deferred income	3,000	3,332	2,739	3,400	2,684
Total liabilities	16,045	18,132	12,957	13,117	10,054
Total equity and liabilities	27,220	31,970	25,224	25,478	22,978

Income Statement

Consolidated Income Statement for the Year	2017E	2016E	2015A	2014A	2013A
Net turnover	10.000	8.000	9.000	11.000	13.000
Cost of sales	264	108	196	234	325
Gross margin	9.736	7.892	8.804	10.766	12.675
Wages and salaries	3.400	3.040	3.420	3.960	4.550
Social security charges and pensions	170	152	171	198	228
Other operating expenses	5.330	4.408	4.709	5.942	6.923
Amortization and depreciation	1.600	1.300	1.400	1.500	1.500
Total operating expenses	10.500	8.900	9.700	11.600	13.201
Result from operations	764-	1.008-	896-	834-	525-
Financial expenses	1.010-	985-	975-	850-	800-
Result before taxations	1.774-	1.993-	1.871-	1.684-	1.325-
Income taxes	444	498	468	421	331
Result from nonconsolidated companies	—	—	—	—	—
Net result after taxes	1.331-	1.495-	1.403-	1.263-	994-

Long-Term Cash Flow Statement (18 months)

(Adjusted net income method)

Consolidated Income Statement for the Year	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Cash flow from operating activities												
Result after taxes	125-	125-	125-	125-	125-	125-	125-	125-	125-	125-	125-	125-
Amortization and depreciation	108	108	108	108	108	108	108	108	108	108	108	108
Decrease/(increase) of trade receivables	21-	21-	21-	21-	21-	21-	21-	21-	21-	21-	21-	21-
Decrease/(increase) of other current assets	196-	196-	196-	196-	196-	196-	196-	196-	196-	196-	196-	196-
(Decrease)/increase of provisions	47	47	47	47	47	47	47	47	47	47	47	47
(Decrease)/increase of short-term part of loans	37	37	37	37	37	37	37	37	37	37	37	37
(Decrease)/increase of short-term liabilities	116	116	116	116	116	116	116	116	116	116	116	116
Cash flow from operating activities	32-	32-	32-	32-	32-	32-	32-	32-	32-	32-	32-	32-
Cash flow from investing activities												
Investment in intangible fixed assets	42-	42-	42-	42-	42-	42-	42-	42-	42-	42-	42-	42-
Investment in tangible fixed assets	407-	407-	407-	407-	407-	407-	407-	407-	407-	407-	407-	407-
Disposal of tangible fixed assets												
Investment in financial fixed assets	32-	32-	32-	32-	32-	32-	32-	32-	32-	32-	32-	32-
Disposal of financial fixed assets	—	—	—	—	—	—	—	—	—	—	—	—
Cash flow from investing activities	481-	481-	481-	481-	481-	481-	481-	481-	481-	481-	481-	481-
Cash flow from financing activities												
Issue of ordinary shares	—	—	—	—	—	—	—	—	—	—	—	—
Proceeds from borrowings	—	—	—	—	—	—	—	—	—	—	—	—
Repayment of long-term liabilities	—	—	—	—	—	—	—	—	—	—	—	—
Increase of long-term liabilities	486	486	486	486	486	486	486	486	486	486	486	486
	486	486	486	486	486	486	486	486	486	486	486	486

Consolidated Income Statement for the Year	**Jan**	**Feb**	**Mar**	**Apr**	**May**	**Jun**	**Jul**	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**
Change in cash and cash equivalents	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-
Net foreign exchange difference	—	—	—	—	—	—	—	—	—	—	—	—
Total change	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-
Cash & bank—beginning of the month	113	86	59	32	5	22-	49-	76-	103-	130-	157-	184-
Total change	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-	27-
Cash & bank—ending of the month	86	59	32	5	22-	49-	76-	103-	130-	157-	184-	211-

Short-Term Cash Flow Statement (6 weeks)

(Cash and disbursement method)

Consolidated Income statement for the Year	24/05/16	25/05/16	26/05/16	27/05/16	28/05/16	29/05/16	30/05/16	31/05/16	01/06/16	02/06/16
Cash Inflow										
Revenues	24	25	21	19	23	24	18	19		
Additional loans							125			
. . .										
. . .										
. . .										
. . .										
. . .										
Total Cash Inflow	24	25	21	19	23	24	143	19		
Cash Outflow										
Disbursement for cost of sales	—	—	3	—	—	3	—	—		
Disbursement for payroll	—	—	101	—	—	—	—	—		
Disbursement for other expenses			36			36				
Disbursement for financial expenses	—	—	—	—	—	—	—	22		
Disbursement for investments		124								
Total Cash Outflow	—	124	140	—	—	39	—	22		
Total change	24	99-	119-	19	23	15-	143	3-		
Cash & bank—beginning of the day	5	29	70-	189-	170-	147-	162-	19-		
Total change	24	99-	119-	19	23	15-	143	3-		
Cash & bank—ending of the day	29	70-	189-	170-	147-	162-	19-	22-		

FORM 7 Stabilizing Plan

The stabilizing plan contains the following items:

1. Preliminary analysis of causes of decline:
   - Description of the strategy that led to the financial distress and the restructuring situation (cause of decline) (first analysis).
2. Immediate cash requirements:
   - Information on the detailed short-term cash forecast (see also 3)
   - Daily basis for a period of six to 12 weeks
   - Based on reliable starting position.
3. Short-term cash flow forecast:
   - Spreadsheet with cash flow planning (six to 12 weeks).
4. Overview of cash generating activities:
   - Description of each initiative to generate cash including benefits and costs of the initiative
   - Prioritize the cash generating initiatives
   - Examples:
     - Collection of accounts receivable
     - Postpone payment of accounts payable
     - Reduction of inventory
     - Cancelling planned capital and operational expenditures.
5. Emergency cash management controls:
   - Description of implementation of strong cash controls
   - Cash management team
   - Strong forecasting and reporting controls
   - Examples of new controls are:
     - No new employment contracts
     - No payroll increases and promotions
     - Reduce all capital expenditures
     - Additional purchase controls.
6. Cash rationing:
   - Restrictions on the amount of new investments or projects undertaken by an enterprise.

7. Restructuring Management Team:
   - Description of the Restructuring Management Team
   - Roles and responsibilities (new skills).

FORM

8 Restructuring Plan

1. Enterprise profile and cause of decline:
   - Detailed enterprise profile (history, major developments)
   - Description of products and services and a description of the successes from the past (operational activities)
   - Detailed description of the management structure (including key managers)
   - Detailed description of the strategy that led to the financial distress and the restructuring situation (cause of decline).
2. Analysis of external environment:
   - Detailed description of the industry
   - Description of product/market segments
   - Competitive forces (now and in the future)
   - Threats of new entrants in the industry or substitute products/services
   - Description of the most important customers and suppliers.
3. Restructuring vision:
   - In what way does the enterprise want to be renowned for in the market?
   - How should the customers talk about the enterprise?
   - What is the new internal culture?
   - How is technology going to help the enterprise?
   - New partnerships?
   - How will the human resources management look?
   - How should the enterprise be structured?
   - Changes in management?
   - Changes in ownership?
4. Restructuring strategy:
   - Detailed description of the sales growth that is strived for
   - Description of the most important services and products (now and in the future) including the reason why
   - A detailed reasoning on the unique features of the new enterprise compared to its competitors (unique selling points)
   - What are the specific needs the products or services fulfill for the customer?
   - In what way should the products or services be positioned in the market?

- What are the target groups (customers) including the reasoning why these are the target groups?
- Overview of the forecasted savings and improvements of efficiency.

5. Operational analysis:
   - Detailed overview of the strengths and weaknesses of the enterprise based on the preceding SWOT-assessment
   - Identification for possible operational points of improvement.
6. Operational action plan:
   - A detailed plan of attack containing the proposed measures in small, clear, and quantifiable steps, segmented to the various parts of the organization in which specific actions should be taken.
7. Financial projections:
   - An overview of the financial calculation of the expected effects of the strategic and operational actions
   - Balance sheet projections
   - Result forecasts (profit and loss accounts)
   - Forecasts of cash flow overviews, cash planning, long-term (18 months) and short-term (six to eight weeks)
   - Scenario analysis (worst case, best case).
8. Time scheme:
   - A detailed timetable mentioning the milestones which are pursued
   - A timetable and a preference of the sequence of the steps to take within different units and layers of the enterprise (if relevant)
   - A (proposal for a) timetable for reporting about the progress of the restructuring to the external parties involved.
9. Risk analysis:
   - An indication what the possible downside of the restructuring strategy is
   - A description of a more negative (worst case) and a more positive (best case) scenario with regard to the expected restructuring scenario
   - Risk-reward ratio, this concerns a (general) calculation of the maximum loss for a financier when participating in the restructuring (should bankruptcy still follow) versus the immediate withdrawal of the financier (with an instant bankruptcy following in which the chance of incomplete payment is fairly present) against the potential upside which is expected when the restructuring succeeds (resulting in higher repayments than in the case of bankruptcy)
   - Compliance with local laws and regulations.
10. Effects on current creditors:
    - Effect of the restructuring plan on the current creditors
    - Proposed modifications of creditors' rights.

Sources for additional capital (debt or equity).

FORM 9 Letter of Intent to Enter into New Financing Agreement

Parties to this letter of intent:

- Creditors: Lender A, Lender B, Lender C, Lender D, and Trade Creditors
- Debtor: Hotel Group

The parties acknowledge the fact that Debtor needs additional financing to be able to restructure the company and avoid insolvency in general. More specific, the Debtor needs additional financing to:

- Reduce the outstanding amount to Trade Creditors to ensure continuation of the supplying services (housekeeping services) and supplying food & beverages to the Debtor. Without this continuation, the going concern position of Debtor is not guaranteed.

Lender D has expressed to be interested to provide additional financing to Debtor in the form of a secured senior debt. In exchange for the additional financing by Lender D, the following is required:

1. An agreement should be made between the current creditors to provide Lender D with the highest priority with respect to repayment of the additional financing. Lender D will be repaid first in case of insolvency.
2. An agreement to change the collateral/security rights from Lender A and Lender B and involve Lender D. Lender A and Lender B will give up a proportional part of the rights to the collateral in favor of Lender D.
3. A share pledge agreement that deals with the pledge over the shares of Debtor. Lender D will get a share pledge on the shares of Debtor.
4. A guarantee of the personal holdings of the shareholders of Debtor in case collateral is insufficient to repay the new loan.

Parties will finalize the agreements above in the next weeks.

Signed on 24 May 2016 by:

Owners	Lender A	Lender B
Lender C	Lender D	Trade Creditors

FORM 10 Set-Off Agreement

SET-OFF AGREEMENT

This agreement between ("Party 1") and Lender C ("Party 2"),

WHEREAS

A. Pursuant to a loan agreement Party 1 became indebted to Party 2 in the original amount of $900,000 (the "Party 1 Indebtedness");

B. As of the date hereof, the aggregate amount of the Party 1 Indebtedness is $991,000;

c. Pursuant to a sales agreement (employee gathering of Party 2 at Party 1) Party 2 became indebted to Party 1 in the original amount of $25,000;

D. As of the date hereof, the aggregate amount of the Party 2 Indebtedness is $25,000;

E. The parties hereto wish to set-off the full amount of the Party 1 Indebtedness against the Party 2 Indebtedness, to the fullest extent possible.

NOW THEREFORE in consideration of the premises and for other good and valuable consideration, the receipt and sufficiency of which is hereby acknowledged, the parties hereto hereby agree as follows:

1. The parties acknowledge and agree that the recitals above are true and correct in all material respects.
2. The parties hereby set-off the full amount of the Party 1 Indebtedness against the Party 2 Indebtedness, to the fullest extent possible.
3. The difference of $875,000 shall be the outstanding amount by Party 1 to Party 2 during the workout situation.

IN WITNESS WHEREOF the parties have executed this Agreement as of the date first written above.

Signed on 31 May 2016 by:

______________________	______________________
Owners	Lender C

6 Conclusion

The effective resolution of nonperforming loans serves a critical function for a country's financial system—to ensure both stability and liquidity in the banking sector. Sound insolvency and debt resolution frameworks also promote access to credit by ensuring that viable businesses are liquidated efficiently and those that can be rescued are successfully restructured. While ensuring efficient and orderly liquidation has always been a challenge for policy makers, for most countries the larger challenge has been on the restructuring front. International experience tells us that there is no one size fits all solution to the challenge of developing effective restructuring frameworks. Even within the same country, a diversity of restructuring procedures may be necessary because one tool is often not fully effective. Best practices dictate that a country's restructuring system should provide borrowers and lenders with as many tools as possible to restructure troubled companies. Formal, judicial reorganization forms the backbone of such a set of tools, but it needs to be supported with other options. This is what makes a framework for workouts so important.

What this Toolkit has attempted to do is to provide policy makers and other stakeholders with a taxonomy of different workout frameworks and an understanding of how to implement such frameworks. Such a document can never hope to be exhaustive, as there are infinite variations at the country level in how these frameworks have been put in place. At the same time, however, the taxonomy provides a broad understanding of the different models that can be deployed under the larger banner of "out-of-court workouts." Some of these models will involve courts or administrative bodies—to varying degrees—and others will be purely driven by the parties. Some models are heavily reliant on external advisers, both financial and legal, while others are highly dependent on a strong cadre of insolvency representatives and/or mediators. In all cases, however, borrowers and lenders need to be willing to negotiate and drive the process forward. While the formal legal framework for business liquidation and reorganization will always provide a "backstop" when negotiations fail, decades of experience in insolvency cases tell us that consensus-driven solutions usually provide better outcomes to all stakeholders. The aspiration of this Toolkit is to ensure that such solutions, which today are far too rare, become commonplace.

Glossary

To ensure consistency with terms used in the World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes *and the* UNCITRAL Legislative Guide on Insolvency Law, *definitions have been taken from the Legislative Guide where feasible.*

Administration is a procedure (aimed at restructuring) under which an ***administrator*** is appointed to run an enterprise for a finite period of time in the interests of all of the creditors.

Arbitration is an out-of-court dispute resolution mechanism in which an independent third party (the ***arbitrator,*** often an expert on the disputed topic) hears the opposing claims and delivers a binding ruling. Arbitration is less formal and quicker than a court process.

CAPEX, or ***capital expenditure,*** is spending directed towards physical assets (either new assets or repairs/improvements to existing assets).

Cash flow is the amount of cash moving into and out of a business. Positive cash flow is necessary for long-term operations. Negative cash flow may lead to liquidity problems.

Claim is a right to payment from the estate of the debtor, whether arising from a debt, a contract, or other type of legal obligation, whether liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, or fixed or contingent.[106]

Collateral is an asset that is offered by a borrower or a third party to secure a loan. The lender can seize the asset if the borrower breaches its obligations.

Conciliation is used synonymously with *mediation* for the purposes of this Toolkit, and is assigned the same definition.

Cram-down is a mechanism in some insolvency laws whereby a decision adopted by the legally pre-stipulated majority of creditors can be imposed on the opposing minority group of creditors (the "dissentient creditors").

Creditor is a natural or legal person who has a claim against the debtor that arose on or before the commencement of the insolvency proceedings (used in this Toolkit synonymously with *lender*).[107]

Debtor is a natural or legal person who owes a debt to a creditor (used in this Toolkit synonymously with *borrower*).

Debt-to-equity ratio is a financial ratio based on an enterprise's balance sheet that indicates the proportion of an enterprise's debt to its shareholder equity.

EBITDA, or ***earnings before interest, tax, depreciation and amortization,*** is an accounting principle that represents a company's operating profitability prior to subtracting interest, tax, depreciation, and amortization.

Foreclosure is a remedy available to creditors wherein the creditor can gain ownership of a defaulted debtor's secured property.[108]

Going concern is a concept that stands for the general assumption that a business will continue to operate for the foreseeable future.[109] A *sale as a going concern* is the sale or transfer of a business in whole or substantial part.[110]

Hybrid procedure, for the purposes of this publication, is a workout that combines features of an out-of-court workout and a formal reorganization process.

ICR Standard is an assessment tool that represents the international consensus on best practices for evaluating and strengthening insolvency regimes.

INSOL Principles refers to the INSOL Statement of Principles for a Global Approach to Multi-Creditor Workouts.[111] It encompasses a set of best practices for multi-creditor workouts and can be considered as a modern version of the London approach.

Insolvency is when a debtor is generally unable to pay its debts as they mature or when its liabilities exceed the value of its assets.[112]

Insolvency proceeding is a collective proceeding subject to court supervision that, for the purposes of this Toolkit, includes either a restructuring or a liquidation process.

Lead bank is a position given to a bank creditor to oversee the loan restructuring and represent all creditors in negotiations with the debtor and any professional advisors if the number of bank creditors is great enough to make coordination difficult.

Liquidation is a proceeding in which the debtor's assets are sold and disposed of, with proceeds distributed to creditors in accordance with the insolvency law.[113]

London Approach is a set of OCW principles to negotiate nonperforming loans and other obligations favoring active out-of-court workout arrangements by bringing together both the debtor and its creditor banks to an agreement.

Mediation is a means in which disputes can be resolved in a flexible process, conducted in confidentiality, in which a neutral person (the ***mediator***) actively assists parties in working toward a negotiated agreement of a dispute or difference.[114] For the purposes of this Toolkit, *mediation* and *conciliation* are used synonymously.

Moratorium is a period of limited time during which the debtor can develop and implement its reorganization plan and the creditor(s) cannot seek legal remedies.[115]

OCW principles or guidelines are nonbinding principles that parties follow when conducting an OCW, such as those issued by the Bank of England titled the "London Approach."

Out-of-court-workout (OCW) is a workout that involves no judicial intervention. The negotiations are aimed at securing contractual arrangements both between the lenders themselves as well as the lenders and the debtor for the restructuring of the debtor, with or without rearrangement of the financing.[116]

Pre-arranged plan or **pre-negotiated plan** is a restructuring plan in which the debtor negotiates with its major stakeholders and receives their support for a plan. The debtor then enters the reorganization process, and when a formal solicitation of votes is held under the auspices of the court or an administrative authority, the major stakeholders support the pre-arranged plan.

Pre-packaged restructuring plan (pre-pack) for the purposes of this Toolkit combines voluntary restructuring negotiations, where a plan is negotiated and agreed by the majority of affected creditors, with reorganization proceedings commenced under the insolvency law to obtain court confirmation of the plan in order to bind dissenting creditors.[117] It should be noted that pre-packs have different legal definitions in different jurisdictions, which is explored further in Chapter 3.

Receivership is when a creditor appoints a receiver over one or more of the insolvent enterprise's assets specified in a legal charge within a secured loan agreement.

Reorganization for the purposes of this Toolkit is used in the sense of a judicial reorganization. It is the process by which the financial well-being and viability of a debtor's business can be restored and the business continue to operate, using various means possibly including debt forgiveness, debt rescheduling, debt-equity conversions, and sale of the business (or parts of it) as a going concern.[118]

Rescheduling is the changing of an outstanding loan's terms due to the debtor's difficulty to make interest or principal repayments. Usually the terms are changed to defer payments or extend the repayment period (which reduces the amount of each payment).[119]

Rescue is the act of restoring an enterprise to financial viability with as few changes as possible to its structure.[120]

Restructuring is the adjustment of a debtor's liabilities to make the debtor more capable of meeting its obligations. It can be financial, operational, or a combination of both. For the purposes of this Toolkit, *restructuring* is taken to include both workouts and reorganization processes.

Restructuring plan for the purposes of this Toolkit is a plan by which the financial well-being and viability of the debtor's business can be restored,[121] and is used synonymously with *workout plan* and *reorganization plan.*

Secured creditor is any creditor or lender that takes collateral for the extension of credit, loan, or bond issuance and is recognized as such by the insolvency law.

Senior debt is borrowed money that takes precedence over other debts.

Silent trustee is, in the context of the Dutch pre-packaged restructuring framework, a trustee that the court states it will appoint in the event of an enterprise's insolvency proceeding (but who is not yet appointed). This trustee works with the enterprise to create a pre-packaged plan. When the enterprise files for an application for an insolvency proceeding, the silent trustee is appointed as the acting trustee by the court, and implements the restructuring plan.

Standstill agreement for the purposes of this Toolkit is a contractual agreement between the debtor and some or all of its creditors to give the debtor time to restructure. The parties agree not to seek legal remedies during this period.[122]

Standstill period is the time specified in the standstill agreement in which the relevant parties will not enforce their rights against the debtor.

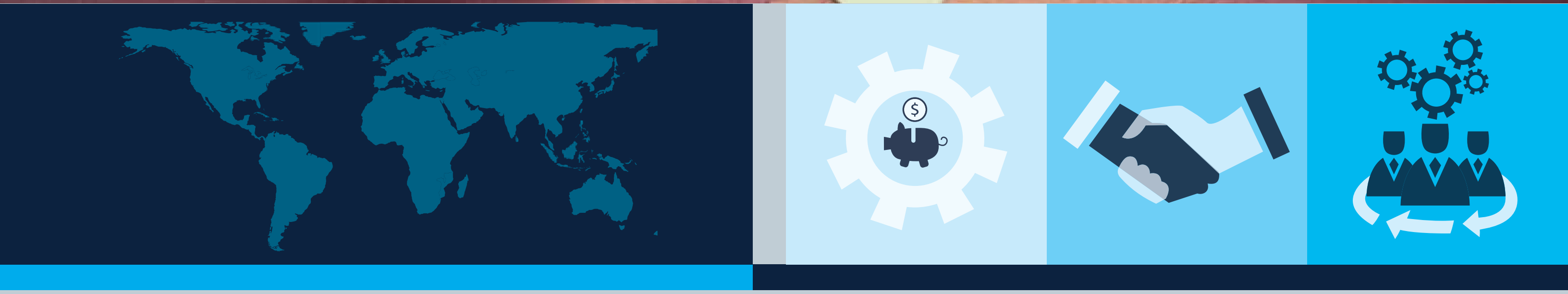
Stay or **stay of proceedings** is a measure that prevents the commencement of, or suspends the continuation of judicial, administrative, or other individual actions concerning the debtor's assets, rights, obligations, or liabilities. The measure includes actions to make security interests effective against third parties or to enforce a security interest. It also prevents execution against the assets of the insolvency estate, the termination of a contract with the debtor, and the transfer, encumbrance, or other disposition of any assets or rights of the insolvency estate.[123]

Steering committee is a committee that is formed by creditors to oversee the restructuring of a debtor on behalf of all creditors.

Unsecured creditor is any creditor or lender without collateral for the extension of credit, loan, or bond issuance.

The WB-ICR Principles refers to the World Bank's Principles for Effective Insolvency and Debtor/Creditor Rights, internationally recognized benchmarks that are typically used to evaluate the effectiveness of domestic creditor/debtor rights and insolvency systems.

Workout is a non-statutory agreement between a debtor and creditors with the aim of easing the debtor's debt servicing burden so that it can maintain its business activities. Workouts, for the purposes of this Toolkit, include restructuring procedures with no judicial involvement (out-of-court workouts) or restructuring procedures with minimal judicial or other institutional involvement (hybrid procedures).



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5. Patrick Fitzgerald, "Spain's Abengoa Wins U.S. Bankruptcy Court Protection," *The Wall Street Journal*, April 27, 2016, http://www.wsj.com/articles/spains-abengoa-wins-u-s-bankruptcy-court-protection-1461783532.

6. Vanessa Finch, "Corporate Rescue Processes: the Search for Quality and the Capacity to Resolve," *Journal of Business Law* 6 (2010).

7. As set out in José M. Garrido, 2012, *Out-of-Court Debt Restructuring*. A World Bank Study, Washington, DC: World Bank, the "continuum is based on the degree of judicial intervention and the degree of 'formality' in general."

8. A feature found in insolvency laws whereby a decision adopted by the pre-stipulated majority can be imposed on dissentients.

9. The support provided as result of the intervention of the courts or an administrative authority is a cramming-down or binding effect. The courts or the administrative authority will ensure that the formal requirements and minimum thresholds have been met to assure that no fraud or deceit has taken place and all creditors have been treated fairly and have had their right to express their will.

10. These proceedings are usually characterized by an initial order declaring the commencement of the process; followed with several procedural steps; and, a final court order implementing an agreed plan or declaring the impossibility of reaching an agreement and subsequent commencement of an insolvency proceeding that terminates with the winding up of the company and its registration cancellation.

11. The law in each jurisdiction will establish the scope and reach of the norm and which creditors are subject to the agreement. Sometimes, secured creditors, preferential creditors and bondholders are excluded. The same may be the case with employees and other specific types of creditors.

12. John Armour, Menezes, Uttamchandani and van Zwieten, "How Do Creditor Rights Matter for Debt Finance," *Research Handbook on Secured Financing of Commercial Transactions*, ed, Frederique Dahan, (provisional title) (forthcoming, Edward Elgar: London, 2015).

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14. Sandra Frisby, "A Preliminary Analysis of Pre-packaged Administrations," Report to the Association of Business Recovery Professionals, R3-The Association of Business Recovery Professionals (2007).

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17. The data for the graph is based on: World Bank Group, *Doing Business 2016: Measuring Regulatory Quality and Efficiency*, 13th ed (Washington, DC: The World Bank Group, 2016). Although the report studies 189 economies, only 160 are represented in the graph. Of the 29 excluded economies, 19 were omitted because they have no insolvency framework in place (the corresponding recovery rate is $0.00 per dollar), and 10 economies were omitted because there is no data on the domestic credit provided by the banking sector in those countries.

18. World Bank Group, "Insolvency and Debt Resolution," Brief, Washington, DC: World Bank, 2015, www.worldbank.org/insolvency.

19. Mihaela Carpus Carcea, Daria Ciriaci, Dimitri Lorenzani, Peter Pontuch, and Carlos Cuerpo, "The Economic Impact of Rescue and Recovery Frameworks in the EU," Discussion Paper 4, European Commission: Brussels, 2015, http://ec.europa.eu/economy_finance/publications/eedp/dp004_en.htm.

20. A "percentage point" and a "percent" are different units of measurement. A percentage point is the arithmetic increase between two numbers, whereas a percent is a ratio (e.g., an increase from 15% to 20% is a 5 percentage point increase, but a 33% increase).

21. Financial Stability Board, "Insolvency and Creditor Rights Standard," January 20, 2011, http://www.fsb.org/2011/01/cos_051201/.

22. Garrido, *Out-of-Court Debt Restructuring*.

23. UNCITRAL, *Legislative Guide on Insolvency Law*.

24. Garrido, *Out-of-Court Debt Restructuring*.

25. Adriaanse and A.M. Griffioen, "Toolkit for Turnarounds, Workouts and Insolvency Procedures in Rwanda," 2015.

26. Sociology mostly considers confidence as the "lubricant" for interactions; it ensures that interactions run more smoothly. See for instance Stewart Macaulay, "Non-Contractual Relations in Business: A Preliminary Study." *American Sociological Review* 28, no. 1 (1963): 55–67. In a more economic sense: business contexts are influenced by two major institutional characteristics: the distribution of information among different market players (stakeholders) and the presence of mechanisms/norms granting or punishing fair or unfair behavior.

27. Adriaanse and A.M. Griffioen, "Toolkit for Turnarounds, Workouts and Insolvency Procedures in Rwanda."

28. Joseph R Nolan and Jacqueline M. Nolan-Haley. "Subordination," *Black's Law Dictionary: Centennial Edition* (1891–1991). 6th ed. St. Paul, MN: West Publishing, 1990.

29. As noted in *In re Enron Corp*., the "[s]ubordination of a claim alters the otherwise applicable priority of that claim within a creditor class; a subordinated claim receives a distribution only after the claims of other creditors have been satisfied."

30. As noted by David Billington, "Interactions with Other Creditors" in Shutter (ed.), *A Practitioner's Guide to Syndicated Lending* (2010), para. 4.5: "To some extent, these arrangements may look unfair to the junior [subordinated] creditors. But the extra return they receive during the life of the junior [subordinated] debt should compensate them. If they have priced the risk incorrectly, that is the consequence of a free market."

31. United Nations Commission on International Trade Law, *UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation*, New York: United Nations Publication, 2009, http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2009PracticeGuide.html.

32. John Armour, Brian Cheffins and David A. Skeel Jr., "Corporate Ownership Structure and the Evolution of Bankruptcy Law: Lessons from the United Kingdom," *Vanderbilt Law Review* 55, no. 6 (2002): 1756.

33. Garrido *Out-of-Court Debt Restructuring*, 1.

34. Chatterjee Sris, Upinder S. Dhillon and Gabriel G. Ramirez, "Resolutions of Financial Distress: Debt Restructurings via Chapter 11, Pre-packaged Bankruptcies, and Workouts," *Financial Management Journal* 25, no. 1 (1996): 12, 13, 18.

35. There is usually no stigma attached to an OCW and a successful agreement is generally followed by a positive market reaction.

36. One inherent weakness of OCWs is the requirement of unanimity for major changes in loan terms built into the terms of the original loan contracts. There is much less scope for minority lenders to be "crammed-down" as is the practice under court-supervised procedures. A favorable development in

this field is to include collective action clauses (CACs) in multi-lender agreements. CACs are clauses whereby, if they are included in the contract, the interaction of the creditors is required. There are four different types of CACs. These are: (1) collective representation clauses; (2) majority action clauses; (3) sharing clauses; and (4) acceleration clauses. Within CACs, majority action clauses are the type of clauses that have been strongly pursued by the official sector and many academics, and they were effectively incorporated in bond issuances. Majority action clauses enable the amendment of any of the terms and conditions of the bonds, including the payment terms, if the required majority therein established is obtained.

37. Herd behavior is a concept of behavioral finance that describes how individuals in a group can act collectively without centrally organized direction just by following the (rational or irrational) actions of others (usually a larger group). The larger group has to start by the action of an individual that then is followed by others, even if it does not transcend to a degree that it becomes a "herd" it can be sufficient to become a holdout problem.

38. David Clementi, "Debt Workouts for Corporates, Banks and Countries: Some Common Themes," Speech to the INSOL International Sixth World Congress held at the Hilton Metropole Hotel in London on 19 July 2001, 2.

39. Pen Kent, "Corporate Workouts—A U.K. Perspective," *International Insolvency Review* 6 (1997): 165–182, available online at http://wss30.reformkurumsal.com/Document%20Library/london_approach.pdf.

40. European High Yield Association, "Submission on Insolvency Law Reform" (2008), 3. In particular, it has been noted that it is essential "to create the conditions that will best allow both informal and formal and insolvency representative-centered rescue systems to operate at lowest cost and highest effectiveness."

41. Clementi, "Debt Workouts for Corporates, Banks and Countries: Some Common Themes," 2.

42. As result of the 1997 financial crisis that hit Thailand, the central bank (Bank of Thailand) set up out-of-court processes for the restructuring of distressed enterprises. In 1998, it was decided to establish the Corporate Debt Restructuring Advisory Committee (CDRAC), which was followed by the establishment of the Thai Asset Management Corporation (TAMC) entrusted with the facilitation of the restructurings and the monitoring of the restructuring processes. In this context, the CDRAC developed a framework of voluntary principles and timelines for voluntary workouts (known as the Bangkok rules) which aimed at resolving the limitations of the applicable legal framework.

43. As result of the 2000 financial crisis that hit Turkey, a large number of Turkish enterprises became insolvent. Financial institutions realized that the enforcement of claims by means of initiating an insolvency procedure or by foreclosing on a security was not always the best possible solution from a commercial point of view and that participating in a restructuring exercise might prove more beneficial. As result of this change of attitude, a large number of Turkish financial institutions entered into a consensual framework agreement for the restructuring of the debts of large enterprises (the Anadolu Approach focused on the restructuring of debts of small and medium sized enterprises).

44. As a result of the 1998 financial crisis that hit Indonesia and to facilitate voluntary corporate restructurings, the Jakarta Initiative was established as a set of principles based on the London Approach to serve as a guide to out-of-court voluntary corporate debt restructurings.

45. The Insolvency and Debt Resolution team of the World Bank Group assists governments in developing OCW frameworks, including developing principles that are most suited to the country context.

46. The term "relevant creditor" means any creditor whose rights are to be affected by any proposed restructuring plan. (See comments under Principle 1).

47. INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts*, London, October 2000, https://www.insol.org/pdf/Lenders.pdf.

48. Ibid., 2.

49. For example, a formal insolvency procedure such as an in-court restructuring (if available under local law) or liquidation.

50. Expedited restructuring mechanisms can provide a way to come to an agreement among a requisite number of creditors and then apply to a court to enforce that agreement against dissentient creditors.

51. Note that the reference is to an "initial" standstill period. It is very common for the standstill period to be extended. Indeed, one of the advantages of the out-of-court approach to workouts is that they enable the debtor to avoid the time limits (which are often unrealistic) imposed by laws governing the conduct of restructurings conducted within the context of a formal court proceeding.

52. INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts*, 2.

53. In some jurisdictions, there is legislative provision for a statutory form of moratorium on creditor claims.

54. INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts*, 2.

55. Ibid., 2.

56. Ibid., 3.

57. Ibid., 3.

58. Ibid., 3.

59. Ibid., 3.

60. The debtor must appreciate that in the event that there are no assets capable of being offered as security for additional funding, the creditors are unlikely to be willing to provide it. In these circumstances, it may be necessary for the debtor's shareholders to introduce additional equity, provide personal guarantees or similar security.

61. The behavior of creditors in an out-of-court workout scenario is very often based on an assumption (itself based on experience) that an out-of-court approach is to be preferred (as it is less value-destructive) to any in court procedure.

62. The plan may, for example, call for selling assets, a repayment schedule for creditors, debt forgiveness, gaining additional financing, and guarantee and loan capitalization.

63. Elizabeth Warren and Jay Lawrence Westbrook, *The Law of Debtors and Creditors* (Little, Brown and Company, 1996), *57*.

64. Philip R Wood, Pri*nciples of International Insolvency,* 2nd ed. Vol. 1 (Sweet & Maxwell, 2007) 36. The author observes that one of the main advantages of judicial reorganizations is "the fact that the business does not have to be broken up, so that potentially the cataclysmic fall in values commonly experienced on a fire-side bankruptcy sale is not so serious."

65. Ibid., 41.

66. For example, the United Kingdom and other common law jurisdictions have concluded that directors have primary duties to shareholders but once a corporation enters the "vicinity of insolvency," the directors fiduciary responsibilities shift so that their duties are owed to the enterprise's creditors. The basis of this theory is the proposition that once a enterprise is near insolvency, its primary economic stakeholders are its creditors and therefore, directors should exercise business judgment in a way that safeguards the interests of creditors. The main issue is the lack of a clear definition on the "vicinity of insolvency" (and its variants) although a wide pool of case law has shed some light on the matter (see e.g., Colin Gwyer and Associates Ltd v London Wharf (Limehouse) Ltd [2002] EWHC 2748 (Ch) at 74; Nicholson v Permakraft (NZ) Ltd (1985) 3 A.C.L.C. 453 at 459; Re New World Alliance [1994] FCA 1117 at 66; Brady v Brady (1988) 3 B.C.C. 535 at 552; Re Horsley and Weight Ltd [1982] 1 Ch. 442 at 455; Geyer v Ingersoll Publications Co, 621 A 2d 784 (Del Ch, 1992); Credit Lyonnaise Bank Nederlander, NV v Pathe Communications Corp (1991) Del Ch WL 277613). However, it is of worthy note that this is a matter on which there is no uniformity. The Supreme Court of Canada rejected this theory, deciding that directors do not change allegiances when the corporation comes under financial pressure. In People's Department Stores Ltd. (1992) Inc., Re, 2004 SCC 68; [2004] 3 SCR 461 at para 43 the Supreme Court of Canada stated that there is only one beneficiary of the directors' fiduciary duties, the corporation itself, stating "[a]t all times, directors and officers owe their fiduciary obligation to the corporation."

67. European Commission, "Consultation on the Future of European Insolvency Law," Work Programme for 2012. Accessed date May 20, 2016. http://ec.europa.eu/justice/newsroom/files/insolvency_en.pdf.

68. European Commission, "Commission Recommendation of 12.3.2014 on a New Approach to Business Failure and Insolvency" (C(2004)1500). Accessed June 3, 2016. http://ec.europa.eu/justice/civil/files/c_2014_1500_en.pdf.

69. Bankruptcy law (r.d. 16-3-1942, n. 267) "Legge Fallimentare."

70. Carpus Carcea et al, "The Economic Impact of Rescue and Recovery Frameworks in the EU."

71. The EC's report was based on a study by INSOL Europe and commissioned by the EC. The INSOL Europe study examined restructuring mechanisms in European Union Member States. The study delves into the details of recommended elements of pre-insolvency frameworks and provides more information about each specific element than the EC's report. See the full study: Stefania Bariatti and Robert van Galen. "Study on a new approach to business failure and insolvency—Comparative legal analysis of the Member States' relevant provisions and practices: TENDER NO. JUST/2012/JCIV/CT/0194/A4." INSOL Europe for the European Commission. Published Dec. 05, 2014. https://www.insol-europe.org/eu-study-group-publications.

72. Giorgio Cherubini, "Restructuring and Insolvency in Italy: Overview," Restructuring and Insolvency

Global Guide 2015/16. *Thompson Reuters*, http://uk.practicallaw.com/8-501-9255.http://uk.practicallaw.com/8-501-9255#a988693.

73. Lawyer in Croatia, "Changes in Bankruptcy Law," September 22, 2015, http://www.vaic.eu/news-and-publications/changes-in-bankruptcy-law/.

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75. Office of the Commercial Courts in Paris, http://www.greffe-tc-paris.fr/en/insolvency--proceedings/ad-hoc-mandate-or-conciliation.html.

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77. Hélène Bourbouloux, and Arnaud Pérès, "France." The International Insolvency Review, ed. by Donald S. Bernstein (London: Law Business Research, 2013); See also "La Reprise de la *SAUR par Trois Banques approuvée." Le Monde*, July 27, 2013, sec. Économie. http://www.lemonde.fr/economie/article/2013/07/26/la-reprise-de-la-saur-par-trois-banques-approuvee_3454251_3234.html.

78. Eva Hupkes, "Special Bank Resolution and Shareholders' Rights: Balancing Competing Interests," *Journal of Financial Regulation and Compliance* 17, no. 3 (2009): 292. The author underlines that "such arrangements could set out contingency plans for circumstances in which the institution becomes financially distressed and include a series of pre-commitments to reorganization measures."

79. Finch, "Pre-Packaged Administrations: Bargains in the Shadow of Insolvency or Shadowy Bargains," *Journal of Business Law* (2006): 568. "[T]he pre-pack is a process in which a troubled company and its creditors conclude an agreement in advance of statutory administration procedures" and, "the pre-pack has the effect of establishing a deal in advance of the appointment of an administrator and it allows statutory procedures to be implemented at maximum speed."

80. John J. McConnell, and Henri Servaes, "The Economics of Pre-packaged Bankruptcy," *Journal of Applied Corporate Finance* 4, no. 2 (1991): 93.

81. Richard F Broude, "How the Rescue Culture Came to the United States and the Myths That Surround Chapter 11," *Corporate Rescue and Insolvency Journal* 16, no. 5 (2000): 194.

82. *Postpetition Disclosure and Solicitation*, United States. Title 11 *U.S. Code*, Sec. 1125(g) et seq. 2012 ed. "Notwithstanding subsection (b) [pre-approval by the Bankruptcy Court of disclosure statements when solicitation is done *after* the commencement of the Chapter 11 case], an acceptance or rejection of the plan may be solicited from a holder of a claim or interest if such solicitation complies with applicable non-bankruptcy law and if such holder was solicited *before the commencement of the case* in a manner complying with applicable non-bankruptcy law" (emphasis added).

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88. For more on Blue Bird, see Ibid.

89. On this matter, see Barbara F.H. Rumora-Scheltema, "Dutch Pre-pack Alternatives on the Rise" (2016) *International Corporate Rescue,* 11 (1), pp. 28–30.

90. Ibid., 28. If the court is willing to provide this information it will usually reserve the right to refrain from appointing that individual in the event the enterprise does not cooperate with the silent trustee prior to the insolvency.

91. Negotiations took place between the trustee and the envisaged purchaser (a newly incorporated entity), as well as between the trustee and the bank. There were also discussions where all three of these parties were present.

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111. INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts,* 5.

112. Ibid.

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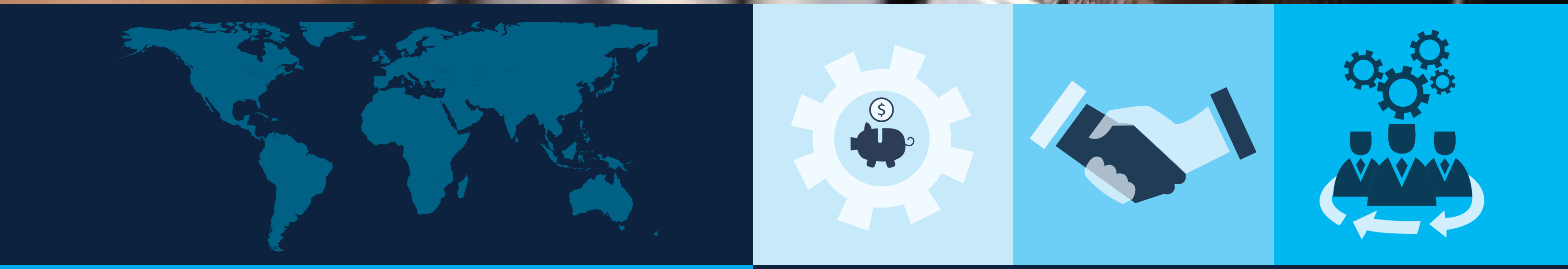

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