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The World Bank
Insolvency and Creditor/Debtor Regimes
Task Force Meetings

Out-of-Court Debt Restructuring

January 10, 2011

Held at the World Bank

Washington, DC

Rapporteur's Synopsis

By Steven T. Kargman

The World Bank Insolvency and Creditor / Debtor Regimes Task Force Meeting (January 10-11, 2011)

Session on Out-of-Court Debt Restructuring

Held at the World Bank

Washington, D.C.

Conference Report: Day 1 – Session 2

16:15 – 18:15, January 10, 2011

Chairperson: Jose M. Garrido, World Bank

Speakers: Jose M. Garrido, World Bank
Tomas Araya, Argentina
Neil Cooper, INSOL
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Michael Pomerleano, World Bank
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Rapporteur's Synopsis

Steven T. Kargman Rapporteur

Introduction[1]

Out-of-court debt restructuring involves changing the composition and/or structure of assets and liabilities of debtors in financial difficulty without resorting to a full judicial intervention[2]. Out-of-court restructurings can help promote efficiency, restore growth, and minimize the costs associated with the debtor's financial difficulties. A policy framework that facilitates out-of-court restructurings that are timely, fair, and reliable is an essential objective for insolvency policymakers. Moreover, at a time of systemic financial and/or economic crises, out-of court restructuring can play an important role in protecting the judiciary from being overburdened with new insolvency cases since out-of-court restructuring does not involve court intervention or requires only limited intervention by the courts or by other authorities. Also, out-of-court restructuring is designed to ensure rapid recovery for distressed companies and thus may provide a more efficient way to address financial distress than would be available in a formal court process.

Out-of-court restructuring, therefore, performs a key role in any insolvency system. In numerous situations, the debtor and the creditors can protect their respective interests more effectively with informal solutions than through resort to the formal insolvency system. Both the World Bank Principles[3] and the UNCITRAL Legislative Guide on Insolvency Law highlight the importance of informal arrangements for restructuring.[4]

Traditionally, out-of-court restructuring was considered a process that is distinct from and set in strict counterpoint to formal insolvency proceedings. The contemporary view, though, is much different: out-of-court restructurings and formal insolvency proceedings are both seen as being on the same continuum of restructuring/insolvency activities. Out-of-court restructuring occupies one end of the continuum while **formal insolvency** occupies the other end of the continuum, and between these two end points on the continuum, there are, in order, enhanced restructuring, hybrid procedures, and formal reorganization.

Out-of-court restructuring consists of purely contractual agreements between the debtor and its creditors that restructure the debtor's liabilities and, possibly, its business activities,

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[1] The comments and observations contained in this report do not necessarily reflect the views of the Rapporteur for this session but instead are merely a reflection of the issues that were discussed at the session by the panelists and commentators from the audience.

[2] The session included a presentation of the general topic of regulation of out-of-court restructuring, based on the issues note produced by the World Bank's Legal Department: see http://siteresources.worldbank.org/INTGILD/Resources/Out_of_Court.pdf. This part of the report summarizes the points contained in that document.

[3] See http://siteresources.worldbank.org/INTGILD/Resources/ICRPrinciples_Jan2011.pdf.

[4] See http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (2005).

too. **Enhanced restructurings are purely contractual workouts that are enhanced by the existence of norms or other types of contractual or statutory arrangements. Out-of-court restructurings can also comprise procedures involving public authorities or even the courts.** Hybrid procedures refer to all procedures where the involvement of the judiciary or other authorities is an integral part of the procedure, but such involvement is less intensive than in formal insolvency proceedings. There are numerous possibilities and variations under hybrid procedures. Purely contractual restructurings, enhanced restructurings and hybrid procedures represent, in numerous situations, an efficient alternative or a useful complement to purely formal insolvency proceedings.

The Relationship between Workouts and Formal Insolvency Proceedings

It is an oft-stated observation that out-of-court restructurings take place "in the shadow of the insolvency law"—i.e., although out-of-court restructurings are not subject to the insolvency law, they are nonetheless affected by the insolvency law. Specifically, out-of-court restructurings work best where there are workable formal systems that, among things, can have a disciplining effect on non-cooperative parties to an out-of-court restructuring. In addition, out-of-court restructuring works well where any proposed restructuring plan accords with statutory priorities applicable to formal proceedings.

Formal procedures for managing the insolvency process are widely considered to provide fairness, certainty and transparency in resolving situations of financial distress. Formal procedures can help manage expectations of the stakeholders and provide clarity as to **who is running the show and what the deal is going to be**.

The main advantages out-of-court restructurings are as follows: i) they provide an effective way to preserve the value of businesses; ii) the parties to a restructuring can select key advisors (e.g., financial, business, legal, etc.) without the necessity of court involvement; (iii) there is greater flexibility in structuring a restructuring plan than would exist in a formal process, **especially where payment is non-statutory**; (iv) given the potential cost savings and speedier timetable of out-of court restructurings, such restructurings potentially yield a better deal for creditors and other stakeholders, and vi) the absence of publicity in an out-of-court restructuring increases the time for the restructuring process to get underway and make significant progress before credit to the debtor is withdrawn, thereby hindering the ability of the debtor to continue operating as a viable going concern. Importantly, as time is the usually the greatest enemy in restructurings, the ability in an out-of-court restructuring to move relatively quickly through the restructuring process facilitates preserving the value of businesses.

On the other hand, out-of court restructurings carry certain disadvantages. These disadvantages include the following: i) the inability to bind dissenting creditors since there is no cram-down mechanism; ii) the absence of a statutory timeframe governing the out-of-court restructuring process can potentially cause delays; iii) **unlike formal restructurings where priority schemes provide the framework for allocation of value among the stakeholders, there may be a reduced sensitivity to value break and valuation basis**; iv) there may be uncertainty as to who is participating in the restructuring process since only key creditors are generally involved and are not under any obligation to keep other creditors apprised of the progress of restructuring negotiations, and for those creditors who are not involved, this lack of transparency can breed distrust; v) out-of-court restructurings are heavily dependent on the goodwill and trust among and between the debtor and its creditors, and such goodwill and trust may not always be present; and vi) the central role played by lawyers in out-of-court restructurings, given their heavy involvement in the formulation and drafting of new contractual arrangements, means that the process can potentially take longer and cost more if things do not proceed as smoothly as was originally envisaged by the parties.

In view of the advantages and disadvantages of out-of-court restructurings, it is apparent that interaction between out-of- court restructurings and formal proceedings can be necessary. More specifically, where there is a holdout problem in an out-of-court restructuring, the ability to convert failed out-of-court restructurings to formal proceedings can be essential. Also, as recommended by the World Bank Principles and by the UNCITRAL Legislative Guide on Insolvency Law, expedited proceedings—namely formal proceedings that proceed on an accelerated timetable (e.g., prepackaged bankruptcies, etc.)—should be an integral part of any well-functioning insolvency system.

Main Incentives and Disincentives in Fostering an Effective Restructuring Regime

The Task Force meeting highlighted a number of obstacles to establishing an effective restructuring regime **whether for out-of-court or in-court restructuring**. First, a country's taxation system can discourage the use of restructuring processes. For example, if the corporate income tax system provides that if a bank forgives debt, it constitutes taxable income to the debtor, this can reduce the incentive for the debtor to restructure its debt. Second, if the tax authorities in respect of tax claims are given too high a priority in the ranking of claims and there are substantial tax claims against the debtor, this may mean that other creditors will see their recoveries substantially reduced, if not eliminated entirely, which may affect their willingness to participate in the restructuring process. Third, management may be discouraged from undertaking the necessary restructuring

since doing so might result in the loss of their jobs as well as a stain on their reputation for having managed a "failed" company. Fourth, if out-of-the-money parties, such as shareholders in the debtor, still have influence in the restructuring process (e.g., their approval is required for debt-to-equity swaps or filing for insolvency itself), this can cause delays in the restructuring process as well as distort the economics of any restructuring plan. Fifth, if the insolvency law is not clear in its rules for imposing liability on management for late filing of an insolvency proceeding where the company is insolvent, management will have no incentive to undertake an early restructuring of the company. Sixth: if the provisioning rules for banks are not clear or are not strictly adhered to or enforced, banks may not feel compelled to restructure troubled credits. Finally, absent a legal framework for binding holdout creditors, such creditors may frustrate efforts to reach a restructuring deal.

On the other hand, if the proper incentives can be established, restructuring activity can be fostered. Such incentives might include: 1) clear management liability for late filing of insolvency proceedings; 2) the possibility of expedited proceedings to confirm a pre-negotiated deal and bind holdout creditors, such as proceedings that can be completed in a matter of weeks, not months or years; 3) the proper tax treatment of debt write-offs; 4) limiting or eliminating the role of out-of-the-money creditors; and 5) providing for the ability of tax authorities to participate in restructuring proceedings **without giving such authorities an outsized priority in the statutory ranking of claims**. Furthermore, the presence of clear and predictable outcomes for formal proceedings could facilitate out-of-court restructurings as well.

Prepackaged restructurings in Argentina: Use of the APE

Argentina's financial and economic crisis in 2001-2002, with massive amounts of outstanding debt that was in default and needed to be restructured, provided a major test for the restructuring framework. During the crisis, legislation was passed that led to the improvement of a then existing restructuring vehicle, the *acuerdo preventivo extrajudicial*, widely known as the APE. The APE, essentially a form of a prepackaged restructuring, was not widely used as a restructuring alternative until the amendments to Argentina's insolvency law in May 2002 in which approved APEs were made binding on all unsecured creditors. Upon the filing of an APE, a stay is imposed on all actions by unsecured creditors. In the wake of the crisis, the use of APEs, exchange offers, workouts, and/or reorganizations (*concurso preventivo*) led to the successful restructuring of the country's private debts.

The APE involves a hybrid of contractual agreement and court approval. It therefore provides flexibility and a range of options. Debtors considered the APE to be attractive for various reasons: there was limited court intervention; there was no appointment of a third party such as a receiver; limited rights were available to creditors to challenge an approved plan; and an approved plan had a binding effect on non-accepting creditors.

However, a number of problems remain notwithstanding the beneficial uses of the APE. Generally, an excessively "debtor oriented" approach tends to lead to abuses. The lack of first priority status accorded to "new money" has proven to be an obstacle in completing restructurings. Other issues that need to be addressed are the taxable income resulting from debts write-offs, the imposition of taxes that affect the restructuring, and the process for sale of assets during the restructuring. Additionally, legal gaps lead to uncertainty. For instance, it is not clear whether consents should be obtained from debt holders before the filing or after the filing of the APE. Lack of sufficient information on the debtor's financial status can be an issue, too. Except for listed companies, there is no legal requirement for the debtor to disclose information to creditors during the contractual out-of-court phase of the restructuring process.

Argentina's experience addressing the fallout from its financial and economic crisis of 2001-2002 yields several important lessons. First, it is useful to be able to draw on an array of restructuring alternatives, including an expedited process such as the APE. Second, it is critical for restructurings to achieve fair burden-sharing, and the courts need to provide the incentive to do so. Third, the increasing involvement of distressed debt investors in restructurings is not necessarily a bad thing, as it provides an exit strategy for banks that want to dispose of a troubled credit. Fourth, greater transparency in the process is required, and an obligation for disclosure of information should be imposed on the debtor in order to achieve fair burden-sharing.

The Cases of Japan and Korea

Non-statutory guidelines for out-of-court restructuring were established in Korea in 1998 and in Japan in 2001. In both countries, there is a history of establishing quasi-governmental organizations for handling business reorganization, acquiring non-

performing loans from banks and infusing new money into distressed enterprises. In Japan, the government created the Industrial Revitalization Corporation of Japan (IRCJ), and in Korea, the government created the Korea Asset Management Corporation (KAMCO). ICRJ was originally scheduled to "sunset" in 2008, but it completed its work a year earlier in 2007.

Japan later introduced a process whereby out-of court restructuring was to be overseen by a private sector organization. Under the procedure known as Business Reorganization by Alternative Dispute Resolution (BRADR), a private sector organization, the Japan Association of Turnaround Professionals (JATP), which is licensed by the Japanese Ministry of Justice and the Ministry of Economy, Industry and Trade, manages the restructuring process. The proceedings are presided over by fair, neutral third-party experts recommended by JATP, and unanimous consent of the creditors, not majority rule, is required for a reorganization plan to be accepted. There is also the possibility of DIP financing.

In 2001, Korea adopted the Corporate Restructuring Promotion Act. The Act provided for the establishment of creditors councils consisting of financial institutions that had extended credit to the debtor. A majority rule—75% creditor approval—was adopted, and the debt of dissenting creditors could be purchased by the Korean Asset Management Company (KAMCO). DIP loans were given priority status. The Act was scheduled to "sunset" in late 2010.

In 2009, Japan established a new organization, the Enterprise Turnaround Initiative Corporation (ETIC), which was similar in some respects to IRCJ. However, the focus of ETIC was on assisting small and medium-sized companies. ETIC was expected to help revitalize local economies with its ability to infuse large sums of money as either debt or equity. It is also a sunset company with the limited duration of five years. The restructuring of Japan Airline was handled through ETIC, but as a general matter, ETIC has not been widely used so far with only approximately 6-7 cases having been handled by ETIC.

The Impact of Guidelines for Workouts

Guidelines for workouts, such as those set forth in the *INSOL Global Principles for Multi-Creditor Workouts*, can be useful for both creditors and debtors. Guidelines are also useful within lending banks that have to deal with restructurings. Banks may give guidelines to

their staff members who have limited or no experience in the restructuring area for use as an instructional tool.

The use of guidelines has several advantages:

- They can help accelerate the whole restructuring process because the parties can deal with the procedural issues through guidelines and thus focus their attention on the substantive negotiation issues which can permit an earlier restructuring.
- They can help to manage the debtor's expectations as to its obligations of full disclosure and consultations;
- They can assist creditors in making an early and quick decision on what businesses are worth being restructured, and therefore the use of guidelines can help to prevent the loss of time and resources associated with restructuring a troubled enterprise that ultimately will not perform or survive.
- From the debtor's point of view, guidelines also give confidence that the rules will be respected by creditors.
- They can encourage a collaborative approach by lenders.

Guidelines were found to be helpful in a range of Asian countries in the wake of the Asian financial crisis in the late 1990s. However, guidelines must keep up with current developments. Thus, the INSOL principles, for example, are being revised to take account of a number of recent developments in the market, such as the widespread use of derivatives and the increased trading of debt claims.

Systemic Crises and Workouts

Systemic crises may pose serious risks for an insolvency system:

- The court system can be overwhelmed with insolvency cases.
- Without timely resolution of cases, uncertainty increases.
- Asset prices may diminish as a result of liquidation processes, and there can be a resulting negative spiral in asset prices.
- Formal reorganizations may become difficult to accomplish and thus end up as liquidations because lenders may not be willing to lend any additional money, with the result that there may be no financing available during the reorganization process.

Therefore, informal workout mechanisms may be effective in the resolution of insolvency during systemic crises and can be a good supplement to formal insolvency procedures. The World Bank Principles have recognized this fact but they are not prescriptive on what

mechanisms shall be used. Countries should determine on a case-by-case basis what kind of methods should be put in place.

A formal framework may be provided through the development of guidelines on corporate restructuring or the implementation of special mechanisms such as:

- Regulatory forbearance (e.g. tax, accounting, and capital adequacy)
- Asset-management solutions including privately managed asset management companies as well as state-run and financed asset management vehicles
- Establishment of a special commission/institution to facilitate workout proposals (e.g. an institution to facilitate loans and guarantees to debtors).
- Specialized state assistance to buyers and sellers of distressed assets and to lenders extending finance to distressed corporations.

However, the establishment of such special workout regimes and mechanisms raises a number of issues that need to be considered:

- For how long should such processes be established and managed? Should they be used for occasional intervention only?
- How should such mechanisms be dismantled?
- How do these processes interact with a country's insolvency laws?
- Who is to decide when exceptional circumstances exist and what measures are to be put in place?
- Can decisions taken at times of systemic crises also create precedent for and change insolvency law and practice?
- Are these systems necessary where the court system remains viable and sufficiently efficient to deal with a heavy influx of cases?

Toward Better Practices in Systemic Corporate Restructuring

In a systemic crisis, a dysfunctional system for resolving corporate insolvency can have a detrimental impact on the capacity of an economy to recover. At a time of crisis, there is a need for countries to have a coherent structure in place to address the restructuring and insolvency issues that will arise, but unfortunately jurisdictions are too fragmented in how they address these issues. It is difficult, if not impossible, to put a proper system in place at a time of systemic crisis. Therefore, countries need to have the proper frameworks in place preceding a crisis.

Countries need to consider adopting and implement elements such as the following:

- A system of surveillance that would allow countries to anticipate problems in the economy.

- A coherent strategic approach that provides the tools to analyze, anticipate and respond accordingly. It implies having coherent and not fragmented **jurisdictions** to resolve corporate insolvency issues.
- Transparency in the market (prices and information) is essential to deal with insolvency during crises.
- Develop the capacity and skills of professionals, as the presence of skilled professionals is fundamental to addressing the fallout from a systemic crisis.

General Comments from the Audience

The first speaker provided comments along the following lines:

- A lead institution is required to drive all the measures during a crisis. Usually the bank supervisory institution is in charge of this.
- Usually the workout system is for large companies, but it is also necessary to look at small businesses. It is necessary to have a framework to inject liquidity into the small businesses sector.
- Workouts subject to some form of regulation are needed, including the need for a time-bound process for restructuring (e.g., 90 day period subject to 30 day extensions). Any such approach needs to deal with tax and policy issues such as forbearance and take into account local specificities and cultural differences.
- It is necessary to put together skilled workout teams with experts on insolvency, banking, finance, etc.

The second speaker indicated that, regarding systemic crises, it seems that policymakers tend to come up with great solutions for yesterday's problems. The panelists reflected different points of view on this issue. For example, one panelist said that when a special framework to tackle a systemic crisis is developed, it might not be a good idea to remove such a framework when the crisis is over. However, another panelist noted that from a legal point of view, it is sometimes very difficult to maintain special measures designed to tackle a crisis outside the context of a systemic crisis.

A third speaker commented that the tools designed for private sector insolvency are not suitable in the case of global systemic crises and that the private sector cannot address these issues alone. Therefore, in these cases, the intervention of the government is essential. Other speakers took a different point of view and noted that it is the private sector that is best equipped to deal with the restructuring and insolvency fallout from crises.

Conclusion

Out-of-court restructurings can provide great utility in any insolvency/restructuring system and provide a number of potential advantages over more formal insolvency options, including speed, flexibility, and cost. Nonetheless, out-of-court restructurings should not be seen as being divorced from the overall formal reorganization and insolvency system but as being part of a continuum of restructuring/insolvency options. Government policy, in its many forms (e.g., taxes imposed on cancellation of indebtedness income, provisioning policies for banks for loan losses, policies affecting a debtor's ability to effect debt-for-equity swaps, etc.) can have the effect of either encouraging or discouraging out-of-court restructurings as well as reorganizations more generally, and governments therefore need to pay careful attention to the impact of policies on the restructuring environment and what will serve as incentives to restructuring and what will serve as disincentives. Out-of-court restructurings can play a very important role at a time of systemic economic and financial crisis, and in such circumstances special purpose government bodies have often taken the lead in bringing about successful restructurings. The use of restructuring guidelines can help provide structure and predictability to the restructuring process. In short, out-of-court restructurings can provide a number of advantages that should not be overlooked in designing a well-functioning restructuring and insolvency system.