

A WORLD BANK STUDY



Out-of-Court Debt Restructuring



THE WORLD BANK

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Jose M. Garrido



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Foreword

This study analyzes and consolidates the lessons we have learned on one of the most important topics in the work of the World Bank's Insolvency Initiative: the use of out-of-court debt restructuring mechanisms in addressing the problem of corporate distress.

Identifying effective legal and institutional mechanisms for facilitating out-of-court debt restructuring has been at the heart of the World Bank Insolvency Initiative's work in response to the current financial crisis that has affected many of our member countries. The recent financial crisis has shown, much like the Asian crisis showed in the late 1990's, how a systemic financial crisis can lead to corporate solvency issues that outstrip the capacity of formal judicial mechanisms. In many cases, the resolution of debt problems through non-judicial means has proven to be less disruptive and more effective than formal insolvency procedures. Indeed, our experience suggests that, restructuring can be facilitated through an appropriate legal enabling framework and the introduction of simplified procedures that encourage parties to negotiate an enforceable solution to corporate indebtedness.

Over the course of the years, the World Bank Insolvency Initiative has developed, together with UNCITRAL, the international standard on the basis of which the comparative effectiveness of insolvency diverse systems can be studied. Today, the World Bank Principles, that form a part of this standard, are used in insolvency assessments around the world, covering the analysis of both formal and informal restructuring techniques through the Reports on the Observance of Standards and Codes (ROSC) initiative of the Financial Stability Board. Taking the international standard as the guiding principle, this study provides succinct guidance on each of the topics in the field of debt restructuring, assisting in the identification of the different technical solutions that can be adopted for the treatment of corporate financial distress.

The study approaches the topic in a non-prescriptive way, and achieves its objective of providing basic information on the relevant legal and policy issues, setting out the alternative solutions, and explaining their respective advantages and disadvantages. The analysis takes stock of the experience of the World Bank's Legal Vice Presidency in carrying out insolvency assessments in more than fifty countries around the world, and on the experience of the Legal Vice Presidency in developing a research agenda designed to assist policy-makers in the choices that have to be made in the design of effective insolvency and creditor rights systems.

The study was presented at the World Bank Insolvency and Creditor Rights Task Force that met in Washington DC in January 2011. I had the honor of opening that meeting and I can attest to the interest that the issues covered by the meeting attracted in the international community of insolvency policy-makers and insolvency specialists. We sincerely hope that the guidance offered in this document will be useful to both policy-makers and specialists from Member Countries.

Anne-Marie Leroy
General Counsel
The World Bank Group

Acknowledgments

This study is based on the experience of the members of the World Bank's Insolvency and Creditor/Debtor Regimes Initiative over the last decade. The current version of the study was prepared and updated by Dr. Jose Maria Garrido, Senior Counsel, with support from other members of the ICR Initiative, particularly, Dr. Adolfo Rouillon, former Senior Counsel, and Yesha Yadav, former Counsel. This study was presented at a roundtable within the World Bank ICR Task Force meeting in Washington DC, in January 2011. The participants at that session included Neil Cooper, Michael Pomerleano, Tomas Araya, Shinjiro Takagi, Sijmen de Ranitz, and Yesha Yadav, each of whom provided valuable insights which helped to enrich this study. Earlier versions of the study have benefitted from the input of participants in the World Bank's Global Judges Forum over the years and from the guidance of Dr. Rouillon and Gordon W. Johnson, former Lead Counsel. The study was prepared under the general supervision of Vijay Srinivas Tata, Chief Counsel, LEGPS.

Abstract

This study provides a conceptual framework for the analysis of the questions of out-of-court debt restructuring from a policy-oriented perspective. The starting point of the analysis is given by the World Bank Principles for Effective Insolvency and Creditor Rights Systems.

The study offers an overview of out-of-court restructuring, which is not seen as fundamentally opposed to formal insolvency procedures. Actually, the study contemplates different restructuring techniques as forming a *continuum* to the treatment of financial difficulties. Thus, from the purely contractual—or informal—arrangements for debt re-scheduling between the debtor and its creditors, to the fully formal reorganization or liquidation procedures, there are numerous intermediate solutions. In the study, these solutions are identified by the terms of *enhanced* procedures—where the contractual arrangements are supported by norms or principles for workouts; and *hybrid* procedures—where the contractual arrangements are supported by the intervention of the courts or an administrative authority. The study discusses the advantages and disadvantages of all the debt restructuring techniques, and concludes, in this regard, that a legal system may contain a number of options—a menu—that can cover different sets of circumstances. In the end, the law may offer a *toolbox* with very different instruments that the parties may use depending on the specific facts of the case.

A substantial part of the study is devoted to the analysis of the enabling regulatory environment for out-of-court restructuring. It is evident that debt restructuring does not operate in a vacuum: in fact, the general legal system influences and to a certain extent determines the possibilities for debt restructuring in any given jurisdiction. The study provides a checklist that can be used to examine the features of a legal system that bear a direct influence on debt restructuring activities.

The different characteristics of informal restructurings, and of enhanced and hybrid debt restructurings are covered by the study. The different approaches to debt restructuring aim at combining the advantages of an informal approach with the advantages of formal procedures: especially, the existence of a moratorium on creditor actions and the binding effects of creditor agreements concluded within the insolvency process.

About The Author

José M. Garrido, Senior Counsel at the World Bank, and at the Insolvency and Creditor/Debtor Regimes Initiative, is a lawyer and academic who has published extensively in the fields of insolvency law, securities regulation and company law. Before joining the World Bank he held a number of positions, including those of General Counsel of the Spanish Securities and Exchange Commission (CNMV), Member of the Spanish Commission for anti-money laundering, Professor of commercial law at the University of Castilla-La Mancha, and Member of the European Corporate Governance Forum. He is one of the drafters of the Spanish Unified Corporate Governance Code.

Background to Out-of-Court Debt Restructuring

1. Introduction

1. *Definition of out-of-court debt restructuring.* 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, and with the objective of promoting efficiency, restoring growth, and minimizing the costs associated with the debtor's financial difficulties. Restructuring activities can include measures that restructure the debtor's business (*operational restructuring*), and measures that restructure the debtor's finances (*financial restructuring*). Out-of-court debt restructuring performs an important role in all insolvency systems. In numerous situations of financial difficulty, the debtor and the creditors can protect their respective interests more effectively if an informal solution is implemented. Throughout this document, the terms "out-of-court restructuring" and "workout" will be used as synonyms and refer to purely contractual agreements between the debtor and its creditors that restructure the debtor's liabilities and, possibly, also its business activities. *Enhanced restructurings* are purely contractual workouts that are enhanced by the existence of norms or other types of contractual or statutory arrangements. Finally, out-of-court debt restructuring can also comprise procedures involving public authorities or even the courts: the expression "*hybrid procedures*" refers to all procedures where the involvement of the judiciary or other authorities is an integral part of the procedure, but is less intensive than in formal insolvency proceedings. Purely contractual restructurings, enhanced restructurings and hybrid procedures represent, in numerous situations, an efficient alternative or a useful complement to purely formal insolvency proceedings.
2. *Importance of out-of-court debt restructuring.* Restructuring can help preserve the business value of debtor enterprises and the interests of other stakeholders, to the benefit of the creditors as a whole. The World Bank Principles and the UNCITRAL Legislative Guide¹ have highlighted the importance of informal arrangements for restructuring. Both texts treat informal debt restructuring as an integral part of an efficient creditor-debtor regulatory system. Out-of-court restructurings constitute the subject matter of principles B3, B4 and B5 of the World Bank Principles for Effective Insolvency and Creditor Rights Systems. The present document integrates the analysis of those principles and seeks to expand that analysis by including ad-

1. See http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf (2005). Pages 21-26 are devoted to the treatment of out-of-court restructurings.

ditional factors and techniques that can be taken into consideration when devising solutions and drafting rules for the informal treatment of financial difficulties. Given the costs and risks associated with even the most developed bankruptcy systems, a policy framework that facilitates out-of-court restructurings that are timely, fair, and reliable is an essential objective for insolvency policymakers. Moreover, in a systemic crisis, the lack of involvement of the judiciary, or its limited intervention, may be necessary to avoid overburdening the judicial system and ensure rapid recovery for distressed companies. This does not imply, however, that countries should not improve their insolvency laws. An effective insolvency system is essential for providing adequate incentives for creditors and debtors to participate in out-of-court restructurings or workouts.² At the same time, an effective debtor-creditor regime should not attempt to restructure all enterprises; there are situations in which the lack of viability of the debtor's business, or the need to investigate its activities, will require fully formal insolvency procedures.

3. *Scope of paper.* This paper explores the main issues that arise in connection with the legal analysis of out-of-court restructurings, including the characteristics of an enabling legal framework and the elements of informal workouts, and analyzes enhanced restructurings and hybrid procedures and their interaction with formal insolvency procedures, following the conceptual framework of the World Bank Principles. Principle B3 establishes the conditions that a legal system should satisfy to foster informal debt restructurings; Principle B4 deals with debt restructuring processes; finally, Principle B5 touches upon the specific questions that affect financial institutions in the context of debt restructuring, but Principle B5 has been divided and integrated into the analysis of Principles B3 and B4, to provide a more succinct analysis of the issues involved. The paper is articulated as follows: an introduction to restructurings; the treatment of questions that define an enabling legislative framework; and, finally, the procedural issues regarding the different types of out-of-court restructurings.

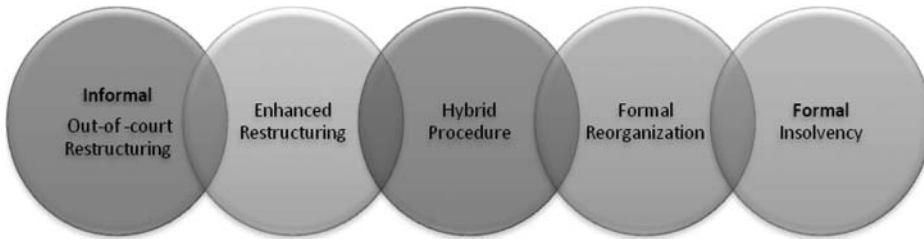
2. Relations Between Informal and Formal Insolvency Procedures

4. *Relations between informal and formal insolvency procedures.* In most cases, informal restructurings constitute an alternative to formal insolvency procedures. However, relations between informal restructurings and formal insolvency proceedings can be complex. In some cases, informal restructurings can operate as a complement to formal insolvency procedures; in others, restructurings may have to be analyzed and dealt with in a distinct insolvency procedure, after the failure of the restructuring plan.
5. *The continuum of procedures.* In numerous insolvency systems, there is no clear dividing line between formal insolvency proceedings and informal restructuring processes. This distinction is blurred with the introduction of workouts that are strengthened by contractual or statutory provisions ("enhanced restructurings") or by different mechanisms that seek to combine the advantages of both formal and

2. See below, number 23.

informal approaches to indebtedness problems (“hybrid procedures”). In this way, informal and formal procedures find points of contact, and formality becomes a question of degree. In reality, the treatment of indebtedness problems can be represented by a continuum, with informal workouts at one extreme and formal insolvency proceedings at the other. This continuum is illustrated in figure 1.1.

Figure 1.1: The continuum of procedures for the treatment of financial difficulties

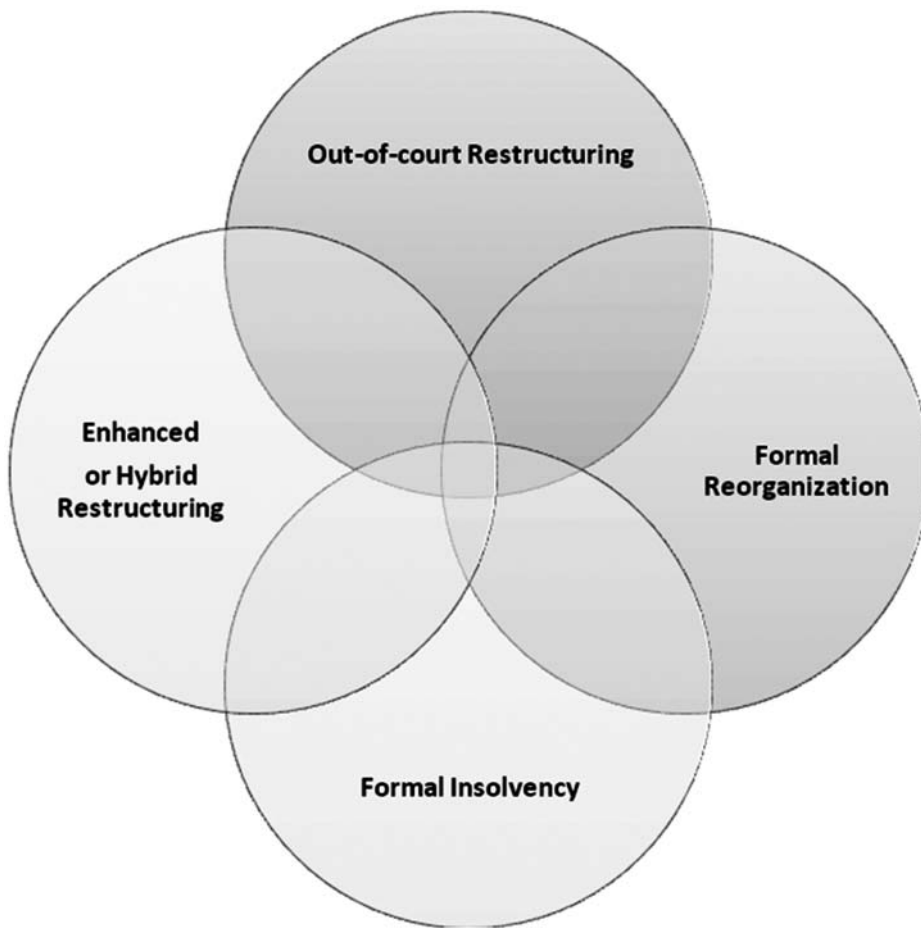


Source: World Bank.

This continuum is based on the degree of judicial intervention and the degree of “formality” in general. It does not necessarily imply successive stages of treatment of a debtor’s situation; rather, it illustrates the existence of different options that may be used, alternatively or occasionally, in certain sequences and that may present some overlapping elements. This continuum provides a simple perspective of the possibilities available to policy makers in charge of insolvency law reform, and provides debtors and creditors with a panoramic view of the range of options at their disposal in a given legal system.

6. *Lack of correlation between formality and degree of financial difficulty.* It must also be borne in mind that there is no direct correlation between the degree of the financial difficulty experienced by the debtor and the best procedural route to deal with it. Minor financial difficulties can occasionally result in formal insolvency proceedings, and it is possible that serious financial difficulties are dealt with within the framework of informal restructurings. In this continuum, purely contractual, out-of-court restructuring would be at one end, whereas formal, fully-fledged insolvency proceedings, traditionally aimed at liquidation of the debtor’s business, would be at the other. In the middle of the continuum, a legal system may have developed enhanced restructurings or hybrid procedures consisting of workouts with a certain degree of formality or with limited court intervention. In this regard, it may be interesting to underline that these alternative techniques overlap in significant ways. A completely informal workout may be the first step towards a fully formal insolvency procedure (reorganization or liquidation). Equally, a hybrid procedure may result in a subsequent formal insolvency process. Of course, a reorganization procedure may also result in liquidation. Therefore, the possible relations and connections of the different procedures are manifold, with multiple overlapping and possible combinations.

Figure 1.2: Overlapping relations between out-of-court restructurings and formal insolvency proceedings



Source: World Bank.

7. *Restructuring Procedures Covered.* This paper analyzes the main issues associated with various types of restructuring procedures comprising different degrees of formality. Countries with modern insolvency legislation and with sophisticated financial operators have developed restructuring techniques that occupy the middle range of the continuum. These intermediate—or mixed—techniques exist because they solve specific problems that arise in the context of informal workouts and fill the gap between purely informal workouts and formal insolvency procedures. Given that essentially all the restructuring techniques, from the purely informal workouts to the totally formalized insolvency proceedings, cover a wide range of situations; it is apt to underscore the different approaches and legal nuances that distinguish them.

8. *Regulatory space and procedures.* The continuum is also a description of the regulatory space the legal system assigns to the different approaches to financial difficulties. If a country's system only covers formal insolvency proceedings and there are no intermediate procedures, such as enhanced restructurings or hybrid procedures (which can range from the existence of a voluntary code of conduct for multiple-creditor workouts to the existence of pre-packaged insolvency plans), the range of options is reduced. Debtors and creditors would therefore have to choose between a contractual workout and a formal procedure. It is important to note that there are no empty spaces in the continuum. In any regulatory system, the features of insolvency proceedings and of informal restructurings determine whether the situations that, in other systems, would be addressed through hybrid procedures or through enhanced restructurings, will fall on the side of the formal insolvency proceedings or under the scope of purely contractual out-of-court restructurings.
9. *Overlapping procedures.* Alternative procedures designed to deal with financial difficulties tend to overlap in many respects, as Figure 1.2 shows. A workout can be transformed into a reorganization plan; an informal workout may be converted into a hybrid procedure; and the hybrid procedure can be transformed into any variety of formal procedure. Within formal procedures, a reorganization may be transformed into a liquidation, and vice versa. Therefore, there can be significant overlaps between different procedures, and, for that reason, it is important that a legal system contemplates adequate relationships between all the available procedures and ensures that the transition from one procedure to another is feasible with as little disruption as possible.
10. *Range of options.* The fact that a legal system covers a wide range of options for the treatment of financial difficulty is generally positive. The wider the range of options, the more opportunities parties have to customize the regulatory treatment of the debtor's particular situation. Despite the overlaps, the techniques used are different in important aspects and their results are not functionally equivalent. Therefore, a wide range of crisis resolution tools is not just desirable, but essential for an efficient creditor-debtor regime.
11. *Different relations between formal and informal procedures.* The relations between the different processes can differ considerably: generally, formal insolvency proceedings can act as an *alternative*, as a *complement* or as part of a *sequence* to out-of-court debt restructurings. As the basic preconditions for a restructuring are practically the same as those for a formal insolvency procedure, a restructuring may well be an alternative to a formal insolvency procedure. In this respect, out-of-court restructuring can be an *alternative* to any kind of formal insolvency procedure (reorganization or liquidation). But restructuring can also be *complemented* by a formal insolvency proceeding: where the out-of-court restructuring cannot, for various reasons, completely solve the debtor's financial problem, formal insolvency procedures can act as a complement to achieve the restructuring goals. The informal process may have the function of garnering support for a solution for the debtor company's financial situation, but this solution may be incomplete for a number of reasons:

- A creditor or a group of creditors insists on recovering its credits in full (the “holdout” problem³). In this case, a formal insolvency proceeding may bind minorities and stay their enforcement actions against the debtor.
- It may be necessary for the debtor to take advantage of the effects of a formal insolvency procedure: for instance, a debtor in crisis due to the pernicious effects of executory contracts may need to avail itself of an insolvency proceeding in order to terminate the contracts and reorganize its business.

In any event, what matters most is the fact that the differences in the legal consequences attached to procedures are often the determining factor in the choice of procedure, and debtors and creditors alike generally have a positive view of the existence of different options.

3. Pre-Conditions for Debt Restructurings

12. *General pre-conditions for debt restructurings.* To understand the similarities and differences between informal restructurings and formal insolvency proceedings, it is necessary to analyze the preconditions for a debt restructuring. The pre-conditions for informal restructurings are very similar to those underpinning formal insolvency procedures. These preconditions can be summarized as follows:

- A situation of “financial difficulty” -generally, illiquidity or insolvency, although the term “financial difficulty” is broad enough to cover numerous situations-; and
- A plurality of creditors.⁴

The problem that informal debt restructuring intends to solve, therefore, is substantially the same problem that formal insolvency proceedings address: a situation where the debtor is unable to pay its debts to a plurality of creditors who, in turn, need to coordinate their efforts to maximize the recovery of their credits against the common debtor. Therefore, the general preconditions apply equally to formal insolvency proceedings and to informal workouts, though, to be successful, workouts require a number of additional specific conditions.

13. *Additional preconditions for debt restructurings.* An informal debt restructuring workout probably would not be attempted unless a number of well-defined preconditions are present, including the following:

- A number of banks or financial institutions are owed a significant amount of debt. In the cases of “monopolistic lending”, i.e., where the debtor has been financed by a single bank or financial institution, an informal workout is not necessary: it suffices that the bank or financial institution negotiates, one-on-one,

3. See below, number 71.

4. If there is a single creditor, or a single financial creditor, the financial difficulties will be normally addressed through bilateral negotiations. If these negotiations fail, the creditor will typically resort to individual enforcement mechanisms.

with the debtor to resolve the latter's financial difficulties. On the other hand, a plurality of creditors is a common requirement for formal bankruptcy proceedings and informal workouts. In this case, homogeneity of creditors is important for the workout to succeed. The creditors of a debtor company can be diverse: financial creditors, trade creditors, workers, tax authorities, social security, etc. However, the multiplicity of creditors, be they public and/or private, national and/or foreign, secured and/or unsecured, creates an *aggregation* problem. This problem worsens where substantial differences exist among creditors and where the sheer number of creditors is also high, which in turn raises a *coordination* problem. Therefore, the more differences between creditors and the greater the number of creditors, the more difficult it is to reach a contractual agreement to restructure the debtor's finances, as those factors produce high transaction costs and difficulties in the aggregation of disparate legal positions. Some creditors may even have conflicts of interest. For example, those creditors with long-standing relations with the debtor may be prepared to accept a substantial haircut in the hope of maintaining the commercial relations with the restructured customer. This applies especially to trade creditors, but also to financial creditors. A very different position is that of the workers of the debtor company, whose legal and financial position is entirely different from that of the rest of the creditors. From these disparities, it follows that it is advisable, in numerous cases, to leave non-financial creditors out of the restructuring negotiation and unaffected by the binding effects of the workout, and engage only financial institutions. Restructuring is feasible where a number of banks and/or financial institutions hold the bulk of the company's debts. The common traits of banks and other financial institutions provide a basis for agreement between the debtor and the financial creditors and among the financial creditors *inter se*. Of course, financial creditors can also differ in their expectations, in their risk profiles, and in their costs, but the degree of heterogeneity is relatively low, when compared with the disparities within other creditor groups.

- *The debtor's inability to service the debt.* The debtor may face financial illiquidity or even insolvency, and the trigger for a restructuring negotiation is the existence of a financial difficulty, actual or foreseen. The difference between financial difficulty, illiquidity or insolvency is immaterial for determining the suitability of a workout process. What is important is to establish, during the restructuring negotiations, the exact nature of the debtor's indebtedness, because the solutions will be determined, *inter alia*, by its characteristics. In any case, the indebtedness problem must affect the ability to service, in a timely manner, the *financial* obligations of the debtor. It is immaterial, for the purposes of establishing whether a workout is a right solution, that the debtor pays or has the ability to pay other debts, such as trade debts, or workers' wages.
- *The viability of the debtor's business.* The existence of a plurality of financial creditors and the existence of financial difficulty are requirements similar to those of formal insolvency proceedings. However, the most important precondition for a successful debt restructuring is the *viability of the debtor's business*, ascertained through a complete analysis of the debtor's finances and a rigorous business

plan. If the business is not viable, it is better to liquidate it as soon as possible: a workout that only delays the inevitable demise of a company does more harm than good. If there are uncertainties as to the viability of the business, using a reorganization procedure is the best course of action, as it offers more tools for the in-depth analysis of the debtor's business, and can be transformed into a liquidation if it is determined that the business has no viability prospects.

- *A positive attitude towards negotiation.* The debtor and the financial creditors should be convinced of the advantages of negotiating an arrangement for the financial difficulties of the debtor—not only between the debtor and the creditors but also between the creditors. Negotiation requires some basic understanding based on good faith. The debtor must disclose its true situation, and the creditors must also disclose to the debtor and to the other creditors the specificities of their financial situation (existence of credit default swaps, credit insurance, debt trading, or sub-participation arrangements, etc.). The parties must agree that there may be more benefit for all through the negotiation process than through direct and immediate resort to individual enforcement or to insolvency law, where the parties would lose control of the negotiation process and would incur significantly higher costs, and which would cause a deep disruption of the debtor's business.
- *The effects of formal insolvency proceedings are unnecessary.* The debtor does not need relief from trade debt or other benefits of formal insolvency, such as the automatic stay or the ability to reject burdensome executory contracts. This is an important factor to take into account when analyzing potential solutions to the debtor's financial problems.
- *An enabling legislative and regulatory framework.*⁵ An enabling legal framework comprises measures that are conducive to workouts. Efficient insolvency and creditor rights systems are also an important enabling function, because formal insolvency proceedings represent the backdrop against which any workout is negotiated and has to be measured.

4. Advantages and Disadvantages of Informal Procedures

14. *Advantages and disadvantages of informal procedures.* In order to decide whether an out-of-court restructuring is the most adequate response to the situation of financial difficulty of the debtor, it is necessary to consider the advantages—and the disadvantages—of informal workouts compared to formal insolvency proceedings. The existence of disadvantages of informal workouts and the rigidities of formal insolvency proceedings underpin the creation of enhanced restructurings or hybrid procedures. The aim of hybrid procedures is to combine the advantages of informal workouts with some of the effects of formal proceedings to achieve a result better suited to certain business situations. Hybrid procedures fill the gap between infor-

5. See World Bank Principle B3, and Section II of this paper.

mal workouts and formal insolvency proceedings, as their place in the continuum shows.⁶

15. *Advantages of informal workouts.* Informal workouts are procedures disconnected from any kind of judiciary intervention. Therefore, the most important advantages relate to a superior flexibility and velocity in dealing with the debtor's financial difficulties. The most common advantages of informal workouts are the following:
 - *Flexibility and ease of adaptation to the specific needs of the debtor's business.* An informal workout, allows creditors and the debtor to reach agreements with a wide variety of contents. Under numerous insolvency laws, the limits to the provisions of an agreed plan under the formal insolvency procedure can be strict, and the law may even set thresholds for minimum credit recovery, or limits to creditor payment delays. On the other hand, a workout can allow for full interest payments, whereas the insolvency proceeding rules may prevent reaching that result, as interest frequently ceases to accrue while the debtor is subject to insolvency proceedings. The non-application of absolute priority rules adds another element of flexibility. A workout situation makes it possible to treat differently creditors that are at the same level of the creditors' ranking, and to provide for full payment of creditors that rank lower than the creditors engaged in the negotiation of a workout (for instance, full payment of trade creditors). The negotiation of new security and the provision of new money for the debtor are also considerably easier under a workout, as important rigidities of formal processes are avoided. A workout could also possibly avoid the application of the rule, present in numerous bankruptcy laws, that establishes compulsory conversion of all debt into the local currency. Finally, the flexibility afforded by workouts also includes the possibility of restructuring an entire corporate group, whereas formal group insolvency proceedings can be extremely cumbersome, or even impossible in many jurisdictions.
 - *Ease of negotiation.* A workout is less confrontational than formal insolvency proceedings and therefore provides a better environment for negotiations, both between creditors and the debtor and among creditors themselves. Procedural rules are extremely light or non-existent, so engagement among creditors and between the debtor and the creditors may take any form that the parties decide to choose.
 - *Timing issues.* In many instances of corporate financial difficulty, time is of the essence to avoid liquidation of the business. Delays result in value erosion for creditors and the debtor itself. Banks and other financial creditors should act earlier and more proactively than in formal insolvency proceedings. A timely response is better articulated under a workout. Workouts are also typically shorter processes compared to formal insolvency procedures, where the intervention of the judicial system subjects the negotiation process to considerable delays. It is easy to see that the negotiation between creditors and the debtor can proceed at a higher speed outside the judicial system.

6. See Figure 1.1.

- *Confidentiality.* A workout is a much more private process than a formal insolvency procedure and, possibly, less prone to unwanted publicity and speculation.⁷ Thus, the reputational damage to the debtor can be minimized. Actually, the announcement that the debtor has reached an agreement with its financial creditors tends to be regarded as a positive development by the markets.⁸
- *Less stigma than formal insolvency.* Workouts are perceived to cause less reputational damages and carry less stigma than formal insolvency processes. In most cases, there is no stigma attached to a workout, and the confidentiality of the process allows the debtor to make an announcement only after the workout has been agreed upon and the prospects of the debtor's business have significantly improved.
- *Continuation of the debtor's business.* It is also clear that the discretion associated with a workout makes it easier for the debtor to continue its business, than a formal insolvency procedure, where loss of goodwill tends to be very substantial.
- *No changes in management.* In a workout, the debtor's management remains in place and there are no formal controls of their activity. This is an important advantage for the debtor, and represents a powerful incentive for the debtor's management especially in legal systems where management is routinely displaced in the case of insolvency of the debtor company.
- *No changes in rights of parties.* A workout allows for interest payments to creditors and it can also avoid compulsory conversion of credits into local currency. Workouts do not interfere with the rights of creditors to enforce their security, although this may represent a disadvantage of workouts in certain situations. Workouts do not prevent creditors from asserting a set-off right, which is especially important in countries where insolvency set-off is prohibited. There is no interference with the general rules on contracts, including termination of contractual relationships with the debtor. This absence of changes, as opposed to formal insolvency, may be beneficial for creditors.
- *No court involvement.* Workouts avoid the intervention of the judiciary, whose pace may be too slow in the face of the emergency of financial difficulties. Furthermore, the costs of formal insolvency proceedings are substantially higher, and the inexperience of judges and their lack of understanding of commercial matters, in certain jurisdictions, can be detrimental to reaching an agreement between the parties.

7. However, extreme caution is needed where the debtor is a publicly listed company, as in that case the debtor company is under the obligation to communicate to the market any relevant facts that may affect the listed price of securities. This requirement does not create an obligation to inform separately of each of the steps in the negotiation, because then it would be virtually impossible to reach an agreement to restructure the company. Therefore, the correct practice would be to inform the market of the workout as soon as the creditors and the debtor have reached an agreement.

8. Naturally, markets react in a strong negative way when the debtor company announces that it has failed to reach an agreement to restructure its debt.

- *Lower cost.* Formal insolvency procedures are costly in terms of time, money, and reputation. Workouts are less costly, even in cases involving numerous advisors and numerous creditors to coordinate. Transaction costs and time costs of workouts are generally lower than those of formal insolvency processes.
- *Lack of regulatory impact.* From a regulatory point of view, a workout does not necessarily imply a risk that the debtor loses a license or any other type of regulatory authorization to operate its business. However, this may be impossible to achieve in formal insolvency, as the fact that the company enters into formal insolvency proceedings may entail the termination of its license or authorization and a ban on procurement of public administration contracts. Depending on the nature of the debtor's business, the lack of regulatory impact may represent a very substantial factor in the decision to use a workout instead of formal insolvency proceedings.

The advantages listed above imply that workouts can be more effective in the recovery of viable businesses than formal insolvency procedures, even if the law contemplates the existence of a specific reorganization procedure.⁹

16. *Disadvantages of out-of-court restructurings.* It would be incorrect to assume that informal workouts are always superior to formal insolvency proceedings. The disadvantages of workouts vis-à-vis formal procedures are connected with the effects that characterize these procedures. If the debtor situation requires certain specific effects, such as a stay on creditor actions that provides some breathing space from collection efforts, or the repeal of executory contracts, a formal insolvency procedure may be the only viable option. The basic disadvantages of out-of-court restructurings as opposed to formal insolvency are those listed below.

- *Analysis of the debtor's situation.* If it is difficult to assess the real financial and economic situation of the debtor, insolvency proceedings are better equipped to analyze in full the finances of the debtor. Analysis is imperative to determine the viability of the business and in some cases this is not feasible within the short time-frame of a workout negotiation. This could also be the case where there are serious controversies regarding creditors' rights.
- *Punishment of fraudulent behavior.* From a public perspective, formal insolvency procedures are better suited to deal with fraud and criminal conducts connected to insolvency.
- *Avoidance actions.* A formal insolvency procedure is necessary to investigate antecedent transactions—such as undervalue transactions and preferences—and potentially avoid them.

9. The existence of a reorganization procedure, however, can reduce the space in the continuum of treatment of financial difficulties that out-of-court restructurings occupy. If the conditions for an out-of-court restructuring are not met, the best option for a viable business is to use the formal reorganization procedure.

- *Availability of different remedies.* In workouts, it is not possible to use some extraordinary remedies, like lifting the veil of incorporation or subordinating the claims of insiders.
- *Lack of unanimity requirement.* Workouts can be quite flexible regarding the contents of the restructuring, but they are extremely rigid in their approval procedure, as they require unanimity of creditors,¹⁰ a need inherent to the contractual nature of the workout. Instead, formal insolvency procedures allow the majority to bind minority creditors. The possibilities of reaching a workout agreement are minimal if unanimity is required when the debtor has issued public debt securities.¹¹
- *No requirement of debtor's consent.* Because of the contractual nature of the workout, the debtor's consent is required. In the case of a company, obtaining consent may be complex because some workouts will require a shareholders' vote (for instance, a capital increase for a debt/equity swap). There is also the risk that directors acting without the shareholders' consent may face liability suits by shareholders, if there are grounds to believe that the workout was not in the best interests of the company. By contrast, in formal insolvency procedures it is possible to sell or liquidate the debtor's business without the need of the debtor's consent.
- *Fewer chances of lender liability actions.* In some legal systems, creditors may face liability if it is found that through the implementation of the workout they were de facto running the debtor's business (shadow directors). They could also face lender liability for the concession of abusive credit. In a formal insolvency scenario, those risks do not exist, because new finance typically requires the consent of creditors and/or the authorization of the court.
- *Difficulties of multi-party negotiations.* In a workout, it is difficult to deal with a large number of creditors, whereas formal insolvency proceedings provide a forum capable of accommodating all creditors, independent of the size and/or nature of their claims.
- *Directors' liability.* If the law contains a duty for directors to file for insolvency, directors may take a less risky route if they use formal insolvency procedures, rather than trying to reach an agreement while the company slides into insolvency.
- *Existence of a formal reorganization procedure.* The existence of a reorganization process substantially affects the balance between advantages and disadvantages. Allowing the debtor's management to continue running the business gives man-

10. The unanimity requirement can be modified by law, or can be best addressed by a contractual framework where the participants have agreed to act according to majority rule in future workouts. See below, number 77 ff.

11. In the United States, it is not possible to bind a dissentient public bondholder to a change in payment terms (Trustee Indenture Act 1939). In this case, a restructuring can only be done if the debtor offers to fully repay the public debt, or offers other securities in exchange for the public debt. This is one of the reasons why, in U.S. practice, informal workouts are linked to the existence of bank debt, whereas formal reorganization is effective where there is public debt (i.e. multiple claimants, with collective action problems).

agement a strong incentive to file for reorganization as an alternative to formal liquidation procedures. This would allow management to continue their business operations while benefitting from a stay of creditor actions. Moreover, reorganization affords the possibility to terminate contracts that are burdensome for the company, and allows the passing of a reorganization plan that is binding on a minority of opposing creditors.

- *Recognition by foreign courts.* Foreign courts are more apt to recognize all formal proceedings, especially formal liquidation proceedings, which may be necessary in the case of a debtor with significant cross-border activities or assets.¹²

17. *Advantages, disadvantages, and alternative informal procedures.* The advantages and disadvantages of out-of-court restructurings suggest that, in a specific situation, after undertaking an adequate analysis, it would be possible to make the correct decision on whether to open a formal insolvency proceeding instead of negotiating a workout. However, the mix of advantages of workouts with certain advantages of formal insolvency proceedings explains the existence of enhanced procedures and hybrid procedures in numerous jurisdictions.
18. *Advantages of enhanced restructurings.* The spectrum or continuum of procedures designed to deal with financial difficulties covers also the workouts that are enhanced by the existence of norms.¹³ The main advantage of norm-based workouts over traditional workouts is that the creditors agree to bind themselves, voluntarily, to a set of principles and guidelines that govern the negotiation and conduct of participants in a workout. It would be a mistake to dismiss this approach because of the norms' lack of binding effects. In practice, moral suasion and peer pressure may be as effective as binding legal rules. In some cases, these norms can be reinforced contractually, where the financial supervisor requires financial creditors to formally adhere to these principles before a debtor is in financial difficulty. In this way, the binding effect of contract enhances norms, and specific workouts will be easier to negotiate in the future.
19. *Advantages of hybrid procedures.* Hybrid procedures are, essentially, private restructurings complemented by minor judicial or public interventions and incorporating some elements of formal insolvency proceedings¹⁴. Hybrid procedures preserve most of the advantages of out-of-court restructurings and incorporate some of the advantages of formal insolvency proceedings. There can be, therefore, multiple ways of regulating hybrid procedures and their structure depends essentially on the particular formal effect needed to reinforce the workout. One of the most widespread hybrid procedures is the "prepackaged plan." The prepackaged plan is negotiated as a workout, but the debtor submits the agreement to the court, initiating a procedure that can result in the confirmation of an insolvency plan that is binding

12. The workouts can be recognized as contracts, but the problem is that a contract that interferes with insolvency policies will not be recognized in formal insolvency foreign proceedings, and could be set aside by the court.

13. See below, Section III.3, number 78 ff. for the treatment of workouts based on norms and other enhanced workout procedures.

14. See below, Section III.4, number 93 ff. for the treatment of hybrid procedures.

on all creditors. Other hybrid procedures are those that allow the debtor to negotiate with its creditors while the court enforces a stay on creditors' actions. In any case, the number of combinations is potentially large, and therefore it is impossible to catalog all hybrid procedures, although the binding effects on the minority and the possibility of invoking a stay on creditors' actions are possibly among the most recurring features of the hybrid procedures existing in numerous jurisdictions.

Enabling Legislative Framework

World Bank Principles B3 and B5.2

Principle B3

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 reorganizations; 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.*

Principle B5.2

***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.*

1. General Conditions of an Enabling Framework

20. *Importance of an 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. Concerns and issues relevant to informal workouts are often addressed in the context of formal frameworks for reorganization or liquidation procedures, but are often overlooked or ignored in their own context. Typically, formal insolvency proceedings may consider the effects—or the lack thereof—of an informal workout in the context of a subsequent insolvency procedure, but there are very few provisions dealing explicitly with informal workouts in most jurisdictions. However, the lack of specific provisions for the regulation of informal workouts does not imply that general law has no influence on them. On the contrary, informal workouts suffer the negative side-effects of legal rules that have been devised for other factual situations and that do not take into account the special nature of informal workouts

and the particular circumstances in which these workouts are negotiated. Thus, an effective framework for workouts must reduce or eliminate the obstacles to negotiation and implementation of restructuring arrangements, and should create an adequate set of incentives for the debtor and for the creditors.

21. *Regulatory space for workouts.* While there are a variety of different policy choices on the substantive and procedural nature of laws and the allocation of risk among participants, the framework governing corporate workouts and restructurings must be clearly specified and consistently applied to encourage consensual workouts. An effective framework for workouts can reduce the space of formal insolvency proceedings in the continuum described earlier:¹⁵ if a general regulatory framework contains no obstacles and actually encourages informal workouts, the courts would have the possibility of concentrating on the cases that are best suited for formal insolvency procedures. That fact alone constitutes an immediate advantage for any legal system, as the workload for courts can be frequently excessive, especially during a general economic crisis. The key requirement for using restructurings, though, is the debtor company's viability: using debt restructuring to keep non-viable companies artificially alive results in more losses for the creditors and for society as a whole.¹⁶ Therefore, the importance of the debtor's viability element in debt restructuring cannot be overemphasized, and that is the reason why workout incentives should not be so overwhelming as to prevent the liquidation of non-viable companies.
22. *Basic rules that allow restructuring.* An environment that enables debt restructuring of viable companies must be based, firstly, on the existence of adequate basic contract rules that allow for modification of debts and that establish good faith requirements in the behavior of the parties to a contract.¹⁷
23. *Insolvency law.* The characteristics of the insolvency law are also fundamental for the success of restructuring activities. An appropriate insolvency law should enable the parties to engage in negotiations without incurring any legal liabilities and to reach agreements protected from subsequent avoidance actions. In fact, restructurings are negotiated *in the shadow of insolvency law*, in more than one sense:
 - In the original sense of the term, bargaining in the shadow of the law means that the parties are conscious of their rights and of the treatment of their claims in insolvency. It is important that the law is clear and predictable, because uncertainty regarding the relative positions of creditors, and the treatment of categories of creditors in the insolvency process, implies that some creditors will try to avoid workouts and try to gain advantage within the insolvency process.

15. See Figure 1.1 above, under number 5.

16. The best example is found in the notorious "zombie banks," that is, financial institutions whose economic net worth is less than zero, but which continue to operate because of different types of external support (typically, governmental support).

17. The existence of pre-contractual duties of good faith can also perform a fundamental role. See below, numbers 65 and 73.

- The general effectiveness of insolvency law is also an important factor for negotiations. If insolvency law is slow and allows the debtor to use a wide array of delaying tactics, creditors will have a strong incentive to avoid insolvency law altogether and to reach an agreement with the debtor. However, the debtor could be inclined to rely on the general ineffectiveness of the insolvency law to gain advantages in the restructuring, as this lack of effectiveness grants the debtor a stronger bargaining position. If insolvency proceedings are costly, there is an incentive for the parties to engage in workout negotiations, because both the debtor and creditors will try to avoid insolvency.
- One of the main characteristics of formal insolvency proceedings, the removal of management from office, creates an incentive for the debtor to negotiate with creditors. If there is a reorganization regime in which management continues to control the debtor's business, the debtor might have fewer incentives to opt for out-of-court restructuring.
- Other issues connected to the insolvency rules can create incentives or disincentives for workouts. The best example is the existence of avoidance actions under insolvency law. These actions are designed to prevent debtors in financial difficulty from selling assets at an undervalue, or from granting special favorable treatment to some existing creditors, to the detriment of the remaining creditors. A carefully designed avoidance regime in insolvency constitutes an important part of an enabling regime for workouts. Indeed, avoidance or preference actions may interfere with restructuring agreements and create a disincentive for their use. In the systems where restructuring agreements are specifically exempt from some avoidance actions, the risk of the restructuring agreement being avoided in a subsequent insolvency procedure is minimized or altogether eliminated. In the systems where avoidance actions are tied to a requirement of proof of prejudice to creditors, the creditors should be able to demonstrate that their actions did not prejudice the debtor or creditors who were not parties to the restructuring agreement.¹⁸
- The debtor's duty to file for insolvency is another important feature of insolvency law. If such a duty exists, it may be risky for the debtor to engage in negotiations with its creditors. A solution to this problem can consist of an exception for that duty in case the debtor initiates, in good faith, negotiations with its creditors, with a view to restructuring its debts.

18. To this effect, it is important that creditors document all the relevant steps in a restructuring in order to show that the restructuring was fair and that no inordinate advantage was obtained at the expense of the debtor or of other creditors. The situation may be much more complex in the case of legal systems where restructurings are not specifically exempt from avoidance actions and there is no requirement of proof of prejudice. Restructuring agreements are at considerable risk of being avoided if the restructuring does not work and a subsequent insolvency procedure is initiated. Restructuring always carries a high avoidance risk, as restructured companies are those which normally are on the brink of insolvency or are facing a severe liquidity crisis. If the restructuring agreement and the debtor's business plan are ineffective, an immediate insolvency procedure is the most likely outcome, with a potential avoidance of the agreement and potential liabilities for participants. Therefore, a balanced avoidance regime which takes into account these circumstances is an important element in an enabling framework for debt restructuring.

2. Other Legislative Provisions For an Enabling Framework

24. *Variety of laws that support or hinder restructurings.* An enabling environment should also include the laws and procedures described in the following paragraphs. It is not possible to draft an exhaustive list of all the legislation necessary or useful to enable workouts. The following paragraphs only contain references to those rules that are more frequently associated with incentives and disincentives for workouts.
25. *Financial disclosure.* According to the World Bank Principles, “*Laws and procedures that require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise*” represent an important element of an enabling framework (Principle B3.1). The disclosure of accurate financial information on the debtor is crucial to the success of a workout, as creditors must be able to evaluate the debtor’s financial situation as well as any proposals made as part of the restructuring. In this regard, the law has to include the obligation to approve and file annual accounts, preferably audited. In the case of listed companies, the financial information should be more frequent and more sophisticated than in the case of Small and Medium Enterprises.¹⁹ Creditors, or their advisors, should be able to obtain, or at least to access for the purpose of a due diligence analysis, all relevant information regarding assets, liabilities, business activities and prospects and to make appropriate personnel available to the parties carrying out the review.²⁰ Where debtor and creditors cannot reach an agreement on the valuation of certain assets or losses, an external and independent due diligence exercise may help reduce the difficulty. The valuation of assets and losses is extremely important for a workout, as is the business plan that must accompany the debt restructuring. A workout must be based on the assumption that the situation of the debtor has been correctly described and that there are no hidden losses and no overvalued assets.
26. *Financing rules.* The World Bank Principles recommend the introduction of “*Laws and procedures that encourage lending to, investment in or recapitalization of viable financially distressed enterprises*” (Principle B3.2). The law should make it possible for distressed companies to have access to financing sources. Without new financing arrangements, the debtor company may have to resort to formal insolvency proceedings for lack of liquidity to continue trading. Thus, additional funding (sometimes referred to as “new money”) is often the foundation upon which a debt restructuring is built. An effective way to encourage lending to distressed companies is to accord priority status to repayment of such additional funding so that new money enjoys priority to reflect the additional risk incurred by creditors, eventually

19. Accounts should always be audited in the case of listed companies and also in the case of specially regulated businesses. The role of international accounting and auditing standards is paramount in this regard.

20. In the case of listed companies, this due diligence process carries some substantial risks: the creditors gain access to material, non-public information, so there could be a risk of insider trading. Therefore, it is important that creditors sign a confidentiality agreement and that creditors refrain from operating in the securities of the debtor company during the workout negotiation. Although the offence of insider trading is normally restricted to the trades in listed securities, there may be general anti-fraud provisions that apply to other transactions over unlisted securities and credits in general.

with the prior approval of a majority of creditors or of the steering committee.²¹ Where such security may not be granted (because of the existence of a negative pledge provision, or because of the lack of available unencumbered assets) creditors have the option to reach a loss-sharing agreement among them designed to ensure that the new money will be accorded priority status. There are basically three techniques to accord priority to the new financing needed for the restructuring. The first consists of creating a security interest that favors the creditor that lends new money. This can only be done if: there are free unencumbered assets; there are no contractual provisions that prevent the creation of new security interests; and there are no legal rules that provide the grounds for a potential avoidance action. The second technique applies to assets that have been used as collateral for loans of an amount significantly lower than the valuation of the encumbered assets (the creditors that benefit from those security interests are sometimes referred to as “over-secured”); a second security interest over the same assets is therefore feasible. Finally, another possibility consists of a contractual priority, agreed among a group of creditors (mainly financial institutions). Typically, these arrangements among creditors have effects only outside of formal insolvency proceedings. Creditors should therefore be aware that these agreements between creditors have effects only *inter partes* and cannot interfere with the ranking of creditors included in the insolvency laws.

27. *Other incentives for investment in distressed debtors.* Priority for new money is just one of the ways to finance the distressed debtor. There are also other ways in which the law may create incentives for lending to, investment in, and recapitalization of distressed companies. There can be special tax rules that allow investments in and loans to distressed companies to be temporarily and/or partially exempt from taxation. Obviously, these tax incentives require a strict definition of what a distressed company is, to avoid misuse and potential fraud.
28. *Hybrid securities.* The creation of a regime of hybrid loans or debt/equity securities is another possible incentive for corporate debt restructuring. Typically, these loans or securities can qualify as the distressed company’s capital, even though in fact the holders of the securities have a right of payment of an interest, which is determined, at least partially, according to the company’s results. The holders of the securities have also a right of repayment of the principal amounts. These hybrid securities may be extremely useful in restructurings, and their usefulness is greatly enhanced when legislative measures complement them with a special tax treatment. Another important factor regarding subordinated securities is that accounting rules allow for these securities to be classified as capital. This is crucial in legal regimes where capital requirements are compulsory for all types of commercial companies and has important regulatory consequences for special types of companies, such as financial institutions.
29. *Capital injections.* Finally, investment in distressed companies may take the form of capital injections. Increases in the debtor’s company capital may be used to acquire new funds or to reduce debts, by means of a debt/equity swap. Obviously, capital increases require that the debtor company’s recuperation prospects be good

21. See below, number 76.

and that there be no corporate law obstacles to a capital increase to which creditors should normally subscribe. In legal systems where the law grants preemption rights to shareholders, this requires that the existing shareholders waive their preemption rights in order to allow the entry of new investors in the debtor company, or the existence, in corporate law, of an exception to preemption rights. In this regard, corporate governance has an impact on the negotiation and implementation of restructuring arrangements.

30. *Contents of restructuring.* According to the World Bank Principles, an effective system should include “*Laws and procedures that flexibly accommodate a broad range of restructuring activities, involving asset sales, discounted debt sales, debt write-offs, debt rescheduling, debt and enterprise restructurings and exchange offers (debt-to-debt and debt-to-equity exchanges)*” (Principle B3.3). The ability to implement a restructuring relies on a legal framework that can accommodate the different contents of a restructuring plan at a fundamental level. It is not easy to delineate *a priori* the different contents that a restructuring plan may include. In any case, the laws of a jurisdiction should be flexible enough to allow the use by creditors and debtors of a wide array of restructuring techniques.
31. *Restructuring measures.* As stated before, restructuring activities can include measures that restructure the debtor’s business (*operational restructuring*) and measures that restructure the debtor’s finances (*financial restructuring*). In the case of financial difficulties, financial restructuring will always be required, but operational restructuring may be unnecessary in some cases, for instance, where the financial difficulties are entirely unrelated to the ordinary course of the debtor’s business operations. Restructuring measures may include, *inter alia*, the following:²²
 - Regarding the restructuring of the business, the law has to accommodate the sale of business units, a downsizing of the continuing business, or a hive-down (creation of a subsidiary to which the profitable business activities are transferred).
 - Regarding the restructuring of the debtor’s finances, the law should allow the modification of the structure of the debt or the debt itself, which is the main object of the agreement between the debtor and its creditors. The agreement may either provide an extension of the period in which the debtor’s obligations become due, without altering the amount of the creditors’ claims (moratorium), or fashion a settlement, sometimes known as “composition agreement,” which will reduce the total amount to be paid to creditors, providing for payments to be made over a period of time.
 - Restructuring of finances may also involve important changes in the financial structure of the debtor company. In effect, some measures involve *legal* changes in the financial structure of the debtor, and pose particular problems. Legislation should provide a framework for debt-to-equity conversions and debt-to-debt conversions by means of which creditors convert their existing debt into equity or into new debt that is convertible into equity. One of the techniques frequently

22. See the expanded list of restructuring measures below, number 74 ff.

used in restructuring arrangements is the conversion of debt instruments into new instruments that are less burdensome for the distressed finances of the debtor company. The conversion of debt may take different forms:

- *Conversion of debt into equity.* The legal system should provide the debtor and creditors with means to convert the company's debt into equity. In this regard, the issue of new capital will likely require existing shareholder pre-emption rights to be waived or an exception to these created for this purpose. If the law does not provide for such an exception to the pre-emption regime, shareholders may have to relinquish their pre-emption rights. The debt offered in consideration for new shares has to be valued according to accepted accounting standards;²³ in the case of a restructuring, the exact percentage of capital awarded to creditors will correspond directly to the recognized value of the debtor company.
- *Conversion of debt of listed companies into shares.* If the debtor is a listed company, conversion can present serious obstacles. In some countries, a conversion of debt into equity may trigger a number of duties for the creditor who becomes a significant shareholder in the debtor company. The most onerous of these potential duties is the obligation to launch a takeover bid, at an equitable price, for the full capital of the company. To promote restructuring, countries with a compulsory takeover regime may wish to consider potentially introducing in their rules an exemption to this kind of provision for distressed companies. The rules on investment by foreign nationals can also include significant restrictions to ownership of shares by foreign investors, especially in certain strategic sectors.
- *Conversion of debt into convertible debt.* It should be possible to convert outstanding debt into debt that is itself convertible into equity. This restructuring technique is different from mere novation. Normally, the debt will also be novated for its conversion into convertible debt. The conversion of debt into convertible debt is a sophisticated way of combining two risk perspectives by creditors. The creditors can have the option to convert their debt into equity, at specific times (European Option) or throughout the whole life of the debt instrument (American Option). As in the conversion of debt into equity, there are usually some specific constraints if the debtor is a publicly listed company.

32. *Tax regulation.* The World Bank Principles stress the importance of “*Laws and procedures that 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*” (Principle B3.4). In practice, tax rules represent significant obstacles to financial and operational restructuring in many countries. Because they may trigger taxable events, restructuring efforts can become unfeasible or significantly more expensive. A non-exhaustive list of examples of tax provisions that can affect debt restructurings follows, illustrating the cases that frequently arise in the

23. In numerous corporate law systems, the intervention of an auditor or expert will be necessary in order to assess the correct value of the debt.

context of debt restructurings. Other situations may exist in which an unexpected taxable event may complicate the restructuring operation. Therefore, the identification of potential obstacles to debt restructuring warrants a complete analysis of the relevant tax regime.

33. *Tax and debt write-offs.* Debt write-offs may be treated as an immediate gain for the debtor; conversely, the creditors' ability to deduct the losses when offering concessions may be limited. With such a tax regime, a workout based on a debt write-off may become prohibitively expensive for all the participants.
34. *Tax and debt/equity swaps.* The tax regime may create disincentives to debt/equity conversions. These disincentives may prevent creditors from deducting losses when accepting shares in exchange of debt for a lower amount, and may also include stamp duty on the issuance of new shares.
35. *Tax in mergers and acquisitions.* In the context of mergers and acquisitions, distressed companies may be denied the possibility to carry losses forward when transferred to corporate acquirers or when merging with other companies. In those cases, the loss of the tax credits may deny to the distressed company the opportunity of a rescue by another company, as the latter will be unable to use the tax credits to offset its taxable benefits.
36. *Transfer taxes.* Some countries also impose value-added or transfer taxes on the transfer of non-performing loans or on the disposal of assets by a debtor to a successor company. The general regimes of asset transfers can imply that there is a taxable event in the sale of distressed debt and this, in turn, may force creditors to keep those distressed debts instead of transmitting them to creditors with more experience in debt restructurings. Equally, the definition of the transmission of assets belonging to the debtor to an acquirer—a creditor or an independent party—as a taxable event may preclude an efficient solution to the indebtedness problem.
37. *Stamp duty.* In numerous countries, the restructuring and/or consolidation of debts and the creation of new security interests to protect new money are subject to stamp duty. Although stamp duty may have a minimal impact in comparison with other taxes, it is an additional factor that may hinder a successful restructuring operation.
38. *Tax neutrality and tax incentives.* In sum, the legal framework should not discriminate against corporate workouts and restructurings. Moreover, during periods of systemic crises, the law should provide tax incentives for the parties that implement solutions that will render the restructured business viable (for example, favorable offsetting tax treatment for debt forgiveness).
39. *Complications of tax policy.* Favorable or tax-neutral systems may however be difficult to achieve in practice since policies that are useful in certain circumstances may present unintended consequences in the context of corporate workouts; alternatively an appropriate tax treatment of corporate workouts may complicate tax regulation and make it difficult to enforce. Besides, it is crucial that if special tax rules exist for debt restructurings, those rules are carefully drafted and are as specific as possible, in order to avoid the creation of loopholes in the general tax regime.

Table 2.1: Checklist for tax regulation issues in corporate restructurings

- Taxable income for debt reduction or debt forgiveness (for the debtor);
- Deduction for bad debts for the creditor;
- Disposal of a debt at a loss—deduction or capital loss availability;
- Debt forgiveness, partial or total—deduction or capital loss availability;
- Debt/equity swaps—deduction for losses;
- Stamp duty;
- Availability of capital gains rollover for corporate reorganizations (mergers, takeovers....);
- Tax consequences of modification of debt agreements;
- Tax consequences of property transfers.

40. *Regulatory provisions affecting restructurings.* According to the World Bank Principles, systems should incorporate “*Laws and procedures that address regulatory impediments that may affect enterprise reorganizations*” (Principle B3.5). Regulatory impediments should be addressed, as they are likely to inhibit the creditors’ ability to design a workout. The impact of special regulations may be particularly acute with relation to financial institutions (either in the role of creditors or debtors) and in relation to debtors that are special regulated companies (e.g., utilities, telecommunications, defense industries, and other strategic sectors). The law should allow financial restructuring of regulated companies so that companies should not suffer any negative consequence by the fact of negotiating a workout with their creditors.
41. *Regulatory constraints for banks.* Bank creditors (either domestic or foreign) may be subject to regulatory constraints that may prevent them from owning or operating a business. Other rules may limit the amount of equity they are allowed to accept in lieu of payment of debts. Banks may also have problems with the operation of risks concentration rules. Finally, state-owned financial entities may encounter problems in writing off debts, due to statutory constraints.
42. *Authorization to acquire shares.* All creditors, and especially foreign creditors, may need authorization to acquire substantial percentages of shares of a specially regulated company.²⁴ This may create a significant obstacle for a debt/equity swap.
43. *Creditor rights in mergers and spin-offs.* In addition, corporate mergers and spin-offs may be constrained, for example, by a multi-month waiting period during which creditors may object and demand immediate repayment of their claims. The treatment of workers in corporate restructurings may also constitute a significant hurdle for a successful workout.
44. *Competition regulations.* Competition rules raise other regulatory questions that may have an impact on restructuring. Regarding authorizations for mergers, competition authorities may have to apply a less rigorous set of rules to facilitate restructurings. Also from a competition point of view, it may be helpful to allow tax-breaks for restructured business, exempting them from the strict application of anti-state aid rules.

24. In certain countries, foreign nationals are also prevented from owning real estate assets, and that may be a factor inhibiting some out-of-court restructurings.

45. *Securities regulation.* Securities regulation may contain hurdles for restructuring that need to be removed. As discussed above, among these, in some jurisdictions there is a compulsory takeover bid for acquisition of control. This can prevent creditors from entering into a debt/equity swap because a large creditor, or a group of important creditors acting in concert, may be under the obligation of launching a takeover bid, at an equitable price, for the whole of the capital of the listed company. The status of creditors as significant shareholders of the restructured company may also trigger the application of restrictive rules on trading. Finally, other obstacles relate to the need for a prospectus for an offering of shares or new debt instruments to creditors. In all of these cases, the regulation should accommodate the special requirements of workouts, by way of exempting workouts from general regulatory requirements, or by providing a more lenient regime for workouts.
46. *Importance of proper diagnosis.* A due-diligence analysis of the legal framework should identify all possible impediments, so that specific waivers, time-bound or permanent general relief may be considered, depending on the circumstances.
47. *Enforcement provisions.* According to the World Bank Principles, an important enabling feature for workouts in a legal system is found in the existence of “*Laws and procedures that give creditors reliable recourse to enforcement as outlined in Section A and to liquidation and/or reorganization proceedings as outlined in Section C of these Principles*” (Principle B3.6).²⁵ Because informal workouts take place in the “shadow of the law,”²⁶ consensual resolution requires reliable fallback options through existing legal mechanisms for individual enforcement and debt collection or through collective insolvency procedures. The existence of arbitration and mediation mechanisms is also an important factor that facilitates the negotiation of workouts.
48. *Sanctions.* For the informal restructuring process to operate effectively there must be a sanction in case the negotiation process cannot be started or breaks down. Typically this will mean that there can be swift and effective resort to formal insolvency laws and creditor rights enforcement systems that are reliable, predictable and efficient. For this purpose, creditors may agree on an inter-creditor agreement whereby, if the debtor does not comply with the restructuring process, does not provide information or does not comply with an agreed restructuring plan, the creditors will commence actions against the debtor to place it into formal insolvency procedures or take other appropriate legal action.
49. *Reorganization procedure as a backdrop.* There are other important factors that may be conducive to a successful workout, such as the existence (or lack of) a formal reorganization procedure, with or without a “debtor in possession” regime.²⁷

25. Principle A5 of the World Bank Principles refers to commercial enforcement systems, while Section C contains the Principles that refer to insolvency proceedings.

26. See above, number 23.

27. Normally, the availability of a reorganization procedure with a “debtor in possession” regime reduces the use of workouts, as the debtor has a strong incentive to use the features of the formal reorganization procedure without suffering the loss of control which is typical of liquidation procedures.

50. *Risk management rules.* The World Bank Principles underline the importance of risk management rules: “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” (Principle B5.2). Financial regulators play a very important role in debt restructuring, especially in general economic crises. Financial regulators should use their supervisory powers to ensure that banks and financial institutions recognize their losses in their accounts as soon as possible and participate in restructuring agreements in order to adequately treat nonperforming loans and distressed assets.
51. *Risk management practices.* Risk management practices must encourage banks to recognize their losses and to rid their balance sheet of “toxic assets.” The treatment of provisions for nonperforming loans is crucial for the overall health of the financial system and it works as an effective incentive for negotiated solutions for insolvency or for the illiquidity problems of corporate debtors. However, rules for classifying and provisioning troubled debt can provide limited incentives for banks to engage in deeper restructuring. Some countries allow the re-classification of restructured loans from non-performing to performing immediately after restructuring; but globally, the more common standard is to upgrade only after several payments have been received and the financial viability of the borrower has been assured. As a result, banks in certain countries have incentives to engage in cosmetic restructuring, including generous rescheduling granted to debtors. A sophisticated regime for debt classification and provisioning is one of the main factors in shaping an adequate restructuring regime. The regime may include forbearance on classification during the workout negotiation period and a shortened period for return to accrual status upon completion of restructuring.
52. *Adequate accounting and auditing rules for financial creditors.* One of the most important features of a legal system conducive to out-of-court restructurings is the existence of adequate accounting rules. Adequate accounting and auditing rules for the debtor imply that its economic situation can be fully assessed and the extent of its indebtedness problem ascertained, avoiding the possibility of hiding the problem or ignoring it until an insolvency procedure represents the only way out. Rules conforming to International Accounting Standards force creditors to write-down or write-off their debts according to a fair valuation. There needs to be pressure for the creditors to write down their debts and reflect the corresponding losses in the accounts. Otherwise, if creditors do not identify the extent of non-performing loans, the balance sheets of financial creditors can be distorted to the point of creating a systemic crisis. Moreover, accounting rules tend to favor restructuring over formal insolvency proceedings, in the sense that the write-downs for a non-performing loan tend to be lower in an informal arrangement than in a formal insolvency procedure, where the write-down will be more substantial. This incentive for restructuring activities may be positive in most cases, but it can also distort the creditors’ decisions in cases where liquidation would be the appropriate route to take. Finally, adequate accounting rules should cover a number of aspects, like limits on research and development (R&D) capitalization, limits on asset revaluation, and consolidation of accounts, both domestic and off-shore.

Table 2.2: List of elements of a legal system to be assessed to verify the existence of obstacles and incentives for out-of-court restructurings²⁸

- General aspects of the law of contract (general good faith requirements, rules for modification of debts);
- General regime for the enforcement of claims (secured and unsecured debt, individual and insolvency actions);
- General features of insolvency law (avoidance actions, liability of directors, duty of the debtor to file for insolvency);
- Financial disclosure obligations;
- Insolvency rules on avoidance actions of antecedent transactions;
- Availability of hybrid securities;
- Corporate Governance issues (powers of the general meeting; directors' liability);
- Rules for suppression of preemption rights;
- Foreign investing rules, restrictions on the ownership of shares, restrictions on the ownership of real estate;
- Restrictions on the types of assets that financial institutions may possess (restrictions on the ownership of real estate by financial institutions, or restrictions in the ownership of shares or convertible debt);
- Securities regulation (need of unanimity or reinforced majorities for public debt restructuring, need for prospectus for new securities, disclosure of information, concept of related parties, concept of control and compulsory takeover bids);
- Tax law (see Table 2.1 above);
- Special regulations applicable to the debtor's business;
- Rules for mergers and acquisitions (specifically, opposition to mergers by creditors, and treatment of workers in corporate restructurings);
- Competition law rules and exemptions;
- Ease of access to effective individual enforcement and insolvency proceedings;
- Existence of reorganization procedures with or without a "debtor in possession" regime;
- Existence of modern arbitration and mediation procedures;
- Risk management practices and regulations;
- Accounting and auditing rules (treatment of non-performing loans, treatment of subordinated loans as capital, etc.);
- Rules on classification of loans by banks and financial institutions

An analysis of these elements will reveal the areas that need improvement and refinement in the legal system to create the proper incentives for effective workouts.²⁹

28. A workout is a complex transaction that is affected by numerous rules of the legal system. This is just an initial list of possible obstacles, including those which arise more often in restructurings, but other specific obstacles may exist in any particular legal system.

29. Of course, the creation of incentives must be the object of careful drafting, as too general provisions that create incentives for workouts can be easily used by private actors to gain unjustified advantages and to defeat other public policies.

SECTION III

Informal Workout Procedure

World Bank Principles B4 and B5.1

Principle B.4

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.*

Principle B5.1

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.*

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. Introduction

53. *General questions regarding the process of an informal restructuring.* An out-of-court restructuring or workout is a contract between the debtor and its creditors, which binds the debtor vis-à-vis the creditors and also binds the creditors *inter se*. Therefore, workouts are multilateral contracts that include covenants governing the conduct of the debtor and the modification of the creditors' rights under their lending relationships with the debtor. Restructuring implies that the lending relationships cannot go on unmodified, as the debtor is unable to fully comply with its obligations under the loans. For creditors, it is better to modify their lending relationships with the debtor than force the debtor into insolvency, where the prospects of recovery may be significantly lower. Therefore, if the debtor can survive in a restructured form, all parties to the workout stand to gain.
54. *Structure of the section.* This section analyzes the practical questions affecting debt restructuring, according to the elements included in the World Bank Principles (principles B4 and B5.1). One part discusses the stages and the contents of *purely*

contractual workouts. The parts that follow address questions specifically related to *enhanced restructurings*, and to *hybrid procedures*.

2. Contractual Workouts

55. *Contractual workouts*. There are a variety of explanations for the widespread use of informal contractual workouts, but the need for flexibility, as opposed to the relative rigidity of the formal insolvency proceedings, is probably the most important one. Several features of the process attest to the flexibility of informal workouts:
 - Contrary to most formal insolvency procedures, the debtor and the creditors can initiate workout negotiations without having to submit evidence of financial difficulties.
 - The parties are free to negotiate among themselves, without applying the rules of formal insolvency.
 - There are no limits for solving financial difficulties (for instance, a certain rate of recovery for creditors, or a time limit for a moratorium).³⁰
56. *Commencing the process*. The informal process essentially involves bringing together the debtor and its creditors. The workout can be successful only if the creditors that hold most of the financial debt of the common debtor agree to participate in the process. As the process is purely informal, it can be initiated in any way and by any of the parties. The debtor has superior information regarding its own financial state, so it is logical to assume that the debtor will most likely initiate negotiations with its main creditors. However, in some cases the debtor may decide to engage in riskier projects with the intention of obtaining the necessary funds to service the financial debt. Many legal systems impose an obligation on the debtor to file for its own insolvency procedure, but there is limited precedent for legal systems requiring a debtor-creditor negotiation before a formal insolvency is brought.³¹ In this type of situation, the main financial creditors must take the lead and initiate the process. In practice, in the case of large corporate debtors, the inclusion of specific covenants in loan contracts helps this process. A default under the covenants gives creditors the possibility of initiating a negotiation with the debtor in order to solve the indebtedness problem, rather than call a default and enforce their claims. Given the fact that most loans have cross-default clauses, the enforcement action of a single financial creditor can initiate a creditors' race, resulting in the debtor's liquidation and extremely high costs and negative effects for all parties involved.³²
57. *Representing creditors' interests*. The appointment of a leading creditor—normally, one of the creditors with a large debt exposure—together with a creditors' committee (steering committee) can greatly enhance negotiations. Creditors' commit-

30. See above, number 30.

31. However, according to general company law, directors can be liable for lack of diligence if they fail to address the problems affecting the debtor company.

32. This reasoning implies the existence of a "prisoner's dilemma." Game theory implications are discussed below, under the heading "negotiation of the workout." See below, number 71.

tees can be particularly important in the case of publicly traded debt, or syndicated loans fragmented in sub-participations. The lead creditor provides leadership, coordination, management and administration, and reports to the creditors' committee. The creditors' committee cooperates with the lead creditor and provides representative reactions to the proposals put forward by the debtor and by the lead creditor. Representing creditors' interests may be particularly complicated, because of the multiplicity of creditors and the differences in their legal and economic position. It is also important to engage other stakeholders (workers, communities, etc.), so that all relevant interests are represented in the negotiation.³³

58. *Coordinating participants.* The lead creditor and the steering committee should be instrumental in coordinating negotiations. Other key constituencies who may be affected by the restructuring are also critical to the resolution of financial difficulties. Where the number of creditors is high, a collective action problem is likely to arise, and empirical evidence shows that a high number of creditors can, of itself, impede the negotiation of a workout. An aggregation problem may accompany the collective action problem. The aggregation problem exists because the positions of creditors, and the creditors themselves, may be very different. A *hidden* aggregation problem arises when the participants at the negotiation ignore that other participants have different incentives (for instance, the presence of creditors covered by debt insurance or covered by a credit default swap). The lack of permanence in creditors' positions is another problem that may affect the initiation of negotiations. A degree of stability is necessary if negotiations are going to take place between creditors and the debtor and among creditors *inter se*. If there is an active market in debt trading, this may affect the possibilities of starting effective negotiations.³⁴
59. *Engaging advisors.* Successful workouts require the cooperation of independent advisors and experts. Advisors should help creditors to get a clear picture of the debtor's situation and its viability according to a new business plan.³⁵ Advisors may come from a variety of disciplines—accounting, finance, law, business reorganization, marketing. An independent valuation of the debtor's business is routinely required, and independent experts may also study the causes of the company's problems and prepare or review a business plan that would put the company back in a healthy economic situation. Regarding advisers, it should be noticed that there

33. See above, number 13, and *passim*.

34. As a matter of fact, an active debt market may create difficulties in the negotiation process, because of the added difficulty in identifying the parties and engaging them in negotiation. However, in some specific circumstances debt trading can facilitate a workout, especially when a large specialist creditor takes the position of a number of small creditors.

35. Viable businesses tend to share a series of characteristics. The size of the business is extremely important where there are economies of scale. A high going concern value is also a common feature. Firms that successfully restructure their debt have more intangible assets and have few creditors, mainly banks. The debtor's bargaining power depends on the type of investments and on the value of human capital. Thus, firms more likely to succeed in their restructuring attempt are highly leveraged, owe more debt to financial institutions, and exhibit higher going concern values. Bankruptcy, on the other hand, is a more likely outcome for firms with deficient lender coordination and high fractions of collateralized debt.

may exist problems caused by their lack of independence,³⁶ the economic cost of their services, and also problems caused by the intrusion of advisers and the surrender of control by the debtor. There can also be frictions among the independent advisers where access to confidential corporate documents is denied by the debtor's management. All of these problems need to be solved in order to reach a successful workout, as the input of independent advisers is essential to restore confidence in the viability of the debtor's business.

60. *Stabilizing the business.* As soon as possible, in order to allow business operations to continue, parties will need to define a negotiation period. This is generally accomplished by entering into a standstill agreement, i.e., a contractual agreement to suspend adverse actions by both the debtor and the main creditors that endures for a defined, usually short, period. This is functionally akin to the moratorium or stay under the formal rescue process. The standstill is voluntary, but it is essential for the probabilities of success of a workout. The voluntary nature of the standstill raises an enforcement problem³⁷ and some creditors may be tempted to enforce their claims against the debtor while other creditors grant the debtor a grace period before enforcing their claims. The debtor must also refrain from taking any action that may affect negatively on the business's recovery prospects. It is normally understood that the debtor will only be able to engage in transactions within the ordinary course of business and in necessary actions for the conservation of the business.
61. *Ensuring adequate cash flow.* Debt restructuring is necessary because the debtor faces illiquidity or insolvency. Successful restructuring requires that the debtor have access to finance that allows it to continue its operations. This requirement imposes a need for additional financing and therefore is often a serious problem, as it implies "*throwing good money after bad.*" In particular, it may be crucial to find cash to satisfy smaller creditors and thus keep the negotiations to a manageable number of parties. Obtaining funds during the informal process can be an acute problem because, even though there may be some provision under the formal rescue law for some type of "super priority" for a debtor's ongoing funding, that law normally does not extend to such an arrangement under the informal process. The law of the jurisdiction under which the informal negotiations take place might not provide for the super-priority of any funding during the informal standstill. It may be possible to provide for this under contract, but the law of the jurisdiction might invalidate such an agreement. What often results is an "inter-creditor" agreement among major creditors according to which emergency funding by one or more creditors will rank for repayment in advance of the other entitlements in the event of a subsequent formal insolvency procedure. Another alternative is the creation of a security interest over unencumbered assets or over collateral whose value is superior to the loans

36. It is arguable that advisers, like auditors, need to be independent and need to *seem* independent. In the case of workouts of large companies, it tends to be the case that some advisers (essentially, large auditing and consulting firms) have worked for the debtor or for some of its major creditors, and this may raise some concern among other creditors.

37. For this reason, some of the hybrid procedures incorporate a stay on creditor actions, in order to reinforce the probabilities of success of workouts. See below, number 95.

secured by it. These security interests should be immune from avoidance actions in a subsequent insolvency procedure.³⁸

62. *Securing access to complete and accurate information on the business.* This is essential for reaching a consensual agreement. The creditors will seek information about the debtor's business activities, current trading position, general financial position and assets and liabilities. This is akin to the statutory requirement for similar types of disclosure found in most formal rescue regimes. The provision of information demands key participation of independent professionals, whose intervention makes the information provided more credible. As stated before, independent experts should review the economic information provided by the debtor.
63. *Disclosure of information by creditors.* A frequently overlooked aspect is the need for creditors to provide complete information about their position. This requirement is functionally equivalent to communication of credits in a formal insolvency procedure. Creditors must disclose the amount of their credits and the features of the credits themselves (secured, unsecured, insured, hedged with a credit default swap, etc.). This allows the creditors participating in the negotiation process to reconstruct not only the situation of the debtor's business, but also the extent of indebtedness and the nature of claims against the debtor.
64. *Negotiating a workout.* A workout is generally based on an agreement between creditors and the debtor on the terms and conditions for the restructuring, and the creditors' unanimous or majority acceptance. Negotiation is multilateral, as it involves negotiation between the creditors' group and the debtor as well as negotiation between the different creditors participating in the workout.
65. *Negotiation and good faith.* The debtor is subject to a standard of good faith as the consequence of contractual obligations vis-à-vis the creditors. Creditors do not have a contractual relationship *inter se*,³⁹ but the good faith standard can be required as a pre-contractual obligation. In some countries, a doctrine of "duties to cooperate" has been established for creditors in workouts. Good faith requires cooperation in negotiating and finding feasible solutions to the financial difficulties of the debtor and requires that all parties to the workout fully disclose their position.
66. *Debtor's management and negotiation.* The debtor should recognize the importance of the workout and senior management should participate in the negotiations with creditors. The law should allow directors to negotiate a debt restructuring and exempt them from the duty to file for bankruptcy for the period needed to negotiate a workout in good faith. Cautions have to be put in place in order to avoid abuse of these exemptions by debtors. During workout negotiations, the debtor's management continues running the business, but should refrain from impairing the position of creditors by engaging in risky projects, or in operations that fall outside the ordinary course of business.

38. See above, number 23.

39. Except in the case of syndicated loans, where there is a contractual relationship among the creditors that participate in the loan. In public debt issues there may also be provisions that bind all the holders of debt securities.

67. *Credible threats.* A recalcitrant debtor may be forced to negotiate if creditors have access to swift enforcement mechanisms. Well-established and widely used creditor remedy and insolvency law regimes can be used to influence the commencement and progression of an informal workout. The invitation to commence a dialogue should rarely be refused. If the debtor declines the opportunity, it faces the prospect that individual creditor remedies or formal insolvency proceedings will be pursued. Unwilling creditors face a similar sanction to their uncooperative behavior.⁴⁰ This threat is generally sufficient to initiate some type of dialogue. In this way, the courts and formal procedures work as a fallback for the negotiation between the debtor and its creditors. The credibility of the threat of resorting to the court system is the single most important element to push for a negotiation between the debtor and the creditors. The debtor needs also a credible threat: that of obtaining a stay against the creditors and affecting their rights through reorganization or other formal insolvency proceedings. The stay of creditors' actions can also operate in some hybrid procedures.
68. *Negotiation among creditors.* Negotiation among creditors is particularly sensitive, due to the different nature and characteristics of credits and to the presence of conflicts of interest among a number of creditors. The workout must recognize the relative positions of creditors: creditors with larger claims must take the lead in the restructuring process and in negotiations with the debtor. The agreement should recognize and accommodate creditors with valid security rights and other priorities. It is not necessary to replicate the ranking of claims in a liquidation procedure, but the restructuring should follow as closely as possible that ranking. If a secured creditor is not treated in accordance with its status in insolvency proceedings, it may decide not to respect the standstill and enforce its security or, even worse, force the debtor into formal insolvency. In workouts, the most difficult negotiations frequently take place not between the debtor and the creditors, but among the creditors themselves. The negotiation among financial creditors faces particular problems: there can be asymmetric information among the firm's creditors and situations where a financial creditor makes concessions conditional on other financial creditors' actions. Conditional concessions may lead to "herding" and to coordination problems among financial creditors. At the same time, there can be an aggregation problem because, apart from the differences in the diverse financial credits, some of the financial creditors could have instruments that distort or eliminate their incentives to reach an agreement. Creditors with credit insurance or with credit default swaps will find themselves in a very different situation, and this will undoubtedly affect negotiations among the parties.⁴¹ Creditors who have hedged their credit risk have no incentives to engage in constructive negotiations. In some cases, they will actually be interested in the *failure* of the negotiation, as opening formal insolvency proceedings would trigger insurance payment or payments under the

40. Naturally, this threat is effective against *secured* creditors only if some form of stay is applicable to them in insolvency proceedings.

41. It is essential to determine what constitutes default ("a credit event") under the relevant swap contract. In most cases, credit events comprise: a) failure to pay; b) a restructuring; or c) formal insolvency procedures. The definition of credit events may provide incentives for strategic behavior of those creditors who are parties to credit default swaps.

swap contract. Enhancing the financial capability of a corporate debtor through a workout enables the debtor to better service debt owed to non-participants. Hence, numerous small creditors rationally and opportunistically decline to participate in a workout. If these creditors, taken together, are substantial enough to dissuade other creditors from agreeing to workout arrangements, an otherwise efficient workout effort will fail.

69. *Obstacles for the negotiating process: overview.* Negotiations in workouts face multiple problems. A creditors' workout negotiation is a classic example of a collective action problem.⁴² Many small creditors experience rational apathy, as they do not have the time or the resources to engage in costly negotiations. The fact that contractual arrangements cannot diminish the rights of the parties that decide not to participate in them means that creditors will abstain from participating and will wait to reap the benefits of the workout, in the form of full payment of their credits. This background to the problem explains why numerous classes of creditors (consumers, workers, and even trade creditors) are excluded from the negotiation and effects of the workout, and receive full payment of their claims. This may make commercial sense to a group of major creditors, as it is better for them to suffer losses in a disproportionate way, and avoid the possibility that the small creditors, or the trade creditors, take the debtor to a liquidation process. The negotiation process, therefore, normally involves only financial creditors. It is important to note, also, that the smaller the financial creditors' pool, the more probabilities there are of reaching an agreement to restructure the debtor. Certainly, an increase in the number of lenders lowers the probability that a single lender is pivotal in renegotiation, but raises coordination and negotiation costs.
70. *The aggregation problem: dealing with different classes of creditors.* In most cases, the number and diversity of the claims will make it impossible to include or involve every creditor in the workout process. A large company may have thousands of creditors, to whom it owes different amounts corresponding to different types of transactions (financial, commercial, etc.) and different legal structures (unsecured, secured, other priorities, etc.). The heterogeneity of credits and creditors complicates a negotiation. There may be secured and unsecured credits; credits with high interest rates and credits with no interest; credits denominated in the local currency and credits denominated in foreign currencies; credits originally extended to the debtor and credits acquired at a fraction of their nominal value; large credits and small credits, held by creditors with little or no commercial expertise, knowledge or will to participate in the process in a constructive manner. This diversity creates an aggregation problem, as it is necessary to give a general solution to situations that are essentially disparate. The distinction between homogeneous and heterogeneous creditors is very important because there can be clear discrepancies between

42. The collective action problems exist also in the stages before the workout: a debtor can decide not to repay selected debts (strategic default, as an example of moral hazard), and the creditors may face coordination problems when collecting the debts that are owed to them (common pool problem). If the creditors coordinate, there is an incentive for each individual creditor to benefit from the agreement by not participating in it (hold out problem, which in itself is a version of the free rider problem).

different creditor groups in terms of the existence and extent of conflicts of interest among creditors in a voting group. A homogeneous voting group generates few, if any, conflicts among creditors thanks to the plausible convergence of interests resulting from the similarities in debts. In contrast, a heterogeneous voting group may well suffer from material conflicts of interest among creditors holding debts of differing nature (for instance, trade creditors may have a strong interest in continuing commercial relationships with the debtor, at the expense of the satisfaction of debts incurred by that debtor). This is the reason why successful workouts tend to involve mainly financial creditors.

71. *Dealing with dissenting creditors: the holdout problem.* As stated before, heterogeneity in a group of creditors may mean that several creditors have different incentives in dealing with the debtor. Some creditors may disregard the negotiation process completely and try to obtain full payment from the debtor, using the enforcement mechanisms for individual claims.⁴³ Where the creditors seeking individual enforcement are non-financial creditors, the best course of action for the financial creditors is to support the debtor's business and to allow for payment in full of the non-financial creditors. However, if the dissenting creditor is a financial institution, it will be difficult for other financial institutions to accept that the dissenting creditor receives payment in full, while they share the sacrifice of the workout. The "holdout" creditors create a collective action problem, as they try to take a free ride on the collective efforts of the creditors participating in the workout. A financial lender may decide to enforce its claim and be paid in full rather than participate in negotiations and recover a smaller amount. If a majority of financial creditors act in this way, there will be a formal liquidation procedure, and probably creditors will all receive less than in a negotiated workout. Therefore, the holdout problem is a fine example of a prisoner's dilemma, i. e., a situation where cooperation yields a better result than individual action, but in which an individualistic act, together with the cooperation efforts of the other parties, would provide a better result for the individual creditor. If the creditor that holds out is a financial institution, it may cause the failure of the negotiation and a creditors' race for the assets of the debtor, which may result in a formal insolvency, even where the debtor's business is viable. Therefore, the holdout problem may cause workouts to fail. There are factors, however, that reduce this free riding problem. For example, the financial institution that tries to recover in full, leaving aside the workout, may face considerable peer pressure from other financial institutions. More importantly, as workouts of debtors are a "repeat game" for financial institutions, a holdout creditor should realize that, in the future, it will find itself in situations where it will need the cooperation of other financial creditors in the restructuring of an important debtor so as to avoid considerable losses. Therefore, holdouts by financial creditors are not as frequent as a purely theoretical analysis would suggest.

43. In some cases, a creditor has the *duty* of requiring full payment, as is the case with tax authorities in numerous jurisdictions, where those authorities lack the power to negotiate due to statutory constraints. In those cases, however, tax authorities should not behave like "lenders of last resort," and they should be diligent in collecting their taxes before the debtor finds itself in deep financial difficulties. Tax authorities should also be able to not impose penalties for late payments, as these penalties are substantially paid by the other creditors in an insolvency scenario.

72. *Negotiation and debt trading.* Creditors may decide to sell their credits before reaching a workout. Although this conduct generally disturbs negotiations and can be contrary to good faith requirements, trading debts can also allow for restructurings that are more efficient. Ideally, debt trading should precede workout negotiations. The parties that are the original creditors (for instance, banks) may suffer regulatory constraints, or may require liquidity.⁴⁴ If there is an active market for distressed debt, and there are no regulatory constraints for debt trading, debt may be transmitted to investors with the necessary experience and skills to deal with a company in crisis (for instance, the so-called “vulture funds”). Generally, permitting debt trading has positive results, as it allows for the concentration of debt in fewer hands, which reduces the transaction costs of restructuring. The existence of specialized operators in distressed debt can also represent a positive factor, as “vulture creditors” help discipline debtor’s management, although there is anecdotal evidence of excessive aggressiveness on the part of these operators. In any event, an appropriate tax regime is necessary to create incentives for the original creditors to sell their debts. Despite all its positive aspects, debt trading has some disadvantages. Since these creditors acquire the debts for a fraction of their face value, they may have very different incentives from those of the original creditors, and would therefore be more willing to make concessions to the debtor, without considering the other creditors’ interests.⁴⁵
73. *Negotiation and good faith requirements.* A workout agreement can only be reached where there is real commitment to negotiate on the part of the financial creditors. Good faith can be expressed in a variety of manners, which may be explicit or implied in the relevant law:
- First, good faith requires that a creditor that decides to participate in workout negotiations stays a creditor and does not transfer its debt to another party. Changes in creditor identities disrupt the negotiation process. However, some changes in the identity of creditors may have a positive effect, for instance where a creditor transfers its credit to an experienced workout specialist. Therefore, transfer of credits may be beneficial in some cases, so that there should not be an outright prohibition of debt trading. In that case, good faith requires that the creditor discloses its intention to transfer the credit and that the creditor does not pursue any action regarding the workout once it has decided that it is going to transfer the credit to a third party.
 - Second, a creditor that participates in the negotiations should disclose the peculiarities of its legal position (for instance, whether the credit is secured, whether

44. There are several hypothetical reasons why such parties might want to purchase bad debts from banks. First, they may be more willing or able than banks to collect the debt. Second, they may be customers of the debtor firm who can use such debt to pay for goods and services, and to continue relationships with the debtor. Third, they may wish to swap the debt for equity and take control of the debtor firm. Under any of these scenarios, debt trading can increase financial discipline and improve corporate governance in debtor firms.

45. For instance, a creditor that acquires a debt for ten per cent of its face value could probably agree to a plan where general creditors will recover thirty per cent of their credits. Original creditors, however, may not agree on the desirability of that outcome.

it is covered by insurance or by a credit default swap, etc.). The reduction of informational asymmetries favors negotiation and contributes to create trust among all parties.

- Finally, if a creditor decides to participate in workout negotiations, it should cooperate in a constructive manner towards finding a solution to the problem. Good faith demands not only permanence and disclosure, but also positive actions towards the solution of the conflict between the debtor and the creditors and between the creditors themselves. The creditors can reinforce this good faith requirement by signing an agreement that fixes, *ex ante*, the necessary majorities to reach agreements on the various points of the workout.
74. *The contents of a restructuring plan.* A restructuring plan or workout should contemplate changes in the debtor's business and changes in the debt and in the financial structure of the debtor. From the debtor's point of view, a workout provides the opportunity of restructuring activities, obtaining funds to overcome liquidity problems, and adjusting cash flow to the maturity of debts. Financial creditors may either loosen financial constraints (for instance, deferring principal or interest and/or providing fresh money) or tighten those financial constraints (for instance, reducing credit lines and/or increasing collateral). Listed below are some of the provisions that typically form part of a workout. It is possible to classify these contents along two axes: the provisions that restructure the debtor's business and the provisions that restructure the debt itself.
75. *Provisions regarding the debtor's business.* There are several provisions that may affect the debtor's business in a workout. Ideally, these provisions have to be integrated in a coherent business plan that seeks to restore the company to profitability.
- *Asset sales.* The law should allow distressed debtors to sell assets in order to obtain new funds for their continuing lines of business or to dispose of assets or units that have proven to be detrimental to the debtor's business. The sale of assets that are detrimental to the debtor's business does not pose particular problems, but the sale of assets or units that are profitable can raise some concerns. In order to address these concerns, it is imperative to correctly document the sale of assets and units for fair value consideration. If the assets are of substantial value, it is advisable to require an independent fairness opinion. The existence of an independent fairness opinion establishing that the sale transaction adheres to fair terms and conditions can eliminate or significantly reduce the possibility that the asset sales will be subject to avoidance actions, in the event of a subsequent insolvency procedure.
 - *Hive-downs.* In the context of a restructuring, it is possible that the debtor's financial difficulties stem from antecedent liabilities that keep the business from operating efficiently. It would be possible, in the context of a business plan, to transfer assets and operations to a newly created company, and transfer its shares to creditors. It is also possible to use special purpose vehicles (SPVs) to isolate assets from potential claims, and grant creditors shares in the SPV.

76. *Provisions regarding debt restructuring.* Debt restructuring may include many different components. It is not imperative that all debts be treated in the same way, even if the workout only affects financial creditors. It should be possible to adapt the restructuring to different creditor perspectives, and distinguish between those who prefer to receive a partial payment as soon as possible, and those with confidence in the future of the debtor, who can elect to recover their credits in full, but later in time. Some of the usual contents of debt restructurings are the following:

- *Rescheduling of payments (e.g. deferral of certain repayment installments, extension of debt maturity).* A rescheduling of payments constitutes a novation of the former debts for the creditors that participate in the restructuring agreement. Therefore, debts with new characteristics substitute the old debts.
- *Roll-overs (change of maturity dates for debt instruments or debts).* This is one of the less radical changes that a restructuring may entail, and consists of modifying the maturity dates, providing for the same interest for the extended period of time granted for payment.
- *Conversion of the currency in which debts are denominated.* Negotiations may also include currency conversion insurance.
- *Alteration of interest rates.* The reduction of interest rate (fixed or variable) also entails a novation of the debtor's original obligations. Debt with high interest rates is one of the common causes of financial distress. These difficulties may derive from the fact that the interest rates were excessively high for the cash flow generated by the debtor's business or from the fact that the evolution of interest rates, as opposed to a fixed rate, has resulted in the company receiving finance at an exorbitant cost, compared with prevailing market conditions.⁴⁶
- *Forbearance of penalties in loan agreements.* A workout may include a waiver (temporary or permanent) of violations of covenants, and may cancel all of the responsibilities of the debtor derived from violation of the covenants in the loan agreements.
- *Alteration of covenants.* The covenants included in the loans may be unnecessarily restrictive and may impose a considerable burden on the debtor. It should be possible to reduce the obligations of the debtor under this heading, and, at the same time, monitor adequately its activities and its financial soundness.
- *Debt/equity swaps; Debt/debt swaps; equity/equity swaps.* All of these combinations are possible and allow creditors to obtain new debt or equity instruments. It is also possible to grant classes of creditors and even shareholders options to purchase other securities. For instance, shareholders should have the opportunity of buying out creditors to avoid seeing their shares wiped out, and to retain

46. Nothing in this paragraph suggests that the debtor has a right to revise interest rates applicable to its loans. The decision to finance at a certain interest rate (fixed or floating) may have been taken recklessly by the debtor, and there is no available defense for that mistake. The issue is that a high interest rate may become the cause of severe economic distress, and it can be more interesting for the creditors to reduce the interest rates rather than risk a complete default of their loans.

control of the debtor company; similarly, junior creditors should be able to buy out secured creditors.

- *New loan facilities.* Providing new financing arrangements may be crucial for the recovery of the distressed company. Therefore, new loan facilities are one of the typical terms in a restructuring agreement, and normally there is additional security—or provisions in inter-creditor arrangements—to compensate for the additional risk incurred by those who provide new financing to a distressed company. In the case of the provision of new money, no lender can be forced to extend new financing against its will. This is an implied assumption in every restructuring, and it can be made explicit in a general agreement among creditors. Normally, creditors with larger exposure to the debtor are expected to be contributors of new money, but there is no strict obligation in that respect.
 - *Restructured debt security.* Creditors may demand that the pre-existing debts against the debtor be covered by security interests, in compensation for the reduction in the amounts to be recovered or in the interest rates for their loans. The law should allow for the creation of new security interests where this priority is balanced with the advantages that the debtor receives because of the restructuring. In this respect, the creation of security interests should be protected from avoidance actions, in case that the restructuring fails and a formal insolvency procedure is subsequently commenced. A correct analysis should prove that the debtor and the other creditors benefited from the new financing and that, therefore, the security interest should not be avoided, as it was instrumental in providing new finance.⁴⁷
 - *Forgiving interest.* Financial creditors will typically prefer to forgive past interest and obtain payment for the principal and future interest. This arrangement is normally favored for regulatory reasons. Future interest payments can also be reduced.
 - *Partial or total debt write-offs.* Debt forgiveness should be a last resort since the possibility of forgiveness can give rise to moral hazard. Clearly, knowing that debt forgiveness is a distinct possibility of a restructuring may induce debtors to engage in riskier projects and to behave irresponsibly. The creditors may agree to reduce the outstanding debt of the distressed company (the so-called “haircuts”). The effect of a write-off is to novate the original obligations, substituting new obligations for a smaller amount, or cancelling debts altogether.
77. *Binding effects of workouts.* Ideally, workouts should be binding on all creditors, but the contractual nature of the workout requires that every creditor gives its individual consent to the agreement. This obstacle can be overcome by using several different legal techniques that enhance purely contractual workouts.⁴⁸

47. However, a fairness opinion by an independent expert may be necessary to protect the creditors' position in future litigation.

48. See Section III.3 below, on enhanced restructurings.

- The use of majority clauses in public debt securities⁴⁹ and syndicated loans;
- Protocols by financial creditors whereby those creditors agree *ex ante* to majority decisions regarding future workouts. The percentage required for approval may vary depending on the acts undertaken during the restructuring,⁵⁰ and are subject to a general agreement among creditors. In any case, majority decisions do not imply that junior creditors may decide on the restructuring of senior debt. On the contrary, the plan must take into account the special situation of creditors with valid security interests;
- Specific legislative provisions that allow creditors to bind dissenting minorities in circumstances defined by law.⁵¹

Without a general agreement among creditors, or without a specific legal provision, all decisions have to be unanimous. This requirement may mean, in practice, that a debt restructuring is not feasible because of the large number of creditors involved, especially in the case of debtor companies that have issued public debt,⁵² and because of the existence of holdout creditors. Passive or untraceable creditors should not justify an effort to reach unanimity. Therefore, barring the existence of these contractual or statutory mechanisms, parties who have subscribed to a contractual obligation would not be bound by the decision of majority creditors, thus raising a risk that the restructuring could be rendered meaningless by the independent action of minority and holdout creditors. In such a situation, it would be necessary to revert to a formal process in which the insolvency legislation will provide the mechanism for binding minority creditors.⁵³

3. Enhanced Restructurings

78. *Enhanced restructurings.* The preceding discussion reveals the issues and difficulties of out-of-court restructuring without any elements of formality. As such, informal workouts are purely a contractual matter and, as with all contracts, they are extremely difficult to execute when the number of participants is high (coordination problem) and when the latter's risk profiles and expectations differ widely (aggregation problem). In essence, a workout is theoretically possible in all legal systems allowing parties to modify their contractual rights and obligations. This tends to

49. In some legal systems, this possibility is forbidden. See footnote 11.

50. For example, typical quorums for decision-making within a restructuring would be 75–90 percent for full restructuring, 75 percent for moratoria, 66 percent for capital spending, credit draws and asset sales, and 100 percent for new money (these percentages correspond to the so-called Istanbul approach, one of the restructuring schemes developed taking the London Approach as a model).

51. See below, section III.3, number 78 ff. and section III.4, number 93 ff.

52. The regime for bonds and debt securities may foresee the existence of a trustee, agent or representative of the bondholders, with authority to negotiate in the name of those bondholders. However, in many cases the representative is not authorized to write off the debt, not even partially.

53. That is why the pre-packaged bankruptcy plan performs an important function in numerous systems. This leads to the conclusion that the existence of a modern reorganization proceeding is also useful for workouts. See below, number 96 ff.

be the case in all jurisdictions. However, coordination problems bring to light the limits of contract, as is the case when creditors threaten the majority with using enforcement actions in order to receive full payment of their claims. These problems require additions to the traditional contractual restructuring framework— i.e. “enhanced restructurings” whereby the contractual nature of the workout is preserved, but the workout is reinforced by some elements that improve its effectiveness in practice. The World Bank Principles refer to this approach: **“An informal workout process may work better if it enables creditors and debtors to use informal techniques, such as voluntary negotiation or mediation⁵⁴ or informal dispute resolution”** (Principle B4.1). Therefore, the Principles state that informal workout processes function better where mediation, negotiation, or other alternative dispute resolution techniques are used. This does not exclude the existence of workout processes conducted with the intervention of a court or of an administrative official (“hybrid procedures”), but this principle refers to informal arrangements used in connection with workouts. These informal procedures are situated, as hybrid procedures are, between purely informal workouts and formal insolvency proceedings in the continuum described before.⁵⁵

79. *Different techniques for enhancing out-of-court restructurings.* There are several methods to enhance out-of-court restructurings, short of converting workouts into hybrid procedures by including limited interventions of the courts.⁵⁶ The first possibility is to use social norms that promote best restructuring practices, but there are many other possibilities, such as adding master contractual agreements for workouts and establishing alternative dispute resolution systems to deal with the inter-creditor conflicts that may arise in the context of a restructuring negotiation.
80. *The role of social norms.* Using social norms and promoting the role of the financial supervisor as a facilitator are some of the most interesting possibilities for enhancing workouts. Codes of practice may perform a useful function for shaping a workout culture among financial firms, but to be effective participants must internalize those norms and this requires, in turn, a high degree of homogeneity, which is difficult to achieve in a globalized and diversified economy. The World Bank Principles refer to restructurings based on norms and the role that the financial supervisor may play in introducing these restructuring techniques.
81. *Restructuring based on norms and financial supervisors.* According to the World Bank Principles, “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” (Principle B4.1). The Principles also state that “A country’s financial sector (possibly with the informal endorsement and assistance of the central bank, finance

54. Mediation is frequently used in the French system, with minimum court involvement (*Mandat ad hoc*, *Conciliation*, and the old *Règlement amiable*), but court intervention, however minimal, justifies the classification of these procedures as hybrid procedures, and not entirely informal procedures.

55. See above, Figure 1.1, and numbers 5 ff.

56. See below numbers 93 ff.

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" (Principle B5.1). Sets of norms have been developed to help banks and distressed enterprises handle financial difficulties at an early stage and put in place workouts and restructurings. Such rules may be adopted by a facilitating agency, such as a central bank or finance industry association. The strength of these norms comes from the *auctoritas* of the financial supervisor, and from the persuasion that these rules effectively correspond with international best practices in the financial sector. Norms do not have a binding effect on financial institutions. However, those institutions that do not respect them may be subject to social reprisals, and, most importantly, will have problems in obtaining assistance from other financial institutions when the situation is reversed.⁵⁷

82. *The London Approach*. The "London Approach" is the archetypal example of norm-based restructuring. The London Approach is defined as a "non statutory and informal framework introduced with the support of the Bank of England for dealing with temporary support operations mounted by banks and other lenders to a company or group in financial difficulties, pending a possible restructuring."⁵⁸ The London Approach comprises a set of non-binding principles that serve as a guide for participants in debt restructuring processes. The guiding objective of the London Approach is to facilitate the restructuring of viable companies in the interests of the economy, of the debtors and of creditors themselves, and to avoid liquidation at the behest of creditors acting in an isolated fashion. As to the scope of the norms, it is quite clear that they should cover not only the broad basis upon which an informal workout process should operate but also areas such as the criteria upon which banks may initiate the process and the requirement that any institution should attempt to involve distressed debtors in the process. Consideration should therefore be given to the possibility of formalizing the basic principles and rules to be applied through the development of a code of conduct.
83. *Requirements of the London Approach*. The London Approach requires that all relevant creditors collectively avoid taking any enforcement actions against the debtor for a period (the "standstill period") during which all relevant information on the debtor might be obtained and evaluated. The debtor should help the creditors to obtain such information and should agree not to take any action that would adversely affect the return to creditors. Information so obtained would be available to all creditors, but would otherwise remain confidential. The creditors should agree to coordinate their response to the debtor through elected representatives and with

57. It has been said that the bank that frustrates an orderly workout for a company may find that other banks are less likely to be constructive next time, when their roles are reversed. Sooner or later, the tables are turned, and those who have not cooperated will require cooperation from those who were previously let down.

58. This definition appears in a document of the British Bankers Association, dated 1996. The Approach was originally designed by the Bank of England in the 1970s, and was developed further in the 1980s and 1990s.

the assistance of professional advisers. The creditors should conduct themselves in accordance with existing legal principles and, finally, any funding of the debtor during the standstill period should have priority treatment vis-à-vis any other claims of the creditors.

84. *Principles of the London Approach.* The London Approach, therefore, rests on four major principles: 1. Lending banks agree not to exercise their rights to initiate an official insolvency process (*standstill*); 2. Any decision is made based on reliable information that must be shared among all the lending banks and that remains confidential (*information*); 3. Banks should work together to try to form a collective view on whether support for the debtor should continue and, if so, in what form (*negotiation and decision on viability*); 4. All lending banks should share equally the burden of supporting the debtor (*business plan and new money*).
85. *Expansion of the London Approach: the INSOL Principles.* The London Approach owes its success to its flexibility and its ability to adapt to a number of environments and situations. The London Approach inspired the Principles approved by INSOL International in 2000 ("Statement of Principles for a Global Approach to Multi-Creditor Workouts").⁵⁹ In its document, INSOL sets out eight principles as statements of best practice regarding workouts:

- **FIRST PRINCIPLE:** Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate 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.
- **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.
- **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.
- **FOURTH PRINCIPLE:** The interests of relevant creditors are best served by co-ordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination 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.
- **FIFTH PRINCIPLE:** During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and

59. See <http://www.insol.org/page/57/statement-of-principles>.

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.

- **SIXTH PRINCIPLE:** Proposals for resolving the financial difficulties of 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.
- **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.
- **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.”

Professionals involved in restructurings in numerous jurisdictions have absorbed these principles and their success means that nowadays the principles are merely descriptive of the informal restructuring practices worldwide.

86. *The London Approach and financial supervisors.* The London Approach relies on the role of the financial supervisor acting as a mediator or providing access to independent mediators that create the conditions for negotiation among all the parties involved. This is especially important in countries where creditor remedies and formal insolvency regimes present deficiencies, as it may be desirable to provide, in some semi-official way, for a facilitator to encourage the commencement of the process. In this way, the debtor and the creditors can select a forum in which they can gather to negotiate an arrangement to deal with the debtor’s financial difficulty. It is important to note that, although supervisors and regulators play an important role in the process, the financial supervisor should normally refrain from actively intervening in restructurings.⁶⁰
87. *Shortcomings of the London Approach.* The limitations of the London Approach and of the INSOL Principles stem from the unanimity requirement for their operation and from the nature of social norms that characterize the Principles and the Approach. These norms require a high degree of social consensus and internalization of their principles by all major players in the financial sector. The principles are problematic in scenarios where financial institutions belong to different cultures and some

60. The Supervisor should rather focus on supervising financial institutions and enforcing supervisory rules; eventually coordinate with other agencies such as the finance ministry on issues of regulatory forbearance. This task includes ensuring that banks have fully taken into account their risks from their exposure to a specific sector or region and made adequate provisions once losses have occurred, and encouraging banks to cooperate with their counterparties and central banks. It is crucial that banks recognize their losses, and the influence of the financial supervisor is instrumental in the strengthening of provision requirements and in the introduction of loan classification standards based on forward-looking criteria.

of them do not adhere to “international best practices.” Moreover, the wide use of debt trading relieves banks from the “peer pressure” that underpins the Approach. Disintermediation of corporate debt has caused the surge of dealers and investors specialized in distressed companies (“vulture funds”), who feel detached from those principles and are insensitive to the influence of the financial regulator. The fact that there are more players and that not all the players are traditional financial institutions makes negotiations more complicated and maintaining confidentiality more difficult. Vulture funds have no problem in exchanging their debt for equity and even taking control of the debtor, and their approach to negotiation is clearly different from the more traditional approach that banks and other financial institutions adopt. Therefore, the presence of new players has resulted in the relative decline of the London Approach.⁶¹ The existence of active, not always transparent, debt markets and of new hedging techniques for loans makes it difficult to determine who the important lenders are at any given moment.⁶² Active debt markets also mean more difficult negotiations because buyers of debt below par have to negotiate with lenders that have originated their own loans at par value, and therefore the differences in the negotiations could be enormous. Another important development to note is that the particular features of countries require changes in the original conceptual framework. The London Approach needs reinforcement in the face of systemic crises, as the experience in the Asian crisis in the 1990s showed.

88. *Norms reinforced by contract.* Taking as a starting point the London Approach, some countries have enhanced these rules and created a more institutionalized framework for corporate restructuring to complement in-court procedures. The response to the shortcomings of the London Approach is found in the “second generation” or “second degree” of enhanced workout procedures, in which Asia has been prolific.⁶³ Thailand is one of the best examples. In addition to specifying in more detail the contents of the principles for workouts,⁶⁴ the financial supervisor persuaded the financial institutions subject to the central bank’s supervision to sign adhesion

61. Vulture funds also have different incentives and less regulatory problems to accept debt/equity swaps, and eventually take control of the debtor. They also tend to be more aggressive than banks.

62. In some cases (for instance, in syndicated loans), lenders are prohibited from selling their participation in the loan to parties that are not members of the syndicate, or to parties that are not financial institutions. However, there are sub-participation agreements that circumvent that prohibition. The existence of credit insurance and of credit default swaps also implies that some of the apparently important lenders will have no interest in the workout negotiations.

63. Indonesia established the Jakarta Initiative; the Republic of Korea, the Corporate Debt Restructuring Committee; Malaysia, the Corporate Debt Restructuring Committee; and Thailand, the Corporate Debt Restructuring Advisory Committee. Turkey approved the Istanbul Approach, and an interesting approach to workouts was also used in Argentina.

64. The Thai norms for restructuring constitute a fine example of a developed London Approach, operating as an enhanced workout regime (note that in this version, the principles do not actually include references to the need of a master agreement among creditors):

1. *Any corporate debt restructuring should achieve a business rather than just a financial restructuring to further the long-term viability of the debtor.*
2. *Priority must be given to rehabilitate assets to performing status on full compliance with Bank of Thailand regulations.*
3. *Each stage of the corporate debt restructuring process must occur in a timely manner.*

letters to the scheme. In this way, financial institutions were committed, by way of contract, to negotiate a restructuring with the debtor and the other financial institutions, respecting the best practices embodied in the principles. The parties agree to negotiate and to substantiate their differences in out-of-court venues, through mechanisms based on arbitration. The existence of alternative resolution schemes, or arbitration, may help creditors solve their coordination problems in negotiating a workout with the debtor. The arbitration techniques may include specific deadlines and penalties for parties that do not comply with deadlines. Other Asian countries have followed a similar approach.

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4. *From the first debtor-creditor meeting, if the debtor's management is providing full and accurate information on the agreed schedule and participation in all creditor committee meetings, creditors shall "Stand Still" for a defined, extendable period to allow informed decision to be made.*
 5. *Both creditors and debtors must recognize the absolute necessity of active senior management involvement throughout.*
 6. *A lead institution, and a designated individual within the lead institution, must be appointed early in the restructuring process to actively manage and coordinate the entire process according to defined objectives and deadlines.*
 7. *In major multi-creditor cases, a steering committee representative of a broad range of creditor interests should be appointed.*
 8. *Decisions should be made on complete and accurate information, which has been independently verified to ensure transparency.*
 9. *In cases where accountants, attorneys and professional advisors are to be appointed, such entities must have requisite local knowledge, expertise and available dedicated resources.*
 10. *While it is normal practice to request the debtor to assume all the costs of professional advisors, lead institutions and creditors' committees, creditors have a direct economic interest, and hence a professional obligation, to help control such costs.*
 11. *The Ministry of Finance and the Bank of Thailand should be kept informed on the progress of all debt restructuring to aid the review and regulatory and supervisory framework and to facilitate corporate debt restructuring.*
 12. *The roles of the Corporate Debt Restructuring Advisory Committee are as follows:-*
 - a. *Follow-up developments in debt restructuring;*
 - b. *Review and implement policies to facilitate debt restructuring for the public good;*
 - c. *Act as an independent intermediary in the restructuring process where cases are particularly difficult or where other efforts have failed. The committee may well be a catalyst to activate sluggish negotiations.*
 13. *Creditors existing collateral rights must continue.*
 14. *New credit extended during the restructuring process above existing exposures as of the standstill date on reasonable terms in order that the debtor may continue operations must receive priority status based on title orientated security, inter-creditor agreements or indemnities.*
 15. *Lenders should seek to lower their risk and hence their requisite returns, through an improved security package and profitability-based benefits rather than increased interest rates and imposition of restructuring fees.*
 16. *Debt trading is appropriate under certain conditions but the selling creditor has the professional obligation to ensure the buyer does not have a detrimental effect on the restructuring process.*
 17. *Restructuring losses should be apportioned in an equitable manner which recognizes legal priorities between the parties involved.*
 18. *Creditors retain the right to exercise independent commercial judgment and objectives but should carefully consider the impact of any action on the Thai economy, other creditors and potentially viable debtors.*
 19. *Any of the principles or implementing policies contained in this framework can be waived, amended, or superseded in any particular restructuring with the consent of all participating creditors.*

89. *A reinforced approach based on binding agreements in workouts.* Another contractual technique used to reinforce norms-based restructuring is to demand the consent of financial institutions not just to the principles and best practices regarding the workout process, but also to future or potential workout results. This technique raises the norm-based restructuring's degree of formality by developing an agreement among banks and financial institutions under which they would be bound to use a majority mechanism for the resolution of workouts. In practice, this approach is similar to mediation or arbitration clauses introduced in contracts, in that the parties agree to negotiate among themselves and not take the matter before the courts. Although such norms or agreements cannot be imposed on debtors, this system presents many advantages. It provides a degree of acceptance and credibility to the process; it may help establish precedents or a practice and may assist in speeding the process. Financial institutions would agree beforehand to subject themselves to specified majority decisions taken in connection with workouts. This *ex ante* consent allows workouts to proceed, as the rules for majority decision have been accepted contractually by the potential participants in a workout. Obviously, the debtors will not have consented to the workout procedures, but the aim of the agreement is to reinforce the norms-based approach in its weakest link, namely the negotiation among financial creditors. Otherwise efficient workout attempts often fail in large part because some financial creditors—individually non-pivotal actors—opportunistically, but rationally, opt to stay out of workout arrangements. The agreement to accept the results of voting resolves this holdout problem.
90. *Advantages of restructurings enhanced by contractual provisions.* Enhanced restructuring procedures present clear advantages over a classic, purely norm-based, London Approach. However, some problems remain. The fact that debt trading is possible means that vulture funds, or other specialized players, may enter into play without being bound by the agreements to which the financial institutions have adhered. At the same time, the fact that the debtor is not part to the restructuring agreements can be problematic, as it may threaten financial creditors with the presentation of an insolvency petition.
91. *A reinforced approach based on statutory rules.* A fourth degree of reinforced workout arrangements includes statutory support for the decisions taken by a majority of creditors in the context of a workout. A voting scheme requires a statutory basis in order to be binding on the voting group, which includes dissenting creditors.⁶⁵ The vote may require different majorities depending on the decision to be taken (for instance, the provision of new money usually requires the consent of the affected

65. For instance, the vote is compulsory in the Republic of Korea; see Corporate Restructuring Promotion Act, Law No. 6504 (2001), that binds financial institutional lenders to a workout arrangement if favored by a three-fourths majority. Of course, the majority can also bind the minority if all the participants have voluntarily agreed to such a procedure beforehand. A mixed approach was used in Turkey (Banking Law 4743, of 2002, incorporating the "Istanbul Approach"). The main bank and financial institutions reached a framework agreement and specific cases of restructurings needed the approval of a reinforced majority. If the majority that approves the plan is 55 to 75 per cent, the plan is reviewed by an arbitration committee. If the plan is passed by a majority of creditors holding more than 75 per cent of the claims, the plan is automatically approved.

lenders).⁶⁶ As with contractual arrangements, majority voting helps solve collective action problems connected with the negotiation of workouts among creditors. In this way, even if the debtor has not agreed to the workout procedure, and even if debts can be transmitted to dealers in distressed assets, the majority of creditors will be able to impose a solution on the rest of participants, because the power of the majority to bind the minority has its origin in a specific statutory provision. In this way, the workout has similar effects to a composition within formal insolvency proceedings, without judicial intervention. This is the most aggressive mechanism for favoring out-of-court restructurings, and may collide, in some countries, with constitutional rules that guarantee access to the court system, as in this case the rights of particular creditors could be sacrificed without intervention of the courts and without the creditors' consent.

92. *Reinforced workout procedures: a summary assessment.* Reinforced workout procedures may be one of the best techniques to help the financial sector and the general economy in the context of a systemic crisis, especially if the procedures are accompanied by tax incentives for restructurings.⁶⁷ Reforming bankruptcy laws takes time, and building capacity for judges and restructuring professionals takes even longer. However, a London Approach, alone or in one of the reinforced versions, can be implemented in a very short time, especially if all the players involved in the negotiations are financially sophisticated. Informal approaches profit from synergies of a public-private interface,⁶⁸ and can be tailored to any specific debtor restructuring needs. The drawback, however, is that the principles for restructuring tend to be too general and lack prescriptive force, which is the reason why reinforcing the informal approach with some binding rules is desirable.

4. Hybrid Procedures

93. *Hybrid procedures: definition.* In the context of the present paper, the term "hybrid procedures" designates workout procedures in which there is a mixture of the features of contractual workouts and limited court intervention.⁶⁹ These procedures are "hybrid" because they incorporate some elements of formal insolvency proceedings in an attempt to eliminate the problems that arise in the context of informal workouts. There are many options available for the regulation of hybrid procedures, with varying degrees of court intervention. The degree of court intervention

66. The Korean framework went so far as to establish the obligation of contributing pro rata to new financing, and imposed penalties on existing lenders who failed to provide their share.

67. Normally, the fiscal incentives are implied in a special regime that allows for loss deduction for the amount that the lenders decide to reduce the debt. There can also be explicit tax incentives for investment in restructuring companies.

68. In some cases, the adoption of the approach has served as a platform for the creation of other public solutions, like asset management companies, that complement the techniques and objectives of the approach.

69. In some cases and countries, the intervention may come from a government agency, instead of a court (Italy). In other jurisdictions, an insolvency practitioner may be appointed without significant court intervention (Australia).

should depend, in turn, on the court's preparation and availability and on the nature of the problems that informal workouts encounter in any given jurisdiction.

94. *Hybrid procedures where the court appoints a mediator.* One of the hybrid procedures existing in several jurisdictions involves the appointment of a mediator, or a similar figure, to assist in the negotiations between the debtor and the creditors. The appointment of a mediator aims to overcome the negotiation's coordination problems. Under this approach, it would be possible to appoint a mediator to initiate contacts between the debtor and the creditors. The procedure may require that the debtor make an application to the court, and the court may appoint the person suggested by the debtor in its petition,⁷⁰ or another independent expert. It would also be possible, in theory, that the court appoints the mediator at the suggestion of one or several creditors.⁷¹ The intervention of a neutral party such as the mediator may result in a smoother negotiation process, and the possibilities of a successful workout may increase significantly. The mediator should possess the necessary technical skills to conduct an effective negotiation with the debtor and the creditors. The mediator is not a representative of the debtor, but an independent figure whose mission is to engage all parties related to the distressed debtor in a constructive dialogue.
95. *Hybrid procedures where there is a stay on creditor actions.* One of the problems that out-of-court restructurings face is the holdout by a creditor or by a significant number of creditors. In and of itself, the fact that a creditor uses an enforcement action against the debtor may mean the end of the negotiations and the start of a race among creditors. This usually ends with the opening of a fully formal insolvency proceeding, frequently aimed at liquidation—without consideration for the fact that the debtor could have been rescued with an adequate workout agreement. A hybrid procedure may allow the debtor a limited period for negotiation with creditors. During that time, the debtor will not be under the obligation to file for insolvency proceedings and the creditors will be subject to a stay of their enforcement actions.⁷²
96. *Hybrid procedures where the court validates an agreement among creditors (prepackaged bankruptcy).* The last hybrid procedure is located on the side of the continuum that is closest to completely formal insolvency procedures. The World Bank Principles mention these hybrid procedures: “Where the informal process relies on a formal reorganization, the formal proceeding should be able to quickly process the informal, pre-negotiated agreement” (Principle B4.2). Such a plan would be the likely result of a formal insolvency process. If the workout negotiation does not obtain unanimity,

70. For instance, the French system of *mandataire ad hoc* and *règlement amiable/conciliation*. The procedure also enhances the workout in the sense that approval of the plan does not require unanimity of the creditors.

71. In practice, that approach may not be always workable, as it is unlikely that a creditor possesses sufficient information on the indebtedness of the debtor at a time when it is still possible to find a solution to the debtor's financial difficulties. So, generally, this process, as all hybrid procedures, will typically be initiated by the debtor.

72. A procedure may combine the appointment of a mediator and the granting of a stay to creditor actions. This was the approach in the old *reglément amiable* in French law, but apparently the stay lent itself to numerous abuses by debtor, so the new conciliation procedure does not contemplate a stay for creditors' actions. The debtor can ask for grace periods, however.

the debtor volunteers itself under that law and the plan is approved by the majority and binds the dissenting creditors. This highlights the desirability of an adequate formal rescue law. Only with such a law in place is it possible to transfer the informal process to the formal process. As a matter of practice, the mere possibility that the debtor and the main creditors may agree to a prepackaged plan acts as a catalyst for the negotiation of a workout, so that, paradoxically, the formal procedure may be unnecessary.

97. *Interplay between informal and formal procedures.* In the case of prepackaged bankruptcies, the majority of creditors have reached a basic agreement with the debtor and among themselves, but they need the intervention of the court under a formal insolvency procedure in order to bind the minority. The fact that the debtor files for a formal insolvency procedure means that all the effects of the procedure, including a stay on creditor actions and the possibility to terminate onerous contracts, are available for treatment of the insolvency situation. Therefore, although there is a formal insolvency procedure, in practice the parties seek only some of the effects of the procedure and, most importantly, look for the binding effect of a court-approved composition between the debtor and the majority of the creditors. Involvement of the court tends to be minor, and these pre-packaged procedures are typically fast, especially when compared with full-fledged insolvency procedures.
98. *Pre-arranged plans.* A “pre-arranged” or “pre-negotiated” plan is similar to the prepackaged reorganization or insolvency plan since it is also negotiated between the debtor and its creditors on an out-of-court basis and then filed with a court to obtain the benefits of its approval. Although the parties will have conducted substantial negotiations prior to the filing, there is no formal solicitation of votes in a pre-negotiated plan. Indeed, the difference between the “prepackaged reorganization plan” and the “pre-arranged” or “pre-negotiated plan” lies in whether it is “pre-voted” or “post-voted.” In a pre-arranged insolvency procedure, the debtor, before commencing the formal insolvency proceedings, negotiates a reorganization plan and solicits votes on the plan from the number and classes of creditors and of shareholders required for formal insolvency proceedings, or by the representatives of the most significant creditors and shareholders.
99. *Prepackaged sales.* Under the insolvency practice of certain countries, the expression “prepackaged insolvency” refers to procedures in which a sale of the business as a going concern is already planned before the formal proceeding is opened. Therefore, the business is sold at a very early stage of the insolvency proceedings, and the proceeds are distributed among the creditors in the fastest possible way.⁷³ Prepackaged sales may be the best solution for businesses that have accumulated liabilities but have positive prospects.
100. *Symbiosis between informal and formal procedures.* Prepackaged plans show that there can be a symbiosis between informal and formal insolvency procedures. Prepack-

73. However, prepackaged sales may be difficult to operate in a systemic crisis environment, as bidders will face a financing problem and the market for distressed assets may be overflowed with supply.

aged procedures demonstrate that it is possible to combine and incorporate some of the typical effects of formal insolvency procedures, such as the possibility of a majority of creditors binding a minority, and contribute to a fast and less costly resolution of financial difficulties.

101. *Regulatory guidelines for prepackaged plans.* Prepackaged plans require a set of preconditions in order to work smoothly. First, creditors need to be authorized to negotiate with the debtor and to have contacts among themselves. This can be particularly risky in the context of listed companies, as the negotiation of the plan requires that the debtor provide confidential information and the existence of the negotiation itself can be price-sensitive information. Therefore, parties to the negotiation should sign confidentiality agreements. Ideally, the plan should be disclosed with the filing of the petition. The debtor itself should file the petition for formal insolvency proceedings, which should include a list of creditors and the plan itself, together with the names of the creditors that have voted in favor of the plan, the amounts of their claims, and proof that these creditors have already consented to the plan. The court should treat the proposed plan expeditiously, and should validate the plan *before* disputes among creditors are solved. This poses a particular problem, as votes for the plan will be accounted for without the legal certainty that all the persons who decide on the plan are creditors or are correctly classified in the creditor hierarchy. There should also be a procedure for creditors to adhere to the plan. In this way, it might be possible to avoid holding a creditors' meeting and to obtain the necessary majority through the adhesion of creditors. Once the court validates the plan, there could be actions among creditors regarding the relative standing of their claims, but those disputes can be adjudicated without affecting the overall efficacy of the plan. The procedure may deal with other elements typical of formal insolvency (avoidance actions, liability of directors) without any impact on the plan's approval and execution.⁷⁴ In conclusion, countries should consider the possibility of adopting an expedited process for the conversion of an informal workout plan into a formal reorganization plan. This technique aims to combine "the best of both worlds" so that insolvency proceedings cause minimal disruption to debtors' business activities by combining the efficiency, speed, cost, and flexibility of workouts with the binding effect and structure of formal insolvency proceedings.
102. *Shortcomings of prepackaged plans.* In spite of its apparent advantages, a prepackaged plan may not be the best solution when applied to cases that call for the whole effects of formal insolvency proceedings. In a prepackaged environment, it may be more difficult to solve questions related to directors' liability for fraud or mismanagement. It can also be difficult to use avoidance actions for antecedent transactions, which may require a proper investigation. The concerns raised by prepackaged insolvency procedures have to do with the lack of transparency of the negotiations and the fact that small creditors and shareholders can be potentially disadvantaged, as there is nobody that represents their interests in the critical phases of the negotiation before the plan is presented to the court together with the formal insolvency

74. Except for the economic impact of those actions, that may affect the distributable proceeds in the insolvency proceedings. However, the plan itself may foresee that effect.

petition. Small creditors and minority shareholders are normally left out of the negotiation that precedes the opening of the formal proceedings, and they can only adhere to the plan that financial creditors have devised and agreed upon. Moreover, if there are doubts about the existence of claims, or about the secured status of some claims, a prepackaged insolvency may be ill-suited for handling these inter-creditor disputes.

5. Relationships Between Out-of-Court Procedures and Formal Insolvency Procedures

103. *Relationships between out-of-court procedures and formal insolvency procedures.* Procedures are not separate from each other but, rather, they exist in a continuum of different degrees of formality and court intervention. It would be extremely unusual that a formal insolvency procedure turns into an informal one, but the opposite route is extremely frequent in practice. Therefore, a legal system should foresee the situation in which an informal workout is followed by or converted into a formal insolvency procedure. This may happen because the parties have intended it (prepackaged insolvency procedures), but it may happen also because the creditors that have not participated in the workout initiate formal insolvency proceedings. The debtor's negotiation of a workout in good faith should be considered as a potential ground for dismissing a creditor's petition to open formal insolvency proceedings. Otherwise, the holdout problem is exacerbated.
104. *Failure of workout.* A formal insolvency procedure may also be necessary because the workout fails to solve the debtor's financial difficulties. There are situations in which a workout may be undesirable and cases in which a workout will not be successful. It may well be that the business of the debtor is not viable, or it may happen that external circumstances worsen the debtor's situation to a point in which the creditors will be unable to support it. In those cases, the main problem will be the treatment that insolvency law will apply to the antecedent workout. The workout, as an agreement between the debtor and a number of its creditors, could conceivably fall within the general definitions that the law provides for antecedent transactions that may be subject to avoidance actions. This can be particularly troublesome because of the additional security that the debtor may have granted in exchange for new money⁷⁵ or for additional concessions to the creditor group. It is therefore extremely important that the creditors and the debtor preserve adequate proof of the negotiations and justify the granting of new security with adequate consideration provided by the creditor group. In some systems, there may be special rules to exempt workouts from insolvency avoidance actions; if so, the exceptions must be carefully drafted to avoid creating a loophole that allows the debtor, for instance, to grant preferred status to connected creditors. Another problem that may arise refers to the payment in full of some creditors in execution of the workout agreement (for instance, workers and trade creditors). If there is a subsequent insolvency

75. If the security interest is granted for "old" money, the possibilities that the security interest is avoided in a subsequent insolvency procedure are extremely high, if the restructuring has taken place within the prescribed period before insolvency is declared.

procedure, these payments could potentially be avoided. Finally, the fact that the financial creditors may have influenced the management of the debtor's business may expose them, in a subsequent insolvency, to liability claims by other creditors. To avoid this liability, financial creditors should not manage the debtor's business and should establish a relationship "at arm's length" that would eliminate any doubt regarding their potential liability for interfering with the management of the debtor's business.

6. Systemic Crises and Debt Restructuring: Decentralized and Centralized Approaches

105. *Systemic crises and debt restructuring.* The World Bank Principles state that "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 to address the special needs and circumstances encountered with a view to encouraging restructuring. Such measures are typically of an interim nature designed to cover the crisis and resolution period, without undermining the conventional procedures and systems" (Principle B4.3). Systemic crises can put stress on the whole legal system, and especially on the judiciary. In systemic crises, the potential for workouts is significantly larger:⁷⁶ given the excess corporate debt typical of a systemic crisis, corporate viability cannot be restored without workouts with creditors, and those workouts should be undertaken as case-by-case corporate restructurings under non-systemic circumstances. Liquidating companies, or selling companies as a going concern, may not be realistic, as the market for distressed assets and companies could be saturated, in which case a restructuring agreement may be the only possibility. However, if the debtor requires new financing for its operations, the banks may be unable to offer new finance because of their own exposure. In fact, corporate workouts will leave banks with many assets that they are poorly equipped to manage and that might be difficult to dispose of during the crisis. Moreover, these assets will not earn interest and will impair banks' reported financial performance. For example, excessive debt could require debt-equity conversions or the swap of straight debt, at high real interest rates, for longer-term convertible debentures at low interest rates. In addition, many companies going through a workout will require additional long-term debt or equity injections to operate in the future. Banks may need to divest themselves of land and buildings acquired as collateral during the crisis. In a financing crisis, state entities must provide finance, in the form of loans or guarantees, to cover the needs of distressed companies. The State may also support companies by acquiring equity in them. The current global financial crisis

76. The Group of 22 stated that "National insolvency regimes provide the standard mechanism and appropriate legal and institutional framework for the restructuring and workout of corporate debt, including foreign currency-denominated corporate debt. However, even effective insolvency regimes can be overwhelmed by a general crisis in the corporate sector. A crisis in the corporate sector can be of sufficient magnitude to threaten the solvency of the financial system in the crisis country. Consequently, there may be occasions when the government will need to develop a framework for encouraging negotiations between private debtors and their creditors." The report recommends the establishment of creditor committees, the removal of legal and regulatory obstacles to debt restructuring, and mechanisms for exchange rate insurance. (Report of the Working Group on International Financial Crises, 1998, 33).

has shown that the State must act where collapse is general. It is also apt to remember that the State should return to its usual functions when the economic system recovers from the systemic crisis.

106. *Demands on the court system.* In systemic risk situations, using multiple procedures has serious consequences for the insolvency system. First, the court system lacks capacity to deal with numerous complex insolvency cases at the same time. Second, in this sort of scenario, if the system is based on liquidation or even on the sale of businesses as a going concern, the market for distressed assets or for distressed businesses can collapse. Third, in systemic crises, even reorganization procedures face serious difficulties, as lenders are not interested in acting as financiers for reorganizing businesses. A framework of informal workouts is better equipped to deal with all these difficulties, especially if the enabling legislative framework is in place. However, a systemic crisis may require special measures.
107. *Enhancing the corporate restructuring framework.* Because of the breadth, severity and complexity of corporate restructuring in the midst of systemic crises, and because enforcement and insolvency systems are often not fully effective, special guidelines for corporate restructurings may be necessary and desirable to preserve asset values and to induce corporate restructuring.
108. *Further special measures.* Whether additional special measures for distressed companies are necessary in a systemic crisis is less clear. Before deciding on the necessity of a special regime, for instance a moratorium on debt service or the creation of a restructuring agency, governments should ensure that the general environment and framework for corporate restructuring described above is in place.
109. *Forbearance as a special supporting measure for workouts.* Special measures can include regulatory forbearance (where existing supervisory regulations and standards are waived for an institution); accounting forbearance (where an institution is exempted from following standard accounting practice); and tax forbearance, that exempts a class of institutions from paying their full taxes. Forbearance may result in lower capital adequacy requirements; more lenient tax treatments; tax breaks; loan loss reserves and provisioning requirements that are lower than expected losses; and lenient accounting standards and practices. It can also affect the duty of filing for insolvency that exists in certain jurisdictions. Forbearance can also be implicit—authorities decide to ignore violations of laws, standards, and regulation by either individual banks or the entire banking system.
110. *Other special measures include tax incentives for restructuring activities.* These tax incentives would relate to the treatment of write-downs as losses for fiscal purposes. Tax incentives will have to be carefully designed to avoid loopholes in the regulation, and they should be significantly reduced when the economic situation is stabilized.
111. *Decentralized and centralized approaches.* Workouts can be decentralized through internal workout units in banks, through separately capitalized banks, or through separate asset management companies that are subsidiaries of banks. Further segregation, through separate banks or asset management companies, can clarify the bank's financial situation and avoid skewed incentives and drains on its managerial

effort. This will be necessary in any case if government provides support. However, there are risks involved, including breaking the link between the bank and a corporation (allowing the bank to have privileged access to corporate information) and increasing the time needed to organize an asset management company and transfer assets to it. In addition, restructuring often requires new lending, and normally only banks have the capacity to lend. The choice between the two approaches is complex. The decentralized approach requires a strong enabling framework and proper incentives for private agents to undertake restructuring. The centralized approach requires highly specialized skills and independent government agencies, free from political pressure.

112. *Centralized restructuring.* Centralized restructuring entails setting up a government agency, an asset management company, with the full responsibility for acquiring, restructuring, and selling of the assets, while a decentralized approach relies on banks and other creditors to manage and resolve non-performing assets. In complex systemic crises, centralized restructuring is a viable alternative. In this type of restructuring, a State, publicly owned company, acquires distressed companies' shares in, or their whole capital, in order to reorganize them. This approach requires a strong agency, with considerable capital requirements, and with no political intervention. Otherwise, the decision on which companies are rescued could be based on grounds unrelated to actual economic viability. In general, private sector solutions should be adopted where feasible, but centralized restructuring may be justified in specific circumstances.
113. *Lead restructuring agency.* Successful operational and financial restructuring of corporations requires proper valuation of distressed assets and the right incentives for restructuring. These factors depend on the agent selected to lead the corporate restructuring. Possible choices are banks and other financial institutions, governments and existing or new corporate shareholders (foreign or domestic). The choice of a lead restructuring agency will determine not only the depth and sustainability of restructuring, but also the medium-term financing and governance structures of the corporate sector. In theory, privately managed assets will yield higher returns (or smaller losses) than those managed by government. This is especially so in emerging markets, given the historically large role the State has played in allocating resources, with mixed success.
114. *Asset management companies.* Under a centralized approach, a single publicly owned asset management company (AMC), restructuring agency, or deposit insurance agency takes over bad assets from many financial institutions and centralizes their management. The advantages of recovery on centrally held financial assets are economies of scale, easier securitization of assets and rebuilding confidence in failed banks from which bad loans are clearly removed. To perform the asset resolution role more effectively, the public asset management company can receive super-administrative powers to seize collateral and take over the management of debtor companies. There are risks as well, mainly related to the incentive structure of the management of a public asset management company.

115. *Pricing of assets.* If a centralized unit is used, it must be set up quickly with a clear pricing mechanism for transferring assets. The market value of loans should be recognized early on—using international principles and ensuring verification by independent accountants and auditors—and loss provisions made accordingly. Any agency must be adequately funded and have the authority and incentives to place assets in the private market as quickly as possible. An asset management company cannot be used to hide the size of losses and should be audited regularly, with third-party validation of asset quality. Finally, it must be established with a clear mandate and a short life.⁷⁷
116. *The Authorities should execute bailout programs only as a last resort.* In the context of a global systemic crisis, the Authorities may be tempted to supply the funds needed to financial institutions in crisis or to large industrial companies through subsidized loans or capital injections. These schemes are only justified in the case of market failure, where the credit market is unable to sustain even profitable businesses. Otherwise, these plans interfere with free market competition and create moral hazard. Firms and creditors may be induced to overinvest or to seek out riskier projects, cross-subsidized by the official sector. Taking *ex-ante* and *ex-post* efficiencies together, there is a clear case for favoring workouts over bailouts in the handling of solvency crises. Bailouts may bring short-run benefits, but at the expense of longer-run moral hazard costs.

77. A review of country experiences with asset management companies shows a very mixed record, with more success in industrialized countries than in emerging markets. Much of this disparity can be attributed to the much larger systemic crises in developing countries, which make asset management companies not easily replicable. Moreover, capital and other financial markets are typically better developed in industrialized countries than in emerging markets, allowing faster disposal of assets, and qualified personnel are more widely available.

Conclusion: A Policy Agenda for Out-of-Court Debt Restructurings

117. *The continuum of the treatment of financial difficulty and the variety of techniques.* Solutions to financial difficulties of debtor do not exist in an isolated or separate form. The treatment of insolvency occupies a continuum, and there is overlap in some of the techniques used. Moreover, formal and informal elements are not incompatible or mutually exclusive. A combination of informal and formal elements can perform complementary functions. Policy makers must understand the existence of different procedures in the continuum, and the way in which these procedures can interact to cover the needs of a particular economic system. It is also essential to understand that there are differences between purely contractual workouts, enhanced restructurings, and hybrid procedures. It is possible to use all of these techniques at the same time in a legal system, as these are not mutually exclusive, and some may be more suitable than others for specific sets of circumstances.
118. *Viability as an implicit element of restructuring.* In any case, the element of viability of the business must not be overlooked. An efficient system does not restructure all debtors, but allows the debtor and the creditors to analyze possible solutions to the financial difficulties, and take, as soon as possible, the decision that is better suited for the debtor's business and for the creditors' interests. The objective must not be to keep companies alive for as much time as possible, because that can be a waste of resources and efforts. Therefore, it is imperative to gather exact information on the debtor and to decide quickly on its viability. Restructuring must be effective, and must therefore take into account the viability of the business and cover the reshaping of the debtor's business, if necessary, apart from the restructuring of the debt. An inadequate or superficial restructuring can result in a subsequent formal insolvency with abundant legal problems, and with great losses for all parties involved.
119. *Reforming the enabling framework.* Generally, countries should reform their laws in order to create an adequate enabling framework for out-of-court restructuring. Diagnosis is of utmost importance in deciding the reforms in a particular legal system. The range of legislation needing review is extremely broad and requires in-depth knowledge of the legal system and the relationships among its different parts. No matter how developed a jurisdiction is or how well prepared the judges are the court system may become easily overwhelmed in the event of a general economic crisis. Therefore, a revision of all aspects connected to debt restructurings may give insight on the issues that need to be addressed in order to create an environment that is more conducive to workouts.

120. *Elements of the enabling framework.* The elements of an enabling framework are mainly the following:

- General aspects of the law of contract (general good faith requirements, rules for modification of debts);
- General regime for the enforcement of claims (secured and unsecured debt: individual and insolvency actions);
- General features of insolvency law (avoidance actions, liability of directors, duty of the debtor to file for insolvency, etc.);
- Financial disclosure obligations;
- Insolvency rules on avoidance actions of antecedent transactions;
- Availability of hybrid securities;
- Corporate governance issues (powers of the general meeting; directors' liability);
- Rules for suppression of pre-emption rights;
- Foreign investing rules, restrictions on the ownership of shares; restrictions on the ownership of real estate;
- Restrictions on the types of assets that financial institutions may possess (restrictions on the ownership of real estate by financial institutions, or restrictions in the ownership of shares or convertible debt);
- Securities regulation (need for unanimity or reinforced majorities for public debt restructuring, need for prospectus for new securities, disclosure of information, concept of related parties, concept of control and compulsory takeover bids);
- Tax law;
- Special regulations applicable to the debtor's business;
- Rules for mergers and acquisitions (specifically, opposition to mergers by creditors, and treatment of workers in corporate restructurings);
- Competition law rules and exemptions;
- Ease of access to effective individual enforcement and to effective involuntary insolvency proceedings;
- Existence of reorganization procedures with debtor in possession;
- Existence of modern arbitration and mediation procedures;
- Risk management practices and regulations;
- Accounting and auditing rules (treatment of non-performing loans, treatment of subordinated loans as capital, etc.);
- Rules on classification of loans by banks and financial institutions.

121. *Regulation of informal workouts.* Regarding the regulation of workouts, it is important to establish clear rules, or court-developed principles, on the *cooperation duties* that creditors have, which derive from a general principle of good faith. Creditors

should disclose their position, creditors should refrain from trading in their debts once they have engaged in a negotiation and should cooperate positively in order to reach an agreement satisfactory to all parties. It is important to introduce some rules that can improve significantly the workout environment, for instance a legal rule or a court doctrine that establishes the conditions for negotiation in good faith by creditors, even where there is no contractual relationship (pre-contractual obligation). Managers should have the duty to negotiate a workout before the company is insolvent. In fact, legal duties can help overcome free rider effects. A duty to negotiate and to cooperate should become effective the moment any of the stakeholders initiates a workout negotiation.⁷⁸

122. *The aggregation problem and the holdout problem.* Naturally, there are forces that will work against reaching an agreement. The differing positions of creditors create an aggregation problem, which could be solved, at least partially, by excluding certain creditors from the effects of the workout (e.g., workers, trade creditors). Another important problem is the existence of holdout creditors that threaten the success of the workout. There are a number of ways to address the holdout problem. The widespread use of social norms, the signing of contracts by all financial players, the statutory introduction of majorities for workouts, or the use of prepackaged bankruptcy procedures can all help avoid the holdout problem.
123. *Enhanced and hybrid workout procedures.* An insolvency system may work efficiently with just an enabling environment for purely informal workouts and effective formal insolvency procedures. However, it may be possible to further reinforce the treatment of financial difficulties if the country develops an enhanced restructuring approach, a hybrid procedure, or both. The decision on which procedure to use to strengthen informal workouts depends on the features of the legal and business culture in the relevant jurisdictions. In any case, the goals and results should be transparently formulated. Time can also be a factor in the decision to use a certain approach. In this regard, enhanced restructurings are easier to implement than hybrid procedures, which require changes in the insolvency law.
124. *Policy options in the definition of enhanced restructuring procedures.* Different policy choices should be defined to introduce a system of reinforced out-of-court restructuring regimes. When creating an enhanced restructuring approach, the following questions need addressing:
 - The degree of formality required for workouts. It would be possible to simply encourage the adoption of best practices such as those embodied in the London Approach or in the INSOL Principles. The level of formality increases when the State, or the financial regulator, requires the financial institutions operating in a given market to sign a commitment to negotiate among them and with the debtor according to similar principles. Another, supplementary, step consists of persuading the financial institutions, beforehand, to commit to majority resolu-

78. This means that there is no fixed point in time for the duties to arise, and that the informational advantage that the debtor or a main creditor has obtained needs to be used for the benefit of all the participants.

tion of workouts. This would be tantamount to accepting an arbitration clause. The level of formality increases even more when there are statutory rules that determine the majorities required to bind the minorities in out-of-court workouts.

- The degree of public intervention. It is necessary to define whether private participants will make decisions to restructure or if there will be public intervention in decision-making.⁷⁹
- The creation of a forum for negotiation, depending on the decision of using mediation and arbitration mechanisms. Institutions could be forced to participate, and there could even be penalties for lack of compliance with the program (penalties for failure to meet specific deadlines, for instance).
- The program's rigidity or flexibility. This also depends on the acceptance of norms and the legal and business culture of the jurisdiction.
- The degree of voluntariness of the restructuring program. This can vary, going from purely voluntary social norms, to persuasion to sign agreements in order to behave according to best practices, to agreements to be bound by majority decisions, to statutory provisions that force institutions to accept majority decisions in workouts.
- The system's predictability, quickness, and workability. If all those features are present, the workout procedure will enhance the stability of the financial system and will also alleviate the problems of the productive economy.

125. *Hybrid procedures.* A hybrid procedure may be a better solution than a norms-based restructuring in jurisdictions where the legal and business culture is resistant to the concept of social norms, especially in connection with insolvency.

The questions to be considered when devising a hybrid procedure are the following, depending on the shortcomings of the system that the hybrid procedure can address:

- If it is a holdout problem, the best solution is a prepackaged plan;
- If the problem is associated with difficulties in workout negotiations, it is possible to create a procedure with a court-appointed mediator;
- If creditors act too aggressively, the solution is to provide for an automatic stay granted by the court, for a short period, to allow the negotiation to proceed;
- Depending on the institutional framework of the country, it may be possible to use organisms other than the courts, such as a government agency or other administrative authorities.

126. *Systemic crises and restructuring.* Systemic crises may require special rules for workouts. Several regulatory solutions may alleviate the problems due to systemic cri-

79. The involvement of governments, especially in countries with weak institutional frameworks, can create more problems than it solves.

ses, and eventually it may be necessary to use a centralized, instead of a decentralized, approach to workouts. Centralized approaches and government intervention in systemic crises deserve special and separate attention, especially in the context of the global financial crisis, and may be justified by the threat of market failure.

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The study offers an overview of out-of-court restructuring, which is not seen as fundamentally opposed to formal insolvency procedures. On the contrary, the study contemplates different restructuring techniques as forming a continuum for the treatment of financial difficulties. Thus, there are numerous intermediate solutions between informal arrangements for debt rescheduling between the debtor and its creditors and fully formal reorganization or liquidation procedures. The study discusses the advantages and disadvantages of debt restructuring techniques, and concludes that a legal system may contain a number of options that can cover a variety of circumstances.

A substantial part of the study is devoted to the analysis of the enabling regulatory environment for out-of-court restructuring. It provides a checklist that can be used to examine the features of a legal system that bear a direct influence on debt restructuring activities.

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