Multi-creditor restructurings in transition countries: lessons from developed jurisdictions

A consensual out-of-court restructuring or “work-out” is a non-judicial process through which a financially distressed business and its significant creditors reach an agreement for adjusting the obligations of the business enterprise. This article identifies and describes the factors that result in successful out-of-court restructurings involving multiple creditors.
The choice for creditors

When a company or group faces financial difficulty, creditors can choose to follow one of two paths. Either they can adopt the “each man for himself” approach and try to remove or reduce their exposure by pressing for total or partial repayment or, if this is not possible, seeking security for their debt. The alternative, “the coordinated approach”, is where creditors seek to work with each other to devise a collective response which is in their mutual self-interest.

The obvious problem with the “each man for himself approach” is that if other creditors pursue the same policy (with equal enthusiasm and dexterity), the debtor will rapidly be driven into formal insolvency, thus producing the very result that the concerned creditor was seeking to avoid.

Over time, financial institution creditors (who have to factor the possibility of debtor default into their usual business planning) have learned that, generally speaking, they achieve better returns as creditors if formal insolvency can be avoided. They have also learned that a collective and coordinated approach by the main creditors can often assist the debtor to find a “solvent” solution to its difficulties to the benefit of all concerned.

Background to coordinated approach

In the United Kingdom, the coordinated approach to restructurings had its origins in the late 1970s, when the Bank of England began encouraging UK banking institutions to produce a collective response when dealing with a major UK corporation in financial difficulty. In those days the most typical problems were issues of liquidity where additional short-term funding was needed.

In the 1990s, however, there was a spate of cases in which banks had to overcome massively insolvent balance sheets caused by the collapse of the UK and US property markets. The Bank of England lent its support to such initiatives by offering to act as an “honest broker” to help resolve any disputes or difficulties between the participating creditors and by lending moral encouragement for the coordinated approach. The UK methodology for multi-creditor rescues culminated in the “publication” and use in the early 1990s of what is now known as the “London Approach”.

While the London Approach has the relatively unique feature of central bank involvement and endorsement, the principles behind the London Approach are of general application and have been reflected in codes of practice produced in a number of the “tiger” economies (e.g., Thailand, Hong Kong, Indonesia and Malaysia).

The involvement of an official body such as the central bank or monetary authority, although very helpful in persuading creditors to adopt a collective approach, is not a sine qua non to coordinated approaches to restructurings. Nor is it the case that the principles behind typical methodology of the coordinated approach are only suited to common law jurisdictions.

The rescue culture

The so-called “rescue culture” currently “in vogue” in a number of jurisdictions reflects the general recognition by financial institution creditors that the formal or court-supervised insolvency process, unless “pre-packaged”, is very often disadvantageous for creditors, not least because its result is unpredictable. It usually produces lower returns than can be achieved through a solvent restructuring or a managed work-out. Coordinated multi-creditor approaches to restructurings are not therefore the product of philanthropic or charitable tendencies on the creditors’ behalf, nor should the current ascendancy of the “rescue culture” be taken as signifying a willingness on the part of financial institution creditors to rescue companies or businesses from insolvency at any cost.

Where investigation reveals that saving a company reduces the likely return for creditors compared with an insolvency, creditors are always likely to choose the formal or court-supervised insolvency option. In such cases attention switches from saving the corporate entity to the most efficient and cost-effective way of business or asset realisation. Sometimes this can best be achieved through a formal and preferably a “controlled” or “pre-packaged” insolvency and sometimes by a sale through a managed work-out. The general experience remains however that rescue is better for creditors than insolvency.

Creditor stability

The initial objective of all attempted restructurings is creditor and business stability. Rescue or restructurings is very difficult unless at least the creditor position is stabilised. Other forms of instability also can be highly prejudicial to efforts at restructuring (e.g., political or general economic instability). Sometimes creditor stability proves unachievable (usually because management has left things too late), and the downward spiral to financial collapse becomes irreversible. In most cases, however, a “standstill” by the major creditors of the distressed debtor gives time both for the position of the debtor to be properly analysed and for rescue proposals to be formulated and presented to the participating creditors.

The initial stabilisation process is traditionally achieved by a standstill agreement. Typically, in a standstill agreement the participating creditors agree between themselves and with the debtor group:

I not to press for repayment of their debts or issue or pursue proceedings against the debtor during either a defined period or until a majority of their number decide otherwise (“the standstill period”);
not to try to improve their individual positions by obtaining or enforcing security; and

III to allow continued utilisation of existing credit lines and facilities either at the limits which previously existed or at least at the exposure levels at the date the standstill commenced (the “standstill date”).

In return for the support from the participating creditors, the debtor group will generally agree not to take any action which would disadvantage the participating creditors, either individually or collectively during the standstill period (e.g., by offering security to non-participating creditors, transferring assets from companies that participating creditors have recourse against, or otherwise running down its business or assets so that the prospects of repayment for creditors are diminished). In some cases the participating creditors will demand that security be given for their collective benefit at this stage in return for their support.

The standstill agreement serves to reassure the directors of the debtor group that it is appropriate for them to continue their business and to incur credit and that for the time being there is a reasonable prospect of a successful rescue. This is because under the corporate governance laws of several countries, including the English Insolvency Act of 1986, directors can incur personal liability if the business continues and credit is incurred beyond the point at which insolvent liquidation becomes unavoidable.2

In some jurisdictions, a formal standstill agreement between creditors and the debtor group may itself trigger technical insolvency. Even in these jurisdictions, however, there is still benefit in the creditors agreeing between themselves to “standstill” relative to the debtor and for the debtor to agree in favour of the participating creditors not to take any steps or carry out an action that might prejudice the position of the participating creditors while a review of the business is carried out.

Fairness between creditors

Attempts to persuade creditors to participate in a coordinated approach will often flounder if either the debtor or participating creditors (particularly those seeking to promote the rescue) are perceived to have taken actions which unfairly prejudice one or more of the creditors. A recent example of the difficulties that can arise is the Holtzman case in Germany, where it was reported that one of the major bank creditors took considerable exception to the fact that the debtor group had drawn down substantial additional amounts under its facilities immediately before calling for a standstill and seeking support from its financial creditors. Not surprisingly the bank took the view that the company should have called for support before increasing its borrowings from that bank and was very disinclined either to be sympathetic to the management of the debtor or to participate in the attempted rescue operation.

As one of the main objectives of the standstill is to preserve the status quo and the relative position of creditors inter se, actions that have clearly advantaged or disadvantaged particular creditors shortly before the rescue process is initiated are likely to be a major hindrance to any coordinated approach. On the other hand, it is very rare that creditors (except where the only lendings are through syndicated facilities) are in exactly in the same position as each other, and usually certain creditors are far more exposed to the debtor than others. The coordinated approach can cope with disparity of self-interest in the rescue, but “unfair” treatment is a major obstacle. This issue of “fairness” is not one of legal definition but is something that can nevertheless be easily appreciated in practice.

Basis of standstill arrangements

Typically, standstill arrangements between participating creditors reflect their relative positions and exposures as at the standstill date. The relative limits or exposures of each participating creditor on the standstill date are used to determine issues such as risk sharing, voting and distribution of recoveries. The emphasis of standstill arrangements is therefore both to preserve and to reflect those relative positions.

New money

If during the standstill period (or at any other time during the restructuring process) it becomes apparent that the debtor needs additional funding (i.e., in excess of the exposure/limits available at the standstill date), this additional lending or exposure is supposed to be accorded a priority of return in any pay-back or (if the support operation is terminated or collapses) in any insolvency. This priority of return can be achieved either through the granting of security for the “new money” lending and/or through arrangements between the participating creditors themselves under which they agree to apply amounts they receive from the debtor (including any amounts received by way of dividend in any liquidation) first in repayment of the new money lending. Occasionally, the participating creditors will commit to underwrite the additional new money exposure but are increasingly reluctant to commit beyond the amount of any prospective receipt in an insolvency.

The issue of “new money” is complex, particularly when one has to consider contingent exposures that are “marked to market” (e.g., Forex, swaps, derivatives, etc.). Originally the “new money” concept only applied to traditional loans but nowadays, where financings take a number of exotic forms and institutions tend to mark their exposures to market where they can, changes in market position between the standstill date and the date of pay-back are often treated as if they were new money loans. Difficulties arise because not all contingent exposures can be marked to market and it is therefore debatable whether it is “fair” to treat fluctuations in some contingent exposures as “new money” but not others.
Another modern day feature is the proliferation of negative pledges which can make it problematic to provide security in support of new money lending. A “cat and mouse” game can continue between those seeking to provide creditors with cover for their exposure and the drafters of negative pledge clauses. Usually the problem can be ameliorated by using arrangements such as transferring assets into new special-purpose vehicle companies or by the creditors “acquiring” assets either in the traditional sense or through repurchase structures (although the dividing line between a true repurchase and a security arrangement is sometimes a fine one).

**Steering committees and coordinators**

To assist with the coordinated approach it is usual for the participating creditors to appoint a representative steering committee to facilitate dialogue with the debtor group and to help manage the restructuring process. The steering committee (or the creditors themselves) will also often appoint a coordinator who will take much of the administrative burden of the process and who acts as the chairman of the steering committee.

Creditors are usually reluctant to allow steering committees/coordinators to speak on their behalf or to commit them to any particular course of action. Equally, steering committees and coordinators will not wish to assume a representative position for fear of incurring liability to the participating creditors, the debtors or third parties. Coordinators are best described as facilitators and the steering committee as a sounding board for the likely reaction of the participating creditors to proposals that the debtor may be thinking of making to the creditors group.

The advantages of channelling communications between the debtor group and the participating creditors through a steering committee/coordinator are considerable, but the process can be time-consuming for the creditor representatives who sit on the steering committee or act as coordinators. The assistance of professionals can reduce this burden, but the input of creditors is always necessary when commercial choices are required.

The steering committee/coordinator is often delegated authority to instruct outside professionals such as accountants and lawyers, and it is common for them to seek indemnities from the participating creditors for costs incurred if these cannot be recovered from the debtor. As a result, the participating creditors will expect to receive the benefit of advice or information provided by the retained accountants or lawyers. One major advantage of the steering committee structure is that it helps to ensure that all participating creditors receive the same information and advice. While the practice of having single shared advisers to the creditor group as a whole works well in most cases, individual creditors sometimes also need separate advice as to their positions compared to other creditors. Costs of such advice have to be borne separately by the creditor concerned and are not shared with the other creditors.

Importantly, each of the creditors will be expected to make its own credit assessment and decisions regarding any information, advice or proposals relating to the restructuring process and coordinators and cannot rely on the steering committee coordinator in that regard. It is therefore important for any coordinator/steering committee to ensure that disclosure of relevant information is made on a timely basis to all participating creditors and that they do not assume responsibility by a course of conduct.

General and open-ended indemnities from the participating creditors in favour of the coordinators and/or the steering committee are becoming increasingly problematic. However, as reward for their efforts, the coordinators and steering committee members usually receive special fees which are time-based and/or contain incentives for success.

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1. Under section 214 of the Insolvency Act of 1986, a director can be made liable to contribute to the assets of the company when that person knew or ought to have concluded that there was no reasonable prospect that the company would avoid going into insolvent liquidation. However, the court cannot make a contribution order if it is satisfied that the person took every step with a view to minimising the potential loss to the company’s creditors.
Legal and accounting due diligence

The other main objective of the standstill is to enable the creditors to obtain and verify information concerning the debtor group. Typically, the legal due diligence aspects will involve obtaining accurate corporate information identifying and categorising assets, identification and review of main contracts and analysis of potential counter claims or set-offs against receivables and the likely impact of any insolvency or security enforcement on leases, contracts, licences or other assets. Certain assets, e.g., land, intellectual property rights, investments in joint ventures, technical or other terminable licences and franchises, will require particular investigation.

The legal due diligence exercise also often includes a general analysis of the validity of recourse which individual lenders have against particular debtor companies and considers issues such as fraudulent and preferential transactions (as well as other transfers for less than reasonably equivalent value), and the validity and priority of any security.

The accounting due diligence exercise is usually carried out in parallel and seeks to verify financial information produced by management, assess systems and management capabilities, conduct critical reviews of budgets and forecast, estimate realisable values of assets, verify liabilities, evaluate cash flow requirements, earnings, and CAPEX requirements, review management, and generally report on the viability of the business and any business plan.

The reasonable costs of both the legal and accounting due diligence will be for the debtors’ account, and it is customary for some of the accounting due diligence (except any security review or cash flow estimates) to be made available to management.

The insolvency model

From the information obtained during the due diligence phase, the accountants are then able to produce an insolvency model based on certain stated legal and accounting assumptions (e.g., as to validity of security, operation of set-off, etc.). Such models seek to include all relevant claims (e.g., inter-company, subrogated and third-party claims) which would be counted in any insolvency of the relevant debtor company. Insolvency models can either be used simply to identify where assets will go in the event of an insolvency (applying usual insolvency principles) or can be more sophisticated and seek to predict likely returns to creditors in any insolvency using assumed realisation values and a contemporaneous liquidation and asset realisation model of all companies in the debtor group at the same time.

Insolvency models consider each debtor company separately and then aggregate the results for each company in the debtor group on a creditor by creditor basis so that the net expected return to each creditor can be determined. This provides a benchmark against which the creditor can evaluate any debtor proposals for the restructuring.

In the case of larger groups, the insolvency models can be extremely complex and have to take account of insolvency regimes in different jurisdictions. The output from the insolvency models is not only used to identify the claims of lenders against each company and to estimate the likely return from lenders, but can also be used to calculate the comparative percentage return to creditors compared to other creditors and the amount of indebtedness which appears to be covered as opposed to uncovered. These calculations can in turn be used when considering such issues as whether to agree to convert debt to equity or (in extreme cases) to permit debt write-offs.

Exits

Once independently verified information has been obtained, it then becomes possible for the participating creditors to evaluate the restructuring proposals suggested by the debtor. Where the problem is merely one of short- or medium-term liquidity difficulties, the creditors may be satisfied that the business case supports additional funding or a rescheduled repayment arrangement. In this event the restructuring will be embodied in a new financing agreement that reflects the terms of the rescheduling. Typically, rescheduling facility agreements are carefully tailored to the particular business.

It is also customary for the participating creditors to obtain security at this stage if they have not already done so. This security is usually taken for their collective benefit by a trustee or agent and charges all the assets and undertakings of the debtor in all relevant jurisdictions.

If the evidence suggests that the business cannot sustain the existing level of debt, the participating creditors will compare the likely consequences of a formal insolvency and a solvent restructuring. Provided they are satisfied that the restructuring should produce better returns, they may then consider issues such as debt-to-equity conversion or other methods of removing some of the debt from the debtors’ balance sheet. Inevitably, there is some tension between the wishes of management to remove as much debt as possible and the creditors’ desire to convert as little debt as possible. The common objective should, however, be to restore the solvency of the debtor, help create a profitable business capable of supporting the restructured levels of debt, and produce acceptable returns for the shareholders which may by this stage include former creditors (due to debt-to-equity conversion).

Having agreed on the commercial terms of the restructuring, it is then necessary to consider the methodology for implementing both the restructuring of the balance sheet and the rescheduling of the residual debt. In many cases, both can be achieved by agreement between the relevant parties. However, when publicly traded debt or equity
It is also not uncommon for the lenders to insist on strengthening the management of any realisation proceeds. Once again, the benchmark for these agreements will be the perceived position of various participating creditors as at the standstill date. In addition to a priority agreement covering the sharing of proceeds of security, there will also often be loss-sharing or risk-sharing arrangements between these participating creditors which again reflect their perceived relative positions as at the standstill date.

In a number of cases the restructuring is assisted by a partial equity raising, the issue of new debt (e.g., a high yield bond) or with a partial or total takeover by a third party. It is also not uncommon for the lenders to insist on strengthening the management as a condition of their support for the restructuring proposals.

**Tiering and turnover clauses**

The coordinated approach to restructurings is not confined to cases in which all creditors are unsecured or hold the same security. It is also suitable in cases where there are significant differences between the position of individual creditors not only in terms of exposure but also in the priority ranking of their exposures in any insolvency. In these cases the objective is to seek a solution that satisfies the aspirations of the different categories of creditors (it being recognised that sometimes those aspirations will differ but that the creditor group should not oppose attempts by others in lower rankings to benefit unless the aspirations are mutually exclusive). The fundamental principle remains that any arrangements should, when compared with a putative insolvency, preserve and reflect the relative positions of the participating creditors, including any advantages they may hold.

“Tiering” of claims is the technique used where either individual creditors or groups of creditors would hold different relative positions in terms of priority in any insolvency. The claims of the participating creditors are “tiered” in a priority agreement to respect those relative priorities (e.g., secured creditors are placed in a higher tier for payback than unsecured) and proceeds of realisation or repayment cascade down the tiers reaching the lowest tier of priority last.

A variant of this approach, used in the US, is “turnover”, whereby “junior” creditors agree to turn over any realisation proceeds to senior creditors so that the senior creditors are paid off first.

Other ideas used to develop coordinated approaches where there are differences of position between the creditors include “shortfalling”, in which those who hold separate security against other companies sometimes agree only to make a claim against the security given to the participating creditors as a group to the extent that they are unable to recover loss from their separate security. This is an approach that is often used in relation to finance leases.

**Documentation**

The decision to resort to a standstill arrangement will be motivated, in part, by a desire to avoid the consequences of embarking upon formal insolvency proceedings. Any such restructuring will therefore be dependent on effective contractual documentation. A non-exhaustive list of the typical documentation required would include:

- letters recording appointment of co-ordinator/steering committee;
- standstill agreement;
- new money agreement;
- new money security;
- restructuring facility agreement;
- restructuring security agreement;
- inter-creditor agreement; and
- equity-related agreements.

**Conclusion**

Although recourse to formal or court-supervised insolvency proceedings may be inevitable in some cases, the London Approach provides an effective framework for cooperation between creditors. The procedure is informal and flexible, allowing creditors to take an active role in restoring the company in difficulty. In addition, taking an agreed form of collective action prior to the commencement of any insolvency proceedings reduces the risk of an economically inefficient free-for-all raid on the assets of the debtor.

The late 1980s and early 1990s saw a number of successful and high-profile rescues of major UK-based groups, many of which had significant overseas operations. In many cases, the coordinated approach was successfully adapted in overseas jurisdictions to work in parallel with the restructuring in the UK. The “truth” which has emerged is that the principles of the coordinated approach to multi-creditor restructuring apply equally in other jurisdictions. There is now increasing international interest (including from the EBRD, IMF and The World Bank) in the possibility of developing a protocol or code of best practice that can be universally applied and can provide an internationally accepted framework for creditor cooperation as an alternative to resorting to formal or court-supervised insolvency procedures.