# WORK-OUTS — THE CHALLENGES OF THE 90s

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## PROS AND CONS OF JUDICIAL WORK-OUT VERSUS PRIVATE WORK-OUT

The debate about the pros and cons of judicial rehabilitation vs private work-outs tends to focus upon the following main issues:

- trauma and taint of formal proceedings and the frequent cataclysmic effect on the business and goodwill (the main weakness of formal proceedings)
- ability to procure and breathing-space; attitudes of trade creditors
- binding dissentient creditors
- binding bondholders
- preferences and improved security
- stays of creditor rights (set-off, security, repossessions, contract cancellations, utilities)
- erosion of frozen security
- freezing oppressive litigation
- comparative management and control
- lender liability
- involvement of all creditors as opposed to banks only
- comparative ease of debt/equity conversions
- comparative cost and expense
- comparative time, delay and consequent destabilisation
- comparative ease of new money
- disclosure duties
- tax

- loss-sharing problems
- jurisdictional problems.

## CLASSIFICATION OF JURISDICTIONS

It is possible to classify jurisdictions by their attitude to work-outs. Some jurisdictions favour the work-out as a means of restructuring debt while others actively discourage the private contractual composition between creditors.

It is difficult to tell whether countries which have laws which make it impossible or dangerous to achieve a work-out of an insolvent company did so as a matter of deliberate policy or whether they stressed other policies which in fact have this effect and simply ignored the work-out.

The following are some of the main criteria in assessing whether a country facilitates or impedes private work-outs.

(1) **Compulsory petition on insolvency.** A number of countries make it compulsory for a debtor to petition for his bankruptcy or a rehabilitation proceeding if he is insolvent. The test may be inability to pay debts as they fall due, or excess of liabilities over assets, or both.

Debtors which are eligible for a work-out are often technically insolvent - at least in balance-sheet terms - with the result that if the law imposes penalties on management for failure to petition, it is not possible for the debtor to negotiate a work-out in the hope of eventual recovery.

England and the English-based countries do not generally impose penalties for failure to petition when insolvent and the filing of a petition by the debtor is permissive. Many countries in the Napoleonic group do make it compulsory for a debtor to petition on insolvency, including balance sheet insolvency. The objective of the compulsory petition is presumably to prevent the debtor from adding to his debts by continued trading.

The difference is narrowed in practice because the English-based countries impose penalties if the directors continue to incur debts when the position is hopeless. But there still is a difference and there have been recent UK work-outs where the company has gone through a work-out even though insolvent on a balance-sheet basis because new money left them solvent on the liquidity test and the directors could form the view that there was a light at the end of the tunnel.

Under 'mandatory petition' statutes, the company would have had to petition and hence a work-out would be statutorily negated.

A related provision requires management to call a meeting of shareholders if, usually, one-half of the capital has been lost: eg Art 17, EC 2nd Company Law Directive; Argentina, Switzerland, Finland, Saudi Arabia.

(2) **Penalties on directors.** The leading test is whether the jurisdiction imposes penalties on directors for continuing to incur debts while insolvent. If the directors are easily made personally liable or subject to criminal penalties or disqualifications, it will be more difficult to persuade them to agree to a work-out.

Broadly countries are divided into three classes on this issue.

First, there are those which impose personal liability on directors only if the continued incurring of debts is fraudulent, ie the directors knew that there was no hope of the company being able to pay its debts or were reckless and shut their eyes to the obvious. This class comprises the traditional English-based countries which did not adopt the English 1986 changes (which worsened the lot of directors) and countries like Denmark.

The second group of jurisdictions imposes liability on directors if on an objective 'reasonable' test the company would not be able to pay its new liabilities. In effect the test is closer to a negligence standard as opposed to actual knowledge and, because it is much more difficult for the directors to know whether there is any hope, the test is much easier to satisfy and hence the directors are less inclined to continue. This group of countries includes England, Scotland, the Republic of Ireland and Australia (under CLRA s588G).

The third group of countries imposes liability on directors if they made negligent business judgments which led to the insolvency - something which is easy to prove with hindsight since in many cases it is obvious what the directors should have done once the future has become history. This group includes, pre-eminently, France and also Belgium and Luxembourg. Spain is probably also in this group.

Finally, there is an idiosyncratic group, comprised mainly of the United States and Canada, which does not impose liability on directors or officers for continued trading to anything like the same extent as the other groups. The US has no fraudulent or wrongful trading section, as such, which imposes personal liability on corporate officers. But a similar result tends to be achieved by parallel doctrines - in the United States, by the doctrines of equitable subordination and lender liability, and in Canada (to a much lesser extent) by personal liability on directors for unpaid taxes.

Some jurisdictions also impose other penalties on directors, eg disqualification, which may also act as a disincentive to continued trading, eg Britain.

(3) **Attractiveness of judicial rehabilitation proceedings**. Another important criterion is the attractiveness or otherwise of formal court-supervised rehabilitation proceedings. Some of the chief factors are:

- the ease of entry, eg whether this is a high opening requirement that the debtor must pay an impractical proportion of his debts as a condition of the composition, or whether actual insolvency must be proved, or only threatened insolvency, or no insolvency.

- the immediacy of the freeze on creditor enforcement proceedings so that the debtor has a breathing-space to assess its position and formulate a plan with its creditors.

- whether management can retain its position or is displaced by an insolvency administrator.

- the extent of the erosion or disturbance of other creditor rights - enforcement of security, repossession of leased assets or assets held under retention of title, set-off, or cancellation of contracts or forfeiture of real property leases. This interference will be unattractive to the affected creditors, but attractive to the general body of unsecured creditors.

- the impact of other rules, eg the avoidance of preferences, the imposition of personal liability on directors, the compulsory conversion of foreign exchange liabilities and so on. Again, the importance of these rules will depend upon the amount of the debts which are affected.

If the formal composition or rehabilitation proceeding is unattractive or cumbersome, then creditors are faced with the choice between a work-out and the nuclear bomb of a final liquidation. This may tend to incentivise them to agree a work-out since a final liquidation is generally highly destructive of values.

If the formal rehabilitation proceeding disturbs vested creditor rights to a serious extent, the proceeding might be unattractive to the extent that the disturbance goes beyond what creditors would typically agree in a work-out and to the extent that the creditors most affected are those essential to the work-out, eg banks or public bondholders. Thus a stay on the enforcement of security or the repossession of leased equipment or on set-offs will typically be a feature of a consensual standstill. The difference is that in a standstill, creditors can still control the situation, whereas in a formal proceeding, they are absolutely divested and depend on the indulgence of the administrator or the court.

(4) **Binding dissentient bondholders.** A further test is whether it is possible to bind dissentient bondholders to the composition or to the restructuring of the debt or the postponement of maturities or to a conversion of debt to equity.

If it is not possible to bind minority bondholders, then if the bondholders are essential to a restructuring, eg because the debtor will not be able to pay them even if the banks agree to postpone their debt, the result is that formal proceedings must be commenced which will either compel them to be bound by a composition or by court confirmation of a plan.

In most jurisdictions there are arrangements whereby dissentient bondholders can be bound. For example, in the English-based jurisdictions it is generally true that provisions in a trust deed constituting a bond issue to the effect that the bondholders can by voting in a meeting alter the terms of the bonds are generally binding on minority bondholders in the absence of secret deals, discrimination or obvious oppression.

A similar effect is achieved by bondholder statutes in many civil code countries which provide that meetings can by voting settle a broad range of matters, including debt postponement, eg Japan and Switzerland. But there are many solutions as to which bondholder rights are entrenched and which are not.

However in a small group of states, there are consumerist laws which effectively entrench the rights of bondholders and prevent any changes without their individual consent. In practice it is not usually possible to obtain the consent of every single bondholder, even though depositary systems have tended to ease the tracing of bearer bondholders. Thus in the United States, the *Trustee Indenture Act* of 1939 provides that it is not possible to postpone a bondholders entitlement without his consent. This can only be achieved in a Chapter 11 formal proceeding where a plan confirmed by the court will override the minority in the class. This is a critical factor if the debtor has US bondholders: the TIA is not limited to American issuers in contrast with European Continental statutes which tend to be limited to local issuers.

(5) **Security and guarantees.** Creditors are more likely to be willing to continue if their debts can be adequately secured, especially if existing unsecured debts can be granted new security. This will tend to incentivise banks to agree on a rescheduling, thus enabling trade and other creditors to be paid out.

The main factors here are:

- the scope of the security on offer. Some jurisdictions allow comprehensive universal business charges, eg the English-based floating charge and general charges in Sweden, Finland and (sometimes) Argentina, while others (eg Italy) allow very limited security except over land, or make the security cumbersome or of reduced practical value, eg because of enforcement problems (most civilian jurisdictions) or because of the security is primed by taxes, wages and liquidation expenses (France).

- whether security for pre-existing debt is inevitably a preference so that the work-out must survive the suspect period. In most countries, this security is automatically deemed preferential. The exceptions include England (if the intent of the debtor is to survive) and the Netherlands. In practice, banks taking security hope to survive the suspect period through a successful work-out and hence this is a factor only if the suspect periods are very long - anything over six months. France is 18 months.

- whether there are problems in taking guarantees, eg from other companies in the group. Typical problems would be: corporate benefit rules; the treatment of guarantees as gifts and therefore liable to avoidance on insolvency as a preference; problems with financial assistance by a company in connection with the purchase of its shares; and consumerist protections in favour of guarantors.

(6) **Others.** There are many other potential tests, eg the presence or otherwise of a supervisory authority with sufficient clout to umpire a work-out, and the presence or otherwise of a homogeneous work-out culture (eg the London Rules).

## RANKING OF JURISDICTIONS

Using the above criteria, one may, very tentatively and provisionally, rank jurisdictions according to whether they encourage work-outs as the favoured solution or whether they prefer a formal insolvency proceeding. Point one on the scale indicates extreme favourability to work-outs. Point five on the scale indicates extreme hostility and a strong preference for judicially-controlled insolvency proceedings.

1 Austria; Germany (so far); Switzerland; Traditional English-based countries which have not enacted rehabilitation statutes (eg Hong Kong)
2 Netherlands, England, Japan, Ireland, Australia, New Zealand (?)
3 Italy, Canada (?)
4 United States
5 France

This ranking must be regarded with great caution because of the problem of weighting the various criteria and the impracticability of comparing the actual experience of work-outs in the countries concerned (and, of course, the writer's inadequate research).

However, it seems right to place the traditional English countries which have not substantially changed their insolvency laws from those pertaining in England prior to 1986 as being favourable to work-outs. This is because, for example, there is:

(a) no compulsory petition on insolvency;

(b) a tolerant test of director's personal liability based on fraudulent trading only;

(c) no attractive composition or rehabilitation proceeding so that the only realistic alternative is the nuclear bomb of final liquidation;

(d) a judicial tendency to uphold bondholder trust deed provisions in the widest terms whereby dissentient bondholders can be bound by majority votes;

(e) a universal floating charge and quick enforcement of security so that banks can get reassurance;

(f) the potential validity of security for pre-existing debt because of the 'intent' doctrine (abandoned in the US and Australia); and

(g) guarantee inhibitions which do not go beyond the normal.

By contrast, France seems to go the other way. Directors are very vulnerable to personal liability for the debts of the company so that this incentivises them to stop earlier. The rehabilitative *redressement judiciaire* offers the debtor company a powerful weapon against creditors. Security is very weak and limited in scope; security for pre-existing debt is automatically preferential and there is a long suspect period of 18 months. But there appears to be no right for the debtor's management to remain in possession.

The United States is towards the upper end of the scale. There is no compulsory duty to file if the debtor is insolvent and management is shielded from personal liability for the company's debts. On the other hand, there are expansive notions of equitable subordination and lender liability which may discourage some creditors from a work-out. The debtor has many incentives to file for a Chapter 11 proceeding, including substantial stays on creditor enforcements, set-off, contract cancellations and repossessions, and the ability of management to stay in place. The latter is a major factor encouraging directors to go for Chapter 11. Another significant factor pushing the US up the scale in practice is that dissentient bondholders can be effectively bound only by a Chapter 11 proceeding (because of the post-Depression trustee indenture legislation). But security has a wide scope and, although security for pre-existing debt is preferential, the Federal suspect period of three months is short by international standards - a factor which is weakened by the presence of longer suspect periods under state insolvency laws.