WORK-OUTS — THE CHALLENGES OF THE 90S

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In addressing the subject of work outs from a practical aspect, I think it is appropriate to note that each work out is unique - none are the same, although there will be some common aspects.

One simple definition of a work out is a negotiated agreement between a borrower and its lenders whereby those lenders vary the terms and conditions upon which they are prepared to continue to provide accommodation and the borrower agrees to certain conditions which may restrict or limit the way in which they can conduct future business.

One of the most interesting aspects of a work out is the question of how it is implemented - what is the initiative that commences the process?

A fundamental problem that has existed in many of the work outs in which I have been involved is that of having management recognise there is a problem. In many cases it is the external third party - lender, creditor or professional adviser, who identifies there is a problem and who initiates the action which leads to a work out.

Examples of this include:

Ariadne Australia Limited:

- Borrowed $700,000 million at 30 June 1987;
- Borrowed $1.2 billion by October 1987;
  - lines fully drawn;
  - lenders' meeting to discuss common concerns, but company refusing to acknowledge a problem.

The Adelaide Steamship Company Limited Group: Management held the lenders at bay for nearly twelve months.

Qintex Australia Limited: Management's view that it was only a temporary liquidity problem.

Acceptance of the fact by directors and management that there is a problem is often a giant step forward. The new insolvency laws due to come into operation no later than 24 June 1993 should help considerably in getting directors and management to focus on such issues.

In saying that the recognition of the problem is a giant step forward, it is usually at this time that the directors find religion - they suddenly learn about the Corporations Law and more particularly about directors' duties, responsibilities and importantly directors' potential liability. They become particularly concerned with section 592 and directors' personal liability for incurring debts when there is no reasonable expectation that those debts can and will be repaid.

In deciding to embark upon a work out strategy there is a fundamental presumption that the end result will be better than the available alternatives:

> ie the return (usually measured in monetary terms) will be greater after consideration of amongst many other things:
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> i) time value of money - Discounted Cash Flow calculations;
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> ii) cost of management resources devoted to the work out:
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> (a) in the initial negotiation; and
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> (b) ongoing monitoring;
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> iii) risk reward calculations - in reality lenders in a work out are really equity holders taking an equity risk; and
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> iv) the available alternatives.

Consideration of each of those issues on an individual basis will often provide conflicting results as, for example, a work out may well mean that the business can be sold as a going concern and therefore realise a greater price than would be achieved under a formal insolvency regime, but because unanimity of lenders is required to commence a work out, considerable costs may be incurred in negotiating and accommodating the requirements of all participants.

Most of the major work outs that have been implemented in Australia during the last few years have been with companies who have borrowed on an unsecured, negative pledge basis from a number of lenders who may or may not have been members of a lending syndicate.

There are clearly some lessons that can be learned from these work outs which will hopefully assist in the future.

One of the most difficult aspects of implementing a work out is the problem of obtaining the unanimous support of lenders. This requirement provides scope for those lenders who do not want to participate for any one of a number of reasons to effectively blackmail the other lenders into agreeing to a course of action which is not necessarily in the best interests of the majority of lenders or the borrower. It is with this in mind that while endeavouring to implement a work out arrangement it is also necessary to concurrently work towards the adoption of a formal scheme of arrangement. Mr Poulton refers in his paper to the schemes of arrangement for Massey Ferguson and International Harvester. Both of these schemes commenced as a work out proposal, but on each occasion there was one or more lenders who refused to participate:

- one out of nine in Massey Ferguson; and
- two out of thirty-five in International Harvester.

The end result was that the majority will prevailed and the work out strategy was implemented through a formal scheme of arrangement.

It is important to realise at the time that lending and borrowing arrangements are being put in place that there may be a need for a work out at some time in the future. Accordingly, the make-up and rules relating to syndication should be considered in the light of this possibility. For example, the rules relating to voting, selling down exposures, are important. Equality of exposure of members of a syndicate is useful, ie do not allow significant differences in exposure between syndicate members to occur.

The considerable time and effort associated with the implementation of a work out significantly increases the professional costs incurred, adds to the costs by way of lost management time for both borrowers and lenders and because of time delays has the potential to reduce the viability of the businesses and therefore reduce the ultimate return likely to be achieved.

It never ceases to amaze me how some lenders with significant exposures send junior people to participate in work out discussions/negotiations and who are not in a position to make any meaningful contribution to the process.

International Harvester is a good example here where the discussions and negotiations extended over a period of six months. It was only when the documentation appeared in semi final form that the decision makers in certain lending institutions applied their minds to the issues and endeavoured to reinvent the wheel. This was very costly in professional fees, very time consuming, and potentially damaging to the business.

The opposite occurred in Ariadne and Adsteam. It was in these cases that the validity of Alan Bond's statement was brought home to me. Bond said that if you owe $100,000 to the bank you have a problem, but if you owe $1 million, the bank has a problem. The size of the exposures and the lack of understanding of the underlying assets was important in both cases. In the case of Adsteam the four major trading banks were involved and they provided senior executives to participate in the negotiation of the initial standstill arrangement as well as the ultimate work out agreement. These senior executives had authority to make decisions or alternatively had immediate access to those who could make decisions and thus the restructuring proceeded quite quickly. Importantly in this case additional funding was able to be provided on an agreed basis because the banks had a common purpose.

The same situation applied in Ariadne when the decision makers attended the initial meeting of lenders and were able to commit to a standstill without a prolonged period of negotiation.

I do not have a solution drafted but I leave you with the thought that it would be in the interests of both lenders and borrowers if a term of the original lending agreement could contain an obligation on the lending organisation to commit their senior credit executive to participate in work out negotiations. There will be some interesting drafting to achieve this, but the end result will, I am sure, lead to quicker and more effective restructurings.

MANAGEMENT OF THE WORK OUT

In participating in a work out the management of the businesses owned by the borrower is fundamental. Lenders need to be satisfied that there is integrity in the management process and the right people are put in place.

In many instances, if not all, there will be a need to inject management resources and it is often very difficult to attract quality people to participate in a work out.

A fundamental issue in attracting new management is that of section 592 and the potential liability for directors continuing to trade when the company is insolvent. This problem exists both during the period of the initial standstill arrangement as well as during the period of the work out.

It needs to be understood that directors and officers may be liable for debts incurred if at the time those debts are incurred there is no reasonable expectation that the company will be able to pay all of its debts.

In many instances the rationale for proceeding with a work out is to maintain the viability of the business or businesses run by the company. Thus the question of dealing with trade creditors and maintaining their confidence and continuity of supply of goods and services is fundamental.

The solution to both problems, ie section 592 and directors' personal liability and the maintenance of ongoing supply of goods and services was dealt with in the Adsteam and Channel Seven work outs/restructurings in similar vein. You will have read no doubt of Adsteam's PCORNs and Channel Seven's CRUSTS. A PCORN is a Perpetually Convertible or Redeemable Note while a CRUST is a Contingent Residual Unsecured or Undated Subordinated Tranche. Put simply, the PCORN and/or CRUST are financial instruments that have been created to subordinate lenders' debt to the extent that the assets available are inadequate to repay liabilities in full, including the claims of unsecured trade creditors. The result is, in essence, an effective elevation of unsecured creditors' claims or ranking.

This point has been recognised in many work outs such as the Adelaide Steamship Group where there were many operating businesses and it was essential to ensure ongoing supply of stock.

DOCUMENTATION

There has been a lot of debate in respect to the documentation of a work out proposal.

The documentation of the work out is often fundamental to the ultimate workability. There is a need to not only protect the rights of lenders, but also to recognise that the borrower must be able to continue to run, maintain and hopefully improve the businesses which will ultimately provide the funds for repayment to lenders. The funds may come either from profits or sale as a going concern.

Thus I would argue for simplicity with a limited number of meaningful covenants and to provide scope for business judgments. Do not be too smart/cute, and could I also suggest that the lawyers involved in the drafting of the work out arrangement should not be the lawyers who prepared the original loan documentation.

Reference is made in the paper to the work outs providing flexibility compared to schemes of arrangement because the terms of the work out can easily be varied. Careful consideration needs to be given as to how this can be achieved - as a rule of thumb I would suggest that if a work out agreement has been executed *ipso facto* 100% of lenders have agreed to the proposals. Therefore amendments should, under existing law, require no more than the majority necessary to implement a formal scheme of arrangement, ie a majority in number representing 75% in value. Under the new law only a simple majority is required, and this should be used as a useful yard stick with the qualification of a majority in value.

In addressing the issue of documentation it will be recognised that the aim of the work out is to protect the business and not necessarily to save the company. Thus there must be the ability to incur capital expenditure when necessary and to raise additional funds either to cover, for example, seasonal working capital deficiencies or to enable agreed expansion to take place.

There is need for a commercial approach and if lenders can be satisfied that any management problems can be overcome, then the interests of borrower and lenders should be one in respect to maximising the return from the businesses.

Frequently it is the requirement of lenders that a condition of participating in the work out is that they take security. At first glance this is an understandable position, but on closer inspection may not provide the comfort lenders are looking for.

Firstly trade creditors may well take fright and either refuse to supply or put the company on COD with a consequent cash drain.

Secondly because of the section 592 problems referred to earlier, unless directors can be satisfied all debts can be paid as and when they fall due they will have a problem in granting security and continuing to trade.

Thirdly there is a period of six months which must pass before the security can be relied upon.

Fourthly you may be making a significant donation to the public purse by way of stamp duty for no tangible return.

I believe that the granting of security has only one real benefit and that is in the case of the work out not progressing as agreed. It is then possible for the holders of security to exercise that security to take control of the business and through that control influence the direction in which the future operations may be directed.

ROLE OF THE COMMITTEE OF LENDERS

It is important that the lenders generally and the Committee of Lenders in particular, understand clearly what their role is and that they have very limited powers and should not participate in the management of the company.

This is a question of educating the lenders to the fundamentals involved in a work out. There is a dichotomy of thinking in the minds of certain lenders where they want a work out in order to maximise returns, but not be liable as a shadow director for instructing the company on how to run the business, but on the other hand wanting all the authority and control they would have had if they had appointed a receiver.

The Committee may be given certain other duties which could include a requirement to:

i) Review operations;

ii) Approve business plans or variations thereto; and

iii) Waive defined events of default.

In conducting this role there may well be a conflict between those lenders serving on the Committee and having access to information which is not available to the general body of lenders. There is a need to ensure that the members of the Committee do not become shadow directors nor expose themselves to claims by other lenders for having acted in an inappropriate manner.