Asian Principles of
Business Restructuring

Text

Guide on Conducting an Out-of-Court Workout in Asia

INTERNATIONAL
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INSTITUTE

ASIAN BUSINESS LAW INSTITUTE

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Preface

Workouts

One way of dealing with insolvency is a private agreement between creditors — often just banks and bondholders — and the debtor to effect a restructuring.

Such a restructuring might entail, for example, a rescheduling of the debts of the debtor, the conversion of such debts into shares, a disposal of the debtor's assets and a trimming of the debtor's business. Reaching a private agreement is by far the most common solution to dealing with insolvency and does not involve the courts.

This is referred to in industry jargon as an "out-of-court workout", a "consensual workout", an "informal workout" or simply a "workout".[1]

Asian Principles of Business Restructuring

This guide is produced under the auspices of the Asian Principles of Business Restructuring project (**Project**) jointly undertaken by the Asian Business Law Institute (**ABLI**) and the International Insolvency Institute (**III**). The Project was conceived with the ultimate vision of producing a set of Asian Principles of Business Restructuring (**Asian Principles**).

The Asian Principles are not intended to be legally binding. Rather, they are intended to promote convergence in the philosophy and approach that the region takes to business restructuring in an insolvency context. This guide is one component of the Asian Principles.

This guide sets out a model of best practices, in the form of both principles and practice tips, for workouts of corporate debtors in Asia. Although focused on workouts that are entirely consensual and out of court, this guide inevitably makes some reference to the court process since such process is the next step if consensus cannot be reached in a workout. The potential involvement of the courts also looms large in all workout discussions, not always as a menace to compel concordance, but sometimes as an agreed appropriate enforcement layer to the planned restructuring. That further aspect is beyond the scope of this guide.

1 For the purpose of this guide, the term "workout" is used throughout for consistency. This guide does not discuss hybrid workouts.

Progenitors

This guide has lineage and pedigree with earlier iterations of workout philosophy in other jurisdictions, such as the *London Approach* developed by English banks in the late 1970's,[2] which has influenced the *INSOL Statement of Principles for a Global Approach to Multi-Creditor Workouts* (**INSOL Principles**), the *Bangkok Rules*,[3] the *Jakarta Initiative*,[4] the *Hong Kong Approach to Corporate Difficulties,*[5] the guidelines for facilitating workouts issued by the Association of Banks in Singapore[6] and *A Toolkit for Out-of-Court Workouts of the World Bank* (which adopts the INSOL Principles).

Necessity

With such distinguished forebears, the question might be fairly asked as to why this guide is necessary in the first place. The answer is simple to those working in Asia.

First, anyone seriously involved in multinational insolvency policy-making knows that reform can never be achieved solely by top-down normative processes. The real driver for effective reform is inevitably grass-roots, or in modern parlance, local geographies "taking ownership" in the project to reform. This applies to both the nature and the geographical location of the institutions driving policy changes.

Second, although many of the principles in this guide are well traversed in its forebears, the emphasis and accentuation of this guide is markedly different.

For example, there is significant emphasis in this guide on the duty of the debtor to be transparent and on seeking reform to debtor behaviour. In the Asian context, the debtor is very often headquartered in a developing Asian jurisdiction, having perhaps raised its finance in a developed regional international financial centre (such as Hong Kong SAR or Singapore). As such, less effort is spent on creditor behaviour in this guide than in other literature.

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2 The "London Approach" was intended only to bind banks but not other creditors such as bondholders, employees or trade creditors. See Pen Kent, "The London Approach" (1993) Q1 *Bank of England Quarterly Bulletin* 110. The broad features of the London Approach are: (a) supportive approach by creditors; (b) a role for the Bank of England as peacemaker; (c) a standstill to allow situation analysis; (d) provision of full information; and (e) a role for the lead creditor in particular to ensure that other creditors are kept informed.

3 The Bank of Thailand Policy on Out-of-Court Workouts (3 August BE 2551 (2008), as amended by the Policy dated 31 October BE 2561 (2018)). As result of the 1997 Asian Financial Crisis that hit Thailand, the Bank of Thailand set up out-of-court processes for the restructuring of distressed enterprises. In 1998, the Corporate Debt Restructuring Advisory Committee (**CDRAC**) was established, followed by the establishment of the Thai Asset Management Corporation which is entrusted with the facilitation of restructurings and the monitoring of restructuring processes. In this context, the CDRAC developed a framework of voluntary principles and timelines for voluntary workouts, known as the Bangkok rules, which aimed at resolving the limitations of the applicable legal framework.

4 The Jakarta Initiative was established as a set of principles based on the London Approach to facilitate voluntary corporate workouts in Indonesia. It was terminated in 2003 without being replaced.

5 Hong Kong Monetary Authority and Hong Kong Association of Banks, *Hong Kong Approach to Corporate Difficulties*, November 1999.

6 The Association of Banks in Singapore, *Principles & Guidelines for Restructuring of Corporate Debt: The Singapore Approach*, undated.

Another example is the approach to standstills. In Asia, early standstills are not plausible without a debtor first showing good faith by providing disclosure. This guide therefore proposes a *de facto* standstill early on with a contractual standstill to follow — slightly later in the staging than other international models such as the INSOL Principles.

Third, although other regions of the world, especially developing jurisdictions, may fairly be said to have similar characteristics to Asia, increasing financial interconnectedness, the growing importance of Asia in global financial arrangements, and Asia's projected economic dominance warrant a guide specifically on conducting workouts in Asia.

Fourth, there are certain characteristics in Asia that are, if not unique, certainly unusually potent which deserve special attention. For example, there is the presence of two international financial centres in Asia, Hong Kong SAR and Singapore, which both service variegated regional capital allocation needs (often from less developed jurisdictions). Neither of these international financial centres has an agrarian economy, nor any material manufacturing sector, which means that their specialism (in this context) is inevitably finance — to be "exported" regionally. This often creates an asymmetry of sophistication and experience between creditor and debtor.

With no inherent conflict between this guide and other literature on workouts despite different focuses, the hope is that this guide will be an added tool that stakeholders can refer to along with other highly distinguished work.

Asia's distinctive characteristics and challenges

This guide considers the diverse cultures, heterogeneous economic development, and different legal systems in Asia by being respectfully restrained. It does not seek to overly prescribe. It leaves room for difference. It is worth acknowledging that the variegated legal and commercial landscape spread across a huge geography means that certain identified characteristics or concerns in this guide will be more or less relevant in certain parts of Asia. For example, it is axiomatic that concerns about tax treatment in Japan are irrelevant in Singapore, and that concerns about the level of expertise of the judiciary are applicable in some places but not others. This guide includes references to Asia's near-neighbours such as Australia by reason of the intellectual contribution from the insolvency community there, and from its professional financier, accountancy and legal diaspora situated in the region. Moreover, there is significant commerce between the two areas.

Putting variegated systems to one side, this guide confronts head-on the challenges of workouts in Asia, with especial challenges in developing jurisdictions. In particular, this guide accentuates issues which are not necessarily identified, or accentuated, in the approaches of other jurisdictions and which may apply in some parts of Asia (but again, not all), as will be detailed later. In addition, this guide takes a much more granular, practice-oriented approach out of consideration that workout as a concept is arguably still in its infancy in not a small number of Asian jurisdictions.

Exclusions

This guide does not specifically address workouts between debtors who are micro and small enterprises (**MSEs**) and their creditors. Given the different realities in which MSEs operate and the important role played by MSEs in a country's economy, especially Asian economies, ABLI and III have earlier released the *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia*, another component of the Asian Principles, which details policy recommendations for dealing with the insolvency of MSEs, including concrete suggestions for workouts by MSEs.

Further, in its current, this guide does not specifically address workouts in “newer” scenarios, such as workouts involving digital markets and digital market operators and treatment in workouts of environmental aspects.

Opportunity

Workouts can be challenging. In particular when the debtor is large, it can be difficult to balance the competing interests of creditors, and unravel and restructure a labyrinth credit structure, all the while trying to ensure the debtor is capable of continuing as a going concern. Nonetheless, the rewards of a workout can be great, particularly where the alternative is for a potentially viable debtor to be placed into liquidation. Workouts are, moreover, especially effective “in those countries with a vulnerable corporate sector and an inefficient insolvency system”.[7] The workout process itself can be effectively managed with the support of experienced professionals who act with an eye towards complying with industry best practice.

As readers will find out, Asian jurisdictions have taken diverse approaches to workouts. However, this is a significant *opportunity*. Particularly in jurisdictions which do not presently have formalised rules and structures for workouts, there is clearly considerable scope for common and consistent standards to take root in Asia in the years to come. It is hoped that this guide will serve as a useful foundation for that road to convergence.

7 World Bank Group, “COVID-19 Outbreak: Corporate Insolvency – How Can Out-of-Court Workouts Help?”, *COVID-19 Notes: Finance Series,* 15 May 2020 at p2.

Figure 1. Jurisdictions considered by this guide

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Summary of principles for conducting an out-of-court workout in Asia

Principle 1

A critically important foundation for any workout is that the debtor has a viable underlying business that can be rescued, that the specific reasons for the debtor's financial distress are fully understood by all stakeholders, and that any elements that might render a workout unsuitable have been satisfactorily addressed.

Principle 2

It is the responsibility of the debtor to alert creditors to its distressed position early. The debtor should provide to the creditors, in a timely manner, full, honest and accurate information concerning its affairs. This is usually a time-consuming and onerous process. The debtor should appoint its most senior persons to undertake workout tasks.

Principle 3

When it is apparent that a debtor may be experiencing financial distress, creditors' initial attitude should be one of support in order to avoid insolvency proceedings if rescue is viable. Such support at this early stage should include a non-contractual standstill, with a contractual standstill to follow.

Principle 4

Both the debtor and its creditors must have the joint objective of rescue in a workout. If the debtor is acting in bad faith manifesting itself, for example, by failing to disclose information, then the workout will fail.

Principle 5

In a workout, each creditor is entitled to exercise its own commercial judgment but must be realistic and pragmatic and recognise the impact of its decision on other creditors and the debtor (or debtor group). No one creditor should act unilaterally or gain an unfair advantage, in particular that the security position of creditors relative to one another is preserved, and that each creditor will not improve its position during a standstill.

Principle 6

A standstill should be agreed promptly on principal payment, and perhaps also on interest. Creditors should not withdraw facilities or hastily put the debtor into receivership, or initiate lawsuits demanding repayment. The purpose of the standstill is to allow the viability of rescue to be assessed. Realistically, however, although creditors will agree to a de facto standstill early on, they are unlikely to enter into a contractual standstill until the debtor proves its good faith by beginning to provide disclosure.

Principle 7

The debtor must present a credible and viable business plan during a workout.

Principle 8

Any workout agreement must set out what are effectively "exit" strategies for stakeholders, intended to maximise their value in a workout. A variety of workout techniques are available and can be deployed in combination and applied to different classes of creditors.

Principle 9

In a multi-jurisdictional workout, organising a steering committee or appointing a lead creditor is of particular value. To the extent feasible, parties (or at least those with common representation) should appoint *common* teams of professionals and experts among them. Each team of advisors should be composed of professionals from *all* affected jurisdictions. Specifically for a legal team, even as it may comprise lawyers and firms from multiple jurisdictions, it is generally wise to ensure that, as between lawyers, there is a clear understanding of which firm is to take the lead.

Summary of practice tips for conducting an out-of-court workout in Asia

Practice Tip 1

A debtor should aim to identify its financial distress early in a transparent and honest manner. A key step is for the debtor to instruct its own legal, accounting and financial advisors to conduct a thorough review of all its facilities and financing documents.

Practice Tip 2

Creditors will want to ensure that, whilst discussions are ongoing and eventually as part of the standstill and even the workout agreement, there should be some oversight or control of material disposals or transactions by the debtor. Creditors may look to examples of early warning signs described in this guide to identify a debtor's financial difficulty.

Practice Tip 3

Both the debtor and its creditors should engage professional advisors to guide the workout process at an early stage. The level of advice sought and/or obtained and the types of professional advisors needed depend on the size of the debtor and what is being restructured.

Practice Tip 4

The debtor needs to ensure that the requisite information is made available to creditors to facilitate the conclusion of any standstill agreement or the extension of any facility in a workout. The mode by which such information is shared will vary depending on the circumstances, subject to appropriate confidentiality arrangements as some information may be commercially sensitive.

Practice Tip 5

Valuations lie at the heart of the workout process, and valuation issues will continue to suffuse the entire workout process, even after the preparatory phase. It is generally sensible to obtain at least provisional valuations at an early stage of the workout process.

Practice Tip 6

Both the debtor and its creditors should ensure that they have a comprehensive list of relevant creditors, and that all creditors who are interested in a workout participate, and failing which, that they are, at minimum, party to an informal moratorium on any formal enforcement action.

Practice Tip 7

It is helpful at the outset to decide which creditors are likely to lead the workout process. Several factors will influence that decision, including, among others, the size, resources and experience of a creditor and the nature of the debts owed.

Practice Tip 8

In some cases, a steering committee can be a helpful means of aggregating creditor interests and facilitating negotiations. In other cases, having a *lead creditor* (or a lead group of creditors) to manage and effectively administer the overall workout process can be sufficient. What is essential is that creditors all feel they are treated equally and fairly.

Practice Tip 9

Short-term waivers of a pending financial covenant default are generally a sensible idea where a workout is being proposed to ease the immediate liquidity tightness and avert the immediate risk of default, benefitting the debtor and its creditors alike.

Practice Tip 10

As new money is almost inevitably afforded priority status, the quantum, timing, and rationale for extending new money are heavily scrutinised. The source of new money will vary depending on the nature of the workout. Granting security on the provision of any new money may be desirable but may not automatically follow.

Practice Tip 11

The main challenge of dealing with the proceeds of asset disposals in a workout is how such proceeds ought to be distributed. A useful starting point is to look at the Day 1 Position of each creditor.

As asset disposals may also take place *after* the workout agreement has been implemented (and potentially may not appear on the schedule of agreed disposals), it is prudent to ensure that the workout agreement itself contains a clear mechanism for calculating the entitlements of various creditors to the proceeds of any future asset disposal.

The workout landscape in Asia

The workout landscape in Asia

The degree to which governments and industries have taken steps to facilitate workouts varies significantly among Asian jurisdictions.

The Asian Financial Crisis in 1997 gave rise to several workout models in different forms in Asia, although those models do not account for all the workout models that can be found in the region.

Formal legislative or regulatory frameworks for workouts in Asia

Firstly, some Asian jurisdictions have established legislative or regulatory frameworks for workouts.

India

The Reserve Bank of India has issued the Reserve Bank of India (Prudential Framework for Resolution of Stressed Assets) Directions, 2019, which adopt a board-approved policy for the resolution of distressed assets *before* a default has occurred. The Framework prescribes, among other things, a "review period" within which a resolution plan must be reached, as well as deadlines for implementation of such resolution plan.

South Korea

In South Korea, the Corporate Restructuring Promotion Act[8] lays down various frameworks for the resolution of distressed debts based solely on private agreements. It provides that companies may convene meetings to pass specific resolutions restructuring a business debt, and if validly passed, such resolutions will bind all financial institutions. Dissenting institutions obtain the right to have their claims against the debtor bought out.

Philippines

In Southeast Asia, the Philippines stands out as having a statutorily regulated procedure for workouts. The Financial Rehabilitation and Insolvency Act of 2010[9] prescribes, among other things, the length of the standstill period, a minimum number of creditors and debtors needed to vote on proposals, and requirements for advertisement of the workout process.

Guidelines for workouts in Asia

Secondly, in the absence of formal legislative or regulatory intervention, governments and industries in some Asian jurisdictions have (to varying degrees) created guidelines and agencies intended to facilitate workouts.

Thailand

The Bank of Thailand has issued a series of recommendatory policies on workouts, which encourages (among other things) compliance with Thai accounting standards in the production of records in financial statements, as well as guidelines for banks as regards the policies, methods and steps they need to take in managing workouts and assessing a debtor's capacity for repayment.

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8 Corporate Restructuring Promotion Act (Act No. 6504, Aug. 14, 2001; last amended by Act No. 15855, Oct. 16, 2018) (South Korea) (unofficial English translation).

9 Financial Rehabilitation and Insolvency Act of 2010 (Republic Act No. 10142) (Philippines).

Thailand has also introduced tax exemptions on gains received from workouts and permits the establishment of permanent asset management companies to address non-performing loans of financial institutions.[10]

Hong Kong SAR

The Thai approach is similar to that taken by the Hong Kong Monetary Authority, which (jointly with the Hong Kong Association of Banks) has issued a set of guidelines for out-of-court debt restructurings known as the *Hong Kong Approach to Corporate Difficulties*.[11] These are non-statutory guidelines, but banks are generally expected to adhere to them, and act cooperatively in trying to agree to a workout agreement among themselves. These guidelines apply only to banks, however, meaning that other creditors like bondholders, employees or trade creditors may act outside the scope of the guidelines and commence separate enforcement proceedings.

Malaysia

Malaysia, by contrast, does not have a freestanding, generally applicable policy for workouts. Instead, Bank Negara Malaysia, Malaysia's central bank, established the Corporate Debt Restructuring Committee (**CDRC**) in 1998. The CDRC is intended as a forum for the mediation of debt restructuring arrangements between participating entities. However, participating entities are generally limited to banks and other institutions falling within the central bank's purview. Any debtor seeking restructuring under the CDRC must apply for a workout, and any application must fulfil a set of fixed criteria. Once an application is accepted, the participating entities will observe a standstill period. An CDRC workout is subject to a code of conduct, which includes provisions for the establishment of a creditors' committee, six key principles for debt restructuring, and rules governing confidentiality.[12]

Singapore

Singapore's central bank has no official policy on workouts, but the Association of Banks in Singapore has issued its own set of guidelines for facilitating workouts. This 11-page document sets out, among other things, the importance of encouraging a "rescue culture", imposing a standstill period, and appointing a steering committee where there is a large group of lenders.[13]

China

China has issued several policy documents to facilitate workouts, such as measures allowing businesses to defer tax payments and establishing bailout funds in specific provinces. However, there are no formalised rules or processes, and workouts remain at the sole discretion of debtors and creditors.

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10 Emergency Decree on Asset Management Companies BE 2541 (1998) (Thailand) (Unofficial English translation).

11 Hong Kong Monetary Authority and Hong Kong Association of Banks, *Hong Kong Approach to Corporate Difficulties*, November 1999 .

12 Bank Negara Malaysia, *Corporate Debt Restructuring Committee Participants' Code of Conduct*, last updated 18 August 2020 .

13 The Association of Banks in Singapore, *Principles & Guidelines for Restructuring of Corporate Debt: The Singapore Approach*, undated .

In China, there is the added aspect that non-performing loans present a perennial problem in the banking sector such that asset management companies are used by the government as a policy tool to purchase these loans. This has an impact on the workout environment.

Further, in many of the State-owned enterprise workouts, the influence of local governments persists.

Japan

The Guidelines for Out of Court Workouts 2002, drafted in line with the London Approach and the INSOL Principles, was promulgated by a panel established by the Japanese Bankers Association, the Japanese Federation of Economic Organisations and others.[14] Japan also introduced several workout schemes to overcome the financial crisis of the early 1990's.[15] Debtors and creditors enjoy certain tax preferences under these workout schemes which are managed by government-licensed organisations.

More specifically, the schemes mainly used are the procedures of:

- Turnaround Alternative Dispute Resolution (**Turnaround ADR**);
- Regional Economy Vitalization Corporation of Japan, or REVIC; and
- Small and Mid-sized Enterprise Revitalization Support Councils.

Turnaround ADR is designed for medium and large-sized companies, while the Small and Mid-sized Enterprise Revitalization Support Councils scheme, as its name suggests, is mainly used to provide business rehabilitation support to local micro-, small- and medium-sized enterprises.

As a general rule, all three schemes focus primarily on the workout of debts owed to financial creditors and require unanimous consent of all creditors covered by the processes. In the latest development, the Japanese government announced in October 2022 that it was considering introducing new workout rules under which a workout agreement will be binding if a majority vote of creditors and confirmation of the court are both obtained.[16]

Brunei, Cambodia, Indonesia, Laos, Myanmar and Vietnam

Finally, Brunei, Cambodia, Laos, Myanmar and Vietnam do not have formal rules or industry policies relating to workouts. Indeed, it appears as though some of these jurisdictions have regulations which actively *discourage* workouts.[17] Indonesia formerly had the Jakarta Initiative, a government framework constituted after the 1997 Asian Financial Crisis to facilitate workouts, but terminated that programme in 2003 without replacing it.

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14 Shinjiro Takagi, "The Recent History of Business Reorganisation Workouts in Japan" (2015) 12(4) *International Corporate Rescue*.

15 Mariko Fujii and Masahiro Kawai, "Lessons from Japan's Banking Crisis, 1991–2005", *Asian Development Bank Institute Working Paper Series* (No. 222, June 2010).

16 Hiroshi Kasuya, Junya Suzuki and Masayoshi Kobayashi, "Japan: Japan to introduce long-awaited majority voting rule for out-of-court workout", *Baker McKenzie,* 12 October 2022.

17 For example, Article 9(1) of Cambodia's Insolvency Law 2007 mandates that a debtor file a petition to open insolvency proceedings within 30 days from the date that it fails to meet a valid and mature obligation in a prescribed amount.

Figure 2. Approaches to workouts in Asia

Need for convergence

What the above survey of Asia's divergent approaches to workouts demonstrates is the need for convergence because with convergence comes lower transaction costs of cross-border, regional restructurings through workouts.

The benefits of having consistent and transparent rules for the management of workouts are self-evident. The World Bank notes that workouts, including out-of-court workouts:

> "[a]re positively associated with increased returns to creditors, better access to credit, job preservation, and the promotion of entrepreneurship and venture capital — fundamentals that are all positive for private sector development and economic growth. Corporate workout frameworks, being key to the effective management of credit risks and insolvency risks, also play a vital role in protecting the health of the financial sector. This is particularly the case in emerging markets and developing economies (EMDEs) where finance of nonfinancial corporations is predominantly provided by the banking sector".[18]

The European Commission published a 2015 report based on data from its member states which demonstrates that efficient pre-insolvency frameworks can:

- spur entrepreneurship;
- mitigate the impact that deleveraging has on GDP growth; and
- improve financial stability by quickening the normalization of non-performing loans in an economy.

It is not just a matter of minimising the economic upheaval that can be caused by business collapse. It is also that jurisdictions with fair and efficient frameworks for exit in distress situations are inherently more attractive to private investors. In fact, "a country's insolvency regime should seek to limit the costs arising from potential market failure, for example by supporting effective private sector mechanisms for reorganising viable companies".[19]

For a region which is estimated to require some USD 1.7 trillion in annual investment until 2030 to maintain growth momentum, Asia's need to create a robust insolvency infrastructure and to converge on best practice in workouts is more pressing than ever. At its core, distressed corporates must be given the time and protection from legal action to restructure their debts, but also, and of fundamentally equal importance, creditors need to be assured of a level playing field, with a rigorous and independent assessment of the feasibility of a restructuring and confidence in the judicial process.

The precise form of implementation will vary among jurisdictions. For example, having non-binding normative guidelines published by a national association of banks (e.g., in Singapore) or a bank regulator (e.g., in Hong Kong SAR) may work for some jurisdictions. In others, the involvement of a central bank (e.g., in India) or even the legislature (e.g., in the Philippines) may be needed. Clearly, the nature of bank regulation, the history of bank incorporation and their level of independence and regulatory scrutiny will affect the optimum strategy.

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18 See Preface by Jean Pesme (Global Director, Finance, Competitiveness & Innovation Global Practice, World Bank Group) in World Bank Group, *A Toolkit for Corporate Workouts*, January 2022.

19 David Clementi, "Debt workouts for corporates, banks and countries: some common themes" *INSOL World Congress,* 19 July 2001.

For Asian jurisdictions which implemented World Bank and International Monetary Fund reforms post the 1997 Asian Financial Crisis, their existing frameworks may be different. At the minimum, however, as the nature of modern commerce is cross-border, the present divergence of workout procedures across Asia engenders significant uncertainty for multi-national businesses looking for certainty of outcome in an exit.

Flexibility in implementation is necessary (and inevitable), but the greater the degree of flexibility, the more likely the result will move away from convergence. Indeed, such fragmentation may even create opportunities for jurisdictional arbitrage, not in a workout itself, which is contractual, but in later court proceedings when workouts fail, resulting in significant inefficiencies. Familiar processes across borders also build trust among stakeholders. Therefore, there is still clear utility in harmonising principles of workouts, especially in cross-border cases.

Effect of commercial culture on workouts in Asia[20]

The effect of commercial culture on workouts, or the ineluctable restructuring zeitgeist, perhaps informed by how a restructuring took place historically in a jurisdiction, should not be underestimated. A large disastrous former restructuring case can have profound influences on a society's restructuring zeitgeist.

Closely held debtors

It has been noted that:[21]

> "In Asia, there is often intense privacy in business and very substantial businesses remain family-controlled, with many listed on Asian stock exchanges. Over 50 per cent of the world's billionaires are Asian, with highly entrepreneurial individuals building empires and dynasties and displaying justifiable pride in their achievements."

Further, in Asia, shareholdings in large debtors tend to be concentrated in the hands of families or the State. These shareholders, being families or the State, therefore have influence over the outcomes of restructurings of large debtors in Asia – in other parts of the world, they would not feature. In these circumstances, the boards of directors are appointed by the controlling shareholders and therefore can be expected to have aligned interests.

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20 Workouts are also affected by the backdrop of local legislation and policy incentives and disincentives. It is beyond the scope of this guide to examine each jurisdiction in Asia at this level. However, it is worth noting that the UNCITRAL Legislative Guide on Insolvency Law provides a comprehensive statement of the key objectives and principles that should be reflected in a State's insolvency laws. While UNCITRAL texts do not deal directly with workouts, they create an enabling environment for holding workouts and recognising and enforcing their outcomes. For example, part four of the UNCITRAL Legislative Guide on Insolvency Law encourages directors in the period approaching insolvency to negotiate with creditors or commence other informal procedures, such as voluntary restructuring negotiations.

21 Ian Chapman, Rishi Hindocha and Michael Pek, "Pride may hurt Singapore's aim to be Restructuring Hub", *Business Times*, 7 April 2022.

Moreover, this feature can have an adverse effect on corporate culture:[22]

> "[a] strong corporate governance culture is often less likely to take hold in jurisdictions in which most companies are closely held – i.e., family controlled – and less responsive to outside public pressure. Closely held companies are often reluctant to disclose adverse corporate news."

Culture cannot change overnight – or by legislative or other legal changes alone – but there is a natural inclination to try to maintain the *status quo*, rather than to acknowledge the reality, engage with key stakeholders and professional advisers, and provide the access, information and cooperation essential for the workout process. An acknowledgment of these problems leads to more sophisticated and realistic redress at both the policy level and in particular workouts.

Fairness among creditors

In some Asian jurisdictions such as Japan, there is reportedly excessive emphasis on fairness among creditors, and the fact that the establishment of creditor classes is not practised and that all procedures require unanimous consent leads to rigidity in practice. This strong rigidity in determining the scope of target creditors, involving creditors who have not given their consent (or excluding them from the proceedings), and establishing reasonable differences in the details of repayment, hinders the progress of a workout.

Debt structures

In smaller Asian economies, international finance is not the main source of debt; instead, it is mainly local bank debt. This means that there will be fewer conflict of law issues, fewer choices of jurisdiction for enforcement, and sometimes less complexity in the capital structure and therefore creditor group.

For example, a factory in Thailand, owned by Thai nationals, which has borrowed money from two regional Thai banks will be spared the complexity of multiple governing laws of the debt burden, multiple venues for enforcement, competing security, multiple layers of debt (secured, unsecured, revolving and instalment) with multiple rankings of security (senior, mezzanine, junior and/or subordinated). There will be no holders of debtor-issued publicly tradeable bonds to contend with, and no concerns that these holders tend to turn up to the first workout meeting apparently engaged to negotiate, and then trade out, and disappear before the second meeting. There is simply less complexity in the capital structure and therefore fewer contingencies to worry about.

In Hong Kong SAR and Singapore, large companies generally have more dispersed debt structures than those in, for example, Cambodia and Myanmar. This is due, at least in part, to the more developed (and more market-based) financial systems existing in Hong Kong SAR and Singapore.

In Hong Kong SAR and Singapore, creditor groups are sophisticated, and the capital structures of debtors are international and complex. The world's largest financial institutions – with all their knowledge – have significant presence in these financial centres. Workouts are well understood by creditors but are still asymmetrically understood by debtors which are often closely held in a concentrated shareholding of families or the State. This is in part because the debtors often hail from across Asia, including from less developed Asian jurisdictions, and look to Hong Kong SAR and Singapore, which are developed jurisdictions, for access to international finance.

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22 Jay Lawrence Westbrook, Charles D. Booth, Christoph G. Paulus and Harry Rajak*, A Global View of Business Insolvency Systems* (Martinus Nijhoff Publishers, 2010).

It is not unusual for a Cayman Islands-incorporated debtor, with operations in Asia, to borrow from a syndicate of Hong Kong banks, secured by guarantees from British Virgin Islands (**BVI**) subsidiaries and personal guarantees from a Mainland Chinese owner-entrepreneur of the debtor. That debtor may well raise further capital by issuing a public tradeable bond at a later date. The financing documents may therefore be governed by various laws including Cayman Islands law, BVI law, Hong Kong SAR law, New York law and/or English law.

There are very good and legitimate reasons for the complexity of this arrangement.

First, the capital structures are complex since the finance raised from the international market demands its own laws and procedures to be used as part of its risk profile, and in turn pricing. International lenders are reluctant to lend to debtors that are incorporated in jurisdictions that have less developed insolvency laws and hard-to-predict outcomes. Offshore obligors, such as the Cayman Islands and the BVI where both the legal systems and practitioners are highly robust, are often used when money is lent to a debtor whose operations are in a jurisdiction where the laws are less predictable.

Second, finance is not always available locally. For example, it is said that in the 1990s Mainland Chinese banks would not lend to Internet companies since they had, by definition, no collateral (e.g., a factory) to take security over. Some of China's most famous and successful Internet companies today had to look to foreign capital in the early days, and later foreign capital markets, i.e., US listings.

Third, in China, companies, banks and individuals must comply with a "closed" capital account policy. This means that money cannot be freely moved into or out of the country unless it abides by strict foreign exchange rules.

Fourth, in China, offshore creditors are structurally subordinated to onshore creditors unless they have the benefit of security or guarantee by subsidiaries in China. However, any such arrangement must be approved by China's foreign exchange regulator and such approval is not easy to obtain. In recent times, "keepwell deeds" have been deployed. These are essentially letters of comfort by a Chinese parent company to keep its subsidiary, which is the issuer of bonds, in good financial shape. The enforceability of these deeds is patchy. All these factors create risks for international lenders. Nevertheless, workouts tend to happen in Hong Kong SAR since experts in various laws are attracted to inhabit the city as an international financial centre offering access to international capital; and since finance was raised there in the first place, creditors expect that the workout will similarly happen there.

Fifth, the nature of the credit product may influence the utility of a governing law. For example, publicly traded bonds are normally governed by New York law on the recommendation of the investment bank, acting as manager to procure initial subscribers to the bonds since potential subscribers will have that expectation.

Bondholders as bank creditors

Further, the nature of debt, and therefore its issuers and lenders, have changed. For example, prior to 2015, in Mainland China, it was primarily bank debt for which restructuring was sought. Post-2015, more debtors have raised debt financing in the public markets and more debtors defaulted on their bonds. Mainland China now accounts for the second largest onshore bond market in the world, after the United States. Likewise in India, onshore bond issuances have risen since 2010, and an active market of distressed loans has developed. In Singapore, the debt market has a significant retail investment due to institutional factors encouraging the same.

The diversity of creditors has a normative effect on the workout culture and approach. This is largely because bonds have vastly different characteristics to bank loans. For example, bond issuances normally have collective enforcement provisions or “no action clauses” which prevent bondholders from taking individual enforcement action against an issuer-debtor unless a specified percentage of the bondholders consent. There are often also provisions prescribing what percentage of votes would be necessary to approve a rescheduling of the debt due by the issuer-debtor.

Moreover, a trustee is often involved whereby the bond issue may be constituted by the trustee in the sense that it acts on behalf of the bondholders to administer their rights and interests. It is often the case that the trustee is charged with the responsibility for enforcement, following a certain voting threshold of the bondholders being met. A trustee has a right of indemnity, and negotiations to receive the upfront cash to make good on the indemnity before enforcement can occur are often problematic since expectations of the trustee and the bondholders as to what is sufficient can be mismatched.

Bonds are liquid and transferable whereas bank debt is less likely to be traded on the secondary market, since transfer of loans can be complex due to contractual restrictions.

Bondholders can, if they wish, sell their bonds to avoid taking part in a workout. This means that there is less capacity at the level of institutional bondholders to participate in a workout. They are unlikely to have the same specialist workout teams that banks possess.

In addition, the identity of bondholders is not known, and as a result it is difficult to coordinate meetings with them. They are often numerous and geographically disparate.

All these factors make bondholders less likely to have the skillset nor the inclination to negotiate in a workout. Even if bondholders do participate, overcoming the consent thresholds for rescheduling the bonds may prove too difficult.

Publicly traded bonds will require that the offering memoranda for bond issues be subject to listing rules as to prescribed disclosure. The issuer-debtor must be careful to continually notify bondholders of events which may lead to a false market in the securities such as adverse changes which are not public knowledge.

Bondholders who wish to participate in a workout will normally form ad hoc groups built around legal and financial advisors. This is a typically small group of bondholders who will liaise with a debtor as a temporary forum ahead of the debtor submitting a detailed refinancing or restructuring proposal to the wider group of bondholders. Some bondholders may be reluctant to join the ad hoc group since they may be provided with material non-public information which will preclude them from trading those bonds until the information becomes public.

Further, bank loans have much stronger protections in the form of warranties, covenants and events of default. Bond terms are, after all, not achieved by a negotiation between the bondholders and the borrower. At most, any negotiation would take place between the borrower and the arranging investment bank which was looking for terms that make the bonds saleable on the market. The bonds would then be issued and offered pursuant to an offering memorandum. The stronger protection for banks means that bank debt will be in default much earlier than bond debt by reason of a breach of covenant or warranty. Often bondholders are not invited to a workout since there is no event of default in the bonds at that stage where bank debt has already defaulted.

In an established capital market such as Japan, debtors are often listed. If a debtor is listed on a stock exchange, it will likely be subject to regulations, including disclosure requirements and possible suspension of trading in certain circumstances.

Outside of such established capital markets, even if the debtor is not listed, the bonds are listed to enable certain kinds of institutional investors to purchase them. Once the bonds are listed, the issuers are also subject to disclosure obligations (though not as onerous as companies whose shares are listed).

Creditor hold-outs

In Singapore, sophisticated foreign creditors to an Indonesia-based debtor may find that they have no choice but to focus simply on a workout of the Singapore law-governed debts since the local Indonesian bank creditors see no particular advantage in participating in the workout. There may be several reasons for this lack of participation, including the fact that those bank creditors have sufficient local security over assets. This is a form of hold-out based on geographical enforcement realities. There are many other similar examples in Asia.

A complex workout in Hong Kong SAR or Singapore tends to lead to greater coordination and hold-out problems that may require additional elements imported from formal reorganisation proceedings such as a stay, unless other jurisdiction-specific factors can help companies solve those problems through alternative arrangements. It should be noted that the more complex a capital structure, the more difficult it is to achieve a successful workout, and court involvement may be required.

Even in a financial centre such as Hong Kong SAR or Singapore, most of the workout teams at banks know each other from previous cases, and the community of lawyers and advisors is relatively small. It is well known that bad behaviour, i.e., not seeking cooperation or being less than honest, by a creditor in one workout will result in less cooperation from creditor-peers in the next.[23] This can be positive since the knowledge and familiarity among workout teams may in fact assist in facilitating coordination and cooperation among major creditors. The other jurisdiction-specific factors may include the commitment of the banking industry. For example, does the jurisdiction even have a national association of banks? If so, is this association influential and respected? The history, competence and integrity of a jurisdiction's central bank may well inform these issues.

Common hurdles to workouts in Asia

Some common hurdles to workouts in Asia have emerged over the years in practice. The hurdles identified below may apply to some (but not all) Asian jurisdictions.

Debtor culture

A culture of secrecy and avoidance by debtors leading to less than transparent reporting to creditors and a culture of debtors hoping to use a workout to delay and trade out of difficulties instead of embracing the opportunity to genuinely restructure their debt burden.

Debtors perceiving creditors' demands for reporting and monitoring during a workout as intrusive and perhaps even humiliating. A particular problem is the debtor refusing to allow creditors onto the premises of its factories and other facilities due to, for example, a discerned "loss of face".

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23 This point is expressly made in the London Approach, the Hong Kong Approach and the principles and guidelines issued by the Association of Banks in Singapore. See, respectively, Pen Kent, "The London Approach" (1993) Q1 *Bank of England Quarterly Bulletin* 110; Hong Kong Monetary Authority and Hong Kong Association of Banks, *Hong Kong Approach to Corporate Difficulties*, November 1999 and The Association of Banks in Singapore, *Principles & Guidelines for Restructuring of Corporate Debt: The Singapore Approach*, undated.

Lack of experience

There is a lack of experience and awareness of workouts, other than the simple "amend and extend" type of arrangements negotiated, usually by banks, in straight-forward bilateral loans. This issue may be exacerbated by creditor representatives being fearful of making any decisions that involve debt write-offs and needing to seek time-consuming approvals internally.

Lack of training

There is a lack of training at creditor institutions as to the benefits of rescue, namely lower transactional costs as compared to liquidation and better returns to all stakeholders over time.

Similarly, training on the value of open communication and cooperation with other creditors is also insufficient at creditor institutions.

Fraudulent use of credit

Fraud is often detected in the use of the credit supplied. For example, instead of being used to produce widgets, the credit supplied was used, in part or in full, to purchase a residential home for the owner. Or, instead of being used as working capital, the credit supplied was used to pay an undisclosed earlier facility. Alternatively, there is, more generally, fraud in the debtor siphoning assets to owners, which has caused the debtor's insolvency in the first place. In these circumstances, the objective of a debtor which finds itself in a workout is to obfuscate and delay.

Bank culture

Banks tend to share the culture of not wishing to accept any reduction in return and being focused only on extension to temporal loan terms – sometimes prompted by government policy that either penalises or discourages write-offs, and conversely does not incentivize them in appropriate circumstances.

Government policy

Government policies often do not allow central banks to provide the right mix of incentives and disincentives for debt restructuring. For instance, loan classification and other prudential norms can affect bank behaviour.

It is notable that State-owned banks may prefer formal rescue involving a court process as a means of protection to government officials lest they be accused of squandering State assets through poor lending decisions and concomitant contractual out-of-court debt forgiveness.

Legal gaps

There is also a lacuna in the laws, or the enforcement of laws, which regulate and/or motivate honest reporting by debtors. For example, there is no real sanction for fraud against directors. Well enforced directors' rules encourage early engagement with creditors.

Factors protective of the debtor

In developing Asian jurisdictions,[24] enforcement of unsecured debts may be ineffectual, and a liquidation process may take a long time. Secured creditors may not be able to repossess collaterals without court orders or other burdens. In these environments, the restructuring regime is systemically and inherently protective of the debtor.

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[24] This hurdle is pertinent, but necessarily unique, to Asia.

Overview of a workout

Overview of a workout

Types of responses to financial distress

Broadly speaking, when a business is in financial distress, there are three possible responses which can be classified according to the degree of formality and judicial involvement:

- liquidation or insolvency proceedings;
- judicial reorganisations; and
- workouts.

Liquidation or insolvency proceedings

These are court-supervised processes by which the distressed business is wound up, and outstanding claims paid from the proceeds of the insolvency.

Such a process is generally at the upper end of the spectrum of formality, since the entire process is court-supervised and is typically managed by court-appointed officers.

Judicial reorganisations

Judicial reorganisations are formal proceedings supervised by a court (or similar tribunal), which are commenced with the aim of facilitating the survival of the business as a going concern, and thereby preserving employees' jobs and maximising potential recovery for creditors.

There are typically rules requiring a majority of creditors holding a certain threshold of the debt to agree to a reorganisation plan, and the reorganisation plan will in turn have to be approved by the court.

If approved, judicial reorganisations are binding on all creditors irrespective of whether they have agreed to such reorganisations.

Workouts

A workout is a non-judicial, private contractual arrangement between the debtor and its creditors aimed at easing the debtor's debt burden so that it can maintain its business activities.

Very often, only habitual creditors, such as banks, participate in a workout such that other creditors, such as employees and trade suppliers, get paid anyway. Occasionally, a workout might involve shareholders — especially where an existing shareholder is advancing new capital in a proposed restructuring. More often, the involvement of shareholders in an insolvent company is restricted to obtaining their consent to the issuance of new equity following a debt-for-equity swap.

Workouts are not generally the product of insolvency legislation but are instead the consequences of consensual negotiations between the debtor and creditors. In other words, these workouts are subject to general contract law with all its possibilities and limitations.

Because they are entirely consensual negotiations, creditors that do not participate in the workouts are not bound by the resulting contractual agreements. In addition, as a general rule of thumb, acceptance of a workout agreement needs unanimous consent of all parties involved. The flexibility and consensual nature of workouts are why they occupy the lowest end of the spectrum of formality. It is said that "if the going concern value of a firm exceeds its liquidation value, most stakeholders will have an incentive to prefer a workout".[25]

Figure 3: Level of formality of possible responses in insolvency

Both judicial reorganisations and workouts are intended to rescue the debtor. In contrast, a final liquidation terminates the debtor. Compared to a workout, the disadvantages of a final liquidation are the cessation of the debtor's business and a sale of its assets. There may also be a cascade of knock-on insolvencies from suppliers, and there can be no conversion of debt to equity with future recoveries. Further, in liquidations, the debtor's estate available for unsecured creditors may be diminished by realisations by secured creditors, repossessions by vendor and/or lessor title financiers, set-offs and the cancellation of valuable contracts.

25 World Bank Group, *A Toolkit for Out-of-Court Workouts*, 29 November 2017 at p 27.

Typically, only creditors with a priority get paid in a liquidation. The ladder of priority, whether or not mandatory, is generally followed in workouts because creditors with a liquidation priority generally will not agree to get less than they would in the event of liquidation. There are exceptions, possibly temporal and hardly worse in the aggregate, where a creditor might agree to something that might be less than in a liquidation for the purpose of keeping a buyer alive or avoiding litigation costs. In Asia, however, due to concentrated shareholdings in large corporations, including listed companies, often owned by families or the State, applying the ladder of priority too strictly, such as the “absolute priority rule” in the United States, may simply be impractical since it would wipe out the shareholders who may be key to the future success of the debtor. Although unpalatable, and certainly not something to aspire to, it is not uncommon in these situations to have to give a “sweetener” to such shareholders even though their strict legal rights do not warrant it.

Readers of this guide will naturally enquire as to the statistical proof that workouts are better at resolving distress in debtors than liquidations. There is no way of doing so, since workouts are in most places confidential contracts that are not filed in public registries. In place of publishable empirical data, the author has relied upon real-world practitioner experience of his own and of fellow practitioners. As the world-renowned insolvency practitioner and author, Philip R. Wood, has noted:[26]

> “The ultimate question is which process is most likely to maximise creditor recoveries. The use of judicial reorganisations in most jurisdictions seems not as great as expected and many of these are just a slow-motion liquidation. Most proceedings are actually liquidations. Nobody knows the rate of workouts, but it is believed that a high proportion of financial problems are solved this way.”

The World Bank has similarly noted:[27]

> “As many workouts are confidential, it is difficult to get empirical data on the success of these restructuring regimes, particularly those that take place with no court involvement. Nonetheless, more general studies show that effective insolvency regimes, which include both judicial reorganization and more informal restructuring tools, preserve jobs by facilitating the survival of distressed but viable enterprises, reduce credit risk and help strengthen access to credit at a lower price.”

It cannot be stressed enough that workouts are most beneficial for a viable debtor who is experiencing temporary liquidity problems. Such a debtor will most likely have a viable underlying business.

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26 Philip R. Wood, *Principles of International Insolvency* (3rd ed, Sweet & Maxwell, 2019) at 5-0001.

27 World Bank Group, *A Toolkit for Out-of-Court Workouts*, 29 November 2017 at p 5.

Advantages of a workout

A workout has several potential advantages over a judicial reorganisation or commencing liquidation proceedings.

Greater potential returns for the debtor and its creditors

First, in the right circumstances, a workout can result in greater returns for both the debtor and its creditors. It is often the case that an ailing business can be resuscitated with certain targeted changes (e.g., replacing the management, an equity injection, or even a merger). A workout allows the business to continue as a going concern, with the potential for greater returns to shareholders and creditors in the medium to long term. It also bears noting that because there is no court process to traverse, the costs of a workout are generally lower. These are sometimes described as “agency costs” by economists referring to the costs associated with the relationship between a "principal" and an "agent". Agency costs typically arise in the wake of core inefficiencies, dissatisfactions and disruptions, such as conflicts of interest between shareholders and the management. The agency costs of conflicts between minority and controlling shareholders are well documented.

Flexibility

Second, a workout is highly flexible. This flexibility is reflected in multiple aspects.

- Because a workout is, in the main, an entirely contractual arrangement, there are generally no particular statutory requirements, procedural rules or time limits which need to be complied with (albeit, of course, there are certain principles of best practice whose adoption is encouraged). Admittedly this is not always the case. For example, in Japan, the prerequisite for a tax-free debt waiver by creditors is that the procedure be carried out in accordance with certain quasi-rules. In other words, there are rules governing the procedures of workouts, and those procedures are subject to certain restrictions. Save for certain exceptions such as what is described for Japan, each workout deal can be tailored to fit the circumstances. This flexibility is particularly important if a business’ financial arrangements are complex or if there are cross-border elements.
- In a workout, different incentives can be provided for different classes of creditors, ranging from partial repayments, additional security, to equity buy-outs. All creditors often have to be involved in a formal insolvency proceeding, whereas this is often not the case in a workout, especially a workout of bank debts.
- A workout may also be “short leash”, i.e., give only short-term relief so as to maintain creditor control and enable creditors to see how the situation develops so that they do not give too much initially.
- In a workout, the debtor and the main creditors decide the essential information that must be disclosed. In contrast, since all creditors are involved in a formal insolvency proceeding, there usually has to be a statutory disclosure of information which is most of the time much more comprehensive and time-consuming.

Confidentiality

Third, as mentioned above, workouts are usually confidential. The absence of any requirements to advertise winding-up proceedings, file court reports or attend public hearings presents significant advantages for companies concerned about disclosing sensitive details of their operations and finances, or perhaps worried about potential reputational damage done in the marketplace by drawn-out restructuring proceedings. Any formal public insolvency proceeding involves the trauma of insolvency, the loss of goodwill and a reluctance of other parties to continue to deal with the insolvent debtor (often described as "rancour"). "Trauma" is no hyperbole. Senior management of major corporations have gone on record to say that the personal emotional toll of even a successful restructuring is profound.[28]

Minimises business disruption

Fourth, a workout minimises the degree of business disruption. Because workout deals are tailored and do not come with the pressure of court deadlines, they are less of a distraction to management than a formal insolvency proceeding would be. After all, a liquidation, once granted, will displace the management. Moreover, whereas the commencement of formal insolvency proceedings can often trigger boilerplate termination clauses in key contracts with customers, employees or suppliers, this is much less likely to happen in a workout. For example, the enforcement of *ipso facto* clauses can destroy enterprise value and often spell the end of any effective rescue attempt for a distressed but viable debtor.

Promotes certainty

Fifth, a workout promotes certainty. For one, it is not always clear whether a scheme of arrangement will be sanctioned by the court, particularly if there is vocal opposition from a minority of creditors. Judicial approval, even if given, is susceptible to challenge and attack. Judicial reorganisations, for example, can be challenged on the grounds of serious procedural defects or unfair class compositions. "By taking an informal route, the rehabilitation can be conducted without the necessity of oversight or approval by the court, which can be costly, complicated and time-consuming."[29] There may also be concerns about the integrity of court processes and the sophistication and honesty of the judiciary, particularly in emerging jurisdictions. This can be highly problematic, especially in Asia if the debtor is often owned by an influential family or group who may have the power to improperly influence the rule of law. Less ominously, some Asian jurisdictions may simply lack formal judicial reorganisation proceedings, and workouts may thus be a feasible alternative. As a matter of culture, some Asian jurisdictions may also prefer workouts with the aim of keeping personal information confidential and avoiding incurring social stigma. Concisely, a workout removes the matter of a debtor's restructuring from the judicial framework, returns control to the parties, and insulates them from the uncertainties of the court process.

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28 Teodor Teofilov, "INSOL International: learning from failure, CEOs retell their stories", *Global Restructuring Review*, 2 August 2022.

29 Jay Lawrence Westbrook, Charles D. Booth, Christoph G. Paulus and Harry Rajak, *A Global View of Business Insolvency Systems* (Martinus Nijhoff Publishers, 2010) at p 125.

Promotes business stability

Sixth, a workout promotes business stability. In terms of new money and further security, once formal insolvency proceedings have begun, it is usually difficult for creditors to improve their security positions by taking security for existing debts. In the case of a workout, bank creditors can, and commonly do, take security and cross-guarantees for their existing debts and hope to outlive the suspect period. Due to the trauma of formal insolvency mentioned above, it may be more difficult in a judicial reorganisation to raise new money to keep the business going. In the case of a workout, the stability of the business is less threatened by the taint of insolvency.

Figure 4: Advantages of a workout

Drawbacks of a workout

In certain scenarios, however, workouts may also carry significant disadvantages.

Unanimity or near unanimity needed among participating creditors

First, the main disadvantage of a workout as compared to a judicial reorganisation proceeding is the need for unanimity or near unanimity among participating creditors. This is referred to as the problem of the "hold-out creditor". Other disadvantages include problems of getting shareholder approval for debt-equity conversions which swamp the existing shareholders. Such shareholders will normally have a vote outside insolvency.[30] Shareholders probably get more in a workout than in a judicial reorganisation proceeding because in the latter priority rules will dictate that they get nothing unless creditors are paid in full. However, a sweetener may still be required in a workout.

Creditor participation not compulsory

Second, since a workout is consensual, creditors who do *not* participate in the workout are not bound by any agreement the parties reach during the workout. One of the most serious risks to a workout is the destabilisation of the workout plan or negotiations by individual creditor enforcement actions or threats to enforce. Equally, even if an agreement is reached, in some Asian jurisdictions such as Vietnam, if a party to a successful workout subsequently breaches the workout agreement, the remaining parties to that agreement may still need to commence in-court proceedings to enforce the agreement.

This disadvantage also has a bearing on cross-border enforcement of workouts. The lack of automatic cross-border recognition of agreements reached in workouts becomes a problem if *enforcement* across borders becomes necessary. This means that a third party can *still* commence winding-up proceedings notwithstanding that the debtor has entered into a standstill as part of its workout. This would not be the case in a judicial reorganisation where there would ordinarily be a statutory moratorium imposed. There is also no statutory "cram-down" procedure in a workout, by which the workout agreement can be imposed on a dissenting group of stakeholders. This means that the workout relies on consent from all relevant parties, and dissenting creditors may in turn have disproportionate bargaining power.

Lack of investigative powers

Third, judicial reorganisations or liquidations will typically involve the appointment of court officers who have a duty to report on improper conduct by management or on transactions intended to defraud or prejudice creditors. However, a workout cannot confer on any given party such investigative powers, with the consequence that improper conduct or suspicious transactions are not automatically investigated. "The lack of court oversight may, however, also be an advantage where, for example, the debtor takes advantage of it to defraud creditors."[31] Nor, in the absence of judicial intervention, will the full armoury of legal options be available to, for instance, rescind fraudulent transactions or penalise errant directors.

30 Shareholders often erroneously believe that they are entitled to something even though the debtor is insolvent, and sometimes benefit from stock exchange rules requiring, for example, equal treatment or pre-emptive rights.

31 Jay Lawrence Westbrook, Charles D. Booth, Christoph G. Paulus and Harry Rajak, *A Global View of Business Insolvency Systems* (Martinus Nijhoff Publishers, 2010) at p 125.

Less favourable tax treatment

Fourth, cancelled debts may have to be added to gross taxable profits in a workout but not in the context of a formal insolvency proceeding, and a formal insolvency proceeding may allow the carry-forward of tax losses even if there is a change of control in a debt-equity conversion. This has been rightly pointed out by the World Bank.[32]

In the United States, mortgage recording and similar taxes are lifted in the case of transfer under a judicial reorganisation plan. In Japan, where debt is forgiven, creditors do not have to pay taxes on that forgiveness. Similarly, in Hong Kong SAR,[33] if the instrument represents a debt in respect of money lent in the ordinary course of the business of lending money in Hong Kong SAR by the person who carries on that business, the impairment loss is allowable as a deduction up to the amount of the debt. This limits the tax deduction in write-offs to institutions. However, as to Hong Kong tax treatment from a change of control on a debt-equity conversion, loss is disallowed from tax exemption if it was for the sole or dominant purpose of using the loss. In some jurisdictions, where inter-company debt (e.g., parent to subsidiary) is being waived for non-business reasons (e.g., improving the capital structure), then it may well not form part of the taxable profits. In Singapore,[34] the tax treatment of debt forgiveness granted by creditors in corporate reorganisation may – with some exceptions – be treated as taxable income. As a result, financially distressed debtors may be required to pay taxes for certain income that did not involve any actual generation of cash flows. In Cambodia, a cancelled debt is considered a taxable profit.[35]

Does not always result in a comprehensive resolution

Fifth, in some jurisdictions, a workout will not achieve a comprehensive enough result at all levels of debt for legal reasons. For example, in the United States, dissentient bondholders can be bound effectively only by a Chapter 11 court proceeding. Therefore, if there are public bondholders, a workout is usually more difficult to achieve cleanly. Alternatively, in some areas of credit, for example in credit derivatives, a workout may not be effective since it does not need to involve transfers of the debtor’s debt until, in the case of physical settlement, a credit event occurs. The knowledge that debt will change hands following a credit event might, however, affect the incentives facing the debtor, its “pre-credit event” creditors and its potential “post-credit event” creditors in unpredictable ways. One possibility is that a bank which has purchased credit protection via a credit derivative may have an incentive to put an ailing debtor into liquidation in order to obtain a payment from its counterparty rather than participate in a workout whose outcome is uncertain. At the very least, active markets in credit derivatives and secondary loans might make it more difficult to identify and organise creditors in order to negotiate any debt workout.

32 For example, see World Bank Group, *A Toolkit for Out-of-Court Workouts*, 29 November 2017 at p23.

33 Inland Revenue Ordinance (Cap 112) (Hong Kong SAR) section 18K (“Financial instrument: special treatment of impairment loss”).

34 Aurelio Gurrea-Martínez and Vincent Ooi, “The Tax Treatment of Haircuts in Financial Reorganizations” (2020) *Revenue Law Journal* 27(1) (DOI: 10.53300/001c.13682).

35 Ministry of Economy and Finance of the Kingdom of Cambodia, *Prakas No. 098 on Tax on Profit*, 29 January 2020 Article 10(3)(f).

Lack of incentives

Sixth, a debtor may have incentives to file for a judicial reorganisation proceeding in debtor-in-possession type jurisdictions,[36] where there are generous tools for stays on creditor enforcement, netting, contract cancellations and repossessions, and where the management can stay in place. The ease in which a debtor can be put into a judicial reorganisation process – rightly or wrongly – may weigh in favour of avoiding a workout.

In Napoleonic and Roman-Germanic jurisdictions,[37] it is common for directors to be under a duty to file within a specified period if the debtor is insolvent.[38] This makes a workout more difficult and threatens the veil of incorporation which is at the heart of the idea of a company. This is generally not true of the English common law jurisdictions (such as Hong Kong SAR, Malaysia and Singapore in Asia) or the United States. However, in Australia, strict insolvent trading liability imposed on directors – albeit somewhat lessened by the recent introduction of the “safe harbour” regime – can make it a disincentive for debtors to admit that informal or formal restructuring is needed. The responsibility of directors not to trade while a company is or is about to be insolvent means that very often, directors appoint an administrator to produce a deed of company arrangement. This is a usual form of workout used in Australia, but it is within the context of liability provisions in the Corporations Acts for trading whilst insolvent. The benefit, of course, is that it reinforces the need to act in advance of actual insolvency or default.

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36 A majority of Asian jurisdictions have characteristics that can fairly be described as debtor-in-possession, even if nomenclature and degree may vary, the notable exception being Hong Kong SAR. Notable debtor-in-possession jurisdictions in Asia include Cambodia, China, Indonesia, Japan, Laos, Malaysia, Myanmar, the Philippines, Singapore, South Korea, Thailand and Vietnam. See, for example, Rajah and Tann Asia, “Restructuring & Insolvency Regimes in Southeast Asia: A Comparative Overview”, September 2020.

37 Philip R. Wood, *Principles of International Insolvency* (3rd ed, Sweet & Maxwell, 2019) at 2-029. In France, for example, if a debtor can no longer pay its current debts with its available assets for more than 45 days, the legal representative of the company or the director must file a declaration to the court to file for insolvency (déclaration de cessation des paiements/ dépot de bilan). Not doing so is considered mismanagement, which may be addressed by civil and/or criminal law.

38 Vietnam is an example for Asia. Article 5.3 of the Law on Bankruptcy (No 51/2014/QH11) (Vietnam) imposes a duty on the company's legal representative(s) and certain other management personnel to file for bankruptcy when the company is insolvent.

Figure 5: Drawbacks of a workout

When is a workout suitable?

Principle 1

A critically important foundation for any workout is that the debtor has a viable underlying business that can be rescued, that the specific reasons for the debtor’s financial distress are fully understood by all stakeholders, and that any elements that might render a workout unsuitable have been satisfactorily addressed.

In view of the advantages and disadvantages of workouts outlined above, as a general principle, debtors and creditors alike are advised to first consider carefully whether a workout is suitable for their specific circumstances.

When workouts are viable

Generally, for a workout to be a viable option for a debtor, the debtor must satisfy the following conditions at a minimum:

- the debtor has a viable underlying endeavour, with a clear route to profitability if its debt issues can be resolved;
- the debtor recognises its financial distress early;
- liquidity is being extended to the debtor while the suitability of a workout is being investigated; and
- the debtor has support from key stakeholders, notably secured creditors and existing shareholders.

In addition, a workout will prove a viable solution if the financial distress of the debtor arises from:

- an asset or part of the business (e.g., legacy business) of the debtor being loss-making;
- loss of a major customer or supplier by the debtor;
- pensions[39] and/or other worker liabilities of the debtor being too high; or
- base costs of the debtor having increased unsustainably due to temporary price shocks.

In any of the above scenarios, a workout provides a route to sustaining the debtor as a going concern, while also targeting the specific cause of its financial distress.

When workouts are not desirable

By contrast, a workout may be inappropriate for a debtor where:

- the debtor's entire business product is at the risk of becoming redundant or unprofitable in the long run;
- formal insolvency proceedings have already been commenced; or
- there is evidence of fraud or improper practice.

In all of the circumstances described above, if the debtor is in serious, irresolvable financial difficulty, then the proper route is a winding-up. Alternatively, where there is evidence of bad faith on the part of the debtor's management, a workout simply cannot properly proceed without a formal investigation into their wrongdoings.

[39] In Japan, pension obligations cannot be resolved by a workout, making the use of court proceedings the only option.

How to conduct a workout in Asia

How to conduct a workout in Asia

Generally speaking, a workout has three phases in the following order:

- A **preparatory phase**, where a debtor's financial distress is first identified, and foundational work is done to evaluate the viability of a workout, ease the immediate pressure of default, and coordinate creditors.
- A **contractual phase**, where the parties enter formal contractual arrangements which will govern the workout, most notably the standstill agreement, and begin to negotiate details of the ultimate workout agreement.
- A **restructuring phase**, where the parties agree on the terms of the workout agreement and proceed to implement those terms.

Figure 6: Three phases of a workout

Each of these three phases is discussed in detail below.

Phase 1: Preparatory phase

Principle 2

It is the responsibility of the debtor to alert creditors to its distressed position early. The debtor should provide to the creditors, in a timely manner, full, honest and accurate information concerning its affairs. This is usually a time-consuming and onerous process. The debtor should appoint its most senior persons to undertake workout tasks.

Function of the preparatory phase

The preparatory phase is where creditors assess the debtor's position and determine if a workout is appropriate. Creditors cannot make this assessment if the debtor is not open, communicative and transparent. It is the responsibility of the debtor to alert creditors to its distressed position early. If so, then this phase is also where the preparatory work to put in place the foundation of the workout is carried out. The debtor should provide full, honest and accurate information concerning its affairs to the creditors in a timely manner. This is usually a time-consuming and onerous process. The debtor should appoint its most senior persons to undertake workout tasks. Failure to meet these standards of transparency and honesty is the single largest impediment to workouts in Asia.

Steps in the preparatory phase

Broadly speaking, there are eight steps in the preparatory phase. Depending on the size of the debtor, the number of creditors and the complexity of the credit structure, the preparatory phase can take anywhere from one to six months to conclude.[40]

- Step 1. Identify signs of financial distress from the *debtor's* perspective
- Step 2. Identify signs of financial distress from the *creditor's* perspective
- Step 3. Assess the viability of a workout
- Step 4. Instruct appropriate experts
- Step 5. Put in place information sharing protocols
- Step 6. Perform valuation of the debtor
- Step 7. Properly organise creditors in attitude and structure
- Step 8. Avoid the risk of default

Each step is discussed below.

Step 1. Identify signs of financial distress from the *debtor's* perspective

Early, transparent and honest identification of financial distress enables the debtor to determine, at an early stage, if a restructuring is required. The process of assessing a debtor's financial position requires precision and sound judgment. From the debtor's perspective, announcing that it has potential financial problems which may or may not materialise could inadvertently precipitate a crisis by inducing panic among creditors.

Practice Tip 1

A debtor should aim to identify its financial distress early in a transparent and honest manner. A key step is for the debtor to instruct its own legal, accounting and financial advisors to conduct a thorough review of all its facilities and financing documents.

Early identification of potential financial distress prompts early engagement with creditors, which in turn increases the likelihood of a successful workout. This is because the debtor loses significant leverage if it is *actually* in default at the outset of the workout. The ideal stage at which to prompt a workout is when the debtor is forecasting a tightening of liquidity but has not yet reached the point of default. The debtor should be organised in a way to be able to detect early signs of distress.

40 In Japan, there are reportedly many companies that have been going through a trial-and-error process of business restructuring for an exceedingly long period of time, in some cases several years, before proceeding with a "formal" workout.

A key step, therefore, in the preparatory phase is for the debtor to instruct its own legal, accounting and financial advisors to conduct a thorough review of all its facilities and financing documents, to establish if:

- there is any breach (or imminent breach) of any financial covenants; and
- whether there are any potential events of default or events which might fall foul of "material adverse change" clauses.

The aim is to determine the degree of risk that creditors may be entitled to accelerate their debts, thus placing the debtor in financial distress.

Step 2: Identify signs of financial distress from a *creditor's* perspective

From a creditor's perspective, early identification of a debtor's financial difficulty enables it to decide if early intervention is necessary. The process, however, is a sensitive one. Declaring default prematurely can have unintended consequences, including inadvertently waiving the relevant loan obligation or perhaps creating an estoppel to the same effect. A lender should ensure that it is not estopped from calling or acting upon an event of default. Whilst Loan Market Association loan documentation contains so-called "non-waiver" provisions whereby only waivers in writing will be deemed valid, most law firms will not opine cleanly on such provisions and a default may still be waived by words or conduct so as to create a promissory estoppel.[41]

A creditor necessarily has less oversight of a debtor's financial performance than the debtor itself. Clearly, commercial lenders will benefit from covenants that will require information to be periodically provided, whereas high-yield bondholders will have no such recourse.

Practice Tip 2

Creditors will want to ensure that, whilst discussions are ongoing and eventually as part of the standstill and even the workout agreement, there should be some oversight or control of material disposals or transactions by the debtor. Creditors may look to examples of early warning signs described in this guide to identify a debtor's financial difficulty.

If a workout commences, the debtor should expect that its creditors will appoint a financial advisor to inspect its position and to perform a cash monitoring role – with approval thresholds to be agreed – e.g., there should not be material disposals of assets without creditor consent. Creditors will want to ensure that, whilst discussions are ongoing and eventually as part of the standstill and even the workout agreement, there should be some oversight or control of material disposals or transactions by the debtor. It is usual for debtor activities to be circumscribed during a workout. The debtor should allow the monitor full access.

41 See Chris Howard, Presley Warner and Chris Beatty, *Restructuring Law and Practice* (3rd ed, LexisNexis Butterworths, 2022) at para 2.51. See also *Royal Bank of Scotland v Luwum* [2008] EWCA Civ 648 (Court of Appeal of England and Wales, 15 May 2008), which illustrates the potential for an estoppel to arise when a default is declared prematurely.

The usual warning signs of a debtor's financial distress are breaches (or impending breaches) of financial documents. Commercial creditors will almost always require, as a condition of their lending, that the debtor give certain representations, warranties or covenants which, if breached, give the creditors the ability to accelerate repayment of the debts, thereby giving the creditors leverage in subsequent restructuring negotiations.

Clearly, failure to pay any amounts owed, whether in interest or other fees, is a sign of financial distress. Equally, repeated requests for extension to payment deadlines are also hallmarks of financial distress. In most financial documents, such failure or extension will amount to events of default entitling the creditors to recall the entire debts.

In addition, breaches of certain contractual clauses may signal that a borrower is in financial difficulty:

- **Loan covenants.** These are provisions which require a borrower to notify lenders in the event of certain signs of financial difficulty, and which, if met, will amount to an event of default. These provisions are typically included to ensure that any signs of financial trouble are caught *before* an actual default occurs.
- **Representations and warranties.** These are statements and promises to the effect that there has been no default under existing financial agreements and that information provided to the lender is accurate. If any representations and warranties prove untrue, that will normally amount to a default entitling the lender to accelerate the debt, or as the case may be, cancel the bond issue.
- **"Material adverse change" provisions.** These are provisions which enable the lender to declare an event of default in the event that there has been a material adverse change to the borrower's financial position. This is not so much an early warning sign, as much as a clause which permits the lender to avoid needing to advance fresh funds in the event there are significant changes in the commercial climate.
- **Commencing negotiations with other creditors.** In certain loan agreements, the commencement of negotiations with other creditors could amount to a material adverse change, or alternatively, an event of default in itself.

Other signs of a debtor's financial distress may include:

- extraordinary changes in its management structure;
- extension of payment deadlines;
- taking on new debt, and/or provision of extra security in respect of existing credit facilities;
- irregular transfer of receivables (by way of factoring or invoice discounting);
- erratic payments to suppliers;
- suppliers refusing to continue their supply;
- departure of employees responsible for its finances and other key[42] employees; and
- issuance of demands for payment by other creditors.

[42] For example, the chief technology officer in a technology company.

The existence of an event of default (or a potential event of default) should not necessarily result in the immediate declaration of default. It may be prudent for the lender to instead use this as a prompt to request transparency and cooperation from the debtor, in effect kickstarting the workout process.

Principle 3

When it is apparent that a debtor may be experiencing financial distress, creditors' initial attitude should be one of support in order to avoid insolvency proceedings if rescue is viable. Such support at this early stage should include a non-contractual standstill, with a contractual standstill to follow.

Step 3: Assess the viability of a workout

Once early warning signs are detected, both the debtor and its creditors should take steps to determine if a workout is a sensible next step. It is tempting to say that at this stage, a standstill must be a priority to be granted contractually. This is often not realistic. At the initial stages, the creditors may well grant a de facto standstill, but they would not have built up the necessary trust and confidence in the debtor to enter into a contractual standstill.

It bears emphasising again that a workout is, fundamentally, a means of giving the debtor *time* to resolve its financial problems. Therefore, all parties should be looking to confirm that:

- the debtor's business is viable;
- any breach (or imminent breach) of covenant is marginal, and/or can be explained by the subsistence of exceptional circumstances;
- the debtor's problems are temporary in nature;
- there is a roadmap to recovery for the debtor, with realistic milestones; and
- the debtor's management team is capable of delivering on that roadmap.

In short, creditors should be looking to decide if (and the debtor seeking to establish that) the debtor is capable of a turnaround and that what the debtor really needs are time and short-term liquidity. The initial attitude of creditors should be one of support in order to avoid insolvency proceedings if rescue is viable. This is described in shorthand as the "rescue culture" since without this underpinning philosophical conviction and commitment, no progress can be made to subsequent phases of a workout.

Principle 4

Both the debtor and its creditors must have the joint objective of rescue in a workout. If the debtor is acting in bad faith manifesting itself, for example, by failing to disclose information, then the workout will fail.

As identified earlier in this guide, one of the common hurdles to workouts in Asia is that often the debtor is not serious towards the workout and seeks only to engage creditors in order to delay or fend off enforcement actions. In this scenario, the debtor's objective is to drag out the workout process for as long as possible whilst actively working on other solutions. This is bad faith.

A means of ensuring that sincerity governs the joint objective of rescue of the debtor and creditors is for both the debtor and creditors to engage appropriate experts to progress the workout to the next stage.

Step 4: Instruct appropriate experts

To carry out the assessments described above (and, indeed, to facilitate the process of a workout going forward), both the debtor and its creditors should obtain appropriate advice. Ideally, the debtor needs specialist turnaround and restructuring, corporate finance, legal and accounting advisors in place. It may potentially require public relations advice too.

Practice Tip 3

Both the debtor and its creditors should engage professional advisors to guide the workout process at an early stage. The level of advice sought and/or obtained and the types of professional advisors needed depend on the size of the debtor and what is being restructured.

The level of advice sought and/or actually obtained will depend on the size of the debtor. For example, a debtor that is a micro or small enterprise is likely to struggle to obtain as much advice as a larger debtor. Further, the types of experts required will depend on what is being restructured. A lot of the restructurings in Asia after the 1997 Asian Financial Crisis were "merely" financial restructurings that require a different skillset to operational restructurings at industrial complexes or facilities. The latter will require an examination of changes to plant equipment, technology, logistics, machinery and more.

There are two reasons why, from the debtor's perspective, engaging proper expert advisors is essential.

First, as will become apparent in the remainder of this guide, the process of navigating a workout (and adhering to the workout agreement thereafter) is not simple. Crucially, it is likely that the debtor will only have *one* chance at securing a successful workout – creditors are unlikely to have the patience for repeated attempts to broker a deal. Experienced advisers are therefore required to ensure that the process is guided by a steady hand.

Second, it is essential that the debtor has the confidence of its creditors if they are to be persuaded that there is a viable business plan in place. By working with experienced advisers at an early stage, the debtor is clearly signalling that it is in control of the process, that all creditors are likely to be treated fairly and equally, and that information provided to creditors has been independently verified. This maximises the probability of a successful workout.

From creditors' perspective, they should encourage the use of advisors to achieve a more durable workout. The costs for professional advice are borne by the debtor but are financed as part of the workout by the creditors.

Step 5: Put in place information sharing protocols

Both the debtor and its creditors will want to conduct initial due diligence before reaching any formal standstill arrangement or extending any existing facility in a workout. To facilitate that, the debtor needs to ensure that the requisite information is made available to creditors. Usually, a financial advisor will be appointed to conduct the due diligence and verify debtor information before reporting to creditors. Site visits will more than likely be required.

Practice Tip 4

The debtor needs to ensure that the requisite information is made available to creditors to facilitate the conclusion of any standstill agreement or the extension of any facility in a workout. The mode by which such information is shared will vary depending on the circumstances, subject to appropriate confidentiality arrangements as some information may be commercially sensitive.

At a minimum, commercial creditors participating in a workout will likely want to ensure that they have available to them:[43]

- a corporate structure diagram of the debtor;
- an analysis of bank debts owed by the debtor (including its subsidiaries);
- a list of the debtor's trade and other debts;
- a list of the debtor's assets;
- an analysis of the debtor's inter-company debts;
- copies of all facilities, agreements and guarantees of the debtor;
- short and medium-term cash-flow projections of the debtor;
- budgeting of the debtor, particularly on capital expenditure;
- management accounts of the debtor; and
- copies of key contracts of the debtor.

The above list is the minimum level of information required to evaluate the scale of the problems facing the debtor, the assets available to address those problems, the debtor's general business strategies, recent trading, cash flow and degree of exposure, and the positions of its various creditors.

Some of the information above may be commercially sensitive. The debtor will therefore be interested in ensuring that any such information (save for that which is publicly available) is provided on a confidential basis. It is possible for the information described above to be shared with *all* creditors, in which case such information will be confidential as between them.

43 See also World Bank Group, *A Toolkit for Out-of-Court Workouts*, 29 November 2017 at p 12.

However, it is also common for individual non-disclosure agreements (**NDAs**) to be signed with different creditors, depending on the order in which these creditors are engaged. In some cases, it may be thought that each creditor should be required to give the debtor written consent for disclosure or sharing of information to other creditors to avoid the risk of breaching its confidentiality duties under the relevant loans. The arrangements will depend on loan documents.

No mode of information sharing is inherently more desirable, and the decision on which mode to use will depend on the circumstances. One potential problem, however, with entering into NDAs with individual creditors at too early a stage in the workout is that it may result in creditors being segregated from one another, thereby hampering the formation of cooperative relationships among different creditors or even among different classes of creditors.

Step 6: Perform valuation of the debtor

An essential part of the workout process is valuation. This is because stakeholders (and distressed investors) will invariably have on their mind whether the debtor is worth more than its debts. The answer to that question will have an impact on several critical issues in the workout.

First, it determines which parts of the debts are impaired, and whether creditors will want to seek partial or even full equity ownership of the debtor as part of the workout agreement.

Second, it determines which creditors are likely to have leverage.[44]

Third, the proportion of equity which can or will go to creditors, and which creditors are willing to invest, will turn on the valuation of the business.

Practice Tip 5

Valuations lie at the heart of the workout process, and valuation issues will continue to suffuse the entire workout process, even after the preparatory phase. It is generally sensible to obtain at least provisional valuations at an early stage of the workout process.

Valuations therefore lie at the heart of the workout process. They are frequently complex and contentious, because different classes of creditors will have different interests in higher or lower valuations. For example, junior creditors will have more interest in higher valuations than senior ones.

It is likely that valuation issues will continue to suffuse the entire workout process, even after the preparatory phase. However, it is generally sensible to obtain at least provisional valuations at an early stage of the workout process. This is because creditors will want to know what the various exit options mean in monetary terms *before* committing to any standstill arrangement. This means reporting accountants may well need to provide liquidation and going concern values to creditors.

There is no single, universally accepted method of valuation. Different approaches are adopted in practice.

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44 See below for discussion of fulcrum creditors.

Principle 5

In a workout, each creditor is entitled to exercise its own commercial judgment but must be realistic and pragmatic and recognise the impact of its decision on other creditors and the debtor (or debtor group). No one creditor should act unilaterally or gain an unfair advantage, in particular that the security position of creditors relative to one another is preserved, and that each creditor will not improve its position during a standstill.

Step 7: Properly organise creditors in attitude and structure

The next step in preparing for a workout is to organise the various creditors. Several key points need to be born in mind in this regard.

In developed jurisdictions, creditors tend to be sophisticated and experienced in workouts. They appreciate that good faith and high ethical standards of commercial behaviour are essential for the current workout and for future workouts with their creditor-peers. In developing jurisdictions, these standards may not always be understood by creditors since local central banks or equivalent authorities may not have promulgated the expected norms required of creditors, such as those contained in this guide and/or promulgated by earlier iterations from the London Approach.

However, the real issue in developing jurisdictions is the behaviour of debtors, which as has been adverted to earlier in this guide, from practitioner experience, causes the most significant impediments to the success of a workout. Such debtor behaviour may take the form of lack of transparency on the part of the debtor (through ignorance, false hope, a sense of being untouchable in a jurisdiction where it may have undue influence at a State level, loss of face, loss of pride, etc.), inexperience of the debtor in terms of the necessary steps for a workout to be executed, and in many cases, dishonesty of the debtor in seeking to defraud creditors.

The participants that comprise the creditors have different economic motivations and internal investment rules as to what they can and cannot do. It is critical for all participants in a workout to understand the respective perspectives of each other creditor and class of creditors.

The main creditors in a workout have traditionally been banks who offer various facilities. Those facilities are too numerous to list exhaustively but include term loans, revolving loans, bank overdraft facilities, letters of credit, bank guarantees, lease finance, etc. Such facilities are often suitable for re-scheduling, and banks are well capitalised enough to do so.

Bank loans generally have strong protections for creditors in easily triggered events of default and deep covenants – although market fashion has varied over the years. Further, banks' own "provisioning policies may lead to a desire to advance new money for interest to keep the loan current, without a special reserve impacting on bank profits and balance-sheets".[45]

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[45] Philip R. Wood, *Principles of International Insolvency* (3rd ed, Sweet & Maxwell, 2019) at 37-003.

Banks with long-term relationships with the debtor may be more willing to reschedule debts and/or offer new money. As one commentator notes:

> "Differences of provisioning policies, capital adequacy constraints or policies on investment returns, influenced by management, auditors or their regulator, might provoke contrary attitudes to the acceptability of the work-out, e.g., if one bank would have to recognise a bad debt and reserve against it in its accounts, but the other would not."[46]

Increasingly creditors comprise bondholders. Bondholders are usually sophisticated investors such as insurance companies, mutual funds, pension funds and investment funds. Unlike bank loan debt, bond debt can be easily transferable and liquid. The bonds are usually publicly listed and can therefore simply be sold by the bondholders in order to achieve an exit from the capital structure of the debtor.

Bondholders generally do not have strong protections in events of default provisions or covenants. This means that unless the coupon payment – the interest payment – is missed, the debtor is not in default to the bondholders. In many workouts, therefore, banks can assert there has already been a default and participate in the workouts, while bondholders have no seat at the table.

Often there are very many bondholders who have bought the bonds issued by the debtor but who may not be internally structured to be able to conduct negotiations with the debtor and will not have the type of experienced workout teams that exists at international banks. These bondholders are unlikely to be able to offer new money.

Seeking consensus from bondholders is also notoriously difficult. Structurally, bonds usually contain collective action clauses, which prevents individual enforcement actions by bondholders when a debtor is in default unless a percentage threshold of bondholder support is met. Often a bond issue is constituted by a trustee which acts on behalf of the bondholders to monitor the debtor and/or take collective enforcement action. Trustees may be slow to take enforcement action even if the percentage threshold of bondholder support is met because the trustee will require substantial indemnities. Equally, such clauses may govern what percentage of bondholders is required to agree to a rescheduling of the debt.

Practice Tip 6

Both the debtor and its creditors should ensure that they have a comprehensive list of relevant creditors, and that all creditors who are interested in a workout participate, and failing which, that they are, at minimum, party to an informal moratorium on any formal enforcement action.

As explained earlier, a workout is an entirely consensual process, and there are no "cram-down" rules available. This means that creditors who have no intention of participating in the workout will *not* be bound by the resulting workout agreement, and could potentially upset negotiations by, for instance, commencing formal insolvency proceedings on their own.

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[46] Philip R. Wood, *Principles of International Insolvency* (3rd ed, Sweet & Maxwell, 2019) at 37-003.

Therefore, it is essential for both the debtor and its creditors to ensure that they have a comprehensive list of relevant creditors, and that all creditors who are interested in a workout participate, and failing which, that they are, at a minimum, party to an informal moratorium on any formal enforcement action.

Creditors should be open with each other about their exposure and cooperate in finding a solution, even across different classes of banks, bondholders and noteholders. For example, a creditor that sells its claims should inform the other creditors promptly.

Loan trading arguably makes the problem of creditor coordination more challenging, but at the same time provides an exit route for those unwilling to be involved in the workout and an entry for specialist turnaround investors.

Equally, decisions by creditors as to the workout need to be made collectively. Each creditor is entitled to exercise its own commercial judgment but must be realistic and pragmatic and recognise the impact of its decision on the other creditors and the debtor (or debtor group). No one creditor should act unilaterally or gain an unfair advantage, in particular that the security position of creditors relative to one another is preserved and that each creditor will not improve its position during a standstill. The decision to offer the debtor financial assistance – or not – should be a collective one by creditors.

Practice Tip 7

It is helpful at the outset to decide which creditors are likely to lead the workout process. Several factors will influence that decision, including, among others, the size, resources and experience of a creditor and the nature of the debts owed.

Separately, it is helpful at the outset to decide which creditors are likely to lead the workout process. The factors that influence this decision will vary from case to case.

For one, the size, resources and experience of a creditor will clearly influence who takes the lead. A multinational or institutional creditor with significant workout experience is likely to manage the workout process.

The nature of the debts owed will also have a significant impact on a creditor's desire to manage the process. A highly leveraged debtor with senior and junior debts will also have a "fulcrum creditor". Suppose, for instance, that a debtor has senior debt of $250m, mezzanine debt of $100m, and unsecured debt of $50m. If the debtor's enterprise value is $300m, the value "breaks" at the mezzanine lender. These creditors are fulcrum creditors, in that their recovery based on enterprise valuation is only partial. They are not clearly "out of the money" in the same way that an unsecured creditor is, but nor is their position fully secured. To the extent that reductions in debt level are required to sustain the debtor's business, it is therefore the fulcrum creditor who has the greatest interest in reaching a compromise and who has the most negotiating leverage.

Practice Tip 8

In some cases, a steering committee can be a helpful means of aggregating creditor interests and facilitating negotiations. In other cases, having a *lead creditor* (or a lead group of creditors) to manage and effectively administer the overall workout process can be sufficient. What is essential is that creditors all feel they are treated equally and fairly.

It is often the case that steering committees are constituted to represent creditors. Steering committees can be useful, particularly if such a committee has a mandate from the creditors they represent.

However, this may not always be the case – for example, in complicated workouts with many creditor classes, it is unlikely that disparate creditors will find that a steering committee (likely composed of banks) can properly represent their interests. In Japan, for example, creditors' committees, even *ad hoc* ones, are not established.

Financial creditors do not initiate workouts themselves, either singly or collectively. Indeed, the interposition of a steering committee can end up duplicating communications since the debtor may end up needing to deal with *both* the steering committee *and* individual creditors separately.

What is essential is that creditors all feel they are treated equally and fairly. For that purpose, there is no inherent need for a steering committee to exist and having a *lead creditor* (or a lead group of creditors) to manage and effectively administer the overall workout process can be sufficient. A lead creditor has a key role in liaising with the debtor. It is important to ensure that the lead creditor is remunerated for this work, usually by way of an indemnity from the creditors' committee. Professional standards, mutual respect and maintenance of confidentiality are expected. Conflicts of interest must be declared.

Nonetheless, in many cases, a steering committee can be a helpful means of aggregating interests and facilitating negotiations. As a general rule, a steering committee should ensure the following basic requirements are in place:

- the steering committee should comprise representatives from all (or substantially all) classes of creditors;
- the steering committee's remit should be clear, i.e., it should be clear what decisions the committee is authorised to make; and
- to the extent necessary, it should be made clear whether the steering committee is entitled to vote on behalf of the classes of creditors it represents (and if so, if there needs to be any weighting in its voting rights).

Step 8: Avoid the risk of default

It is likely that a debtor in financial distress is on the verge of defaulting on its debt obligations. Most of the time, the options which are immediately available to the debtor to avoid default are limited. Refinancing is not regularly available, unless the debtor has readily available collaterals and can thus execute a financing facility swiftly. Similarly, while it is possible to sell unencumbered assets (e.g., receivables) to achieve some short-term liquidity, creditors will often see the disposal of assets as a diminution of the quality of the borrower covenants.

Practice Tip 9

Short-term waivers of a pending financial covenant default are generally a sensible idea where a workout is being proposed to ease the immediate liquidity tightness and avert the immediate risk of default, benefitting the debtor and its creditors alike.

The most straightforward option to ease the immediate liquidity tightness and avert the immediate risk of default is to secure a short-term waiver of a pending financial covenant default. This waiver can be structured in diverse ways, including by waiving the relevant covenant for the next test date,[47] imposing a covenant holiday for an agreed period, or even a covenant reset. A creditor may also decide (prior to the imposition of a formal moratorium) to defer interest or principal repayments. In some Asian jurisdictions such as Japan, creditors are usually not able to properly discuss future business plans and other matters with a debtor to agree to any waiver. As a result, in many cases, the failure of payment by a debtor is a sudden event for creditors.

There are complexities accompanying waivers which are beyond the scope of this guide. These include difficulties in determining how covenants are to be calculated when they are "switched" back on, and the procedural complexities in approving waivers in syndicated loan structures (where waivers must typically be approved by a majority of lenders).

The instructive point for the purpose of this guide is that short-term waivers are generally a sensible idea where a workout is being proposed. Unless a debtor is clearly on the verge of insolvency (in which case a workout may not be viable anyway), an initial waiver will give the debtor breathing room to gather the necessary information and prepare for the workout. Moreover, from creditors' perspective, a defaulted facility can trigger cross-defaults in other financing arrangements, or trigger rights to renegotiate trade and supply contracts. This could collapse the workout before it starts, which in the long term results in a worse outcome for all parties involved.

47 The test date can be understood as the date in the covenant to a loan agreement that stipulates when the debtor must evidence that it has not drawn upon a revolving facility above a certain level of total borrowing commitments as specified in the covenant.

Phase 2: Contractual phase

Principle 6

A standstill should be agreed promptly on principal payment, and perhaps also on interest. Creditors should not withdraw facilities or hastily put the debtor into receivership, or initiate lawsuits demanding repayment. The purpose of the standstill is to allow the viability of rescue to be assessed. Realistically, however, although creditors will agree to a de facto standstill early on, they are unlikely to enter into a contractual standstill until the debtor proves its good faith by beginning to provide disclosure.

Function of the contractual phase

Once the preparatory phase has been concluded, the parties should be in a position where:

- there is a general consensus that the debtor has a viable business, for which a workout can resolve temporary financial difficulties;
- all key creditors are largely aligned as to the need and desirability of a workout, and a steering committee (if required) has been constituted;
- temporary waivers have been secured, avoiding the immediate risks of a default by the debtor; and
- some information sharing protocols have been put in place.

From this point onwards, the parties can begin to enter into formal contractual arrangements to progress the workout.

Key considerations in the contractual phase

There are three key considerations in the contractual phase.

- reaching a standstill agreement;
- scrutinising new money; and
- preparing a business plan.

Standstill agreement

The first step in the contractual phase of a workout is to enter into a standstill agreement. The standstill is essential, because it ensures that no creditor is allowed to unilaterally commence insolvency proceedings, an action which would likely destroy value for all other creditors. Creditors should endeavour to ensure that the debtor has sufficient liquidity to continue trading until a considered view of its prospects can be reached.

It is in the interests of all creditors that they enter into a standstill, which enables them to act collectively on the basis of shared information. The standstill agreement should also set out clear timelines and milestones for finalising workout proposals and potential investment, and possibly set out the consequences of breaches of the standstill by either a creditor or the debtor. If the debtor breaches the standstill, for example, by failing to meet timelines, the creditors should be at liberty to terminate the standstill and commence legal or enforcement action.

A standstill agreement could set out the consequences if a creditor breaches the standstill by taking legal or enforcement action. There may simply be an enforceable binding estoppel by reason of a specific performance clause, or a possible natural contractual mechanism could be that the debtor may immediately file for court protection. This may be seen as an escalatory provision destined to lead to a failed workout and court intervention at an early stage. The consequences set out in the standstill agreement will depend on the situation.

The precise terms of a standstill agreement will naturally vary depending on the circumstances, and often, on the jurisdiction in which the workout takes place. However, several key features need to be put in place in a standstill agreement.

First, the standstill agreement must cover all relevant facilities required by the debtor, including syndicated lines of credit, asset finance lines, overdrafts and any other ancillaries.

Second, as part of the standstill agreement, each creditor must declare its exposure at the drawn level on a specific, designated day. This is referred to as the "Day 1 Position", which is normally the day of the first creditors' meeting. Identifying the Day 1 Position serves two purposes – one, as a barometer for determining the amount of *new money* injected thereafter, and two, as a tool for determining what level of credit the creditors must continue to make available to the debtor.

Third, a creditor must undertake not to –

- commence or continue any recovery action and proceedings against the debtor or any of its assets;
- accelerate or require payment of any liability of the debtor in respect of the facilities which are subject to the standstill;
- take any action to enforce, or make demand under, any security, guarantee or any other similar arrangement;
- exercise any right of set-off;
- attempt to secure any further security from the debtor save with the prior consent of the other participating creditors;
- take any action referred to above, in each case against any of the debtor's subsidiaries (usually defined as the "Debtor Group"); and
- transfer or assign its rights or obligations under its existing facilities without the consent of majority creditors and on terms that the proposed transferees or assignees undertake with the creditor group to be bound by the standstill agreement.

Fourth, the debtor must undertake to continue managing and conducting the usual course of its business, and to avoid taking any action without prior approval of the participating creditors that would materially alter the status quo. This includes not incurring further indebtedness, granting further security on its assets, disposing of its assets, paying dividends, or buying back its own shares.

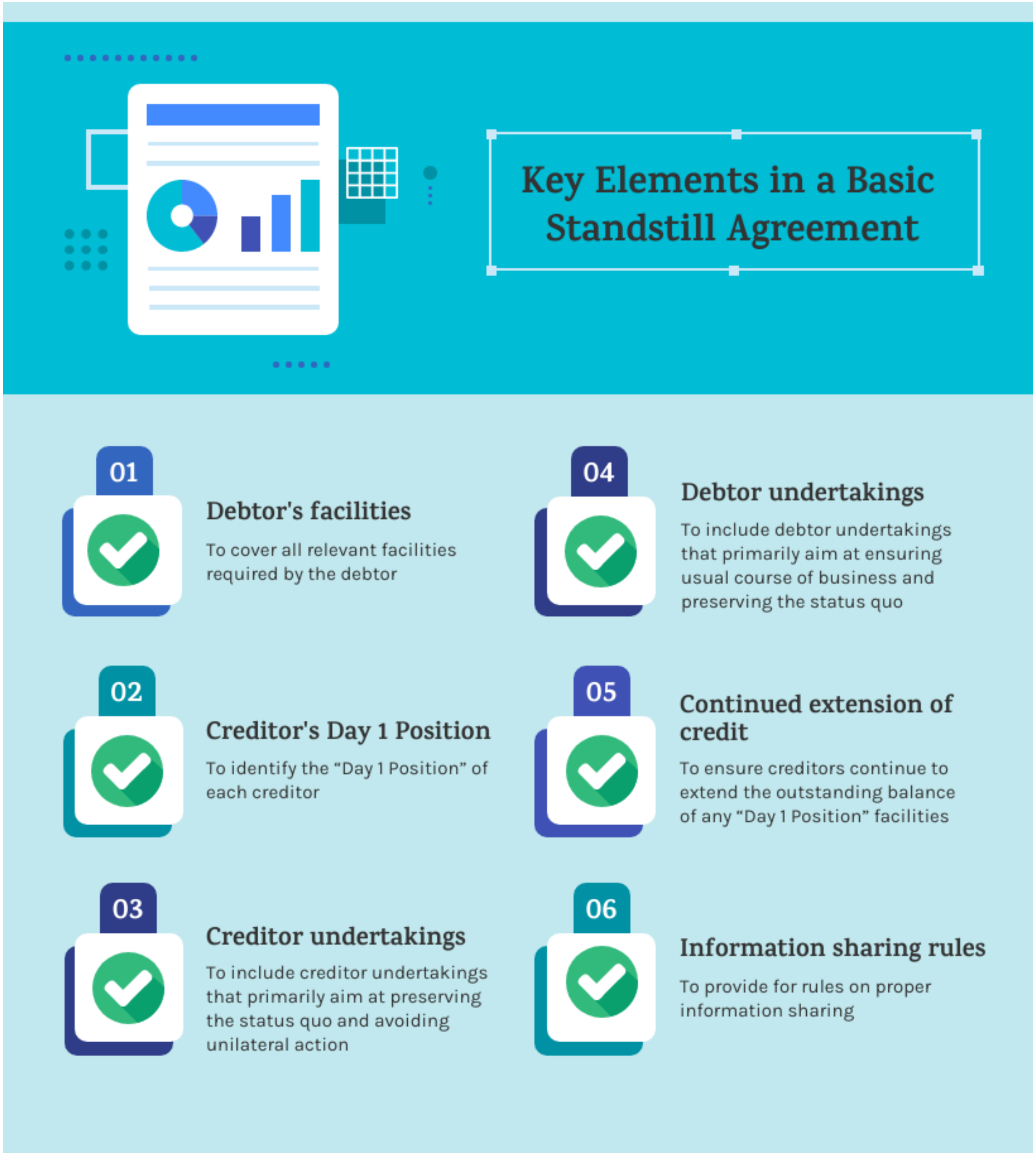
Fifth, participating creditors should continue to make available the outstanding balance on any facilities granted to the debtor as at the Day 1 Position.

Sixth, to the extent not already provided for, the standstill agreement should provide for information to be shared evenly, and on a confidential basis, among all participating creditors.

Certain minor adjustments may have to be made to this basic standstill agreement, depending on the jurisdiction in question and the nature of the facility extended. For example, with maturing contingent liabilities, such as guarantees or indemnity bonds, it may be necessary to make available equivalent replacement loans with a maturity date that corresponds with the termination of the standstill period.

The essential objective is that the parties preserve the status quo and buy the debtor additional time and liquidity to execute an effective workout.

Figure 7: Key elements in a basic standstill agreement



New money

It is often the case that creditors will agree to extend additional funding to the debtor as part of the workout process. This may be for the purposes of addressing critical liquidity needs or funding a critical asset disposal that will in turn de-lever the debtor. It may even be to simply ensure the debtor has sufficient working capital to enable the debtor's auditors to prepare accounts on a going concern basis.

There are a few points of general application to bear in mind about the provision of new money.

Practice Tip 10

As new money is almost inevitably afforded priority status, the quantum, timing, and rationale for extending new money are heavily scrutinised. The source of new money will vary depending on the nature of the workout. Granting security on the provision of any new money may be desirable but may not automatically follow.

First, and most critically, new money is almost inevitably afforded priority status. The quantum, timing, and rationale for extending new money are therefore heavily scrutinised, most notably by those creditors who are effectively subordinated to it and thus have their "old money" recoveries diluted by the extension of new money. This is also the reason why the Day 1 Position is essential – any funds extended after that date are considered new money.

Second, the source of new money will vary depending on the nature of the workout. In smaller workouts, new money is typically provided by each participating creditor in proportion to its original Day 1 Position. Alternatively, in larger and more complex workouts, new money may be provided by larger creditors with undrawn commitments. Further in the alternative, the bank with the largest exposure, which may have also taken on the role of the lead creditor in the workout, may provide the new money.[48]

Third, while it may be desirable for security to be granted on the provision of any new money, this does not automatically follow. Indeed, it may be wise on occasion to refrain from requiring full asset security because this may result in suppliers having an adverse reaction to the sudden grant of new security, particularly if the grant of any fresh security is registrable and thus discoverable in the public domain. Also, it may sometimes be the case that there simply are not any viable assets over which security can be granted.

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48 In Japan, for example, new money is primarily provided by the debtor's main bank, arguably a unique characteristic of the Japanese procedure.

Business plan

Principle 7

The debtor must present a credible and viable business plan during a workout.

It is essential that the debtor presents a viable business plan to its creditors during a workout. A large part of the purpose of entering into a standstill agreement is to enable the debtor to take stock and present to its creditors a picture of how it intends to resolve its financial problems. There is no point in creditors agreeing to a non-viable workout plan since it will only lead to the debtor being in distress again. The worst possible outcome in any workout is for the workout to fail such that the entire process becomes an expensive, pointless and slow-motion liquidation. In these circumstances, it would be better to have liquidated the debtor at the outset and save on workout fees.

Little concrete guidance can be given as to what the business plan of a debtor should be since it will necessarily vary depending on the business in question. However, thought should generally be given at this stage to how the eventual workout agreement will factor into the business plan. This includes considering:

- based on the business plan, when it is likely that the debtor will be able to begin servicing its debt repayments (and therefore when these repayment dates or maturity dates need to be deferred until);
- whether *additional* injections of cash are required (which may factor into the structure of any debt-for-equity swaps);
- what cash conservation measures will be implemented; and
- what assets will remain over which fresh security may be granted.

Phase 3: Restructuring phase

Function of the restructuring phase

The final phase of the workout process is to agree to and implement the terms of the workout agreement. The financial advisor will prepare a liquidation analysis for comparison against the proposed workout agreement. Any creditor decision must be informed by a report from the appointed financial advisor.

As stated earlier, one of the attractions of a workout is its flexibility. This means that the terms of a workout agreement can differ greatly from situation to situation. It is therefore unwise to set out any particular model or form which a workout agreement should take. Instead, this guide will point out a few points regarding considerations which recur frequently in workout agreements.

Recurring considerations

The restructuring phase of a workout usually involves the following considerations:

- workout exits;
- pricing and fees;
- financial covenants; and
- asset disposals.

Figure 8: Recurring considerations in a workout agreement

Common workout exits

Principle 8

Any workout agreement must set out what are effectively "exit" strategies for stakeholders, intended to maximise their value in a workout. A variety of workout techniques are available and can be deployed in combination and applied to different classes of creditors.

A core part of any workout agreement is to set out what are effectively "exit" strategies for stakeholders, intended to maximise their value in a workout. "An effective workout agreement recognizes the available options for creditors to collect their debts (or parts of them) while simultaneously facilitating a rescue of the enterprise."[49]

It is not possible for this guide to go into detail as to all those strategies.[50] As a brief overview, some strategies may include:

- debt buy-backs;
- debt-for-equity swaps; and
- extending repayment or maturity dates.

Debt buy-backs

Debtors can purchase their own debts (or issuers their own bonds) at a discounted price. The rationale for a debt buy-back is essentially as a de-leveraging device whereby a debtor effectively acquires its debt at a discount. It enables the debtor to reduce debt service costs, and if the debt is extinguished, generates covenant headroom for the debtor to avoid an event of default. Debt buy-backs can be funded by fresh equity from a sponsor.

Debt-for-equity swaps

In a debt-for-equity swap, creditors discharge the indebtedness owed to them by the debtor, in exchange for one or more classes of its share capital (or other similar equity-linked instruments). This is typically utilised where a debtor's balance sheet is no longer capable of servicing its indebtedness,[51] but there is a credible business plan which promises a turnaround in the longer term. In these circumstances, a debt-for-equity swap has the benefit of reducing leverage, easing cash flow concerns, and potentially attracting new investment. Some debtors may be wary of creditors who seek a debt-for-equity swap if the creditors are pursuing a loan-to-own strategy as a means of takeover.

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49 World Bank Group, *A Toolkit for Out-of-Court Workouts*, 29 November 2017 at p 2.

50 A useful general guide, albeit one based on the European debt market, is set out in Chris Howard, Presley Warner and Chris Beatty, *Restructuring Law and Practice* (3rd ed, LexisNexis Butterworths, 2022) at Ch 6.

51 In Japan, creditors are not enthusiastic about debt-for-equity swaps, especially in privately held companies. However, if the debtor is unable to raise funds to repay the debt, its creditors may be forced to subscribe to shares – most usually in listed debtors.

Extending repayment or maturity dates

Lenders can agree to extend the repayment or maturity dates on some or all of the debtor's existing loans, and potentially agree to other concessions like amortisation or additional covenant headroom, in exchange for improved loan terms (e.g., additional fees). This is a less intrusive solution and can typically be agreed with less difficulty than any other workout option. However, this solution does entail persisting with a "legacy" facility, and its suitability will depend on several considerations, including the financial position and prospects of the debtor in the medium-to-long term.

The workout techniques described above are by no means exhaustive, but they are some of the most common. They can be deployed in combination and applied to different classes of creditors.

Pricing and fees

Creditors will need to agree whether there are to be any fees, harmonisation of interest rates or increased commitment fees as part of the workout agreement with the debtor. There will also have to be clarity as to whether the creditors' costs and expenses in the workout are to be borne by the debtor. Creditors should ensure that these costs are reasonable. A creditors' committee will usually appoint legal, financial and technical advisors. These shared expenses reduce overall costs.

Financial covenants

Creditors will rely on financial covenants to fix a threshold below which they will cease support for the debtor. These covenants may take the form of:

- a financial objective that the debtor must not fall below (e.g., net valuation); or
- a given debt-to-equity ratio that the debtor must meet.

Creditors may also impose what are known as "short-leash" covenants as a cash conservation measure. Such covenants may include restrictions on dividend payments, further borrowing, asset disposals and acquisitions, and changes in management. There will, invariably, be reporting obligations attached to any such covenants.

In the case of a financially distressed debtor, the parameters for any financial covenants may need to be set with a measure of leeway. While the debtor may have a clear business plan, it is generally not wise to hew too closely to the limits of that business plan; otherwise the financial covenants may not be flexible enough to account for scenarios where a recovering debtor misses its covenant targets due to unexpected contingencies.

Asset disposals

There may well be a pre-agreed asset disposal programme in a workout, under which non-essential assets of the debtor are sold and applied to service its indebtedness.

Practice Tip 11

The main challenge of dealing with the proceeds of asset disposals in a workout is how such proceeds ought to be distributed. A useful starting point is to look at the Day 1 Position of each creditor.

As asset disposals may also take place *after* the workout agreement has been implemented (and potentially may not appear on the schedule of agreed disposals), it is prudent to ensure that the workout agreement itself contains a clear mechanism for calculating the entitlements of various creditors to the proceeds of any future asset disposal.

A particularly challenging aspect of dealing with the proceeds of asset disposals is how such proceeds ought to be distributed. Asset disposals may create problems if the workout is not successful. There is a risk of clawback actions in the event of insolvency. It is for this reason that most industry or government guidance[52] lays out general principles as to the equitable treatment of creditors and on preserving the priority status of creditors when crafting the distribution.

A useful starting point is to look at the Day 1 Position of each creditor and treat that as a barometer for deciding how a distribution is to be made. At face value, this means preserving priorities for creditors that do enjoy such priorities and generally disregarding the unsecured claims of non-institutional trade creditors.

The process can be much more complex than it would appear on its face. Some complications that usually arise are as follows:

- Where the debtor consists of a group of companies, it will be necessary to determine which subsidiary owns the relevant asset, and whether any creditors have direct claims against an asset-owning subsidiary. If so, such creditors have "entity priority", which may in principle entitle them to recover against the entity whose asset has been disposed of in priority to others that do not have such similar claims as at Day 1.
- Similarly, restructuring a group of companies necessarily means addressing the problems arising from inter-company borrowings. For instance, a creditor may have advanced facilities to the parent in a group of companies, and such facilities are then funnelled around the group on an inter-company basis. Absent a group guarantee, these inter-company claims will need to be incorporated into the calculation of the creditor's Day 1 Position, since the inter-company claims are, in effect, an asset to which the parent (and thus the creditor) would have recourse.

[52] For example, Pen Kent, "The London Approach" (1993) Q1 *Bank of England Quarterly Bulletin* 110; INSOL International, *Statement of Principles for a Global Approach to Multi-Creditor Workouts* (2nd ed, 2017); Bank Negara Malaysia, "Corporate Debt Restructuring Committee Participants' Code of Conduct," last updated 18 August 2020 and the Association of Banks in Singapore, *Principles & Guidelines for Restructuring of Corporate Debt: The Singapore Approach*, undated.

- The Day 1 Position of an existing creditor can only ever be used as a starting point, because it is likely to be distorted by the new money that is later advanced to the debtor, since any creditor making new money available will likely insist on its new money being repaid with priority.

In addition, asset disposals may take place *after* the workout agreement has been implemented (and potentially may not appear on the schedule of agreed disposals). It is therefore prudent to ensure that the workout agreement itself contains a clear mechanism for calculating the entitlements of various creditors to the proceeds of any future asset disposal. Such a mechanism can take various forms:

- The parties can instruct reporting accountants to model the competing claims based on a variety of factors, including the impact of new money, existing or new security and any "ancillary" facilities such as hedging instruments. The model can then be referred to in the workout agreement itself. This has the advantage of precision but the disadvantage of complexity which not only slows negotiations down, but may also generate disputes in future.
- The parties can simply look at Day 1 Positions, and perform a rough calculation of each creditor's pro rata recovery from the debtor, disregarding the complexities arising from inter-company claims, new money, currency fluctuations, etc. This has the advantage of simplicity and speed, but a risk of potential perceived unfairness.
- A combination of the above approaches, which will entail constructing a simplified model taking account only of the impact of certain limited factors (e.g., inter-company debt or new money).

Conducting a workout in multiple Asian jurisdictions

Conducting a workout in multiple Asian jurisdictions

The complexities that can arise when a workout crosses national boundaries are manifold. It is beyond the scope of this guide to set out in detail each of the different issues that can arise or prescribe a fixed method for dealing with those issues. After all, each workout faces its own particular problems, and specialist advice is essential to properly address them.

This part of the guide will instead outline some of the various categories of problems that can arise in multi-jurisdictional workouts and set out a rough model of best practice which helps to place both the debtor and its creditors in the best position to navigate these challenges.

A useful starting point is to recognise that a workout can cross jurisdictions in diverse ways:

- the debtor may comprise companies incorporated in different jurisdictions;
- the debtor owns assets, or employs people, situated and based in different jurisdictions; or
- the debtor has creditors based in different jurisdictions.

These scenarios can occur in isolation or in combination. It is helpful to have this taxonomy in mind, however, because each scenario creates distinct types of problems, as explained below.

Coordination issues

If a distressed debtor is multi-jurisdictional in nature, for example, an oil company with Houston Headquarters, oil refineries in Indonesia, finance functions in Singapore, a marketing team in the Philippines and a scientific research centre in Japan, that typically presents fewer problems with coordination and decision-making. This is because the debtor will normally have a structure for deciding how decisions are to be taken at the group level. The debtor is by its nature rather accomplished at coordination and probably logistics too.

Instead, coordination issues mainly arise if the debtor's *creditors* are located in multiple jurisdictions.

Some of these problems stem from the relatively prosaic fact that simply arranging *meetings* is difficult. Parties may not speak the same language or may operate in different time zones. Ironically in an age where digital communication is increasingly normalised, parties tend to be more reluctant to meet in person, which creates its own problems. Furthermore, while creditors who operate within the same jurisdiction are much more likely to have established relationships, this is much less likely when creditors are from different jurisdictions. Where creditors are from different jurisdictions, their *professional advisers*, such as lawyers and accountants, will naturally also hail from different places. This means that they will apply different professional standards and view problems through a different analytical lens.

In isolation, none of these coordination issues is impossible to overcome. But it bears emphasising that workouts require parties with no shared commercial interest to mutually sacrifice their own interests in pursuit of a common solution.

To secure cooperation in the best of times can be difficult, let alone in a cross-border workout. Mediation is increasingly being seen as one of the most viable ways to encourage workouts in a cross-border context and falls within the form of cooperation contemplated by Article 27(a) of the UNCITRAL Model Law on Cross-Border Insolvency. Similarly, the World Bank notes that "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."[53]

Enforceability issues

Which exit strategies are deployed in a workout will often turn on whether that strategy is enforceable. This question is complicated in a multi-jurisdictional workout because different jurisdictions have different laws.

Foreign investment laws will often complicate the picture. These laws have proliferated in recent years, particularly since the start of the Covid-19 pandemic. For example, both China[54] and Vietnam[55] have regulations to the effect that foreign investment is prohibited or restricted in certain industries or business lines. Foreign investments into Australia[56] and India[57] are similarly subject to regulations and reviews. Most foreign investment laws require government approval for certain types of acquisition prior to completion and impose significant civil (and sometimes criminal) penalties for non-compliance.

Executing a debt-for-equity swap (or even insisting on equity as security) may inadvertently trigger merger control laws.[58] These laws differ greatly across jurisdictions, are highly technical, and depend on a variety of different factors in application, such as the geographic spread of a debtor's turnover and assets and the number of acquirers who will acquire shares through the swap.

53 World Bank Group, *Principles for Effective Insolvency and Creditor/Debtor Regimes*, 22 April 2021 at B4.1.

54 The Foreign Investment Law of the People's Republic of China came into effect on 1 January 2020 whereby foreign direct investment is prohibited and restricted in a number of areas through the use of a so-called "Negative List".

55 Decree 31/2021/ND-CP of the Government dated 26 March 2021 contains a list of 25 business lines in which foreigners are not permitted to invest, including trading in goods and services subject to State monopoly, press business, public opinion polls, tour business (except international tours).

56 Foreign investment into Australia is regulated by the Foreign Acquisitions and Takeovers Act 1975 (No 92 of 1975) (Cth) (Australia) and associated acts and regulations and is administered by the Foreign Investment Review Board.

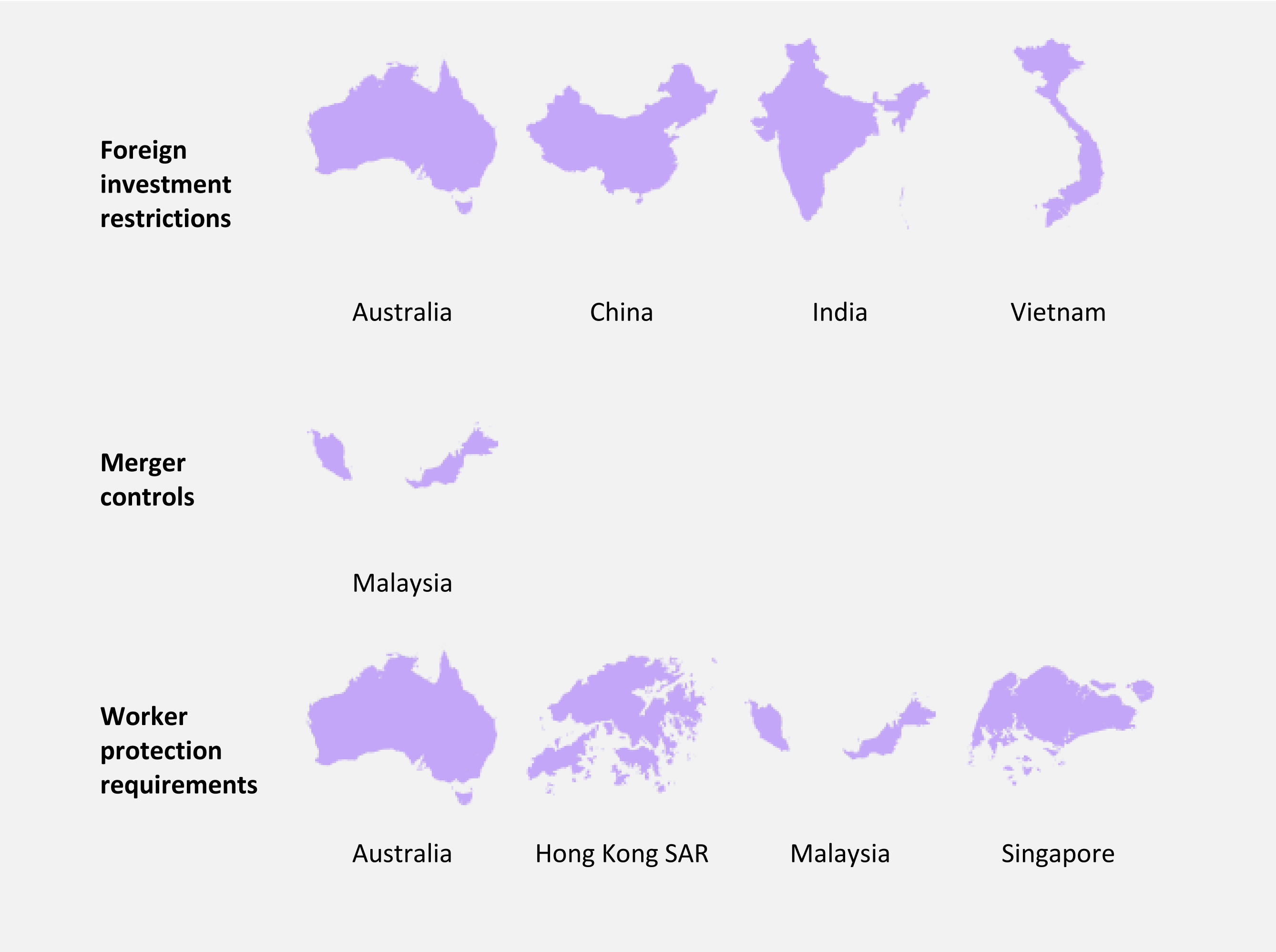
57 Foreign Exchange Management Act, 1999 (India) section 6(3) read with Reserve Bank of India, "Foreign Exchange Management Act Notification No. FEMA 20/2000-RB", 3 May 2000.

58 For example, In Malaysia, policies on foreign investor participation are in the form of equity ownership or board representation restrictions.

Where a workout involves cost-cutting measures and redundancies, employee protection laws will invariably be engaged.[59] Indeed, it is not just a matter of navigating the legal protections (which vary greatly across Asia), but also having the required relationships and expertise to deal with union opposition.

Different jurisdictions have different rules about how and whether security interests can be enforced, the types of assets against which security can be taken, and different formalities that need to be completed to register the security interest. As such, care must be taken to determine where a relevant asset is sited *before* decisions are taken about whether to grant a security over that asset.

Figure 9: Examples of enforceability issues in Asia



59 Most jurisdictions have laws that are superimposed on employment contracts such that freedom of contract in employment is in some way curtailed. Wrongful dismissal rules in Hong Kong SAR and Singapore, and unfair dismissal rules in Australia and Malaysia, are some examples for Asia.

Tax issues

Tax issues invariably crop up in any workout. They are all the more complex in multi-jurisdictional workouts. The complexities are not limited to the need to deal with different tax regimes. What creates particular difficulty is if the exit strategy adopted in a workout agreement spans a period of years, and it is anticipated that there will be changes in the situs of an asset.

To give one example, the management (or employees generally) of a debtor may be granted equity incentives as part of a workout agreement. A party may agree to structure these incentives such that he or she enjoys tax advantages in a particular jurisdiction. But what is tax-efficient in one jurisdiction may not be efficient in another. That becomes a challenge where (a) there are multiple managers of similar level operating in different places; or (2) over the life of these incentives, the managers are likely to move jurisdictions.

Recommended best practice

Principle 9

In a multi-jurisdictional workout, organising a steering committee or appointing a lead creditor is of particular value. To the extent feasible, parties (or at least those with common representation) should appoint *common* teams of professionals and experts among them. Each team of advisors should be composed of professionals from *all* affected jurisdictions. Specifically for a legal team, even as it may comprise lawyers and firms from multiple jurisdictions, it is generally wise to ensure that, as between lawyers, there is a clear understanding of which firm is to take the lead.

The types of challenges for a multi-jurisdictional workout described above come in a multitude of variations, and it is simply not possible to prescribe solutions for all those variations. Rather, some best practices are recommended in this guide which may help put all parties in the best position to succeed. Indeed, many of these recommendations are extensions of the Principles or Practice Tips outlined in the preceding parts of this guide.

First, organising a steering committee or appointing a lead creditor is of particular value in a multi-jurisdictional workout. This is because appointing representatives (who are ideally situated *within* the jurisdiction from which the workout is primarily organised) minimises coordination issues and ensures that chains of communication can flow primarily through the representatives rather than through a litany of diverse creditors.

Second and similarly, it is recommended that, to the extent feasible, parties (or at least those with common representation) appoint *common* teams of professionals and experts among them. This likewise has the advantage of minimising coordination issues since there will always be a central intermediary through which negotiations can take place and decisions can be made. More importantly, it ensures there is coherent, joined-up thinking about how decisions can affect *all* parties in *all* jurisdictions, since there will be *fewer* sets of professional advisors and those who are appointed on behalf of a *range* of different parties based in different jurisdictions will be required to think outside of their limited silos.

Third, it is advisable for each team of advisors to be composed of professionals (be it lawyers or accountants) from *all* affected jurisdictions. These teams should be put together from the outset, because doing so enables them to flag any enforcement or tax issues that can arise from the very beginning. It is rarely a good idea for foreign, jurisdiction-specific advice to be taken only *after* the exit strategy has been formulated in a workout, since enforcement or tax issues could prove fatal to that strategy. It is thus far better for potential flaws to be caught earlier rather than later.

Fourth and relatedly, even as legal teams may ultimately comprise lawyers and firms from multiple jurisdictions, it is generally wise to ensure that, as between lawyers, there is a clear understanding of which firm is to take the lead. That will usually, but not invariably, be the lawyer based in the jurisdiction where the debtor itself, or the lead creditor, is based. This minimises coordination issues and ensures that the legal team with the closest connection to the ultimate decision-makers (and thus the best understanding of their needs) is also the one consolidating information and advice. Further, although it may go without saying, it is also helpful to ensure that the professionals appointed have experience managing multi-jurisdictional insolvencies and workouts.

Recommended approach to adoption of this guide

Recommended approach to adoption of this guide

First, this guide, and its Principles and Practice Tips, are intended to provide practical guidance on how to conduct a workout in Asia and to promote convergence in the philosophy and approach that Asia takes to workouts. It sets out a model of best practice, is descriptive, comparative and hands-on, and espouses high-level principles for progressing workouts in Asia. As such, this guide can act as a reference point for practitioners, businesses, regulators, judges and policymakers alike.

Second, serious consideration needs to be given to creating the necessary tax environment to motivate debt forgiveness in a workout which leads to all of the greater economic benefits already espoused in this guide.[60] At this stage, we cannot hope for Pan-Asian tax harmonisation, but if many restructuring transactions — such as outright write-offs, debt forgiveness, debt-for-equity swaps and simple sales of assets in exchange for debts — result in a tax obligation on the debtor or a creditor, workouts are systemically impeded. Asian jurisdictions, in particular their finance authorities, should carefully consider the tax treatment of debt forgiveness and the deductibility of losses. Both obstacles occur, for instance, when a creditor accepts a partial write-off or a reduction on the principal of a loan in a workout agreement.

Third, it is believed that, at the present time, advocacy and promotion of this guide by the finance ministry, financial sector, central bank, banking association, and legal and accounting professionals in each Asian jurisdiction would seriously enhance the prospect of successful workouts in Asia. Conferences, seminars and other educational fora should be convened by both the public and private sectors at national and regional levels to encourage the early adoption of this guide in a workout. It would be a simple matter to include reference to this guide in commercial loan documentation in a non-binding section after the dispute resolution and governing law clauses, encouraging parties to behave in accordance with the Principles set out herein. One might go further and make it a covenant in some respects. It would be equally simple for creditor institutions to roll out training programmes about this guide in-house. Finally, a regional roadshow to promote this guide with distinguished local guests to open each event would serve the purpose well.

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60 More about this point, albeit in the context of micro and small enterprises, can be found in Aurelio Gurrea-Martínez, *Guide on the Treatment of Insolvent Micro and Small Enterprises* (Asian Business Law Institute and International Insolvency Institute, May 2022) at Aspirational Principle 2 (Grant Tax Incentives for Debt Restructurings).

Annexures

Glossary

Definitions have been taken from the *Guide on the Treatment of Insolvent Micro and Small Enterprises in Asia*, where applicable, for the purpose of ensuring consistency.

Absolute priority rule refers to, in the context of the United States, section 1129(b)(2) of the U.S. Bankruptcy Code which prescribes the hierarchy for payment in a liquidation plan. In general, senior creditor classes must be paid first and in full before junior creditor classes can be paid, followed by shareholders who are paid last.

Claim is a right to payment from the estate of the debtor, whether arising from a debt, a contract, or any other type of legal obligation, whether liquidated or unliquidated, matured or unmatured, disputed or undisputed, secured or unsecured, or fixed or contingent.

Collateral is an asset that is given by a borrower or a third party to secure a loan or the extension of credit. The lender can seize the asset, or collect proceeds associated with the sale of the asset, if the borrower breaches its obligations.

Cramdown is a mechanism available in some jurisdictions which enables a reorganisation plan to become binding on dissenting classes of creditors that have not voted in favour of the reorganisation plan.

Debtor-in-possession is a governance system of insolvency and restructuring proceedings that permits debtors to keep running the business after the commencement of the insolvency proceedings, without being subject to the appointment of any insolvency practitioner.

Fulcrum creditor is a creditor at whose level the debtor’s value breaks.

Insolvency is when a debtor is unable to pay its debts as they fall due or when its liabilities exceed the value of its assets.

Ipso Facto clauses are contractual clauses that allow a party to terminate or modify the contract upon the occurrence of an event typically involving a situation of insolvency or the commencement of an insolvency proceeding.

Liquidation is a proceeding in which the debtor’s assets are sold and the proceeds are distributed to creditors in accordance with the ranking of claims established in insolvency legislation.

Loan-to-own is a strategy whereby a financial investor seeks to convert debt obligations into an equity stake in a target post its restructuring, with the aim of taking control of the target.

Mezzanine debt is usually the middle layer of capital that falls between secured senior debt and equity.

Moratorium is a mechanism providing debtors with a limited period of time during which creditors’ rights to seek legal remedies are suspended or restricted. An automatic moratorium exists when the effects of the moratorium arise automatically upon an application by a debtor seeking to initiate an insolvency procedure. In some jurisdictions, the term "moratorium" is known as "stay".

Reorganisation is a procedure by which the financial situation of a debtor is sought to be restored by using various means including debt forgiveness, debt rescheduling, debt-for-equity swaps, and sale of the business (or parts of it) as a going concern.

Restructuring is an exercise undertaken by a debtor in relation to its business, operations or financial structure which seeks to restore the debtor's viability and competitiveness. This guide only deals with financial restructuring, and therefore with the adjustment of the debtor's financial obligations.

Scheme of arrangement is a procedure potentially used for debt restructuring that exists in most common law jurisdictions, including Asian jurisdictions such as Australia, Hong Kong SAR, India, Malaysia, and Singapore.

Secured creditor is a creditor or lender that has been given collateral for the extension of credit, loans, or bond issuance, and that is recognised as such by insolvency law.

Standstill agreement, in the context of restructuring and insolvency, is an agreement whereby creditors agree not to demand payment of their debts or take enforcement action against the debtor for a period of time during which attempts will be made to negotiate a consensual restructuring.

Standstill period is the period of time specified in a standstill agreement during which enforcement action will not be taken against the debtor.

Steering committee, in a workout, is a committee that comprises multiple creditors who will oversee the restructuring of a debtor on behalf of all creditors.

Unsecured creditor is a creditor or lender which has not been given collateral for the extension of credit, loans, or bond issuance. It also includes a creditor who is owed money as a result of breach of contractual claims, tort claims or other claims such as tax claims.

Workout is a private contractual agreement between a debtor and its creditors with the aim of easing the debtor's debt servicing burden to enable the debtor to continue its business activities. This guide only discusses out-of-court workouts, which are workouts with no judicial involvement.

Workout agreement is an out-of-court, contractual agreement reached between a debtor and one or more of its creditors after negotiations during a workout to restructure the debtor's debts.

References

Primary sources

Statutes and codes

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