Restructuring in the Shadow of the Law. Informal Reorganisation in the Netherlands

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Summary

…Durante causa durat effectus…

This study focuses on the practice of restructuring companies in financial difficulties, and so-called informal reorganisations in particular. An informal reorganisation is a reorganisation route which takes place outside the statutory framework – in the 'shadow of the law' – with the objective of restoring the health of a company in financial difficulties within the same legal entity. Within an informal reorganisation it will often be necessary to reach an agreement with the company's creditors about changing agreements made earlier with regard to provided capital. When this change is effected on a voluntary basis, this is a case of a so-called workout.

For this study, the following problem definition has been formulated (chapter 1):

Which measures are discovered in Dutch companies in financial difficulties which can prevent legal proceedings such as moratorium, Private person Fresh start Proceedings (PFP) and liquidation? Are there any practical bottlenecks which can be removed (whether or not with new legislation)?

In order to be able to answer the problem definition, I conducted a literature search (chapter 2) and carried out 35 comprehensive case studies at the four largest Dutch banks and three consultancy agencies in the field of business restructuring (chapter 3). Furthermore, four surveys were held among credit managers, accountants, insolvency lawyers and management advisors, while 23 interviews were held with various stakeholders (advisors and bankers in particular) of informal reorganisations (chapter 4). Partly on that basis, three proposals were formulated, that is to say the introduction of a so-called 'Statement of Principles for Informal Reorganisations', a so-called 'Banks and Businesses Code' and the structure of mediation during informal reorganisations (chapter 5). The three proposals are an attempt to achieve a more institutionalised approach to informal reorganisations ('Institutionalised Informal Approach') and they aim to increase the efficiency of restructuring processes. Following on from the London Approach, I have called the Dutch version of this approach 'Dutch Approach'. Chapter 6 concludes the study with an overview of the main findings.

From the case studies, interviews and surveys it emerges that the main causes for financial difficulties can be traced back to (a combination of) poor management (management not reacting adequately to both positive and negative developments within and outside the company, often on a strategic level), an excessive cost structure and, following on from this, inadequate management of the company based on (financial) management information. It is remarkable that the case studies show that economic conditions are often *not* the cause of financial difficulties. Furthermore, only three dossiers speak of *possible* fraudulent activities.

Respondents have indicated to prefer informal reorganisations to formal reorganisations. However, the later an informal reorganisation is initiated, the bigger the chances of failure. In general we can say, as all sub-studies show, that companies often start a necessary reorganisation too late. Interested parties in companies (for example banks, accountants and advisors) must play an important role in the timely observation of (potential) problems ('early warning'). Trade organisations in the business sector, the banking sector and the authorities can make entrepreneurs and their interested parties (more) aware of imminent financial difficulties and how to deal with them.

It is difficult to gauge the number of informal reorganisations in the Netherlands, since these processes occur in (relative) silence and are not registered. However, a conservative estimate, based on the success percentages of banks and liquidation figures for the period 2003-2004, yields a result of about 26,000 informal reorganisations in 2003.

Both the literature search and the case studies demonstrate that informal reorganisations often consist of two processes which are closely connected: *restructuring the business operations* and *financial restructuring*. When a company runs into difficulties, the first attempt will be to try and make the business operations, which are usually loss-making, profitable again. This is often done by appointing third parties (advisors/interim managers), improving the company's efficiency (reducing costs and closing loss-making business units), as well as improving the management information system. This is in line with the causes identified. It is striking that strategic reorientation often does not have the highest priority, while most problems can be traced back to this.

Appointing advisors/interim managers/mediators can be a major contribution to the success of an informal reorganisation. The main reason for this is that the relationship between management and creditors has often already been under pressure for quite a while. A third party, as a relative outsider, may be able to prevent or heal a breach of trust. Although the appointment of third parties is generally regarded as a positive thing, it is advisable to examine whether it is possible or desirable in the Netherlands to set up a knowledge centre for all players in the (consultancy) field of companies in financial difficulties. This way it will be possible to work on continued professionalisation, more specific training and systematic research. The authorities and trade organisations can act as a 'catalyst' in this respect. Furthermore,

we, partially on the initiative of the Dutch Foundation for the promotion of Mediation (NMI), must consider to what extent and in what way specialised mediators (so-called *Reorganisation-mediators*) can be (increasingly) deployed in the practice of informal reorganisations.

When it is not possible to make a company viable again just by restructuring the business operations, an attempt is often made to implement financial restructuring either simultaneously or afterwards. All sub-studies show that this requires careful handling, as this form of restructuring often entails a 'sacrifice' of one or more creditors involved. The most common measures within the framework of financial restructuring are, as demonstrated by both the case studies and the surveys, deferring repayments and reduction of the nominal debts with (ordinary) creditors. Furthermore, the search is often on for new risk-bearing capital (equity) in order to finance the reorganisation process and to improve the balance sheet ratios. The case studies also show that banks are often prepared to provide additional funds and to grant so-called waivers in order to increase the chances of a successful informal reorganisation. In addition, the case studies demonstrate that in Dutch practice more (non-financial) options are used in respect of financial restructuring than *generally* mentioned in the literature. Some examples are: banks threatening to withdraw the credit (to induce the company to actually reorganise), providing additional securities, cash sweeps and taking over finance agreements. Trade creditors, like banks, also often continue to deliver despite outstanding accounts. Legislation regarding commitments in this respect could lead to a less flexible attitude of these creditors in an earlier stage, since their risks will increase. The result will probably be that the willingness to deliver and/or finance will diminish in advance. More generally, interested parties in companies in financial difficulties must ask themselves to what extent risks may be transferred to the providers of risk-avoiding capital (debt).

In the Netherlands the role of the banks during informal reorganisation is crucial and in general positive. As they say themselves, banks do not profit from liquidations. Not only is future turnover lost as a result, but loans are often insufficiently covered by rights of pledge and mortgage. Liquidation can lead to extensive losses. This is one of the main reasons why banks frequently assume a 'supervisory and disciplinary role' with regard to management. If this is not complied with, the pressure will be increased. In addition to a (healthy) pressure on management, it is often indicated that the company must try and find additional risk-bearing capital, whether or not in the form of a takeover (especially when the company is unable to rationalise the company via strategic and operational restructuring alone). This partly restores the balance sheet ratios and creates healthier solvency (again). It is striking that many interviewees (advisors, credit managers and accountants) regard the bank's role in companies in financial difficulties as negative. The element of withdrawing credit in particular and the refusal to make additional credit available – when the occasion arises – plays an important role in this.

Banks take the position that they as providers of risk-avoiding capital cannot allow themselves to run any additional risks in situations of financial difficulties and for that reason they are extremely careful in their decision to continue financing (not to withdraw credit) or to make additional credit available. However, many interested parties regard the bank as *the* organisation to keep or make (additional) credit available in times of trouble. Furthermore, other parties are often of the opinion that banks are always better off than the ordinary creditors due to provided securities. From this a moral duty implicitly arises (this seems to be the opinion anyway) to make additionally required liquidity available in times of financial difficulties. Banks, however, regard these securities as a necessary tool to minimise normal risks. In addition, they draw attention to the lower realisable value of assets during a possible liquidation (the case studies show that banks, despite issued securities, must often make provisions for loans which cannot be repaid). The subsequent argument that banks always dispose of more information compared to the ordinary creditors is parried with the statement that anyone can familiarise himself with the financial situation of a company by making some enquiries. The above differences of opinion lead to a tense relationship between the various interested parties. Informal reorganisations may be jeopardised as a result of this. It appears that the difference between risk-bearing financing and risk-avoiding financing is not always seen in practice. Misunderstandings and miscommunication can be avoided by means of more information and awareness in this field, through training by the authorities, trade organisations and/or banks. A so-called 'Banks and Businesses Code' should be introduced following on from the Statement of Principles of the British Bankers' Association, in the Netherlands at least.[1] This code, in accordance with the British model, should be aimed at improving the relationship between bank and company, by making clear to each other at the start of the credit relationship what is to be expected from each other, especially in the event of (imminent) financial difficulties. The expectation is that the process of providing credit becomes more transparent and objective as a result. This may create a win-win situation for both parties.

From all sub-studies it appears that it is important for parties to trust each other and to reach agreement about the reorganisation measures. An important reason for informal reorganisations to fail can be traced back to the loss of trust between the company and its interested parties. Trade creditors are often 'kept in suspense' and at a certain moment they are no longer prepared to cooperate on a workout agreement. Banks lose confidence as soon as management underestimates the seriousness of the situation and takes inadequate

1 After the manuscript was closed, a code of conduct was signed between the Dutch trade association for employers in SMEs (MKB-Nederland) and the Dutch Federation (consultative body) of Banks (NVB). See www.nvb.nl. However, this code of conduct is not as extensive as proposed here.

action. This is enhanced by insufficient insight (non-transparency) among creditors into the true financial situation of the company which is often the result of (over) optimistic prognoses in combination with an inadequate management information system. Failed informal reorganisations share the fact that, as demonstrated by both the case studies and the interviews, the following elements are present in its execution:

- Management and shareholders have a passive attitude with regard to the informal reorganisation.
- The company provides the interested parties with insufficient insight into the true financial situation.
- The company is not able to timely raise risk-bearing capital (whether or not in the form of a takeover).

Successful informal reorganisations on the other hand share the fact that the following elements are present in its execution:

- The business operations are efficiently and quickly restructured by management (often with the help of third parties).
- Important interested parties (financiers) are involved in the reorganisation process.
- There is sufficient transparency with regard to the financial situation and the intended informal reorganisation.
- An active search for injection of risk-bearing capital (whether or not in the form of a takeover) is undertaken.

Based on the above it can be concluded that the chances of a successful informal reorganisation improve in practice if the following conditions are met:

- Active attitude by management and shareholders with regard to the informal reorganisation.
- Involving important interested parties (financiers) in the reorganisation process.
- Adequate reorganisation of the business operations.
- Transparency with regard to the financial situation and the intended informal reorganisation.
- Injection of risk-bearing capital (whether or not in the form of a takeover).

Reorganising companies in financial difficulties can involve high costs. From some case studies, as well as the interviews and surveys, it appears that redundancy costs and employees' employment protection are major bottlenecks in the Netherlands. It appears to be difficult to dismiss personnel in an inexpensive manner during informal reorganisations. This is a significant disadvantage compared to a formal reorganisation procedure such as the transfer

of assets following liquidation (restart). In order to make a higher number of informal reorganisations a success, it should be possible to make staff redundant in a less expensive manner. When the possibilities to this end are increased within a legal reorganisation procedure such as – in the case of the Netherlands – moratorium, these possibilities must at least be created in informal reorganisation procedures as well. Misuse must be avoided at all times however. A special body could be set up in the Netherlands (for example a department of the Enterprise Division of the Amsterdam Court of Appeal) which specialises in issues that arise during informal reorganisations and which takes into account both legal and commercial interests.

Another disadvantage of informal reorganisations is that a workout agreement (which has been adopted by a majority of the ordinary creditors) can be imposed on reluctant creditors only under special circumstances. From the case studies and interviews it appears that in practice this is often handled in a flexible manner. The argument that courts can impose such an agreement within the procedure of moratorium and that the return of a formal procedure will be lower, often speeds things up. Also, there appears to be a bottleneck with regard to agreements with remission of the remaining debt. In the surveys and interviews, creditors indicate to find it unjust to have to suffer a loss in favour of the owners of the company (the reluctant attitude of many creditors in practice can also be traced back to this). Creditors therefore prefer deferment of repayments if possible and insofar as is necessary. Next to that, workout agreements must be concluded in the same manner as compositions within the moratorium scheme. If this is not possible, (more) companies will enter into a legal procedure quite unnecessarily. Moratorium must be regarded as a *tool* to ratify, if necessary, informal reorganisations ('pre-pack procedure') and not as an independent instrument to reorganise companies. This must be taken into account when making decisions about reviewing insolvency legislation, in the Netherlands at least.

The surveys show that the tax authorities and the Industrial Insurance Board are often slow and inflexible when it comes to workout agreements. Informal reorganisations may be jeopardised as a result of this, according to the respondents. Furthermore, interviews with bank employees have shown that the preference the tax authorities in the Netherlands have over other creditors can lead to the failure of informal reorganisations. However, the companies examined in the case study showed no such thing.

It has been mentioned before that, at a certain moment, either risk-bearing or risk-avoiding capital must be introduced (with a view to the deteriorated balance sheet ratios, risk-bearing capital will often be preferred; at least by banks). If a shareholder (or private entrepreneur) is not prepared or able to invest money, then, in principle, neither will the banks. This is how a deadlock is created. In the Netherlands, small independent entrepreneurs have the possibility to apply for a so-called FAE-loan (Financial Aid Programme for Entrepreneur-Debtors) with which they can (financially) reorganise the com-

pany and finance a workout agreement. Larger companies however will usually try and find takeover candidates/investors or a party who is prepared to take over the existing finance agreements.

The examination of the case studies shows that potential investors (who could contribute risk-bearing capital) often pull out at a late stage. Some of the reasons for this are the high costs and risks involved in reorganisations. These costs and risks concern personnel, but also the closure and/or restructuring of loss-making business units. Furthermore, there is a lot of uncertainty about possible 'skeletons in the cupboard' in the form of deferred (as yet unknown) commitments. This pulling out is frequently accompanied by a virtually 'dried-up liquidity'. Banks and other interested parties often regard the investors pulling out as the signal for loss of confidence in the company's future. This will in many cases mean that a moratorium procedure is a foregone conclusion. Moratorium subsequently often results in liquidation. It is many times the same or other investors who, following liquidation, purchase part of the going concern via a transfer of assets (restart). Profitable activities can be continued 'with a clean slate'. The question presents itself whether this practice must or can be avoided. On the one hand liquidation seems to be used to 'avoid' commitments, while on the other 'value' remains intact because business operations are continued. From the case studies, at least, it appears that transfers of assets following liquidation can not, in certain cases, be avoided (thirteen of the fifteen examined dossiers about failed informal reorganisations speak of a full or partial restart in the form of an assets transfer following liquidation). In addition, it has emerged that if an informal reorganisation has taken place – on the basis of a properly detailed plan – a restart can be realised quicker. This way 'value destruction' is further minimised. In that sense, a failed informal reorganisation can from a social and economic point of view still be regarded as a success.

Both the interviews and the surveys indicated that improved cooperation between company and creditors can add to the success of informal reorganisations. A code of conduct ('Multi-Creditor Protocol') can contribute to this, provided the relative positions of creditors are taken into account and that it takes place under the appropriate pre-conditions. It is an efficient tool to clarify the rights and obligations in an informal reorganisation to each other and to use this to create a basis of trust. The core of such a code of conduct is that the company and its relevant creditors (mainly banks, large trade creditors and the tax authorities/Industrial Insurance Board) voluntarily observe a number of fundamental 'rules of play'. INSOL International's Statement of Principles can for many countries – including the Netherlands – serve as a basis for a (specific) 'Statement of Principles for Informal Reorganisations'. Observing the rules has a potentially stabilising effect on the situation created, because there is clarity on all parts. A certain amount of objectivity is incorporated in the process. Creditors are asked to hold back ('stand still') for a while, and 'in exchange for this' the company must do everything it can to recover

from the bad situation. Voluntary cooperation must be the basis however, and the Statement therefore must receive wide social support. From both the cases studies and the interviews it appears that some of its aspects are already applied, especially among larger companies. Nothing seems to stand in the way of applying it to smaller companies. The necessity to introduce a code of conduct for informal reorganisations increases as a result of international economic developments and initiatives in the field of voluntary rescue frameworks of, among others, the European Commission, UNCITRAL and the World Bank. Further research into the application of such a Statement in the Netherlands is desirable; the Ministry of Justice could lead the way, the more so since its policy is to settle future legal disputes – including commercial ones – more and more outside the courtroom.

Taking an overall view we can say that, within the practice of informal reorganisations, the focus should be on realising cooperation and (restoration of) trust between the relevant interested parties, transparency, timely and efficient reorganisation of the business operations and, if necessary, attracting additional risk-bearing capital. The institutionalisation of a Statement of Principles for Informal Reorganisations, a Banks and Businesses Code and principles for mediation focused on restructuring operations could be a significant contribution to the improved functioning of the current practice, both in the Netherlands and hopefully far beyond.