Resolving Financial Distress: Informal Reorganization in The Netherlands as a Beacon for Policy Makers in the CIS and CEE/SEE Regions?

Jan Adriaanse and Hans Kuijl

Abstract

In times of economic decline, increased attention is devoted to companies in financial difficulties. Partly as a result of this basic fact, many countries are currently working (under pressure) to improve existing insolvency legislation. This seems to be largely fuelled—as is the case in The Netherlands—by a strong desire to prevent bankruptcies as much as possible.

Statutory legislation aimed at the deferment (or remission) of debt payments is introduced or relaxed in order to provide a fresh start for insolvent companies. An alternative possibility—in the form of informal reorganization—seems often to have been overlooked by legislators. This type of reorganization, therefore, is the focal point in this article.

As far as the stimulation of rescue operations is concerned, the authors conclude that legislators must particularly focus their attention on informal reorganization. The thought is that such a policy focus for (member states in) the EU may also be of relevance (in whole or in part) for countries in the CIS/CEE/SEE regions.

“Although centuries separate us from the Laws of the Twelve Tables—which allowed the creditor to chop the debtor into pieces—and despite the fact the legislator’s attention has shifted from the body of the insolvent debtor to his assets, the view of bankruptcy as a most serious and acute problem requiring flexible, thoughtful and effective regulation still remains valid today.”

1. Introduction

With regard to the reorganization of a company in financial difficulties, a distinction can be made between formal and informal reorganizations. Formal reorganization includes all possibilities of reorganization laid down by the (insolvency) law or which take place by using legal methods and possibilities. In The Netherlands these are, e.g., moratorium (reorganization

process), (re-start following) liquidation, as well as the so-called private person fresh start proceedings (in Dutch: *WSNP*). In Russia these are both in the 1997 and 2002 bankruptcy legislation, e.g., external administration (reorganization process), competition proceedings (liquidation procedure), and bankruptcy of an individual citizen. An informal reorganization is understood to be a reorganization route which takes place outside the statutory framework—therefore, in *the shadow of the law*—with the objective of restoring the health of a company in financial difficulties within the framework of the existing legal entity. An informal reorganization consists primarily of *business restructuring* and *financial restructuring*.

There is a burgeoning literature on the transition in the region of Central and Eastern Europe and the Commonwealth of Independent States from state and party control of the political, economic, and legal systems to ones that are more democratic, market-oriented, and based on the rule of law. A portion of the scholarly and practical work in this area deals with the issue of legal (and other) transplants. As part of the transition process in the Russian Federation (RF) for example, there has been a decade-long collaboration—beginning early in the 1990s—between legal scholars, judges, and civil servants lawyers in the RF and their colleagues from The Netherlands. This has resulted in a rigorous comparative exercise—not unlike that performed by the compilers of the Imperial Russian draft Civil Code at the end of the nineteenth and the beginning of the

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2 See Title 3 Dutch Bankruptcy Act. The *WSNP* has been set up as a scheme to incentivize a natural person-entrepreneur (more in general: a natural person) and her creditors to come to an arrangement voluntarily in case of financial difficulty. When such attempts are unsuccessful, the entrepreneur can then make an appeal to the *WSNP* scheme aiming a debt-relief—fresh start—within three to five years of entering the proceeding. In theory, it is still possible for the entrepreneur subsequently to offer an arrangement and to make her repayments from the revenues of her continued business operations although, in practice, little use is made of this procedure.


4 See sections 3.1 and 3.2.

twentieth centuries (and that of the draftspersons of the new Dutch Civil Code)—in support of the drafting of the new Russian Civil Code.6

In a sense, The Netherlands Civil Code—the most recent continental civil code at the time of the most intense drafting phase of the RF Civil Code—became a beacon in the 1990s for draftspersons that were charged with presenting the Russian second Constitution to the State Duma.7 There was no intent on the part of the Dutch to transplant their code in Russia soil nor was there any wish (or need) on the Russian side for such an operation. Rather, this collaboration represented a thoughtful consideration of developments in foreign legal theory and practice as opposed to any kind of a reception “lock, stock, and barrel”. Furthermore, after more than a decade of reforms, the exchange of thoughts and ideas among those involved in formulating law and policy in a transition jurisdiction on the one hand and one (or more) group(s) from the “developed” nations on the other hand has lost its novelty.

Yet, we believe that—while this no longer represents a novel approach in the 2000s—there is still a value which can be derived (for both all concerned) from maintaining a dialogue among those from various jurisdictions who are seeking to view the future for signs of possible (necessary) change. It is in this spirit that we put forward the observations and questions contained in this article to members of the legal, business, and policymaking communities in the CEE/SEE and CIS regions. We hope that these will represent (more) food for thought for those persons as regards developments and thinking in the area of informal reorganization; this, we believe, can also be relevant in The Netherlands and elsewhere at a (supra) national level in the EU. 8


7 This is not meant to ignore the collaborative efforts of the draftspersons of the RF Civil Code with professionals from other jurisdictions such as, e.g., Canada, the United States, or Germany. See, for example, Peter Sahlas et al., “Special Issue: The Civil Code of the Russian Federation from Foreign and Comparative Law Perspectives”, 30(1) Review of Central and East European Law (2005), in which some of the results of the Canadian contribution to consideration of future work on the RF Civil Code are discussed.

8 One could argue, in the broad sense of the 1997 Partnership and Cooperation Agreement (PCA) between the EU and the RF, that such consideration in the RF of further developments in the informal reorganization field in the EU is part of the approximation of legislation process described in Art. 53 of the PCA. See the EU/RF PCA reproduced at <http://www.eu.int/comm/external_relations/ceeca/pca/pca_russia.pdf>. The conclusion is strengthened by reading the provisions of the 1999 Common Strategy of the EU on Russia (Part I(a), Part II(b)), and Part III (involvement of eminent experts of the EU) reproduced at <http://europa.eu.int/comm/external_relations/ceeca/com_strat/russia_99.pdf>. The Road Map for the Common Economic Space contains a section on Investment (1.3) under which such activity could also be brought; see <http://europa.eu.int/comm/external_relations/russia/summit_05_05/finalroadmaps.pdf#ces>.
First of all, section 2 of this article will detail the research methodology, while section 3 includes a further description of the concept of informal reorganization. In section 4, the advantages of informal reorganization vis-à-vis formal reorganization are set forth. Relevant evidence from Dutch practice is described in section 5 and derived success factors of informal reorganization are presented. Subsequently, section 6 contains a discussion of a number of practical bottlenecks that can be observed during informal reorganization, after which section 7 offers to the reader our conclusions with regard to the relation between the legislative and informal reorganization routes, as well as the manner in which informal reorganizations can be stimulated.

2. Methodology

This article is based on an extensive research which was conducted in the period 2003-2005 partly at the request of the Dutch Ministry of Justice. In The Netherlands—and outside—relatively little is known and recorded about informal reorganization. This, in particular, seems to stem from the (relative) silence in which this kind of reorganization processes are carried out. In order to gain an insight in the subject matter, our research has therefore been set up to be as wide ranging as possible. The central question with which we have dealt was an identification of practical possibilities used in The Netherlands in order to avoid formal procedures (i.e., a moratorium on payment and/or liquidation) as well as the attendant bottlenecks. To illuminate this identification process:

(a) a literature search has been made,
(b) thirty-five case studies have been carried out among four large Dutch banks (ABN-Amro, Fortis, Rabobank, ING) and three consultancies (KPMG, Resources Global Professionals, Zuidweg & Partners),

and <http://www.kremlin.ru/eng/text/docs/88027.shtml>. The Road Map is linked to the decision taken at the St. Petersburg Summit (May 2003, see the Joint Statement at <http://www.delrus.cec.eu.int/en/p_234.htm> to create a Common EU/RF Economic Space (CES). Similar broad language is to be seen in the EU’s 2004-2006 National Indicative Programme for the RF (also adopted in May 2003, see Section 2.2: Reform in the financial sector) at <http://europa.eu.int/comm/external_relations/russia/csp/04-06_en.pdf>.

This research has been published under the name of Jan Adriaanse, Restructuring in the Shadow of the Law: Informal Reorganisation in The Netherlands (Kluwer, Deventer, 2005); see <http://www.aspenpublishers.com> for more information. See also Jan Adriaanse et al., Informele reorganisatie in het perspectief van surseance van betaling, WSNP en faillissement (Boom Juridische uitgevers, Den Haag, 2004), available at <http://www.wodc.nl> (full governmental report in Dutch as well as a summary in English). See further <http://www.fiscaaleconomisch.leidenuniv.nl> for additional information, as well as articles by the authors in the field of informal reorganization and turnaround management.
Resolving Financial Distress

(c) twenty-three various interested parties of companies in financial difficulties (mainly bankers and consultants) have been interviewed, and

(d) four surveys have been conducted among the Dutch trade association for credit management (VVCM), a (non-profit) organization which aims to provide assistance and support for SMEs (OKB), the Federation of Dutch Insolvency Lawyers (INSOLAD), and a Dutch Federation of Independent Accounting Firms (SRA), in that order. The surveys yielded responses of 30%, 82%, 21%, and 16% respectively.10

A total number of 465 questionnaires were completed and returned. The companies included in the case study research were mainly so-called medium-sized and large-scale businesses within the industrial and business services sectors. A total of twenty successful and fifteen unsuccessful informal reorganizations have been examined.

3. Description of Informal Reorganization

This section will detail the phenomenon of informal reorganization on a more in-depth basis. An informal reorganization is—as set out in the introduction—a reorganization route which takes place outside the statutory framework with the objective of restoring the health of a company in financial difficulties within the same legal entity. In the informal reorganization, a plan to reorganize (business plan) will be drawn up to reach the objective which has been set. This will mostly consist of two processes:
— business restructuring;
— financial restructuring.11

The idea is that it is impossible and undesirable to carry through financial restructuring without restructuring the business operations (which have, usually, led to the deteriorated financial situation within the company). Solving problems should also involve removing the causes thereof. The nature of the problems—as well as the moment action is taken in the organization—will be a decisive factor for the planned measures. First of all, business restructuring (section 3.1) will be examined; thereafter, financial restructuring will be discussed (section 3.2).

10 Non-response is a known problem with postal surveys. Since all surveys are processed anonymously, no details are known about those who have not responded.

11 See also Oscar Couwenberg, Resolving Financial Distress in The Netherlands (University of Groningen, Groningen, 1997), 21.
3.1. Business Restructuring

Particularly important questions when restructuring business operations are the following: which concrete strategic, operational, and financial plans have been made to reach the level of healthy and sound management; and what are the plans for the actual implementation thereof? The process is also, ideally, aimed at a restoration of confidence in the company and its management among interested parties. Business restructuring—often called *turnaround* for which the process can be described as *turnaround management*—can also be defined as follows: a comprehensive plan the aim of which is to restore the (operational) profitability of a company in financial difficulties. The main features of a restructuring process usually consist of the following phases: (i) stabilizing, (ii) analyzing, (iii) repositioning, and (iv) reinforcing. These four phases are described below; in practice however, the different phases (and actions to be taken) will frequently overlap. Therefore, that which follows must be read in that context.

### 3.1.1. Phase I. Stabilizing

In phase I, the focal point is to identify the critical problems which require immediate action in order to stabilize the situation. The emphasis in this phase is on increasing the *cash flow*. This involves actions aimed at increasing the incoming—and reducing the outgoing—cash flow. In this way, the required “breathing space” can be created to meet critical financial obligations. Table 1 shows various possibilities (non-exhaustive).

<table>
<thead>
<tr>
<th>Action</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cutbacks in expenditure</td>
<td>Reducing the current expenses both in the field of costs and with regard to investments</td>
</tr>
<tr>
<td>Optimizing the stock situation</td>
<td>Selling off excessive stock, as well as reducing the stock (which creates both physical and financial space)</td>
</tr>
<tr>
<td>Optimizing turnover times of the accounts receivable (trade)</td>
<td>Quicker collection of receivables and/or reducing the payment periods</td>
</tr>
</tbody>
</table>


3.1.2. Phase II. Analyzing

In phase II, it is necessary for the company to look at its prospects in the long term. As such, drawing up a well-founded reorganization (business) plan is of vital importance, particularly vis-à-vis enhancing and/or restoring confidence of the relevant interested parties. In this phase, the relevant interested parties are the financiers of the company, e.g., the providers of loan capital (for example, banks and large suppliers) and of equity (for example, shareholders). The “ingredients” of a reorganization plan will differ on a case-by-case basis; however, it can be said that the more extensive (qualitatively), the better. Table 2 shows topics which should, in any case, be incorporated in a proper reorganization plan.\(^\text{15}\)

\begin{table}[h!]
\centering
\caption{Subject Matters within a Reorganization Plan}
\begin{tabular}{ll}
\hline
1 & A strategic and financial analysis \textit{ex post} to trace the causes of the negative state of affairs \\
2 & An inquiry into the actual financial position and an assessment as to whether or not the company still offers sufficient basis for recovery \\
3 & Proposed measures and the calculated effects thereof on long-term exploitation overviews and balance projections \\
4 & Cash flow projections in the short and long term from which it appears that the obligations entered into (and to be entered into) can be performed \\
5 & Cash flow projections which show a future improvement in the liquid assets \\
\hline
\end{tabular}
\end{table}

When doing so, it is important for the reorganization plan to adequately set forth the core activities of the company—including the (potential) value which they can create. In addition, consideration must be given to which specific products/services and customers can be retained (or must be axed).

The measures to be taken to restore profitability in the long term can be diverse and will depend—as can be expected—upon the specific situation. Table 3 shows various possibilities (non-exhaustive).

Summarizing, it can be stated that the company must indicate in a reorganization plan which objectives it pursues in both the short and the long term in order to halt the insolvency process and to reorganize the

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\(^{15}\) See, e.g., Peter Vos, \textit{Kredietopvraag en insolventierisico, overlevingskansen van bedrijven in financiële moeilijkheden en de Faillissementswet} (Kluwer, Deventer, 2003), 253.
company, as well as the manner in which the company is going to pursue these objectives.

**Table 3: Measures to Restore Long-Term Profitability**

<table>
<thead>
<tr>
<th>Measure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusting strategy and marketing</td>
</tr>
<tr>
<td>Cutting overhead costs</td>
</tr>
<tr>
<td>Dismissing excessive personnel</td>
</tr>
<tr>
<td>Rationalizing the product assortment</td>
</tr>
<tr>
<td>Improving purchasing processes</td>
</tr>
<tr>
<td>Improving management information systems</td>
</tr>
<tr>
<td>Improving working capital and cash flow management</td>
</tr>
<tr>
<td>Closing loss-making business units</td>
</tr>
<tr>
<td>Capitalize (excessive) fixed assets</td>
</tr>
<tr>
<td>Selling (profitable) operations which are not part of the core activities</td>
</tr>
</tbody>
</table>

It is important that the plans are realistic, particularly so because the interested parties will take decisions on the basis thereof. Financiers decide on the basis of the plan whether or not they are prepared to maintain the credit facilities granted or to make new funding available in order to finance the (period of) reorganization (financial restructuring; see hereafter). Suppliers of products/services decide whether or not to continue to supply (on credit). In addition, shareholders/investors will consider making or not making available (any) required (risk-bearing) capital. This involves, for instance, the depositing of (informal) capital and/or (subordinated) loans.

In order to restore the aforementioned confidence, it is often also necessary to recruit or consult persons (interim-managers, advisors, accountants) who are specialized in carrying out turnaround processes. After all, the management/interested parties relationship is often under pressure as a result of the deteriorated state of affairs, and the question is whether or not the interested parties (still) have sufficient confidence in the abilities of the current management to reorganize the company on their own.

The reorganization plan can somehow be compared with the so-called external administration plan (EAP) in the (formal) external administration procedure of the aforementioned Russian Insolvency Legislation, as it is intended to provide a long-term solution to restoring the company’s solvency. However, the reorganization plan as described here is not necessarily a product of compromise and collaboration between all interested parties—as is required within the EAP chapter of Russian Law (Chap.5, in this context, often called a “bridging loan”.)
Arts.68 ff. in the 1997 law, Chap.6, Arts.93 ff. in the 2002 law)—although
the chances for success will, in fact, increase whenever most or all inter-
ested parties are involved and agree (see also further).

3.1.3. Phase III. Repositioning
In phase III, the management—together with (any) recruitments—will
need to initialize the reorganization as outlined in the reorganization
plan. This process is also called the value recovery process. The company
has hit heavy weather, as value was reversed endangering the continuity;
the process of value reversal is now stopped. It is important that the ob-
jectives which have been established are feasible and that management
reports to the interested parties in an open and timely manner. After all,
the process of the intended recovery of the company is also the process
of the intention to restore confidence among the interested parties of
the company. This is especially important, we believe, in the Russian
Federation (and elsewhere in the CIS/CEE/SEE regions) where trust in
old economic relationships has not always uniformly been replaced by
robust relationships of trust among actors in the emerging private sectors.
Supplying information during the process is, therefore, vital in all cases,
in particular in transition societies.

3.1.4. Phase IV. Reinforcing
In addition to initiating the reorganization—during which the organization
tries to regenerate positive cash flows from the business operations—the
company will often also need to be reinforced. This is understood to mean
“reinforcing” in the field of management as well as in the company’s bal-
cise sheet. In addition, this can (also) be achieved by transferring the
company to another (healthy) company (as a result of which future pay-
ments can be guaranteed).

As stated before, it is often necessary to involve third parties in
the turnaround process, as it still remains to be seen whether the cur-
rent management will be able to independently complete this operation
successfully. During the reinforcement phase, the question emerges as
to whether or not current management is able to successfully run the
company in the future and whether or not the existing organization and
management structure fits within the “new” company. Changing the or-
ganization and management structure—including position changes (or
dismissal) of certain key figures in management—may be required. Situ-
ations can, of course, arise in which decisions on this subject have already
been taken in a previous stage; however, a key point is that—in addition
to the reorganization of the business operations—the “strength” of the
organization and management structure and the current management
also needs to be examined.
Reinforcing the balance sheet, as described in this phase, is interconnected with financial restructuring. Financial restructuring will be described in the following section.

3.2. Financial Restructuring

Although the reorganization plan and the initiation thereof form a basis for a successful rationalization of the company, (some degree of) financial restructuring will often also be necessary. The losses from the past have—in most cases—disturbed the balance sheet ratios to such an extent that the obligations towards the assets are excessive; as a result, (future) interest and repayment obligations cannot be (or no longer have been) met. In addition, high reorganization costs are usually involved (for example, costs for redundancies\(^\text{17}\)). The company will not always be able to clear away the “burden” from the past with its own current cash flows. Therefore, efforts from outside the company (shareholders/creditors) will (must) often be requested. Financial restructuring within the framework of an informal reorganization can, therefore, be described as follows: forming part of the informal reorganization in which, on the one hand, the relevant creditors voluntarily commit to revised terms with regard to the funding they made available (often called a “workout agreement”) and, on the other, if so required, new funding is made available by providers of risk-avoiding capital (debt) and/or risk-bearing capital (equity).

A workout agreement can be compared with the amicable settlement procedure as laid down in the 1998 CIS Model Law on Insolvency (Bankruptcy) (Chap.6, Arts.111-121) and, e.g., the amicable agreement procedure in the Russian Federation’s Insolvency Legislation (Chap.7, Arts.120 ff. in the 1997 law; Chap.8, Arts.150 ff. in the 2002 law), although within an informal reorganization court approval (in Russia: approval of the Arbitrazh Court) and cooperation of secured creditors is not strictly needed, as it is a consensual process. However, the underlying principles are more or less the same as it strongly focuses on mutual agreement.\(^\text{18}\)

Table 4 shows various possibilities of financial restructuring (non-exhaustive).

\(^{17}\) In The Netherlands, ex-employees are often awarded redundancy payments in a redundancy package engineered between the company and employers’ associations or through a court ruling issued with regard to the redundancies. These payments are often based on the so-called “sub-district court formula” in which the number of years of service and the employee’s age play a role. See also Henriette Pellicaan, Reorganisaties, handleiding voor de praktijk (Kluwer, Alphen aan den Rijn, 2003), 107-108.

Core of the measures within the financial restructuring consists, therefore, of deferment or remission of current financial obligations as well as generating additional liquidity. The partial (or complete) takeover of a company fits within the financial restructuring framework since the buying company will usually (in part or in whole) act as guarantor for the performance of current obligations and/or provide additional financial resources.

**Table 4: Measures with Regard to Financial Restructuring**

<table>
<thead>
<tr>
<th>Measures</th>
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</thead>
<tbody>
<tr>
<td>Reducing the repayment obligations and/or reducing current debts</td>
</tr>
<tr>
<td>Reducing interest obligations</td>
</tr>
<tr>
<td>Deferring repayments</td>
</tr>
<tr>
<td>Deferring interest obligations</td>
</tr>
<tr>
<td>Converting risk-avoiding capital into risk-bearing capital (debt-equity swap)</td>
</tr>
<tr>
<td>Generating new risk-avoiding financing</td>
</tr>
<tr>
<td>Generating new risk-bearing financing (e.g., in the form of a partial or complete takeover)</td>
</tr>
</tbody>
</table>

### 4. The Advantages of Informal Reorganization

Important advantages of informal reorganizations—as found in literature and our research—compared to formal reorganizations can be summed up with the terms *flexibility, silence, and control*. The terms will be elaborated below.

#### 4.1. Flexibility

Informal reorganizations can be recognized—first and foremost—by their unrestricted character. The reorganization process is less rigid than is the case with (in) formal procedures. Companies and entrepreneurs can reach mutual agreement on the actions to be taken by the company (both with regard to the restructuring of business operations and financial restructuring) and the terms and conditions under which these take place. Because of the flexible character, “tailor-made” solutions can be elaborated; and, if necessary, deviations can be engineered for the relative positions of creditors—again, by mutual agreement. In addition, it can be agreed that any new funding which is made available takes priority—separate from current positions and guarantees. Although most current laws also theoretically offer this possibility, the focal point in practice—definitely so in The Netherlands—is usually offering an arrangement under strict statutory regulations in which a certain percentage must be waived by the (ordinary) creditors. The possibilities within the framework of informal reorganizations are—in our view—(much) better; this makes the process more flexible.
4.2. Silence

Furthermore, informal reorganizations take place in relative silence. That is to say, the procedure is not made public; this is opposed to formal reorganizations, which are public, both in The Netherlands and in the CIS/CEE/SEE regions.\(^{19}\) The result of these public procedures is that suppliers, financers, and (potential) clients will often approach the company with an increased degree of reserve, which may lead to unwillingness to enter into new contracts (or only be prepared to do so under the most stringent of terms). In addition, in a public context, a *race to collect* can easily develop; creditors “tumble over each other” as they seek to get paid in advance of their sister creditors. This frequently also involves petitioning for liquidation of the debtor (in order to enforce payment). However, these developments place the company in a(n) (even more) vicious circle. This phenomenon is, therefore, often seen as the *self-fulfilling prophecy-effect of a public procedure*.\(^{20}\) The negative effects upon management and the missed opportunities as a result of publicity of procedures can also be characterized as *opportunity costs*.\(^{21}\) In an informal reorganization, these costs are (considerably) less—especially because of the relative silence—than is the case in a formal reorganization.\(^{22}\)

4.3. Control

The final important advantage for management is that—during an informal reorganization—they can continue to fully run the company independently. Neither judges nor trustees (or administrators (in Russia: arbitrazh administrators)) need be appointed in order to commence an informal reorganization. Apart from the fact that this saves costs (as a

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\(^{19}\) See, for example, Art. 47 of the 1998 CIS Model Law on Insolvency as well as Art. 50 and Art. 54 of the Russian Bankruptcy Law (1997 and 2002 versions, respectively).

\(^{20}\) A striking example with regard to negative effects of financial difficulties in the public domain, involved the problems of a Dutch company called Mosa Porselein N.V., situated in Maastricht. Koninklijke Mosa B.V., operating in the same sector and of the same name, also situated in Maastricht, but fully independent from Mosa Porselein N.V. experienced negative effects because of adverse publicity surrounding Mosa Porselein N.V. (as result of a mix-up in names). These effects involved (threatening) to withdraw orders by existing customers, as well as hesitance among potential clients. See the Dutch financial daily: *Het Financieele Dagblad*, 27 July 2004.


result of which the proceeds for the creditors will ultimately be higher and, therefore, the recovery rate\textsuperscript{23} increased), those directly involved will be given the opportunity to determine the speed (and the outcome) of the reorganization themselves. Costs can be saved socially since the judicial system—with all the appurtenances thereof—does not (yet) need to be called into action.\textsuperscript{24}

It is difficult to measure the overall advantages of informal reorganization compared to formal reorganization in terms of gained or preserved going-concern value since companies which choose a formal procedure cannot be compared with themselves. That is to say, if a company decides upon, \textit{e.g.}, external administration (Russia), it is—from that moment—impossible to measure the destruction or gain of value for the (then theoretical) situation if the company had otherwise chosen for an informal workout. However, Gilson, John and Lang have shown—by comparing the stock returns of a sample of listed companies before and after a chosen formal or informal procedure—that, in any case, the stockholders of companies in financial difficulties will generally prefer informal alternatives since these procedures (at least) generate significantly higher share returns.\textsuperscript{25}

So, in addition to the fact that management and owners, in general, will not want to lose control and will want to retain flexibility, important (market) value is to be preserved in informal reorganization. Therefore, management should always attempt to restructure—in our opinion—in an informal manner, rather than only seeking protection within a formal route. Formal reorganization must be seen as a tool rather than a goal in the process of resolving financial distress.

\section*{5. Informal Reorganization in Practice: Restructuring Measures and Success Factors}

To gain more insight into the practice of informal reorganization, some important evidence from The Netherlands will be presented in this paragraph. First, the most important causes of corporate decline (\textit{inter alia} in The Netherlands) will be shown. Thereafter, the most popular measures within Dutch informal restructuring processes will be discussed. Then, the absolute success factors of informal reorganization are presented.

Regarding the causes of financial difficulties, it can be concluded that the problems mainly relate to poor management—\textit{i.e.}, inadequate reac-

\begin{itemize}
\item Recovery rate can be described as that part of the debt which is repaid, divided by the nominal debt.
\item See, \textit{e.g.}, Gilson, \textit{op.cit.} note 20, 311-313.
\end{itemize}
tion of management on both internal weaknesses and strengths, even as external threats and opportunities—and excessive cost structures (fixed and variable costs), as well as the presence of inadequate management information systems within the company (as a result of which important early warning signals of imminent decline are missed by management). The results, particularly those regarding poor management correspond to foreign studies by, among others, the Association of Business Recovery Professionals (R3) in the United Kingdom, as well as the European Federation of Accountants (FEE); the latter also identifies a dire need for adequate management of the company on the basis of financial information, and this confirms the identified causes in the field of (poor) management information. The popular belief to the contrary notwithstanding economic circumstances are often not the (major) cause of the problem, at least in The Netherlands. It frequently seems to be an excuse rather than a real root cause.

With regard to business restructuring, it can be concluded that appointing (specialized turnaround) consultants, taking measures to improve the efficiency of the company, and improving the management information system are some of the most important recovery measures. This is in line with the causes identified above. Financial restructuring is mainly aimed at deferring repayments and proposing workout agreements with remission. In addition, companies often look for an injection of risk-bearing capital in order to improve the balance-sheet ratios and to generate additional liquidity. Furthermore, during an informal reorganization, banks are often prepared to provide additional risk-avoiding capital (debt) in order to improve the chances of success.

The results with regard to business (and financial) restructuring also correspond with the results of foreign studies. For instance, the aforementioned study by R3 showed that cost reduction, debt restructuring, raising new equity, and negotiating with banks, as well as improved financial controls and a change of management—including the appointment of consultants—are measures frequently taken in British turnaround situations. A study by Franks and Sussman is also in line with this. They

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concluded, for instance, that management changes, asset sales, new finance and guarantees given by management are some of the popular measures. They also conclude that these measures generally affect the willingness of banks to help out the company in a positive manner. It is remarkable that the factors regarding adjustments of the company’s strategy and marketing tactics have only been identified to a (relatively) minor extent. This is all the more remarkable since the poor state of affairs is often caused by lack of insight—as a result of poor management—into the market and the existing (and potential) needs of (current and potential) clients. This conclusion is also in line with for instance the studies by R3 and Franks and Sussman.28

On the basis of case studies of both successful and unsuccessful informal reorganizations, an examination has been made of the factors that determine the success of a rescue operation. They have been listed below:

— active attitude by management and shareholders with regard to the informal reorganization;
— involvement of important interested parties (financiers) in the reorganization process;
— adequate and speedy reorganization of the business operations (preferably with the help of third parties);
— transparency (towards financiers) with regard to the financial situation and the intended informal reorganization;29
— injection of risk-bearing capital (equity), (e.g., via a takeover).

It appears that informal reorganizations are especially successful when the company is able to reorganize its business operations quickly and adequately and, thereby, to restore profitability. However, this process must often go hand-in-hand with the introduction of additional risk-bearing capital (as noted above, possibly by way of a takeover). In this way, a foundation can be laid for the future since this positively restores the balance-sheet ratios (relation between equity/debt). Involved creditors are generally prepared to cooperate within an informal reorganization provided that the focal point (in first instance) is the deferment—rather than the remission—of payments (repayments).

A good relationship between the company and its primary stakeholders (usually, banks and/or primary suppliers/vendors) appears to be vital. Informal reorganizations only have a chance of success when these interested parties can be convinced of the (future) viability of the

28 See Survey R3, op.cit. note 24, 21; and Franks and Sussman, op.cit. note 25, 2.
company and the abilities of management. A transparent approach to the problems—often with the help of specialized advisors in the field of business restructuring, in combination with realistic prognostications—are important in this respect. The case studies indicate, for example, that Dutch banks are virtually always prepared to continue financing (not to withdraw credit or levy execution) provided these aforementioned conditions are met. Of course, as we consider the possibility of whether or not some ideas and insights can be transplanted from The Netherlands to one or more jurisdictions in the CIS/CEE/SEE regions, the attitude of bankers who serve businesses in those areas will obviously need to be factored into the chances for success (or the lack thereof) in informal reorganizations there.

Yet in jurisdictions which we have examined in more detail, when the parties involved can be convinced—by means of management actions in line with the aforementioned success factors—that the going concern value is higher than the forced-sale value, the willingness to cooperate and, as a result, the chances of success of a rescue operation will always increase. This elementary “formula” should, we believe, also be attractive to bankers in the CIS, for example, even though they are reputed to have (wildly) different practice than their sisters in, e.g., the EU. The surveys and interviews support the above findings with regard to Dutch practice. In international literature supportive evidence can also be found for this conclusion (See, e.g., research results from the United Kingdom, Germany and the United States.

6. Practical Bottlenecks During Informal Reorganization

“Many companies recognize the need to restructure too late, when fewer options remain and saving the company may be more difficult.”

By taking a closer look at bottlenecks in practice, interesting information can be found as regards decisive failure factors of informal reorganization.


In addition, supportive evidence can (most probably) be discovered as regards the defined success factors. In this paragraph therefore, practical bottlenecks—as found in the case studies—will be detailed.

In our research sample, the main bottlenecks appeared to be (for the most part) in the field of potential investors/takeover candidates who pull out at a late stage—frequently following lengthy, yet unsuccessful, negotiations as well as due diligence research—and an insufficient supply of information from the company to its stakeholders during (and about) the progress of the informal reorganization. Other major bottlenecks have been found in relation thereto, indicating an (impending) breach of trust between the company and its creditors. Striking examples are: financial results which structurally deviate from prognostications, management failing to observe (restructuring) agreements (with creditors) and, more generally, the (imminent) absence among the creditors of confidence in management and/or viability of the company. It would further appear that (strategic and operational) reorganization measures often have insufficient effect so that a loss-making situation continues to persist. In addition, it has been frequently noted that management has ultimately proven not to be up to the task; as a result, the informal reorganization has failed. The bottlenecks, which have been discovered in the course of our research, can be summed up as follows (to be described as failure factors):

— management and the shareholders have a passive attitude towards the informal reorganization;
— (as a result) insufficient strategic, operational and financial measures are taken;
— the company is unable to provide sufficient insight into the actual financial situation;
— the company is unable to find risk-bearing capital (e.g., in the form of a takeover) (in time).

It is striking to see that the failure factors are in fact opposite and, consequently, supportive to the success factors as found in the group of successful informal reorganizations. Furthermore, the bottlenecks with regard to reorganizations tend to stem from the execution rather than the process itself; the behavior of management regarding the problems is most important both in successful and unsuccessful informal reorganization routes.

With that, we believe it is justified to put forward the basic conclusion that insolvency legislation, in itself, does not have a significant impact on the chances of success of a rescue operation. This is an important conclusion, not only for legislators in The Netherlands but for international practice as a whole (and perhaps for the CIS and CEE/SEE regions in...
particular). Legislation to promote reorganization and rehabilitation simply has limited effects. It is not—and will in our opinion never be—a panacea to prevent companies from going bankrupt as, in the end, economic principles and managerial behavior really make the difference. This does not mean, of course, that we think that in rescue operations legal rules can never be of value, yet their impact should not be overstated.

In this context, it is for example interesting to take notice of the fact that, for instance, Dutch legislation lacks the legal possibility to oblige entrepreneurs and their stakeholders to be focused on taking timely measures to prevent bankruptcy procedures. This as opposed to, e.g., Russian Insolvency Legislation (1997/2002) in which a so-called Prevention Chapter is to be found. Legislators in international practice could learn from experiences in Russia with regard to these articles as this legal instrument could—in theory—be of no small significance; it forces entrepreneurs to look for and recognize potential financial distress at an early stage (“early warning”).

The aforementioned conclusion remains the same, however, because an early warning always has to lead to the taking of strategic, operational, and financial measures by management in an informal and relatively peaceful environment, in order to improve the chances of success. Once again, (insolvency-related) legislation is a tool rather than a goal in the real recovery process of companies in financial distress.

7. Conclusions

Looked at as a whole, the success of rescue operations largely depends on the question of whether or not management is able and willing to take action at an early stage and to adequately reorganize business operations. Equally important in the recovery process is that the directly affected parties—particularly important suppliers and financiers—are involved in the reorganization. When they, too, have confidence in the company’s business plan, the chances of success will rise. Informal reorganizations, in that respect, have the advantage that they can take place outside the public domain. When prompt action is taken—regardless of whether or not it has been instigated by the principal banker—this process can usually also take place while continuing to service existing financial obligations. That is to say, there is no direct need to try and carry through a rescheduling of debts during which creditors must waive (part of) the amounts they are owed. Apart from the fact that this can be morally justified, the

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32 See Art.26(30) (“prevention measures”) and Art.27(31) (“pretrial or out-of-court sanation”). It is striking to notice that the specific defined Articles cannot be found in the CIS Model Law (1998). It is not in scope of this article to further investigate this fact, however it is interesting to us for future research.
practical results are also significant. Namely, an uncontrolled race to collect—in which each creditor pursues her own interests demanding direct payment—can be prevented. After all, such a process always causes a self-fulfilling prophecy resulting in a considerable loss in going-concern value as significant insecurities arise. Clients and (other) suppliers no longer know what to expect; as a result, they (too) leave the company for what it is and will conduct their business elsewhere.

Laws are mere beacons. If legislators—those, for example, in the EU but, especially, in countries in the CIS/CEE/SEE regions—truly wish to (help to) prevent more companies from going bankrupt, they will need to become aware of the advantages of informal reorganization. Apart from any changes in the law, they also need to be geared towards stimulating informal rationalization routes. This is possible, for example, by institutionalizing a code of conduct through cooperation—preferably monitored by the national bank or a (to be institutionalized) Federal Body on Insolvency Matters among representatives of the business sector in general and the banking sector in particular. This can enhance work on a rescue plan in a peaceful and controlled manner without all the problems being immediately put out on the street. The Statement of Principles of INSOL International—in this respect—could serve as a framework from which to work. In fact, these principles can be seen as the instrument par excellence through which to achieve a situation where the success factors are fully met.

33 One could argue that—once informal reorganization becomes (more firmly) anchored in the EU—legislators in those jurisdictions which have Partnership and Cooperation agreements with the EU (such as the 1997 EURF PCA) have, in theory, already agreed to implementing such a mechanism. See EU/RF PCA, Art.35, “Approximation of Legislation” provisions.

34 For the Russian Federation, this task could be performed par excellence by the Russian Federal Service for Matters of Insolvency and Financial Rehabilitation. For this governmental body has (had at least in the 1999 legislation governing its activities), Inter alia, the specific task “to participate in the formation and realization of federal and inter-state programs envisioning measures for the restructuring and financial rehabilitation of insolvent organizations”. See Statute on the Russian Federal Service for Matters of Insolvency and Financial Rehabilitation (Art.4(1) in e.g., 25(1-2) Review of Central and East European Law (1999), 129-137, at 131.

35 In 2000, INSOL International introduced the so-called “Statement of Principles for a Global Approach to Multi-Creditor Workouts” which—according to the documents at the time of publication—was at least endorsed by the World Bank, the Bank of England, a number of international commercial banks and consultancy agencies, as well as the British Bankers’ Association (with 320 banks as members; established in more than 60 countries). The core of the Statement of Principles—consisting of eight principles which can be regarded as a best practice for informal reorganizations—is recognized in various “local” versions.

The Statement of Principles was published in order to bring the different globally used informal procedures (voluntary rescue frameworks) more in line with one other and to formalize them in a consistent system. It was drawn up by more than 150 experts from as many (mainly banking) organizations and consists, as mentioned, of eight principles which could/should be used during an informal reorganization/workout in order to increase the chances of success.
its disposal— as well as a structured framework for informal reorganization—the primary ingredients for success are present.

We hope that legislators—including those in The Netherlands but also those in countries in CEE/SEE and CIS jurisdictions—will realize this and will, appropriately and specifically, increasingly shift their focus towards the institution, implementation, and promotion of a robust regime for informal reorganization in the business sector of their countries. After all, legal reform strategies should not only aim at improving legality by carefully choosing formal rules but also—if appropriate and necessary—by choosing informal rules the meaning of which can be understood and the purpose appreciated by domestic law makers, law enforcers, and economic agents who are the final consumers of these rules.37

Finally, the institutionalization of informal reorganization routes is, in fact, one which is not new; regimes of this kind have existed in one form or another in ancient history. The aforementioned Law of the Twelve Tables, for example, gave the debtor breathing space (in those days, literally ...) and the possibility to negotiate a workout agreement. Table III, Law VIII said:

“In the meantime, the party who has been delivered up to his creditor can make terms with him. If he does not, he shall be kept in chains for sixty days; and for three consecutive market-days he shall be brought before the Praetor in the place of assembly in the Forum, and the amount of the judgment against him shall be publicly proclaimed.”38

Although different in practice, the underlying principles—negotiation between debtor and creditor(s), in relative silence and towards a consensual solution—remain the same.

The eight principles confirm the success factors of informal reorganization as mentioned in §5 and can be described, in brief, as follows:

1. Deferment of payment is voluntarily agreed to (“standstill period” by creditors);
2. The debtor ensures that the relative positions of the creditors are maintained;
3. The debtor refrains from any action that may jeopardize the proceeds for the creditors;
4. Creditor committees are set up, if so required;
5. The debtor provides the creditors with relevant information;
6. Reorganization proposals are made in the light of the applicable law;
7. The parties treat all information confidentially;
8. New financing during the process will be given priority status.

For more detailed information see <http://www.insol.org>.

That is to say, bankruptcy legislation should be seen as a “fundamental element underlying the ability to enforce ‘hard budget constraints’ on enterprises—that is, to force them to pay their debts and to operate within their ability to generate income to meet them”. See Sarah J. Reynolds, “The Legal Regulation of Bankruptcy: Russian Legislation and Models for the CIS”, 25(1-2) Review of Central and East European Law (1999), 1-5, at 1.

See Berkowitz et al., op. cit. note 4, 16 (freely interpreted).

See, e.g., <http://www.yale.edu/lawweb/avalon>.