

Summary

Informal reorganisation in the Netherlands

This survey is primarily concerned with the practical shape taken by informal reorganisations in the Netherlands. An informal reorganisation is a reorganisation process that takes place outside the statutory framework with the intention of restoring the health of an enterprise in financial difficulties that forms part of the same legal entity. In an informal reorganisation it will often be necessary to reach a composition agreement with the enterprise's creditors on changes to former arrangements concerning funding that has been provided. An amicable solution exists when an agreement of this kind is reached voluntarily.

The problem was defined as follows for the survey:

What variants of amicable solutions are found in practice that are intended to prevent Dutch enterprises making moratorium arrangements or being wound up? Are there any practical problems that could be removed (by new legislation or otherwise)?

To address the problem, a review of the literature was conducted (chapter 2); 35 case studies were made at banks and consultancies (chapter 3); four questionnaires were conducted and 23 interviews were held among parties concerned in informal reorganisations (chapter 4).

It emerged from the case studies, interviews and questionnaires that the main reasons for financial difficulties can be traced to a combination of poor management, a cost structure that is too high and, by way of extension of that, inadequate control of the enterprise on the basis of (financial) management information. It was striking that the case studies showed that economic circumstances were often not the reason for the financial difficulties. Moreover, only three files appeared to indicate the possibility of fraudulent activities.

Respondents indicated that they preferred informal reorganisations to formal reorganisations. However, the later an informal reorganisation starts, the greater its likelihood of failure. All the constituent studies showed that, in general, enterprises often start the necessary reorganisation too late.

Interested parties (such as banks, auditors, consultants) in enterprises should play a major role in providing an 'early warning' signal regarding possible problems. Sector organisations and government bodies could do more to draw the attention of entrepreneurs and the parties concerned to the threat of financial problems and the ways of dealing with them.

It is difficult to assess the number of informal reorganisations that occur annually in the Netherlands, as the processes take place in relative silence and are not registered. However, a cautious estimate based on success percentages of banks and on corporate failure figures for the period 2002-2003 suggests that almost 23,000 informal reorganisations took place in 2002.

The review of the relevant literature, as well as the case studies, showed that informal reorganisations often consist of two processes that are closely linked: restructuring of the business activities and financial restructuring. When an enterprise gets into difficulties, the first step is to try to make the generally loss-making business activities profitable again. This is usually done by appointing third parties (consultants/interim managers), improving the efficiency of the enterprise (reducing costs and closing loss-making business units), and improving the management information system. This is in line with identified causes.

The efforts of third parties (consultants/interim managers/mediators) can play an important role in determining whether the steps taken succeed. This is mainly because the relationship between the enterprise and creditors has often been under pressure for a long time. As a relative outsider, a third party can prevent or find a way through a lack of trust. Although the deployment of third parties is generally viewed as a positive step, the possibility and advisability of setting up a platform for all actors in the (consultancy) field of enterprises in difficulties is recommended. An approach of this kind would make it possible to work on further professionalisation, more specific education and systematic research. The government and sector organisations could act as a 'catalyst' in this.

If an enterprise cannot be made healthy again solely by restructuring the business activities, an attempt is usually made to implement financial restructuring, either simultaneously or subsequently. All constituent studies show that this has to be done precisely and carefully because this type of restructuring often involves an 'offer' made by one or more of the creditors concerned. The case studies and the questionnaires showed that the most common amicable solutions within the scope of financial restructuring are concerned with postponing payments and reducing nominal debts to (competitive) creditors. New risk-bearing capital is also often sought (possibly in the form of an acquisition) to finance the reorganisation process and to improve balance sheet ratios. The case studies also showed that banks are often willing to provide additional financing and to grant waivers during the informal reorganisation, to improve the likelihood of success. Moreover, the case studies showed that more (non-financial) possibilities were used in connection with financial restructuring in practice than those mentioned in the literature.

Examples of this include threats by the banks to terminate credit (with a view to motivating the enterprise to actually reorganise), the provisions of additional security, cash sweeps, and taking over the financing agreement(s). Like the banks, trade and cost creditors also voluntarily continue to make deliveries, in spite of unpaid invoices. Legislation on obligations to do so could result in these creditors initially adopting a less flexible attitude because their risks would increase. The result would probably be that there would be less willingness to continue delivering/financing. More generally,

the parties concerned with enterprises in financial difficulties should ask themselves to what degree risks can be transferred to providers of low-risk capital.

The role of banks is crucial and generally positive in informal reorganisations. Banks, as they say themselves, have nothing to gain from corporate failures. Not only do they lose future turnover, but also their credits are often not fully covered by rights of pledge and mortgages. A corporate failure can therefore lead to major losses. Therein lies an important reason why banks often take on a 'supervisory and disciplinary role' vis-à-vis the management. If the enterprise fails to pay attention, the bank increases the pressure. Besides (healthy) pressure on the management, the enterprise is often told to look for additional risk capital, possibly in the form of an acquisition (especially when the enterprise is no longer capable of reorganising solely on the basis of restructuring business activities). This approach also restores the balance sheet ratios and establishes/re-establishes healthy solvency. It was striking that many of the interviewees and those who completed the questionnaires (consultants, credit managers, and auditors) had a negative view of the bank's role when enterprises get into financial difficulties. The aspect of credit termination and the refusal to provide additional credit play a major role in this. Banks take the viewpoint that, as providers of low-risk capital, they cannot run any extra risks in situations of financial difficulties and they are therefore extremely careful when considering whether to continue providing funds (not terminate credit) or to provide additional credit. However, many of the parties concerned see the bank as the pre-eminent organisation to provide or continue providing liquidity in difficult situations. The viewpoint is also taken that, as a result of the securities that are provided, banks are always better off than competitor creditors. This therefore gives rise, at least according to this viewpoint, to a moral obligation in the event of financial difficulties to provide extra necessary liquidity. However, banks see the security as a necessary instrument for covering normal risks. They also refer to the lower realisable value of assets in the case of possible failure. (Case studies show that, in spite of the security provided, banks regularly have to make provisions for loans that cannot be repaid.) The argument stating that banks always have more information than competitor creditors is parried with the statement that anyone can ascertain an enterprise's financial situation by conducting an investigation.

The differences in the above viewpoints lead to differences of opinion and a strained relationship between the various parties concerned. Informal reorganisations appear to be jeopardised by this. In practice, the difference between risk-bearing financing and low-risk financing is not always seen. More information and greater awareness of this area provided through information from the government, sector organisations, and/or banks could prevent misunderstandings and communication problems.

All the constituent studies showed that it is important for the parties to trust each other and to reach agreement about the reorganisation measures to be taken. An important reason for informal reorganisations failing is the loss of trust between the enterprise and the parties concerned. Trade and cost creditors are often kept in suspense and there comes a time when they are no longer willing to work on an amicable solution. Banks lose trust at the moment that the management underestimates the seriousness of the situation and fails to take adequate measures. This is often exacerbated by a lack of insight (non-transparency) of creditors into the enterprise's actual financial situation. This is often the result of a combination of forecasts being too optimistic and a defective management information system. The case studies and interviews show that failed informal reorganisations have the following common features in their implementation.

- The management and shareholders have a passive attitude to the informal reorganisation.
- The enterprise provides the parties concerned with inadequate information about the actual financial situation.
- The enterprise is incapable of attracting risk capital in time (in the form of an acquisition or otherwise).

On the other hand, successful informal reorganisations have the following common features in their implementation.

- The management quickly and adequately reorganises the business activities (often with the aid of third parties).
- Parties with a major interest (financiers) are involved in the reorganisation process.
- There is transparency about the financial situation and the proposed informal reorganisation.
- An active effort is made to bring in risk capital (in the form of an acquisition or otherwise).

It can be concluded on the above grounds that the likelihood of an informal reorganisation actually succeeding increases when the following conditions are met:

- Management and shareholders must take an active attitude to the informal reorganisation.
- Parties with a major interest (financiers) must be involved in the reorganisation process.
- The business activities must be reorganised properly.
- There must be transparency about the financial situation and the proposed informal reorganisation.
- Risk capital must be brought in (in the form of an acquisition or otherwise).

The reorganisation of enterprises in financial difficulties may be accompanied by high costs. A few case studies and the interviews and

questionnaires showed that there is a major problem in the area of redundancy costs/employment protection of personnel. There appears to be no cheap way of making personnel redundant in an informal reorganisation. This is an important disadvantage vis-à-vis both a formal reorganisation procedure and assets transaction after corporate failure (restart). To enable more informal reorganisations to succeed, it should be possible to make personnel redundant in a simpler and cheaper manner. If the possibilities for this are increased during a moratorium, the possibilities should, in any case, also be created in the informal reorganisation. However, misuse of the possibilities must always be prevented. A special body (such as a department of the Enterprise Section of the Amsterdam Court of Appeal) could be established to concentrate on insolvency issues and to take into account legal as well as economic interests.

Another disadvantage of informal reorganisations is that a composition (accepted by a qualified majority of competitor creditors) can only be imposed on unwilling creditors under special circumstances. The case studies and interviews show that a flexible approach is often taken to this in practice. The arguments that courts could impose an agreement of this kind during a moratorium and that the yield in a formal procedure would be lower usually tend to speed up the process. There also appears to be a problem in relation to compositions with creditors that involve a waiver of the remaining amount due. In questionnaires and interviews, creditors say they find it unfair that they have to bear the loss in favour of the enterprise's owners. The unwillingness that many creditors display in practice often appears to be connected with this. Whenever possible and necessary, creditors prefer the postponement of payments. Moreover, amicable compositions should come about in the same way as compositions during a moratorium. If this is not possible, more enterprises will have to apply for a moratorium unnecessarily. However a moratorium should be seen as an aid ('pre-pack' procedure) in confirming informal reorganisations and, in principle, not as an independent means of reorganising enterprises. Decisions on the revision of the Bankruptcy Act should take this into account.

It emerged from the questionnaires that the tax authorities and the implementing organisation for employee insurance (UWV) often adopt a slow-moving and inflexible attitude towards amicable solutions. Respondents indicated that this can jeopardise informal reorganisations. Interviews with bank employees also revealed that the tax authorities' right of seizure can lead to the failure of informal reorganisations. However, there was practically no evidence of this among the enterprises investigated in the case study. As mentioned, it is necessary at a certain point to bring in risk capital or low-risk capital (owing to the deterioration in the balance sheet ratios, risk capital will usually be the preferred option, at least of the banks). If a shareholder (or an individual entrepreneur) is unwilling or unable to invest money, banks will generally not do so either. This leads to an impasse. Small

enterprises have the possibility of applying for credit under the terms of Self-Employed Assistance Decree (Besluit Bijstandverlening Zelfstandigen 2004 (BBZ)) to enable the enterprise to be reorganised and to finance a composition. Larger enterprises will often have to find acquisition candidates/investors or a party willing to take over the existing financing agreements. It will be necessary to investigate the extent to which government is permitted to provide risk capital within the restraints of European legislation, when it is not available or cannot be provided in any other manner.

The case study investigation showed that prospective investors (who could provide risk capital) often pull out at a late stage. The reasons cited are the high costs and risks associated with reorganisations. The costs and risks are in the field of personnel but are also associated with the closure and/or reorganisation of loss-making business units. There is also often uncertainty about possible 'skeletons in the cupboard' in the form of deferred (still unknown) commitments. The prospective investors often pull out at a time when there is an almost complete lack of liquid funds. Banks and other interested parties often see the fact that the investors have pulled out as a sign that there is no longer any confidence in the future of the enterprise. This often leads to a moratorium, which usually ends in corporate failure. It is regularly the same or other investors who buy (restart) part of the enterprise as a going concern through an assets transaction, after corporate failure. 'Starting with a clean slate' enables profitable activities to be continued. This gives rise to the question of whether this practice should or could be prevented. On the one hand, corporate failure appears to be being used as a way of 'getting round' commitments. On the other hand, some 'value' remains because business activities continue. In any event, the case studies showed that assets transactions are practically unavoidable after corporate failure in certain cases. (In thirteen of fifteen investigated files on failed informal reorganisations, there was a complete or partial restart in the form of an assets transaction after corporate failure.) It also emerged that when an informal reorganisation has taken place (on the basis of a well-conceived plan), a restart can be achieved sooner, thereby further minimising the 'destruction of value'. In this sense, a failed informal reorganisation can also be seen as a success from the social and economic point of view.

Interviews and questionnaires indicated that better cooperation between the enterprise and creditors could help informal reorganisations to succeed. A code of conduct ('Multi-Creditor Protocol') could aid success, provided the relative positions of creditors are taken into account and it is subject to the right preconditions. The introduction of a code of conduct would be an appropriate way of clarifying each party's rights and obligations in an informal reorganisation and thereby creating a basis for trust. The core of any such

code of conduct would be that the enterprise and its relevant creditors (often banks, major trade and cost creditors and the tax authorities/implementing organisation for employee insurance (UWV)) would voluntarily comply with a few fundamental rules. The Statement of Principles of INSOL International could serve as the starting point for a 'Dutch Approach'. Compliance with the rules would potentially have a stabilising effect on the situation that is arisen, as there will be mutual clarity between the parties. A certain degree of objectivity will be built into the process. Creditors will be asked not to take any action for a while and, 'in return for this', the enterprise will have to do everything possible to get in control of the situation. However, the basis should be voluntary cooperation. The code would therefore need to enjoy broad social support. In practice, as emerged from the case studies and interviews, some aspects of this are already applied, particularly in large enterprises. There appears to be nothing to prevent this from being used in smaller enterprises. The necessity of introducing a code of conduct for informal reorganisations is increasing as a result of international initiatives such as the ROSCs (Reports on the Observance of Standards and Codes) programme of the IMF and the World Bank. A more detailed study of the application of such a code in the Netherlands appears advisable. The Ministry of Justice could take the lead in this.

Looked at as a whole, the focus in the (Dutch) practice of informal reorganisations should be on achieving cooperation and (restoring) trust between the relevant parties concerned, transparency, the timely and proper reorganisation of the business activities and, if necessary, on bringing in additional risk-bearing financing. A 'Dutch Approach' could make a major contribution to enabling the present practice to function better.

