Analysis of international out-of-court corporate restructuring and recommendations for implementation in Hungary

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EY

Introduction

1. Executive Summary
2. Introduction to out-of-court restructuring

EY

1. Executive Summary

- The National Bank of Hungary (hereinafter: "MNB") is seeking to address the high volume of NPLs and the effect of NPLs on the financial stability and long-term economic performance of Hungary as well as on banks operating in Hungary. In 2014, the MNB established a working group, consisting of the Hungarian Banking Association, MARK Zrt., EBRD, EY and the 8 largest systemic banks: Budapest Bank, CIB, Erste Bank, K&H, MKB, Raiffeisen Bank, OTP, UniCredit (hereinafter: "Working Group") to address the NPL situation in Hungary. As part of this initiative the MNB requested the European Bank for Reconstruction and Development (hereinafter: "EBRD") to conduct a review and analysis of the existing **out-of-court restructuring (hereafter: "OOCR")** framework and practices in Hungary which could lead to the development of new OOCR guidelines.
- The EBRD appointed Ernst&Young (hereinafter: "EY") to perform a thorough review of international corporate workout guidelines and best practices applied in selected European countries and their application in Hungary. As part of this exercise EY conducted extensive interviews with Hungarian banks to solicit their opinions and feedback on OOCR market practice. The results of the EY review and consultations are set out in this Report.
- One of the principal recommendations of this Report is the need for new, effective OOCR guidance for the Hungarian banking sector sponsored by the MNB with the active involvement of the Banking Association. It is proposed that such OOCR guidance takes the form of a non-binding recommendation on corporate restructuring **(the "MNB Recommendation")** issued by the MNB this autumn.
- Legal advisors Lakatos, Köves és Társai Ügyvédi Iroda ("Lakatos") have been appointed by the EBRD to work on the drafting of the MNB Recommendation based on the findings of this Report and the consultation with banks. It is intended to work closely with the Hungarian Banking Association and banks on the content of the MNB Recommendation. The MNB will host a workshop for banks towards the end of September at which this Report and the draft MNB Recommendation will be presented. The MNB Recommendation is expected to be issued by the end of October this year.
- The EBRD and EY would like to thank the National Bank of Hungary, the Hungarian Banking Association, MARK Zrt. and the following commercial banks for their active participation and their contribution in these discussions: Budapest Bank, CIB Bank, Commerzbank, Erste Bank, Eximbank, FHB Bank, Gránit Bank, Hungarian Development Bank, K&H Bank, KDB Bank, MKB Bank, OTP Bank, Raiffeisen Bank, Sberbank, Takarékbank and UniCredit Bank.

Background

- In order to provide guidance on OOCR, the Hungarian Banking Association developed the Budapest Approach in 2010, based on the principles of the London Approach. In theory, the Budapest Approach should have enabled market players to apply flexible guidelines to their internal practices; however, since its release, the banks have not been using the Budapest Approach in practice. Possible reasons for this are set out under the section *Application in practice of the Budapest Approach* (page 14).
- Since the Budapest Approach is not referred to in restructuring negotiations or standstill agreements, negotiating parties tend to apply individually developed principles. Moreover, these different principles may vary due to differences in banks' internal work-out and restructuring policies. Divergent out-of-court restructuring practices result in uncertainty around the expected next steps in a restructuring and a low level of trust among the financing banks.
- Therefore, it has been seen as essential to revise and recast Hungarian OOCR framework in cooperation with restructuring practitioners and the MNB, to better serve Hungarian financial sector, burdened by the high level of corporate non-performing loan (NPL) ratios which exceeded 18% as at the end of 2015.
- A joint initiative to revise the existing OOCR framework was called for by the MNB and the EBRD and a kick-off was held at the premises of the MNB. During this introductory meeting, the participating banks reaffirmed that OOCR guidelines are considered as an integral part of the insolvency framework and emphasized that a new framework should be set out providing pragmatic guidance to both financing banks and debtors. Banks have also emphasized the importance of modernizing the Hungarian insolvency framework in line with the recommendations set out in the report "Analysis of Corporate Restructuring and Insolvency in Hungary" issued by the EBRD, Réczicza White&Case LLP and EY on 23 February 2015 (the "Analysis of Corporate Restructuring and Insolvency in Hungary").

Scope and nature of the Report

- The Report focuses on international best practice in corporate workouts including reference to INSOL Principles and regional initiatives (the "Report") which aims to, *inter alia*:
  - Review and analyse the different approaches to the promotion of corporate workouts in Europe, identifying the strengths and weaknesses of each of these approaches and to the extent as possible their overall impact;
  - Advise on which approach by the Hungarian authorities to encouraging greater cooperation by local banks in corporate workouts would best fit the Hungarian context, address as part of its advice whether there should be a compulsory (banking regulatory) element to any such approach; and
  - Consider how the relevant approach could be implemented within the Hungarian framework and any consequential changes which might be needed to the corporate restructuring and insolvency environment.
- Detailed interviews were conducted with representatives of sixteen Hungarian commercial banks, the National Bank of Hungary, MARK Zrt and Hungarian Banking Association with the objective of gathering insight into the existing Hungarian workout practice and related challenges.

Report key objectives

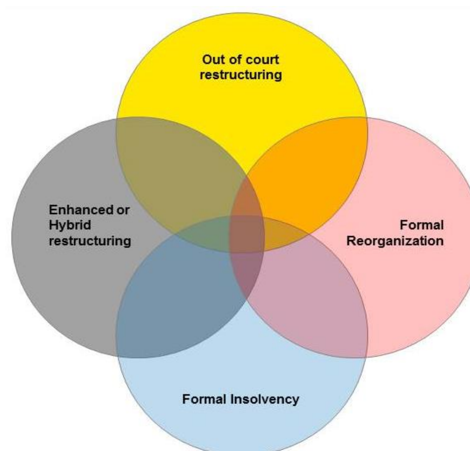
- This report was drafted with the objective of identifying key challenges related to the existing Hungarian OOCR framework (i.e. the Budapest Approach) and key elements to be included into a revised version of the Hungarian OOCR guidelines.
- For the purposes of better understanding the different economic environments and key drivers behind successful implementation of OOCR principles, EY conducted an overview of insolvency and OOCR frameworks in selected countries of Central and South-Eastern Europe (CSE). Research materials and specific practical insights were provided by the respective EY local teams. As observed countries have substantially divergent insolvency and OOCR frameworks; we tried to understand Hungarian framework in a context relative to other countries, to provide recommendations which would also be based on regional best practices.
- The report focuses on a phase-by-phase assessment of Hungarian OOCR process as typically applied in practice. It identifies key challenges and bottlenecks that commonly occur in such a process and recommendations on key issues to be covered in the newly drafted Budapest Restructuring Guidelines (BRG).

Structure of the report

- **Introduction** (page 6): The following pages provide a short general introduction to out-of-court restructuring in order to establish a common understanding of the topic and topic-related terms.
- **Core section** (page 8): The introductory part is followed by the core document which focuses on Hungary specific issues. First, the Report presents a short overview of the Hungarian insolvency framework. Going forward it summarizes key challenges related to the Hungarian OOCR practice and continue by listing the main issues identified based on the bank interview and international best practice review. It concludes with summary of recommendations.
- **Appendices** (page 34): In the appendices there is a high level overview of the Hungarian legal framework (Appendix A) and an overview of the International Best Practices (Appendix B) which starts with a short review of historical best practice development followed by a summary of INSOL principles, which today reflect best international debt restructuring practices and serve as a benchmark for professionals providing a standardized general approach to be applied to out-of-court debt restructurings. The summary of INSOL principles is followed by a comparative study on practices in selected CSE countries.

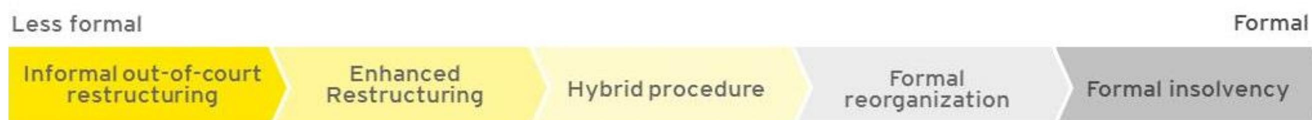
2. Introduction to out-of-court restructuring

- Legislative frameworks typically provide for court-supported restructuring procedures, court-driven formal restructuring procedures and formal insolvency procedures, while OOCR commonly falls, partly or entirely, outside the scope of regulation; however, an effective insolvency system is essential for providing incentives for creditors and debtors to participate in OOCR.



Source: EY compiled, World Bank

- In-court procedures and OOCR are not separate from each other; rather they exist in a continuum of different degrees of formality and court intervention. The World Bank defines the following restructuring procedures with a varied degree of judiciary involvement (e.g. formality):
  - **Out-of-court debt restructuring** is “changing the composition and/or structure of assets and liabilities of debtors in financial difficulty, without resorting to a full judicial intervention, and with the objective of promoting efficiency, restoring growth, and minimizing the costs associated with the debtor’s financial difficulties. Restructuring activities can include measures that restructure the debtor’s business (operational restructuring), and measures that restructure the debtor’s finances (financial restructuring)”[1].
  - **Enhanced restructuring** is informal restructuring, which is purely contractual, yet enforced by elements which increase its efficiency and use in practice. In such procedures social norms or codes of conduct (e.g. London approach, Bangkok approach) are applied, which may inter alia prescribe the roles and responsibilities of relevant stakeholders, procedural steps, unified documentation to be applied in restructuring processes, etc.. As defining key features of informal Hungarian OOCR guidelines governing contractual workouts is the objective of this Report, general characteristics of enhanced OOCR will be further elaborated below.
  - **Hybrid procedures** are contractual OOCRs with limited court intervention. Such intervention may include validation of intercreditor agreements, enforcing stay of enforcing actions, appointing of mediators etc.
  - **Formal reorganization procedures and insolvency procedures** are in-court procedures governed by insolvency legislation which can commonly be initiated by debtors and creditors subject to fulfilment of legislative requirements. For detailed information on Hungarian legal framework please refer to Appendix A.



(Source: World Bank)

Note: For the purposes of this report, insolvency proceedings include formal (e.g. enforcement, formal restructuring, bankruptcy, liquidation) and informal (e.g. OOCR) processes.

- Insolvency procedures will generally take longer, will be more costly and more rigid as compared to OOCR, which were partially also developed as their cheaper, quicker and more flexible alternatives. Creditors, debtors and other stakeholders may benefit from OOCR at several levels. They can save on legal costs, preserve reputation and third party confidence etc.

[1] The World Bank, "Out-of-Court Debt Restructuring", Jose M. Garrido, 2012

- The underlying purpose of OOCR activities is to preserve a going concern status of a company and to ensure the long term viability of its business. The key question to stakeholders considering participation in an out-of-court workout is whether there is a reasonable prospect of solving the debtor's problems in an OOCR process.
- As relevant stakeholders may often have opposite views on the prospects of solving debtors' financial difficulties, it is essential that debtors, their lenders and owners, and (if appointed) their respective financial and legal advisors balance intricate legal and business judgments and attempt to reach a compromise of competing interests.
- Involvement of competent financial and legal advisors can be of critical importance to designing, assessing and explaining the various available options and strategies in an objective manner. Carefully evaluating stakeholders' levels of negotiating leverage, which often stem from their relative positions in a potential formal restructuring or insolvency process, as discussions progress, is key to crafting a solution which can achieve "buy in" from relevant stakeholders.
- It commonly occurs in practice that flexible contractual arrangements are not adequate to deal with complex restructuring situations where multiple financial creditors are involved. Such cases require application of guidelines to assist stakeholders and apply elements of formality to unify actions of all relevant stakeholders involved.
- Informal guidelines were initially developed in periods of financial distress (e.g. London Approach, Bangkok Approach, Istanbul Approach), and seek to prompt participants to internalize these norms in order to ensure their use in practice. In the aftermath of the 2008 financial crisis, there has been a strong tendency of developing informal restructuring guidelines also in the CSE region. Most of the countries in the region have developed some form of restructuring principles either based on INSOL principles (e.g. Austria, Serbia, and Romania) or the Bangkok Approach (e.g. Slovenia). Nonetheless, the success of these informal guidelines varies widely per each respective country. For further information please refer to "Appendix B - International best practices".
- Successful implementation and subsequent use in practice of principles commonly requires the active engagement of all relevant organizations. Most important role is usually undertaken by central financial authority, which apart from taking part in drafting relevant legislation, often has an important role of supporting OOCR use in practice (e.g. England, Thailand and Slovenia).
- Even though a lot of effort has been put into developing effective OOCR regimes across the CSE, there are still several characteristic issues connected with OOCR framework which predominantly stem from underdeveloped business and legal environment in a particular country. Most common issues observed are as follows:
  - adverse tax consequences of debt write-offs and debt forgiveness;
  - legal prohibition against the tax and social security authorities (who are typically a major creditor) to participate in out-of-court workouts;
  - prevalent fraudulent behaviour (e.g. use of a shell or mirror company to hide assets);
  - problems with multi-creditor coordination evidenced by inability to bind in holdouts;
  - debtor's failure to provide all relevant information;
  - lengthy and expensive foreclosure procedures;
  - lack of trust in the judiciary and other stakeholders such as insolvency administrators and bailiffs;
  - distrust among parties especially of small borrowers vis-à-vis their banks;
  - absence of debt for equity swap or additional funding options to finance debtors during the standstill period;
  - avoidance of restructuring measures taken out-of-court in subsequent formal procedures.
- If procedures are well designed, supported by relevant stakeholders and accompanied by appropriate legislation developing OOCR principles is likely to be an effective way of assisting an economy and its financial sector resolving the NPL issue.
- Nevertheless, each of these challenges must be addressed simultaneously for the developed solution to have the desired result – creating value for stakeholders and the economy as a whole.

Hungarian restructuring framework

1. Overview of the existing enforcement and insolvency framework
2. Out-of-court restructuring in Hungary
3. Chronological overview of the restructuring process
4. Summary of recommendations

1. Overview of the existing enforcement and insolvency framework

Introduction

- This section is based on the "Analysis of Corporate Restructuring and Insolvency in Hungary" report prepared and released by EBRD, Réczicza White&Case LLP and EY on 23 February 2015. Further details are set out in Appendix A: Overview of the legal framework in Hungary.

- The current insolvency framework in Hungary provides the following options:
  i) security enforcement procedure
  ii) bankruptcy procedure
  iii) insolvent liquidation

(i) Security enforcement in Hungary

- Irrespective of whether the debtor is insolvent or not, creditors have the right to enforce their security when the secured claim falls due and the debtor does not perform its payment obligation. Creditors may decide to proceed with (a) an in-court enforcement procedure, (b) *expedited security enforcement proceeding* or (c) out-of-court collateral enforcement procedure. However, enforcement of the security is not permitted by law after the commencement of the insolvent liquidation procedure or the bankruptcy procedure.
- Comparison of security enforcement measures *(further described in Appendix A: Overview of the legal framework in Hungary)*:

	In-court security enforcement	Expedited security enforcement proceeding	Out-of-court enforcement procedure
Condition for enforcement	To have an undisputed order for payment against the debtor or, as a result of a successful lawsuit, a final and binding court judgment against the debtor to pay its debt, and non-performance of debtor's obligation at maturity date set in the payment order or in the judgment. If the pre-conditions are met, the creditor needs to request the court to issue a deed to initiate the enforcement proceeding.	To have the creditor's claim incorporated into a notarial deed including mandatory elements, and non-performance of the debtor's obligation at maturity date. If the pre-conditions are met, a notarial enforcement clause is needed to initiate the proceeding (no preliminary lawsuit is required).	In case of non-performance of the debtor's obligation at maturity date, secured creditors are able to sell, or, if the pledger has agreed to the acquisition following the date when the secured creditor became entitled to enforce its claim, acquire the pledged property, or directly enforce the pledged right or claim without the involvement of the court.
Initiator(s)	Can be initiated by the secured creditor(s)	Can be initiated by the secured creditor(s)	Can be initiated by the secured creditor(s)

	In-court security enforcement	Expedited security enforcement proceeding	Out-of-court enforcement procedure
Key steps	1) Starts with a relatively lengthy litigation phase in order to obtain a final, binding and enforceable deed. 2) The debtor has 15 days to meet its payment obligations from the commencement of the in-court security enforcement procedure. The court bailiff manages the process, seizes the debtor's assets and sells them at an auction (or, in certain limited cases, without an auction).	After procuring the notarial enforcement clause, the process is the same as in-court security enforcement.	Sale of the pledged property: 1) Notification of the pledgor and the debtor on the contemplated sale (generally at least 10 days prior to the date of the contemplated sale). 2) The creditor will be entitled to take over the possession of the pledged property, but it is not a precondition to the sale. 3) Sale of the pledged property via auction or without auction. Acquisition of the pledged property: 1) Proposal for the acquisition of the pledged property by the creditor. 2) 20 days for the debtor and other interested parties to object to the contemplated acquisition. 3) If the pledgor accepts the proposal and no objection were made, the creditor acquires the pledged property.
Oversight	Although the enforcement process is managed by the court bailiff, it is supervised by an ordinary court. Creditors may file objections against the actions or regarding the omissions of the court bailiff.	Idem to in-court security enforcement	The creditors themselves, often via an elected representative or committee or appointed 3rd party.
Costs	Considerable. In addition to stamp duties paid in relation to the litigation, creditors have to pay a stamp duty at the commencement of the enforcement procedure (1% of the total claimed amount) and also have to pay the compensation of the court bailiff and 50% of its estimated costs and expenses in advance.	Idem to in-court security enforcement	Lower than in case of court enforcements, as no stamp duty/compensation is payable.

	In-court security enforcement	Expedited security enforcement proceeding	Out-of-court enforcement procedure
Duration	Relatively lengthy (litigation phase may take several years and the enforcement is generally taking more than one year)	Relatively quick procurement of notarial enforcement clause as a first step, in-court enforcement can take an additional year or more.	Relatively quick (a couple of months if the debtor does not file a lawsuit against the creditor disputing the claim or the creditor's actions)
Comment	Being lengthy, costly and of uncertain outcome for the recovery of claims, the in-court security enforcement procedure is not the preferred in-court collateral enforcement procedure.	Although quicker than the normal in-court security enforcement as there is no prior litigation phase, the outcome of the recovery of the claims is also uncertain.	This proceeding is preferred by banks to in-court security enforcement; however, it is usually used as an exit strategy and not for restructuring purposes.

(ii) Bankruptcy procedure

- In principle a bankruptcy is an in-court restructuring method. The purpose of the bankruptcy proceedings is to come up with an agreement which *inter alia* includes a restructuring plan. In Hungary however, a detailed restructuring plan is rarely prepared. It can be initiated by the debtor only, thus it is rarely used, and mostly by debtors seeking favourable bankruptcy agreements with the purpose of hiding their ongoing financial difficulties. Such process is sometimes accompanied by fraudulent behaviour.
- Under Hungarian law, a reorganization plan affects all creditors in a bankruptcy procedure, and it is not possible to limit the scope of the plan only to a certain group of creditors. The composition agreement which contains the reorganisation plan cannot contain provisions and conditions which are clearly and manifestly unfavourable or unreasonable to all or certain groups of creditors.
- In a bankruptcy procedure a composition agreement can only be concluded if the debtor was able to secure the majority of the votes of both the secured and the unsecured creditors. Such composition agreement shall apply to non-consenting creditors, creditors with disputed claims, and to those creditors who failed to take part in the conclusion of the composition agreement in spite of having been properly notified. The agreement, however, may not stipulate less favourable conditions in respect of these creditors than to the creditors granting consent to the agreement in the given categories.
- A moratorium on repayment of outstanding financial obligations applies in bankruptcy proceedings. The length of moratorium is generally 120 days, which is often extended up to 1 year. Nearly all bankruptcies in Hungary end in liquidation. Furthermore, bankruptcy proceedings have several limitations:
  - A formal bankruptcy event has a stigmatizing effect on debtors and can cause further difficulties and/or losses in their business operations, despite the fact that it is a form of (in-court) restructuring.
  - Banks also highlighted the lack of professional capacity and in certain cases biased or dishonest approach of bankruptcy trustees. In terms of timing, the formal bankruptcy procedure is often initiated at a very late stage since debtors tend to hide their financial difficulties and banks do not have the right to initiate such a process even if they recognise potential issues earlier.
  - The outcome of bankruptcies for banks is usually uncertain due to ineffectiveness and the occurrence of fraudulent behaviour.
  - Due to the above, there were very few successful bankruptcies in recent years from the lenders' point of view.

(iii) Insolvent liquidation

- Liquidation proceedings may be initiated by the debtor, any creditor or the bankruptcy administrator, as well as the bankruptcy court. Once the debtor is under liquidation, the management (and shareholders) of the debtor lose control over the debtor and its assets, and banks and other creditors also lose control in the process. A liquidator is appointed subsequently to be in charge of the debtor's operations. Theoretically, an agreement with creditors may be concluded in liquidation as well, but this is an unusual outcome. The liquidation itself is a lengthy procedure, which can last year(s) and it is not cost effective. Therefore, liquidation of the debtor is usually the worst case scenario for the financing banks.
- Any creditor or the liquidator has the right to challenge transactions concluded by the insolvent debtor within 90 days of the date preceding the date when a competent court received a petition for the initiation of liquidation proceedings or at any time thereafter, if the subject matter of such contract or legal declaration is to grant preference to any creditor, in particular an amendment of an existing contract for the benefit of such creditor, or provision of collateral to an unsecured creditor.
- New financing provided 90 days prior to the filing for the commencement of liquidation of the debtor might not be considered as a valid and enforceable claim in the liquidation process. Therefore bridge financing (new funding provided during the Standstill Period) or reorganization financing (new financing provided during the implementation of the restructuring plan) is rarely provided.

2. Out-of-court restructuring in Hungary

Out-of-court restructuring (OOCR) practice in Hungary

- OCCR in Hungary is a voluntary process agreed upon by the debtor and creditors. The Budapest Approach is the only existing official framework prevailing in the industry but its use by the industry's restructuring practitioners is very limited due to its voluntary nature.
- The process of OOCR is characterized by a mix of currently set out "first come first served" and a coordinated approach. Financial difficulties are generally revealed late, as debtors tend to use "hide and try to solve themselves" strategies while creditors on the other hand rarely act proactively. When insolvency problems become obvious, creditors often react individually by trying to enforce collaterals in an uncoordinated bilateral manner.
- This initial period is characterised by uncertainty and instability, and can reduce the chance of a successful restructuring. If this first period is overcome, the banks often call bank meetings in order to reach standstill agreements and avoid liquidation scenarios. If a standstill agreement is agreed upon, external financial advisors are often involved in the preparation of independent information platforms (Independent Business Review or IBR), drafting restructuring options and providing support during the negotiation process.
- Since OOCR is not enforced by law, or governed by rules other than general mandatory provisions of Hungarian legislation[2], parties have to come to an agreement based on the principle of good faith and on common business practice.

Summary of the Budapest Approach

- As a response to financial difficulties triggered by the global financial crisis, the Budapest Approach was developed in 2010, setting out a framework of voluntary, non-binding principles based on the London Approach. The main goals were to introduce out-of-court restructuring principles to which banks would adhere to and to support co-operation between lenders and debtors.
- Financial and legal advisers as well as banking experts were involved in the development of principles set out in the Budapest Approach. The final version was reviewed and released in form of a recommendation by the Hungarian Banking Association.
- The following banks voluntarily endorsed the Budapest Approach since its release: Citibank, Erste Bank, K&H Bank, Takarékbank, MagNet Bank, MKB Bank, OTP Bank, Raiffeisen Bank and UniCredit Bank.
- The Budapest Approach comprises non-binding principles and defines the guidelines that should be complied with in multi-creditor financial restructurings.
- The Budapest Approach is underlined by the following key concepts:
  - A company's deteriorated financial position as a result of the financial crisis should be addressed with the aim of reorganization of the Company rather than its liquidation.
  - In terms of macroeconomic impacts, the co-operation between financial creditors to reach a long-term solution is the preferred approach contrary to the short-term, partial solutions which are only beneficial to some of the stakeholders in a restructuring process.

Structure of the Budapest Approach

- The Budapest Approach[3] is a two page document consisting of the following seven principles which were not developed in detail:
  - Creditors should pursue to conclude an out-of-court arrangement between the banks and the debtor in financial difficulties.
  - Creditors should provide a sufficient but limited grace period (Standstill Period) for the debtor. During the Standstill Period each creditor refrains from taking any steps to enforce its claims against the debtor at the expense of other creditors.

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[2] For example Act V of 2013 on the Civil Code and Act XLIX of 1991 on the bankruptcy and insolvency procedures.
[3] Available in Hungarian on the website of the Hungarian Banking Association:
http://www.bankszovetseg.hu/wp-content/uploads/2012/10/Bp_elvek_1melleklet.pdf

- A Steering Committee should be formed by the creditors in order to manage and co-ordinate the process and to ensure an integrated approach and communication towards the debtor.
- An independent business review should be performed by an external advisor to provide professional support for decision making and to ensure transparency and objectivity.
- Incurring costs and losses should be shared and treated *pari passu* by creditors based on their relative exposures and collateral positions.
- In case the Steering Committee makes a decision on the provision of new money in order to successfully implement the reorganization plan, new money provided during the Standstill Period should have priority over the funding provided prior to this period.
- Creditors involved in the restructuring process should be committed to a long term solution for the debtor.

▶ The following draft documents were attached to the Budapest Approach (available in Hungarian language only):

- Standstill agreement - bilateral;
- Standstill agreement - syndicated loans;
- Standstill checklist;
- Coordinator appointment letter and
- Acceding letter.

Application of the Budapest Approach in practice

▶ During the course of our interviews, we have understood that since its release in 2010 financial institutions have only on limited occasions referred to the Budapest Approach during out-of-court restructuring negotiations in practice. Even during the few restructuring processes with a successful outcome, banks followed guidelines provided by the leading bank (usually a subsidiary of a large foreign bank) or applied their individual approaches. Based on the banks' opinion, the Budapest Approach cannot be applied to out-of-court restructuring processes in the Hungarian economic environment in its current form due to the following reasons:

- Being a two-page document, the Budapest Approach is not detailed enough to provide appropriate guidance for an OOCR process.
- It is a fairly uncomprehensive and brief document accompanied by contract samples and is difficult to refer to in different phases of the OOCR process.

▶ Although the Budapest Approach was prepared with involvement of financial and legal experts as well as banking specialists, it was not drafted based on a systematic bottom-up approach. The fact that a significant number of banks did not participate in the final drafting of the Budapest Approach meant that it was not widely accepted. We were told that concerns noticed by some of the participating banks were not addressed (but have not confirmed this statement).

- The Hungarian Banking Association recommended the Budapest Approach and provided for the possibility for banks to endorse the document published on its website.
- Critically the Budapest Approach was not formally supported by the National Bank of Hungary (or its predecessor in regulation of banks, the Hungarian Financial Supervisory Authority ("PSZÁF")), which limited the incentives for compliance among the banking community.

Summary of certain issues in the Hungarian insolvency framework hindering out-of-court restructuring

- As out-of-court restructuring takes place in the shadow of the insolvency regime, it is vital that such an insolvency regime (and more broadly, the entire legal system) recognizes and acknowledges the outcome of out-of-court procedures. In this respect, the applicable laws need to clearly define the rights and obligations of the relevant parties. However, in Hungary this is not the case, as the existing legal and tax framework still have impediments to OOCR, such as:

  i) Due to restriction in the Hungarian taxation laws and state aid concerns, the Tax Authority cannot accept haircuts as tax exemption or similar benefits which may jeopardise the ability to achieve a solvent restructuring. As mentioned in the Analysis of Corporate Restructuring and Insolvency in Hungary, tax authorities should be granted the possibility of reducing their tax claims as part of a court restructuring under the Bankruptcy Act if this could help the debtor. In addition, the Ministry for National Economy could issue guidance on how the tax authorities should exercise their right to waive tax claims;

  ii) Financing can be challenged if given up to 90 days prior to a potential liquidation. Granting a super-senior status is likely to trigger such a right of challenge. In addition to that, even if no explicit super-senior status is granted in the financing agreement, there is a risk that the liquidator or a judge may consider that the entire transaction resulted in granting preference to a creditor (e.g. because additional collaterals are provided by the debtor to secure the new financing, or the repayment schedule became more beneficial) and, as a result, the transaction can be challenged;

  iii) The Hungarian legal system does not protect the (super senior) status of new money providers adequately Super-senior status is not recognised in formal in-court insolvency procedures and as described above is vulnerable to challenge. If such status is granted by the debtor, the liquidator or other creditors may challenge the underlying agreement As mentioned in the Analysis of Corporate Restructuring and Insolvency in Hungary, rescue financing should be facilitated by the granting of special priority e.g. priority ahead of unsecured creditors in any subsequent liquidation.;

  iv) Any credit write-off pursuant to the restructuring generates an additional tax burden on the debtor which again discourages the use of effective restructuring tools to re-size the debt to a sustainable level; and

  v) The bankruptcy procedure limits the influence of creditors (and to a more limited extent debtors) in important areas such as selection of the administrator, the ability to put forward restructuring proposals and to initiate the procedure.

- Although a restructuring case may have to be dealt with in a distinct insolvency procedure after failure of the restructuring plan, such procedures cannot be considered as viable alternatives to out-of-court restructuring. In-court procedures currently cannot be considered as an effective next step following an unsuccessful out-of-court procedure, as these procedures are far from being flexible, let alone effective, due to the following reasons:

  – Formal procedures (especially bankruptcy and insolvent liquidation) are heavily controlled by court bailiffs or liquidators, where creditors have no influence on the choice of these officers. Moreover, under the existing fee structure there are no real incentives for officers to play a proactive and efficient role in the proceedings.

  – Creditors' control over the course of an insolvency proceeding and particularly over liquidation of assets is weak mainly due to lack of adequate information and limited powers on the creditors' side as provided by law.

3. Chronological overview of the restructuring process as commonly applied in Hungary

To illustrate the current out-of-court restructuring practise in Hungary, highlight key challenges and propose corresponding solutions, we undertook a step-by-step description of the Hungarian out-of-court restructuring process.

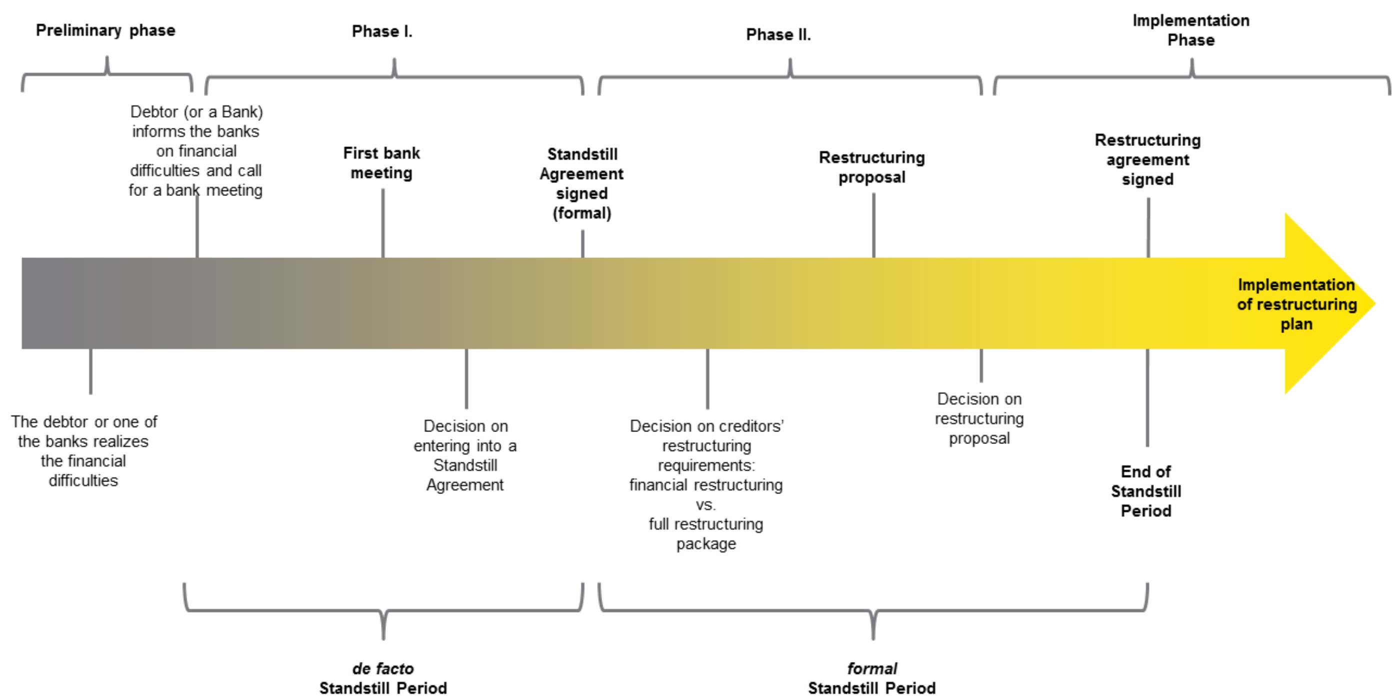
This section is based on EY's key findings from (i) bank interviews, (ii) analysis of a typical out-of-court restructuring process in Hungary, (iii) analysis of Hungarian insolvency framework (for more details please refer to Appendix A) and (iv) comparative study of practices applied across selected CSE markets (for more details please refer to Appendix C).

Our key findings are presented under the four phases as they typically occur in an out-of-court restructuring process, notwithstanding that their occurrence may differ on case-by-case basis:

- **Preliminary Phase:** From the time the debtor or one of the banks becomes conscious of financial difficulties until the decision on whether to inform other banks and call for a bank meeting.
- **Phase I:** From calling the first bank meeting by a debtor or by one of the banks until the bank's decision on whether to enter into a formal Standstill Agreement.
- **Phase II:** From signing of a Standstill Agreement until the decision on whether to accept a restructuring plan.
- **Implementation Phase:** Implementation of the restructuring plan

- Each respective phase is described in subsections: Purpose, Actions to be undertaken, Key challenges and proposed Recommendations.

Outline of key steps in the out-of-court restructuring process



Source: EY compiled

EY

Preliminary Phase: From the time the debtor or one of the banks becomes conscious of financial difficulties until the decision on whether to inform other banks and call for a bank meeting.

i) Purpose of the Preliminary phase

One of the ground rules of restructuring is that success is strongly influenced by events occurring at a very early stage of the process. This has been reaffirmed during the bank interviews. Therefore, the key purpose of the preliminary phase is that as soon as the debtor realizes its non-temporary financial distress, it should promptly involve all relevant creditors and start addressing its financial difficulties proactively.

ii) Actions to be undertaken under the Preliminary phase

As soon as the debtor realizes its financial difficulties:

- Debtor should inform its creditors (primarily its financing banks) about the distressed situation in a timely manner as all unnecessary delays in informing creditors undermine the potential of reaching a Standstill Agreement.
- Debtor should prepare materials to present its financial situation to the creditors.
- Debtor should seek assistance from professional advisors to ensure a credible basis for discussion.
- Debtor should call for a bank meeting and request from the banks to refrain from enforcing any collateral until the situation is properly assessed and a proposal of next steps and possible restructuring options are defined.

iii) Key challenges identified and recommendations during the Preliminary phase

Preliminary phase	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Revealing financial difficulties to creditors	▶ When debtors realise their financial difficulties, they tend to hide their problems instead of revealing them to their financing banks. This often leads to undue further deterioration of the company's financial position and liquidity and largely diminish the chances of debtors' survival and creditors' recovery. ▶ Debtors are concerned that banks would react by cancelling available credit lines, requesting additional collateral and guarantees or even by enforcing collateral and collecting cash - instead of giving debtors an opportunity to explain the reasons for financial difficulties and providing time to develop a solution.	▶ Debtors should be encouraged to inform financing banks of their financial difficulties proactively. ▶ Creditors should be encouraged to preserve value by using the OOCR in case of collaborative borrowers, who are ready to present their financial situation. ▶ Debtors should involve professional advisors when no adequate expertise is available internally to ensure preparation of high-quality materials for the bank meeting and provide a clear reliable insight into debtors' businesses.

Preliminary phase (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Perceived risk by debtors of knock-on effects on suppliers / buyers	▶ Debtors may fear reputational risk, impacting the company's goodwill and affecting their buyers/suppliers relationships in case confidentiality of any potential arrangement is breached and information on the financial issues of the company reaches its business partners or becomes public. ▶ Debtors are further concerned that as soon as suppliers become aware of financial difficulties, any commercial arrangements may be adversely affected (e.g. changing payment terms to requesting payment on delivery), thereby causing further liquidity issues for the debtor.	▶ The debtor must communicate clearly to the creditors the interconnectivities of its business and its fears of knock-on effects so the creditors can understand how to consider those in the restructuring plan to ensure future sustainable viability of the business.
Flow of information during the early phases	▶ Confidentiality rules may lead to information asymmetry between relevant stakeholders. ▶ Individual debtor-creditor relationship prevents equal and timely flow of information to all creditors	▶ The debtor should allow banks before the first bank meeting to waive confidentiality rules related to debtor's financial performance and its loan agreements in order facilitate in depth analysis prior and at the bank meeting.
No guideline on the stay of enforcement actions	▶ The Budapest Approach does not provide guidance on the stay of enforcement actions.	▶ The new Budapest Restructuring Guidelines (BRG) should stress the importance of building new market practice where all relevant financial creditors should be prepared to cooperate and refrain from uncoordinated unilateral actions whenever they are approached by debtors in financial difficulties.

Phase I: From calling the first bank meeting by debtor or one of the banks until the banks' decision on whether to enter into a formal Standstill Agreement.

i) Purpose of Phase I.

Phase I differs from the Preliminary Phase in the sense that during this stage, relevant stakeholders are already conscious of the debtor's financial difficulties yet from the first call for a bank meeting, until an informed decision is reached creditors should refrain from any unilateral action (factual or *de facto* Standstill period).

The key purpose of this phase is to determine whether to enter into a formal Standstill Agreement from the ongoing *de facto* Standstill period or financing banks will initiate a formal proceeding and/or start enforcing collateral as to strengthen their positions.

Such decision must be based on the information received during the course of preceding bank meetings. Generally, banks should be given ample time to evaluate different options and where appropriate opt to enter into a formal Standstill Agreement. The additional purpose of this phase is to determine the main provisions of the Standstill Agreement which is subject to negotiation between the debtor, its creditors and their advisors during the course of bank meetings. Legal counsels are commonly engaged to assist with drafting of this document.

ii) Actions to be undertaken in Phase I.

- Debtors should provide adequate reporting on their financial difficulties and disclose all underlying data before the bank meeting to give creditors sufficient time to assess the circumstances.
- Additionally, debtors should react regarding information requests of creditors throughout the whole process in a timely fashion.
- Banks should be released from bank secrecy by the debtor no later than at the first bank meeting to allow and facilitate meaningful discussions among creditors.
- Debtors are encouraged to appoint external advisor(s) at this stage in order to provide professional guidance in approaching the banks and to prepare materials to be presented to the banks at the first and subsequent bank meetings.
- During Phase I, creditors shall seek to assess the probability of coming up with a viable restructuring plan by the debtor and its advisors during the potential subsequent formal Standstill Period.
- Creditors' loan documentation should, especially in cases of large multilateral loans, include provisions defining their organizational and decision making procedures as well as individual financiers' roles and duties, should the debtor find itself in financial difficulties. Clear and concise provisions eliminate or at least mitigate organizational issues from the very beginning of a restructuring process.
- Final act of this phase involves signing of a formal Standstill Agreement.

iii) Key challenges identified and recommendations during Phase I.

Phase I.	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Lack of trust among parties	▶ General lack of trust among relevant stakeholders. Creditors are sceptic especially if debtors' financial difficulties are revealed partially or late and the relationship is already burdened by unkept promises and generally poor track record. ▶ No unified approach is usually taken to deal with situations of financial distress.	▶ BRG should emphasize the importance of developing trust among creditors and debtors by setting the cooperative approach as best practice. ▶ Cooperation of relevant stakeholders increases the probability of undertaking the cooperative approach in future restructuring cases. ▶ Best practice based guidelines should be developed and supported by the National Bank of Hungary, the Hungarian Banking Association and all relevant banks on the Hungarian market.
Standstill Commencement Date	▶ In Hungary there is no generally accepted Standstill Commencement Date. It is usually determined at, or shortly after, the first bank meeting, until which point banks might have already taken unilateral actions for enforcing collaterals. ▶ A "gentlemen's agreement", which would provide guidance for the stakeholders and preclude individual enforcement of collateral until a Standstill Agreement comes into force, is seldom reached.	▶ The new BRG should provide best practice- based guidance on *de facto* Standstill period lasting from debtors' first call for a bank meeting until an informed decision is reached on whether to enter into a formal Standstill Agreement. ▶ The Standstill Commencement Date should be seen as an intra-creditor point from where there is stay of enforcement in the debtor-creditor relationship until a formal Standstill Agreement is reached.
Co-operation of banks	▶ Cooperation among relevant creditors in the early phases is usually limited or non-existent. There are no guidelines on which bank should take the lead.	▶ Bank with the largest exposure should take the role of informal coordinator and facilitator of meetings while at these meetings banks should seek to align their views regarding the future restructuring process. ▶ Debtors should release banks from bank secrecy as to allow for a timely flow of information related to debtor's financial performance and its loan agreements to mitigate adverse effects of the general lack of trust. ▶ Initial loan documentation should especially in large multilateral cases include duties of finance parties and manner of their organization in case debtor encounters financial difficulties.

Phase I. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Relative position of creditors	▶ Banks with more negotiating leverage may require additional rights/collateral prior to entering into a Standstill Agreement which may alter the relative position of creditors as compared to the Standstill Commencement Date.	▶ According to best practice, all relevant creditors should refrain from any actions that might have an effect on relative positions of other creditors. ▶ In terms of exposures and collaterals, the initial relative positions of creditors should be maintained during the de facto Standstill as well as the subsequent formal Standstill Period.
Creditors' approach to restructuring cases in the early stages	▶ Banks usually have opposing strategies when dealing with debtor's financial difficulties which are either "cooperative" or "exit" strategies. ▶ Creditors often have the tendency to want to take benefit of the first mover advantage over other creditors (they are afraid others might do the same) when they are informed about debtors' financial difficulties and they start unilateral and disorderly enforcement of collateral. ▶ In multi-creditor situations the risk of creditors acting individually by trying to enforce collateral and focus exclusively on their own interest remains high. ▶ Early stage collateral enforcement is usually targeting the liquid assets of debtors (e.g. cash in bank accounts). Such actions severely undermine debtors' liquidity position and thus its day-to-day operations.	▶ BRG should provide guidance on stay of enforcement actions to be adhered to during the early stages for collaborative and potentially viable borrowers. ▶ Coordinated approach to restructuring should be promoted by all relevant stakeholders, especially MNB and the Hungarian Banking Association through active participation in drafting and endorsement of the new BRG.
Handling of suppliers and creditors with exit strategy	▶ Exit strategy is especially pursued by minority creditors which seek timely exit from a distressed situation or as a consequence when some banks become discouraged, by length of the restructuring process ▶ Suppliers commonly become/are aware of the debtors' financial difficulties and they can also threat with subsequent liquidation.	▶ Creditors should decide and inform other creditors on the probability of their participation in the restructuring process at the earliest convenience. Participation should be voluntary. ▶ There is need for potential emergency funding, to be addressed at the bank meeting with the financing banks.

Phase I. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Role of external advisors prior to formal Standstill Agreement	▶ External advisors are often appointed too late to have the desired stabilising effect on the process, while their role in the process is often only limited to analysis of debtor's financial position and preparation of documentation.	▶ The new BRG should encourage debtors to contract professional financial and legal advisors as soon as they become aware of their financial difficulties, ideally in the Preliminary Phase or in Phase I. ▶ A comprehensive external view on the substance of the debtors' financial difficulties already at or soon after the first bank meeting provides comfort to creditors. ▶ Ideally, advisors should be appointed before the formal Standstill Agreement is reached to accelerate the negotiations in the initial phases of the restructuring process.
Harmonization of decision making procedures	▶ Banks generally require approval of their internal decision-making bodies for them to be able to enter into a Standstill Agreement while having different and unharmonized decision-making processes. Different decision-making procedures and corresponding timelines may slow down the process and hinder cooperation.	▶ Relevant decision-making bodies of participating creditors should be informed about the process timeline as to carry out their internal decision-making processes in a timely manner. ▶ The timeframe for such decision making procedures should be harmonized. ▶ Decision on restructuring feasibility should be mutual, unless unfeasibility can be prima facie established or it is likely that debtor's management has acted fraudulently. ▶ In case of new syndicated loan agreements the decision-making process, deadlines and voting mechanism should be defined upfront.

Phase II: From signing the Standstill Agreement until the decision whether to accept the restructuring plan

i) Purpose of Phase II.

The purpose of Phase II is that creditors evaluate financial information and restructuring plan put forward by debtors and come to an informed decision whether to commence the restructuring process by signing a restructuring agreement. The restructuring plans should be accepted only, if the viable operation of the debtors can be re-established.

- A reasonable timeframe should be granted to prepare a comprehensive information platform based on which, decisions can be made.
- During Phase II creditors should support the debtor in its ongoing business operations (e.g. by providing working capital financing).

ii) Actions to be undertaken under Phase II.

- Phase II begins with the signing of a Standstill Agreement which marks the formal commencement of a Standstill Period.
- Following the formal commencement of the Standstill Period, Creditors' Co-ordination Committee (hereinafter CoCom) should be formed by suitable representatives of all relevant creditor groups to provide impartial information sharing and support efficient decision making process.
- Especially in multi-creditor situations, a Coordinator is typically appointed and has the role of facilitating negotiations between creditors and debtors, mediating between banks and other creditors, requesting documents from debtors, setting out deadlines, following-up on outstanding issues, etc.
- According to best practice, an information platform (e.g. Independent Business review or "IBR") should be prepared by professional advisers (preferably acting with the duty of care towards debtors and bank creditors).
- Following the preparation of the information platform, debtors supported by their advisor(s) should prepare restructuring plans based on full disclosure of their financial positions.
- At this stage debtors may need to engage other professional advisors for preparation of other materials which may be requested for collateral evaluation, modelling of debtors' debt servicing capacity as well as legal counsel for drafting the necessary documentation (e.g. a restructuring agreement).
- The proposed restructuring plan should be submitted to creditors' decision making bodies. Following their acceptance of the proposed solution, a restructuring agreement is drafted and signed by the debtor and all creditors partaking in the restructuring process.

iii) Key challenges identified and recommendations during Phase II.

Phase II.	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Standstill Agreement	▶ There are no generally accepted key elements of a Standstill Agreement in Hungary.	▶ The new BRG should define the key provisions to be included in a Standstill Agreement. ▶ The Standstill Agreement should define the content of the requested output documents including restructuring proposal and key process milestones. ▶ The new BRG should define key sections to be included in a Standstill Agreement which should inter alia be: – definition of subject matter of the agreement; – description of representations and warranties of debtors: – debtors' obligations (e.g. terms of principal repayment, interest repayment in accordance with debtor's capacity to service debt); – information sharing provisions; – provisions on confidentiality of the agreement; and – rights and obligations of creditors (e.g. maintenance of existing credit lines, new financing possibilities).
Debtor's behaviour through Standstill Period	▶ In case shareholders and management of the debtor in financial difficulties do not expect to benefit from a successful restructuring, they often act contrary to the interest of the creditors.	▶ It should be incorporated into a formal Standstill Agreement that during this period the debtor should refrain from: – seeking to reduce the potential return of relevant creditors; – engaging in activities outside the normal course of business, especially from entering into new obligations or granting new securities; – providing additional security or collateral to those creditors not participating in the restructuring; – transferring assets or value away from the debtor; – selling assets to third parties or any creditors at an undervalued price; – otherwise depleting the value of debtor's assets and thus undermining the debt repayment prospects for the relevant creditors; – raising additional financing from non-relevant creditors (e.g. factoring, leasing, etc.) and – engaging in any fraudulent behaviour; Non-compliance of the debtor should result in immediate termination of the Standstill Agreement by the banks as defined at inception.

Phase II. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Creditor's behaviour through Standstill Period	▸ Available banks' commitments are often kept at pre-restructuring utilization levels, while new guarantees are not issued even if guarantees are crucial for the ongoing operations and fit into the previously agreed upon limit of revolving guarantee facilities. ▸ Cash accounts are often frozen as collateral related to certain covenant breaches. Banks are reluctant to release cash collateral as cash can be considered a direct recovery of claims in a potential subsequent liquidation procedure; however, this may have an adverse effect on the debtors' already difficult liquidity situations.	The new BRG should define the actions of creditors which are to be either avoided or undertaken for the duration of the Standstill Period as follows: ▸ A stay of enforcement imposes the obligation on creditors to refrain from the individual enforcement of claims in order to reduce their outstanding exposure towards the debtor. ▸ Creditors shall not initiate any proceedings against the debtor during the Standstill Period. ▸ Creditors should allow utilization of credit lines and facilities up to the exposure level at the Commencement Date ▸ Creditors and debtors should agree on new terms for the Standstill Period regarding the outstanding debt (inter alia): interest payment, deferred repayment structure, additional financing and guarantees.
Standstill Period	▸ The Standstill Period can become very lengthy if extensions are needed due to the complexity of information needed for the restructuring proposal.	▸ The Standstill Period should be determined on a case by case basis and should not last longer than necessary to avoid value deterioration. ▸ The Standstill Period granted by the creditors should be long enough for an informed decision, however should be no longer than absolutely necessary since any delay may endanger the success of the restructuring process. ▸ A predetermined majority of debtors can vote to terminate the Standstill Period prematurely (e.g. majority in both number of creditors and value of their claims). ▸ Extension of the Standstill Period is possible based on all lender consent.
Value of collateral	▸ In practise, banks tend to have conflicting views on recoverability of their claims and value of their collateral. ▸ In many cases, it is difficult to assess the relative collateral position of creditors. Moreover, different collateral valuations are accepted by each individual bank.	▸ In case of disagreement, an independent valuation expert accepted by all banks should be contracted to assess relative positions of creditors at the formal Standstill Commencement Date.

Phase II. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Creditors' Co-ordination Committee	▶ In Hungarian restructuring environment there is no generally accepted rule on which creditors should form the CoCom.	▶ A Creditors' Co-ordination Committee (CoCom) should be formed upon signing a formal Standstill Agreement to act as a sounding board to the creditors, as representative in the discussions with the borrower (without decision power) and to resolve conflicts / disagreements. ▶ The structure of the CoCom should reflect the complexity of the financing structure. Relevant constituents should feel represented by a "like-minded" party as this facilitates consensus building. ▶ The CoCom does not necessarily require all creditors to take part. ▶ In complex cases a CoCom should be formed by suitable representatives of all key creditor groups (incl. minority creditors and supplier groups). ▶ Costs and expenses incurred by CoCom / Coordinator should be pre-funded or reimbursed. ▶ Predominantly in large cases, initial loan documentation should already include intra-creditor agreements with provisions on setting up and managing of a CoCom and any other required organizational provisions in case debtor encounters financial difficulties. Additionally, loan documentation can lay down provisions on the majority lender decision making process.
Coordinator	▶ Decision-making on the appointment of the Coordinator usually slows down the beginning of the process.	▶ Coordinator is usually (but not necessarily) the bank with the highest exposure. ▶ The Coordinator should have the following responsibilities: – Information sharing; – Facilitating negotiations; – Mediating between banks and other creditors; – Setting out deadlines; and – Following-up on outstanding issues. ▶ Coordinator and CoCom are mediators but do not have commitment authority / take decisions to avoid any legal responsibilities.
Information sharing during the Standstill Period	▶ Inefficient communication between financing banks and other creditors often leads to information asymmetry.	▶ The CoCom or the Coordinator should be responsible for managing information sharing and ensuring that all relevant creditors receive the same information during the Standstill Period. ▶ In order to have an efficient restructuring process, bank and bond creditors should be involved at the first stage and other relevant stakeholders (such as key suppliers, key customers, employee trade unions, etc.) at a later stage as appropriate.

Phase II. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Confidentiality requirements during the Standstill Period	▶ Debtors are often afraid to enter into out-of-court restructuring processes as such processes have a negative effect on their public image and relations with clients and suppliers.	▶ Creditors and other stakeholders not subject to rules on bank secrecy should be contractually committed to confidentiality at the point where they are included in the restructuring process.
Professional advisers during the Standstill Period	▶ Debtors in financial difficulties (especially SMEs) are often not well-prepared to provide comprehensive and credible information in relation to their businesses and financial performance. ▶ Debtors are usually not prepared to negotiate terms and conditions of restructuring proposals with their creditors or to come up with sufficiently robust restructuring plan. ▶ If the professional advisors are involved (e.g. legal advisors, financial advisors, appraisers, independent appraisers, accountants) there is often no clear view on their respective roles as restructuring standards are not clearly defined. ▶ In addition, debtors are usually not in the position to cover the fees of professional advisers due to liquidity constraints.	▶ Professional advisers should be involved in the preparation of the restructuring proposal, especially in complex cases and/or above certain debt thresholds in order to assure quality and transparency of the process. ▶ The scope should include reviewing the accuracy of accounts, projections, forecasts and business plans related to any proposals for rescue. Debtor's full compliance in providing information is expected. ▶ The debtor should itself also contract professional advisers to provide support in the IBR and in the preparation of a financial and operational restructuring plan and to assist in the negotiations with the creditors. ▶ A list of external advisors to be invited to the process should be agreed upon upfront if they have not yet been engaged in the process prior to reaching a Standstill Agreement. – Such advisors should have the relevant experience and skills in order to be able to assist in the preparation of the information required for the decision regarding the restructuring process. ▶ The Coordinator or the CoCom could be authorized by the creditors to instruct outside professionals such as financial advisors, lawyers and appraisers to provide advice for the benefit of the relevant creditors as a whole. ▶ In general, fees charged by professional advisors should be borne by the debtor. However, in cases sever liquidity constraint the terms of payment should be negotiated between the debtor and its creditors.

Phase II. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Super senior status of Bridge financing during Standstill Period **and Reorganisation Financing** post and prior to Restructuring Agreement	▶ It is commonly recognised at this stage that the debtors are in need of working capital financing. Nonetheless, funds for stabilisation of debtors' business are seldom provided in Hungary. ▶ New loans provided 90 days prior to liquidation can be challenged by the liquidator. ▶ Banks often hesitate to provide bridge financing / reorganisation financing due to uncertainty around its recovery.	▶ Super senior (priority) status of additional funding should be ensured. ▶ Provision of bridge financing and reorganisation financing should be voluntary and should be given priority status contractually in terms of repayment, collateral ranking and legally in the order of payments in insolvency ▶ Status of super senior loans should not be challenged in a liquidation process (legislative amendments followed by supportive use in practice are needed, for more details please see Appendix A. ▶ New money should be provided by willing lenders and approved by all financing banks.
Bank Commissioner	▶ In Hungary, banks refrain from appointing bank commissioners with a management role to avoid litigations for mismanagement of the debtor. Instead, the role of a Bank Commissioner is in practise limited to supervision of debtor's daily operations.	▶ In order to limit litigation risk, a list of acceptable Bank Commissioners should be drafted and confirmed by the financing banks based on which the debtor should be invited to appoint a Bank Commissioner (preferably with a management role as appropriate).
Shareholders' / Sponsors' contribution	▶ Banks require contributions from debtor's shareholders and/or its sponsors; however, they show limited willingness to provide such contributions.	▶ The restructuring proposal should include commitments from shareholders to be agreed upon on a case-by-case basis and incorporated in the Restructuring Agreement.
Participation of creditors with diverse exposure and interest	▶ Creditors with different exposures volumes and quality of collaterals do not have similar incentives to participate in the restructuring process.	▶ Creditors should decide and inform each other whether they intent to participate in the restructuring process. ▶ Banks, which do not wish to participate, should be willing to sell their claims and should not obstruct the process.
Debt trading	▶ In some cases banks sell their debt when becoming conscious of financial difficulties or when they become discouraged, by the length of the restructuring process. ▶ Debt sellers seldom notify all relevant parties in a timely manner. ▶ Debt trading can result in having new lenders in the transaction with different strategies compared to commercial banks (e.g. distressed debt funds).	▶ Ideally, the Standstill Agreement should prohibit banks to sell their exposures or impose a pre-emption right for the sale of their exposure to other creditors. ▶ In case of any kind of debt trading (secondary loan trading, sub-participation, etc.), creditors should be obliged to inform the Coordinator in advance of the trade to minimize the effect of such actions on the restructuring process. ▶ A mechanism for regulating the trading of debt during the Standstill Period should be based on the Standstill Agreement.

Phase II. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Involvement of non-financial creditors and other relevant stakeholders	▶ Non-financial creditors and other relevant stakeholders (e.g. suppliers, utility service providers, debt management companies, etc.) are often not involved and/or systematically handled throughout the process; however, they can significantly influence the process of restructuring or even initiate liquidation against the debtor.	▶ Besides all financing banks other relevant stakeholders such as key suppliers and key customers should also be involved in the restructuring process to mitigate the risk of process failure. ▶ After reaching formal Standstill the CoCom should ensure the proper involvement of other stakeholders at later stages of the process.
Restructuring Proposal	▶ Restructuring proposals often comprise solely financial restructuring plans aiming to ease the financial burden on the debtors. However, banks do not wish to accept such proposals without debtor engaging in a comprehensive turnaround of the underlying business operations.	▶ The restructuring proposal should include strategic, operational and financial restructuring plans (business plan, financial model) which would be focused on long term solutions, a point emphasised by the banks during the bank interviews. ▶ The restructuring proposal should be supported by independent external advisors with duty of care towards the creditors. ▶ A consensual decision should be made on the restructuring proposal. Banks should therefore have the right to assess the restructuring proposal and decide on its acceptance individually since creditors will ultimately compare the restructuring plan to their other options, including collateral enforcement
Tax claims	▶ In Hungary, tax authorities are obliged to collect 100% of outstanding tax claims (no haircut is accepted) and are authorized to collect them directly from the debtor's bank accounts.	▶ Haircut of tax authorities cannot be enabled by a new BRG but should be considered as a required adjustment to the Hungarian legislative framework. ▶ Tax authorities should have the ability or, to avoid any State Aid issues, be required in certain circumstances to reduce their tax claims as part of a bankruptcy reorganisation plan.
Decision on the restructuring proposal	▶ The restructuring proposal is often negotiated by the Debtor with the CoCom. Once the CoCom has agreed to a proposal, the restructuring proposal is often put forward by the debtor at an All Lenders Meeting. ▶ In practise, creditors often have different or even opposing views on the restructuring proposal put forward by the debtor and its advisers.	▶ The BRG should promote a coordinated approach which should result in a consensual decision regarding the restructuring proposal. ▶ Banks should therefore be given ample time to assess the restructuring proposal and decide on its acceptance as based on their individual positions, taking into account the benefits of a common approach by all creditors through all parties making compromises.

Phase II. (cont'd)	Key challenges identified	Recommendations based on international best practices and bank meeting findings
Restructuring Agreement	▶ The Restructuring Agreement does not always appropriately reflect the mutually accepted restructuring proposal and further steps are not defined clear enough.	▶ The Restructuring Agreement should be prepared by professional legal advisors and should fully reflect the mutually agreed restructuring concept and clearly define implementation steps, key milestones, monitoring measures and triggers for breach of the Restructuring Agreement.

Implementation Phase: Implementation of the restructuring plan

- International guidelines have not developed in detail the execution phase of the restructuring plan since it must be adjusted to specific cases. We suggest developing the new BRG accordingly and therefore we also limit the description of the Implementation Phase below.
- Following the end of the Standstill Period the debtor must start implementing the restructuring plan as based on the restructuring proposal included in the signed Restructuring Agreement.
- The success of the implementation of a restructuring plan is dependent on its quality, namely on the timeliness of the relevant inputs and manner of its preparation.
- The debtor's performance and compliance with the restructuring plan is usually monitored on a quarterly basis, while restrictive measures are applied. The monitoring of the debtor's Restructuring plan implementation progress and compliance with restrictive measures should be supported by external advisors.
- In this phase, all stakeholders are committed to the restructuring and all decision-making bodies have approved it. Therefore the key challenges are whether the restructuring plan, together with the financial model including its assumptions is viable and executable by the debtor.
- The execution of the operational restructuring plan is also crucial to provide sufficient cash flows to service the restructured financial debt of the company.

Key characteristics of successful restructurings cases in Hungary are as follows:

- – Professional and co-operative management of debtors;
- – Operational restructuring plan prepared and implemented;
- – Realistic financial restructuring plan prepared and implemented;
- – Tight monitoring and reporting on the deviations from the restructuring plan (usually on a quarterly basis), and immediate corrective actions;
- – Effective co-operation between financing banks;
- – Active role of a coordinator managing the whole process; and
- – Process supported by high quality professional advisors.

- In recent years there have been only a few large successful restructurings concluded in Hungary, which were mostly cases with cross-border elements (e.g. Lasselsberger; Baumax) or solutions based on a new equity injection (e.g. BorsodChem). In those larger cases, international professional advisors were involved to facilitate the restructuring process. Additionally, foreign banks operating in more developed jurisdictions applied their internal practices, which were in line with international best practices (e.g. INSOL principles). Experience with complex cross-border restructuring cases of large banks was in that sense pivotal for the successful outcome of OOCRs.

4. Summary of recommendations

- The review of international best practices together with the detailed interviews carried out with 16 banks (Budapest Bank, CIB Bank, Commerzbank, Erste Bank, Eximbank, FHB Bank, Gránit Bank, Hungarian Development Bank, K&H Bank, KDB Bank, MKB Bank, OTP Bank, Raiffeisen Bank, Sberbank, Takarékbank and UniCredit Bank), the Hungarian Banking Association, MARK and MNB have provided colour on the current Hungarian out-of-court restructuring framework and an important indication of what is needed to improve OOCR in Hungary.
- A number of countries within the CSE region (Austria, Slovenia, Croatia, Serbia and Romania) have gone through a similar process of implementing OOCR guidelines to promote more effective out-of-court restructurings as presented in *Appendix C* in detail, however in the majority of these countries the guidelines are rarely used due to lack of appropriate regulatory authority backing.
- Successful implementation and subsequent use in practice of such principles in many countries largely depends on the involvement and support of relevant banking and regulatory institutions and on the existing insolvency legal framework.
  - The bottom-up approach applied in our analysis gave us a granular understanding of the current out-of-court restructuring practice and related challenges observed on the Hungarian market. Involving local banks at an early stage of the process is key for establishing an improved framework in order to ensure that any concerns or issues are adequately addressed by the envisaged new BRG.
  - In addition, we observed that a prompt and active involvement of the National Bank of Hungary and the Hungarian Banking Association proves to be a key factor in achieving the successful implementation and actual application of local OOCR guidelines in practice.

  Overall, the existing Hungarian practice is not in line with international best practice in restructurings, as (i) debtors tend to hide their problems instead of revealing them to the financing banks, (ii) creditors often enforce collateral unilaterally in an unorganised fashion and (iii) even in cases where standstill agreements are entered into a lack of systematic approach prevents timely solutions.

Proposed Budapest Restructuring Guidelines

- Out-of-court restructuring is a voluntary process, therefore the success depends on taking into account and balancing stakeholder interests. The process is functional only if the debtor believes that OOCR can lead to gain back the viability of the company. The banks will select this option if they believe that OOCR can minimise losses compared to other options.
- The Guidelines should target multi-creditor situations (including cross border financing) where restructuring seems feasible to provide a platform for banks and debtor to agree on a restructuring plan outside of formal proceedings with the benefit of reduced business risk, reputational risk and lower costs / higher return compared to formal proceedings.
- The BRG should take the form of non-binding regulations from which legal claims may not be derived. The BRG should not reduce the right or obligation of each creditor to independently determine whether it supports an extra-judicial restructuring, which decision ultimately rests with the relevant corporate body of the creditor.
- The BRG should not state that every company can be rescued through out-of-court restructuring, although it should recognise that successful restructurings can preserve value for all stakeholders.
- One of the ground rules of restructuring, which was reaffirmed during the bank interviews, is that success is strongly influenced by events occurring at a very early stage of the process. Therefore, the key objective of the new BRG regarding the Preliminary Phase should be to incentivise both creditors and debtors to start proactively addressing financial difficulties as they arise.
- Debtors should be encouraged to inform financing banks of their financial difficulties proactively. The new BRG should stress the importance of building a new market practice where banks allow sufficient time to debtors to present their financial difficulties and address them in a cooperative way.
- Creditors should be incentivised to flag early the financial difficulties of their debtors since international practice shows that restructuring started at a very early stage results usually in higher recovery rate compared to liquidation or other later options. Additionally a fair environment should be created among banks to protect their relative collateral position, subject to any agreement on new financing and early individual collateral enforcement should be prevented.

- The key dilemma of Phase I. (until the decision is reached as to whether to enter into a formal Standstill Agreement) is that banks on one hand are fully aware of the fact that avoiding liquidation and entering into a Standstill Agreement would be beneficial for their recovery potential, while on the other hand the whole process can be difficult, lengthy, and in the absence of principles heavily burdened by the threat of collateral enforcement attempts of individual banks.
- The new BRG, if applied by all parties, should give assurance to the banks that there is less room for first come, first served behaviour which is thereby expected to enhance confidence among banks in OOCR.
- When a formal Standstill Agreement is reached (Phase II.), banks are generally adhering to key action patterns of a Standstill Period but the lack of generally accepted guidelines in most of the cases prevents a fully systematic and best practice based approach and often results in a lengthy negotiation process. The BRG should provide detailed and systematic guidance for Phase II.
- As the formal Standstill Period should be characterized by full disclosure of the debtor's financial situation which is prepared and made available to all relevant stakeholders, the new BRG should provide guidance for information governance by setting up a structure of coordination including Coordination Committee, and using professional advisors to ensure quality of the restructuring plan presented in a predetermined way for the decision-making bodies.
- After the restructuring plan is approved (Subsequent Phase), the debtor must start implementing it in accordance with the provisions of the Restructuring Agreement. During the execution tight monitoring and reporting should be performed focusing on the deviations from the restructuring plan to facilitate immediate corrective actions.
- The new BRG should consider as appropriate the need for both financial and operational restructuring plans as a part of a full turnaround package. In the new BRG, similarly to the international guidelines, discussing the execution phase of the restructuring plan in detail is not recommended.

Key success factors for implementation

The main purpose of the Report is to support the establishment of a widely accepted and used out-of-court restructuring guideline in Hungary. Based on bank interviews and on the review of the international best practices, we consider the following key success factors for the implementation of the new BRG:

- **Basis:** The new BRG should be constructed on international best practices, adjusted to the Hungarian business environment.
- **Content and structure**: The new BRG should provide detailed guidelines on the out-of-court restructuring in Hungary so that banks can refer to the guidelines during execution of restructuring in practice. The guidelines should be detailed only to such extent that leaves room to be applicable on individual cases.
- **Method**: The bottom-up approach applied should give assurance on the commitment of the banks towards the implementation of the guidelines.
- **All relevant banks** in the market should join the initiative in order to have a coherent approach in multi-bank restructuring situations.
- **Support:** Strong support is essential from the Hungarian Banking Association.
- **Recommendation of the National Bank of Hungary** adds great value to the practical use of the BRG, especially taking into account the issues brought up in the preliminary phase.
- **Specific legal and tax environment:** Out-of-court specific legal and tax rules should be supportive. Legal and taxation framework needs to be adjusted to accommodate the practical use of the BRG, clear the disincentive provisions (i.e. additional capital requirements for reorganisation financing, additional tax payable on write-off) and provide a positive environment (i.e. protection of super senior financing; Tax Authority should also be able to take a haircut).
- **Insolvency framework:** OOCR should be considered an integral part of the insolvency framework and a complement to formal insolvency procedure, which provide an alternative in cases where no consensus for OOCR is reached. Modernization of the insolvency framework would significantly enhance the effective use of the OOCR. *For deficiencies of the Hungarian insolvency framework, please see the exact issues listed in Appendix A, for specific issues on bankruptcy procedure please see page 37.*
- **Marketing**: Raised public awareness especially for corporates of the new BRG (e.g. organizing workshops for stakeholders, presentations on conferences, publishing articles etc.) could help change the business culture toward the early rescue of viable firms.

Appendices

1. Appendix A: Overview of the legal framework in Hungary
2. Appendix B: International Best Practices
3. Appendix C: Restructuring practice in selected CSE countries
4. Appendix D: Abbreviations

Overview

Legal framework of insolvency and restructuring procedures in Hungary

- Based on the "Analysis of Corporate Restructuring and Insolvency in Hungary" report prepared and released by EBRD, Réczicza White&Case LLP and EY on 23 February 2015, we highlighted key issues and recommendations identified with respect to the legal framework of insolvency and restructuring procedures.
- In this appendix we are only providing an overview of findings/opinions/recommendations prepared by the aforementioned advisors, this has not been our scope and therefore we cannot give any reliance for the wording as presented in Appendix A.
- Banking experts confirmed in the interviews that the below mentioned issues are still outstanding and applicable to the corporate restructuring procedure, therefore recommendations should be considered when developing the new Budapest Restructuring Principles.
- This section provides a general overview of the legal framework of restructuring in Hungary and sets out a number of systemic and procedure-specific issues within the Hungarian legal framework with a focus on the following procedures:
  - security enforcement;
  - bankruptcy;
  - insolvent liquidation.

Summary of the systemic issues identified and recommendations

Item	Issues identified	Recommendations
No influence on the choice of the bailiff / trustee / liquidator	▶ Creditors have no influence on the choice of bailiff/trustee/liquidator. Consequently, important factors, such as professionalism, workload, previous feedback from stakeholders, cannot be taken into account in the existing appointment system.	▶ Consideration should be given to replacing the randomized system with a system of appointment by the court with significant input from creditors (and in bankruptcy also the debtor) to select the best performing officers or at least facilitate their replacement for under-performance.
Rigid remuneration structure	▶ Under the existing fee structure there are no real incentives for the officers to play a more active and efficient role in the proceedings.	▶ The remuneration structure should be reviewed to take into account best practice and ensure that it provides the right incentives for performance.
Short deadlines for fling objections, unreasonable procedures	▶ The deadline for filing an objection with the court against the act/failure to act of the officer is relatively short, and courts rarely reach a decision within the required time. Objections are typically rejected because of the lack of detailed provisions governing the office holder's duties and the difficulties faced by creditors in establishing breach of duty. Initiating litigation to establish the officer's liability is not a real alternative since this proceeds before ordinary courts and lasts even longer than the objections process.	▶ Legislation should be more detailed in terms of the duties and responsibilities of the bailiff/trustee/liquidator, the various steps in the proceedings and related statutory deadlines. ▶ Greater training and/or specialization within the judiciary would enable judges to deal more effectively and efficiently with creditor objections.

Security enforcement procedures

Summary of the in-court procedure

- The pre-condition of the court enforcement procedure is that the creditor obtains a final, binding and enforceable deed as a result of (i) an undisputed order for payment procedure against the debtor or (ii) a successful lawsuit against the debtor to pay its debt and, in the case of secured debt, to tolerate the enforcement of the security interest against its assets.
- Expedited procedure: If the creditor's claim has been incorporated in a notarial deed specifically setting forth, amongst others, (1) the amount owed, (2) the legal title of the claim and (3) the maturity date of the payment obligation, following the expiration of the maturity date set forth therein, the creditor is entitled to initiate an „expedited" enforcement proceeding based on such notarial document (i.e. without being obliged to commence and conclude a preliminary lawsuit against the debtor and obtain a final and binding court order).
- The management of the court enforcement procedure falls within the competence of the court bailiff. The bailiff will deliver the enforceable document to the debtor and demand that the debtor satisfies the claim of the creditor(s) within 15 days. In case of non-compliance, the bailiff will commence the enforcement by way of seizing the debtor's assets and registering the seizure with the public registries, if applicable. Generally, the seized assets remain in the debtor's possession and will be subject to a sale if the creditor's claim is not satisfied from the amounts available on the debtor's bank accounts. The seized assets must be sold by the bailiff at an auction. The duration of the in-court enforcement procedure is subject to a number of circumstances and it frequently extends beyond one year.

Summary of the out-of-court enforcement procedure

- Irrespective of whether the debtor is insolvent or not, creditors have the right to enforce their security when the secured claim falls due and the debtor does not perform its payment obligation. In addition to the in-court alternatives described above, secured creditors may opt for out-court security enforcement procedures (with some exceptions e.g. enforcement against bank accounts where only in-court enforcement is permitted). The secured creditor may either (i) sell the pledged property, (ii) acquire the pledged property (if the pledgor agrees to the acquisition following the event of default), or (iii) directly enforce the pledged right or claim.

Enforcement-specific issues identified and recommendations

Item	Issues identified	Recommendations
Lack of adequate information	▶ Although the court bailiff's costs must be advanced by the creditor initiating the enforcement proceeding, a creditor may not have sufficient information at the outset to predict whether enforcement will be successful and the bailiff's costs may be significant. The court bailiff is not subject to any regular reporting requirement to creditors. Creditors may not necessarily receive all relevant information in a timely manner.	▶ Creditors with an enforceable deed should be able to obtain any necessary advance information from the bailiff, subject to sufficient data protection for the debtor. The bailiff should have regular reporting obligations towards creditors. ▶ In addition, specific statutory duties and deadlines should be set for bailiffs to respond to creditors and generally conclude the enforcement in a timely manner.
Conflicting legal provisions	▶ Provisions of the New Civil Code and the newly-inserted Article 4/A of the Bankruptcy Act relating to lenders' rights regarding the methods of enforcement (e.g. via a private sale by the lender) of the security deposit (óvadék) conflict with older provisions of the Bankruptcy Act.	▶ The New Civil Code and/or the Bankruptcy Act should be amended to eliminate ambiguities.

EY

Bankruptcy procedure

Summary of the procedure

- The bankruptcy procedure is designed to arrange for the reorganisation of a business entity in financial difficulties (i.e. it is not a precondition that the business entity filing for bankruptcy is actually insolvent) in the form a composition agreement with the consent of most of its creditors by granting it a moratorium (resulting in the temporary suspension of its payment obligations with a view to reorganising its debt in a way that will enable it to continue its business operations as a going concern). The bankruptcy proceeding can be commenced on a voluntary basis, and only by the debtor.
- Upon filing the bankruptcy petition with the court, the debtor automatically receives a temporary moratorium. If the court decides to commence the bankruptcy proceeding it will grant an actual moratorium to the debtor (generally 120 days, which can be extended up to 365 day in total) and the court will appoint a trustee from the registry of the insolvency office holders with a random electronic appointment system.
- If the debtor and its creditors can agree on a composition scheme, such scheme will be compulsory for, and could be enforced against all creditors of the business entity, even if not all of the creditors have consented to it, subject to the necessary ratio of creditors consenting to such composition scheme, provided that the court confirms with its order that the accepted composition scheme complies with the provisions of the applicable laws.
- Market practice shows that the debtors often follow fraudulent behaviour in practice and tend to initiate bankruptcy proceeding to buy time and not for preparing a restructuring plan. If the bankruptcy proceedings are not successful i.e. a composition agreement is not reached with the consent of the creditors, the court automatically orders the insolvent liquidation of the business entity.

Issues identified and recommendations

Item	Issues identified	Recommendations
Blocking of the debt restructuring proposals	▶ Tax authorities are unable to accept less than 100% recovery on tax claims in bankruptcy proceedings pursuant to Hungarian tax law restrictions.	▶ Tax authorities should have the ability or, to avoid any State Aid issues, be required in certain circumstances to reduce their tax claims as part of a bankruptcy reorganization plan.
Lack of professional and reliable reorganization plan	▶ Bankruptcy proceedings can be initiated by the debtor without having a professional and reliable reorganization plan.	▶ The applicable laws should be amended to require that a preliminary business/ reorganization plan (and possibly also independent accountant’s report) is part of the bankruptcy filing.
Lack of “fast track” bankruptcy procedure	▶ Currently it is not possible to file a reorganization plan by the debtor pre-agreed with its majority creditors. Ordinary bankruptcy proceedings take a long time and have material reputational and operational risks for debtors.	▶ Consideration should be given to creating a “fast-track” option in bankruptcy to enable debtors to prepare a reorganization plan with the support of their majority creditors in advance of filing.
Form of the reorganization agreement	▶ The form of reorganization agreement is proposed by the debtor and creditors cannot propose a competing plan (they can only suggest amendments).	▶ Creditors should be given wider rights to make proposals to the overall restructuring (e.g. financial and/or operational restructuring steps and changes in management of the debtor).

Item	Issues identified	Recommendations
Bad faith exclusion of creditors from voting	▶ A claim can be classified as disputed if there is ongoing litigation in relation to the claim or if so decided by the trustee. In practice the entire claim is classified as disputed even if litigation only affects a portion of the claim. Bad faith debtors abuse this rule and frequently initiate litigation against creditors before filing for bankruptcy to exclude creditors from voting.	▶ The trustee and bankruptcy courts should be required to pay particular attention to the circumstances of litigation initiated by the debtor. Both legislation and accompanying jurisprudence should ensure that only the portion of the claim affected by litigation is to be classified as disputed.
Influencing the voting by fictitious claims	▶ Bad faith debtors frequently influence the voting by creating fictitious claims, the beneficiaries of which are related to the debtor. Trustees and judges only conduct a formal review of claims lodged by creditors.	▶ Judges and trustees should (i) receive special commercial and accounting training to enable them to better filter "suspicious" claims (ii) have access to information regarding the financial affairs of the debtor.
Unelaborated "fairness" principle	▶ Although due to recent amendments to the applicable laws and evolving judicial practice, the „fairness" of the settlement is to be reviewed, in general the judicial review is only a formalistic review of the technical details.	▶ Courts should be entitled to rely on expert input where necessary when reviewing proposed settlement agreements. Judges should receive special financial and commercial training to enable them to assess reorganization plans.
No regulated rescue financing is available	▶ There are no existing incentives for rescue financing in bankruptcy. Without rescue financing or additional financing in place, many debtors cannot continue to operate as a going concern during and following bankruptcy proceedings.	▶ Further support should be granted for rescue financing to encourage new lending to borrowers in financial difficulty e.g. priority ahead of unsecured creditors (or possibly, in certain limited circumstances, also other secured) in any subsequent liquidation.

Insolvent liquidation

Summary of the procedure

- The purpose of the insolvent liquidation procedure is to wind-up the insolvent debtor and liquidate its assets within the framework of regulated procedure. Creditors' claims are to be satisfied (in the order of the liquidation waterfall determined by law) from the proceeds of the sale of the liquidated assets.
- The very first step of the insolvent liquidation procedures is the assessment of the debtor's insolvency by the court. The most common reason for creditors to file for liquidation is that the debtor has not disputed or paid its previously undisputed or acknowledged debt within 20 days from the relevant due date and, thereafter, did not pay such debt following receipt of written payment demand from the creditor. The debtor can avoid liquidation if it proves that it disputed the relevant claim in merit in due course. Insolvency judges usually do not examine whether the dispute was well founded since this is within the jurisdiction of the ordinary courts during litigation.
- From the commencement of the procedure the executive officers and the shareholder of the debtor lose their control over the debtor's operations and only the liquidator is entitled to control the debtor's assets; and
- Liquidation proceedings may be commenced by the debtor, the creditor, the administrator appointed in a preceding voluntary winding-up procedure or by the court, for instance in the case of a preceding unsuccessful bankruptcy proceeding, in which case no insolvency test will be applied by the court.
- Although there is no automatic moratorium under the liquidation proceedings, the court, upon the request of the debtor, may grant the debtor a grace period of up to 45 days to settle its debt, provided that there was no preceding bankruptcy proceeding.
- The most important consequences of the commencement of the insolvent liquidation are that (i) any monetary claim against the debtor in connection with any asset being part of the liquidation pool of assets can only be enforced within the liquidation proceedings and the assets can only be sold by the liquidator; (ii) each payment obligation of the debtor becomes due and payable; (iii) any ongoing enforcement procedures relating to assets owned by the debtor are terminated by the court and any claims pursuant to such procedures are added to all other claims against the liquidation pool of assets.
- Creditors' meetings do not determine the course of liquidation proceedings as much as they do with bankruptcy proceedings. However, settlement may also be made in liquidation proceedings.

Issues identified and recommendations

Item	Issues identified	Recommendations
Fraudulent prolongation of the liquidation	▶ No "real" insolvency test only a formal review is applied by courts during the examination of liquidation filings. It appears to be very easy for debtors to avoid liquidation by disputing creditors' claims. Not the liquidation courts, but separate ordinary courts examine whether the dispute is justified.	▶ Insolvency judges should be entitled to resolve on liquidation if they reasonably believe that the outcome of the dispute initiated by the debtor regarding a creditor's claim will not fundamentally affect the fact that that debtor is insolvent and/or if it appears that the dispute is not well-founded or made in bad faith. Specialized training should be provided to judges to assess whether the debtor is technically insolvent. To the extent practicable, the same court handling the insolvency case should also examine the litigation.

Item	Issues identified	Recommendations
Lack of information and unbalanced powers	▶ The fact that during the liquidation proceedings only the liquidator is entitled to dispose of the debtor's (secured) assets, often results in: – general lack of information provided to creditors; – very weak creditor control over the course of insolvency proceedings and particularly any sales by the liquidator; – lack of sufficient creditors' rights in relation to the sale of assets secured in their favour; – conflict between secured creditors who expect the liquidator to sell the secured asset as soon as possible and the liquidator and unsecured creditors who are more interested in the maintenance of the debtor's operations.	▶ More transparency and balance of powers should be added to the insolvent liquidation procedure, by the introduction of more detailed statutory obligations for liquidators regarding (i) sale of the debtor's assets and deadlines for the performance of such obligations, (ii) liquidator's information obligations. ▶ Consideration should be given to (i) providing unsecured creditors with rights to approve a plan of sale by majority vote in respect of unsecured assets and (ii) to creating a separate approval procedure for secured creditors for sale of any secured assets and/or to allowing secured creditors to elect to segregate their secured asset from the liquidation estate at the outset of liquidation proceedings.
Lengthy sale procedures and unreasonable sale rules	▶ The effectiveness of liquidation sales is decreased by the lack of transparency and lack of potential buyers. Secured creditors may only acquire a secured asset in the first two tender/ auction stages by advancing fresh money.	▶ Potential buyers could be incentivized by certain tax and stamp duty discounts for sales in liquidation proceedings. Secured creditors should be given wider rights to "bid their debt at an early stage.
Lengthy insolvent liquidation procedures	▶ Although liquidation proceedings must be concluded within two years of their commencement date, the length of an ongoing litigation between a creditor and the debtor does not count in the two years limit. Judges are overloaded and thus not in the position to properly oversee the proceedings.	▶ Creditors should be given greater rights to scrutinize and object to the liquidator's actions or inactions and the timetable for the liquidation. Greater regulation and supervision of liquidators should be considered to ensure that liquidations are handled in a timely manner.
No effective representation of the creditors' interests	▶ In practice the establishment of a creditors' committee or appointment of a creditors' representative is not common because the administrative burden of establishment and operation of the creditors' committee is high compared with the low recovery rate in liquidation proceedings.	▶ If the efficiency of liquidation proceedings increases and potential returns to creditors increase, they may be more willing to establish a committee or appoint a representative.

Item	Issues identified	Recommendations
Lack of powerful measures for dealing with bad faith debtors	▶ Tools of investigation and recovery of liquidators are not powerful enough to properly assess the debtor's assets and ensure the return of any dissipated assets to the debtor's estate. Lack of information about the assets and pre-insolvency acts of debtors, and the lack of powerful measures for dealing with bad faith debtors significantly decrease the ability of liquidators to maximize the debtor's estate for liquidation.	▶ Legislation should be strengthened to ensure that that the liquidator can be found liable if it failed to investigate and seek the recovery of any material dissipated assets belonging to the debtor's estate or unwind acts detrimental to the creditors. Liquidators should be provided with tools similar to those of court bailiffs in terms of public registry search and direct enforcement measures against bad faith debtors or other third parties.
Soft liability regime for executives	▶ The provisions related to directors' and shareholders' liability do not seem to work properly due to lack of information and evidential difficulties for the liquidator or creditor initiating the procedure. In practice courts only establish liability in the most obvious cases.	▶ More effective and dissuading sanctions should be imposed on the debtor's executive officers (i) to ensure that they take creditors' interests into account when the company has entered the "zone of insolvency", (ii) in the event of non-compliance with their duty to cooperate with the liquidator.
Vague definition of fraudulent business policy in the applicable laws	▶ The provisions for the fraudulent transfer of shares are rather vague and are not well-defined. Judges do not have the capacity to conclude a thorough review of matters where "continuous adverse business policy" is alleged.	▶ Legislation should clarify the provisions regarding shareholders' liability for fraudulent transfer of shares and "continuous adverse business policy".
Ambiguous scope of duties	▶ It is not always clear whether the liquidator should be acting in its name or in the name of the debtor (and any associated liability for its actions). The liquidator's mandate does not refer to the requirement to help to ensure the best possible return for creditors.	▶ Legislation should further clarify the liability of the liquidator and the scope of its duties (including the duty to protect the financial return to creditors).

Historical overview

- Development of informal, out-of-court restructuring guidelines began in England in the 1970s when the Bank of England started to emphasize creditor's collective response when dealing with corporations in financial difficulties. Bank of England (BoE) developed a role of neutral intermediary helping to resolve disputes between creditors while encouraging a coordinated approach. Intended to supplement the purely contractual approach to out-of court restructurings at that time, the methodology was well suited for the relatively homogenous British financial sector which resulted in publication and frequent usage in the early 1990s
- The guidelines developed by BoE are commonly known as the London Approach which is an informal framework comprising a set of non-binding principles and guidelines for participants in debt restructuring processes. The aim of the principles is to facilitate restructurings of viable companies while trying to ensure utmost satisfaction of stakeholders' interests and maximizing the probability of going concern.
- Although the London Approach was never formally documented it sets out four major principles, which were developed in practice by BoE while their use was promoted by both BoE and relevant British banking associations:
    1. Lending banks agree on not to exercise their rights to initiate a formal insolvency process (standstill period).
    2. Any decision made is based on reliable information that must be shared among all the lending banks and that remains confidential (information sharing).
    3. Banks should work together to try to form a collective view on whether support for the debtor should continue, and if so in what form (negotiation and decision on viability).
    4. All lending banks should share equally the burden of supporting the debtor (business plan and new money).
- Considered a standard for the whole sector across several countries, the London Approach has influenced the evolution of government sponsored guidelines for multi-creditor out-of-court debt restructurings especially in Southeast Asia as Indonesia, Korea, Malaysia and Thailand all adopted some variant of the London Approach.
- Compared to the London approach, the Asian variants are considered enhanced, as they are specified in more detail, mostly provide for an out-of-court dispute settling mechanisms for creditors and are sometimes enforced by a contract signed by all the institutions which operate in the financial sector of the respective country.
- In the aftermath of the Asian financial crisis that crippled most of the Southeast Asia in the late 1990s, Thailand managed to successfully implement a revised version of the London approach – The Bangkok approach. The Bangkok approach is enforced by contractual provisions as the financial supervisor persuaded the companies subject to financial supervision to join the scheme in which the role of mediator and facilitator was undertaken by The Corporate Debt Restructuring Advisory Committee (CDRAC) operating within the Bank of Thailand.
- CDRAC played an important role in the mediation process to reconcile conflicts of interest among various parties and to resolve disputes among the creditors themselves. Since the implementation of the Bangkok approach, 15,000 restructuring cases were subject to CDRAC process with a 70 percent success rate which caused for the approach to gain prominence and to be subsequently copied and implemented world-wide.
- Stemming from success of out-of-court restructuring in Southeast Asia, in 2002, the Istanbul approach was developed in Turkey. Istanbul approach is a hybrid framework, characterized by robust institutional structure. The Turkish government cooperated with the Turkish Banking Association (TBA), the Union of Chambers and Commodity Exchanges (UCCE) and Turkish Development and Investment Bank (Türkiye Sınai Kalkınma Bankası or TSKB) to create a set of guidelines for out-of-court restructuring are supported by enabling legislation, while disputes under the Istanbul approach are to be resolved by way of arbitration provided for by TSKB.
- In 2000, INSOL International, a federation of national associations for accountants and lawyers who specialize in turnarounds and insolvency published the INSOL principles (Statement of Principles for a Global Approach to Multi-creditor Workouts). The INSOL principles gained prominence due to widespread recognition and are considered best practice. Moreover, different variants of the principles were introduced in various European countries (e.g. Latvia, Austria, Romania, Serbia etc.).
- The INSOL Principles extended the four basic restructuring guidelines developed in the London Approach to eight principles gathered in a single document together with the accompanying commentary. INSOL Principles is a voluntary framework which aims to provide unified guidance to creditors' approach to debtors in financial difficulties, with the purpose of avoiding adverse impacts of business failures where alternatives exist, while seeking to preserve value for relevant financial institutions. The Principles are further different from the London Approach in sense, that they were not developed during a period of financial difficulties (e.g. recession) therefore, they seek to comprehensively address a variety of multi-creditor restructuring situations and focus more on viability of debtors. For a detailed presentation please refer to the *INSOL Principles* section of the report.

- In the regional context, out-of-court restructurings are also a part of the scope of the Vienna initiative which in its initial form focused on safeguarding financial stability of the Emerging Europe to prevent spill-over to the highly exposed Austrian financial sector in the aftermath of the 2010 financial crisis.
- The Initiative provides for a forum where issues are discussed and conditions are created for the Western banks to remain engaged in the economies of Emerging Europe. An important part of the initiative is also cooperation of the World Bank Group, European Investment Bank Group and EBRD which provide for a flow of credit to the Emerging Europe struck by the crisis.
- The initial success of the Vienna initiative resulted in its extension into ongoing Vienna plus (2009) and Vienna 2.0 (2012) initiatives. Initiatives are extensively supported by the EBRD and are aimed at tackling a wide array of policy issues in the emerging Europe including high levels of NPLs in the respective economies which *inter alia* require development of alternative approaches to debt restructurings.
- Regarding out-of court restructurings, the Initiative recognizes the importance of the enabling legislative framework for out-of-court restructurings to be successful. Actions undertaken by the countries should *inter alia* include removal of legal and tax impediments while simultaneously creating incentives for out-of-court restructurings, encouraging participation of tax and social authorities in debt restructurings, review and modification of business and corporate legislation and raising general public awareness of the enhanced regulatory regime.

The INSOL Principles

Introduction

- "Statement of Principles for a Global Approach to Multi-Creditor Workouts" or INSOL principles (The principles) were adopted in 2000 by the INSOL International available at http://www.insol.org/pdf/Lenders.pdf
- Established in 1982, INSOL International is a world-wide federation of national associations of accountants and lawyers specialized in distressed debt management and insolvency. The organization is considered most prominent in the field and comprises 44 Member Associations with more than 10,000 participating professionals.
- INSOL principles reflect best international debt restructuring practices and therefore serve as a benchmark for professionals providing a standardized approach to be applied to out-of-court debt restructurings.
- Objective of the principles is to provide guidance to companies, creditors, government agencies (due to tax considerations) and all other relevant stakeholders in a multi-creditor restructuring process.
- The principles are norm-based which requires a high degree of social consensus for their successful application therefore the concepts should be internalized by relevant stakeholders in a restructuring process, especially by major players in the financial sector.
- The underlying goal of INSOL principles is that no creditor should be worse off at the end of the out-of-court restructuring procedure as compared to the standstill date First priority of the procedure is to stabilize debtor's financial position, therefore no enforcement action by the creditors is allowed during the procedure while debtor's payments are limited to essential payments, interest rate payments and minimum CAPEX. New money should be granted in an out-of-court restructuring procedure on super-priority basis.
- On the following pages we present eight guidelines for a global approach for multi-Creditor restructuring which constitute the INSOL Principles and provide explanation of related concepts and relevant terminology.

First principle

Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give sufficient (though limited) time (a "Standstill Period") to the debtor for information about the debtor to be obtained and evaluated and for proposals for resolving the debtor's financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

The Principles encourage involving wide-range of creditors (e.g. financial institutions, major supplier and customer creditors, etc.) whose co-operation is needed in order to make any restructuring attempt successful while limiting the number of participants to the minimum due to efficiency reasons.

- It is of primary importance to identify all the relevant creditors while all financial creditors are usually included irrespective of their class and amount of exposure or the nature of facilities provided to the debtor.
- The importance of cooperation and mutual support between all financial creditors is seen as a priority and it should not cause commercial disadvantage to any of them
- Regarding bond or traded debt holders the Principles propose to involve those which want to participate in the restructuring process actively.
- The principle also covers the possibility that other important parties might emerge after the initiation of the process due to dynamics of the debt markets (e.g. credit insurance, debt sale). In case of the identity of any relevant creditor changes the process should remain as inclusive as possible.

Giving time to the debtor (the "Standstill Period")

- When creditors realize that a debtor is in financial difficulties they tend to have two main strategies:
  1. "Each creditor for itself" strategy: pressurize the debtor to immediately repay its debt and/or to provide (additional) security.
  2. Co-operative strategy: creditors recognize that their interest is better served by a coordinated and measured process which provides an opportunity to rescue the debtor.
- Following the first strategy can provoke other creditors to do so which usually leads to formal insolvency or bankruptcy of the debtor. At the end it provides lower recovery than expected.

- The second strategy provides the chance to creditors to collectively represent their interests and make an informed decision based on the assessment of a viable restructuring plan.

Determination of Standstill Commencement Date

- It is up to the relevant creditors to choose the start date of the standstill from which they apply the restructuring principles and standstill agreement is in force.
- It is quite common that the Standstill Commencement Date is the date when financial creditors are first notified by the debtor about its financial difficulties in form of a meeting in which the debtor and all financial creditors participate.

Duration of the Standstill Period

- The length of the Standstill Period may be different in each case. It depends on the complexity of the debtor's business operations and the expected outcome of the restructuring proposal to be prepared by the end of the standstill period.
- However, the Standstill Period should be no longer than absolutely necessary since any delay may endanger the success of the restructuring process.
- It is customary to determine an initial period (e.g. a few weeks or months) with an option for extension if all relevant creditors agree. However, relevant creditors can also decide on the termination of the Standstill Period when it is clear that expected outcome cannot be reached.

Inappropriateness of a Standstill Period

- There are cases when a debtor's restructuring is not feasible (e.g. debtor's management lost trust of creditors due to fraudulent behaviour), therefore giving time to the debtor to prepare a reliable restructuring plan is not reasonable.
- However, when initiating a standstill is not clearly disadvantageous to a creditor, it should not refuse to co-operate and should not obstruct the standstill agreement.
- In case of a creditor prefers to press for formal insolvency it should be encouraged to share the reasons behind the decision with other creditors subject to debtor's prior consent.

Second principle

During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (otherwise than by disposal of their debt to a third party) to reduce their exposure to the debtor bit are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.

- The main objective of a restructuring attempt is to achieve debtor's stability. A moratorium on creditors' claims (a "breathing space" to the debtor) allows the debtor to focus on preparing a proposal for restructuring.
- A standstill accepted by the creditors also provides a reassurance to the debtor's management that the information provided during the Standstill Period will not be used to enforce creditors' claims.
- A Standstill Agreement is an agreement between all relevant creditors and the debtor which typically includes the following:
  - Creditors do not press debtor to repay its outstanding liabilities due to them;
  - Creditors do not initiate any proceedings against the debtor during the Standstill Period;
  - Each creditor does not try to improve its position relative to other creditors by enforcement of any security or requiring preferential treatment during the Standstill Period;
  - Creditors allow the debtor to utilize existing credit lines and facilities, at least up to the balances at the Standstill Commencement Date.
- Regarding derivative contracts creditors should agree on either continuation or termination of these contracts considering whether these contracts are essential to the debtor's business operations.

Relative positions

- Creditors should agree on their position relative to each other at the Standstill Commencement Date and try to ensure that during the Standstill Period it remains unchanged. Since the outcome of the standstill is uncertain at this stage, covenants and warranties are usually determined in the Standstill Agreement to ensure that the position of relevant creditors does not deteriorate due to any act or omission of the debtor.
- Inter-creditor arrangements can also be concluded and linked to the Standstill Agreement to manage facilities with fluctuating exposures (e.g. revolving facilities, contingent facilities, multi-currency facilities, loans denominated in different currencies, etc.) as well as facilities of contingent nature (e.g. foreign exchange facilities, interest rate and currency swaps and other forms of derivatives) during the Standstill Period. It is up to the creditors to take into account the volatility of such arrangements and agree on the treatment of the effects on relative positions caused by these movements.
- Some creditors may have an advantage compared to others regarding security of their loans (e.g. guarantees, liens, insurances, set-off rights). Inter-creditor agreements often allow for the retention of these advantages during the Standstill Period.

Third principle

During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.

Actions that debtor should avoid

- As part of the Standstill Agreement the debtor should commit itself not to take any action which will disadvantage all or any of the relevant creditors. Prejudicial actions performed by the debtor can be the following (including but not limited to):
  - Providing security or collateral (e.g. charges, mortgages, liens, guarantees, indemnities, etc.) to those creditors which are not participating in the restructuring;
  - Transferring assets or value away from the debtor;
  - Selling assets to third parties or any creditors at an undervalued price;
  - Otherwise running down or shifting value from the debtor’s business which harms the potential repayment prospect of its liabilities to the relevant debtors;
  - Raising additional financing from non-relevant creditors (e.g. factoring, leasing, etc.).
- However, during the Standstill Period the debtor has to fulfil its outstanding payment obligations to employees, trade creditors and other (non-relevant) creditors which are not entered into the Standstill Agreement.
- In some cases, relevant creditors may require to receive security from the debtor for their collective benefit in return for their support provided in the Standstill Period.

Fourth principle

The interests of relevant creditors are best served by co-ordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

Co-ordination committee

- In case the number of relevant creditors involved in the process is relatively small, an appointed single co-ordinator should be sufficient to facilitate creditor meetings. Co-ordination committee(s) may be formed in order to (i) assist the restructuring process, (ii) progress dialogue with the debtor and mediate between the relevant creditors and the debtor and (iii) manage the evaluation process of the restructuring proposal when the number of relevant creditors makes it necessary.
- The composition of co-ordination committee should reflect each class of relevant creditors. Members of the co-ordination committee appointed by the relevant creditors can be either individual representatives of each creditor or agents.
- Co-ordination committee usually operates on a consensus basis rather than majority voting.
- When bond or traded debt holders also participate in the process usually ad hoc committees are formed to represent them as a class.

Co-ordinator

- The co-ordinator selected by the co-ordination committee or by the relevant creditors themselves has the responsibility for administrative burdens, chairing the meetings and coordination of committees. Exact responsibilities and purposes of co-ordination committees and the co-ordinator are determined by the relevant creditors.
- In general, the co-ordinator and co-ordination committee do not have the authorization to represent relevant creditors in terms of committing them to any course of action or making commercial decisions on their behalf.
- The co-ordinator should have relevant experience, skills and seniority in this field, therefore this position is often fulfilled by the representative of the financial creditor with highest exposure to the debtor. Nature of co-ordinator's position and role should be defined in writing by all relevant creditors. The co-ordinator's main goals are usually the following:
  - Facilitating negotiations between the relevant creditors and the debtor;
  - Disclosing information with appropriate advice to all relevant creditors to ensure they have the same information basis when making decisions;
  - Assisting in the settlement of disputes or disarrangements between relevant creditors and/or the debtor;
  - Instructing external professional advisers (e.g. accountants, lawyers, valuers, etc.) to provide advice for the relevant creditors.
- Professional advisers should be appointed based on mutual approval of all relevant creditors. Appointed advisers should have relevant experience, skills and be able to provide impartial advice for relevant creditors' benefit. Professionals mainly assist the preparation and evaluation of information received and restructuring proposal prepared by the debtor.
- Remuneration of the co-ordinator and the members of the co-ordination committee and external advisers for their services and incurring costs should be borne by the debtor. However, cost allocation should be discussed and agreed by the relevant creditors and the debtor. In case of an individual creditor wishing to have the benefit of a separate advice, the costs of separate advisers should be borne by the creditor concerned.
- All relevant creditors have to make their own assessment of any information, restructuring proposal or advice received directly or via the co-ordination committee. Co-ordinator does not have duty or any liability to relevant creditors or the debtor in terms of completeness and accuracy of information or advices transferred.

Fifth principle

During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper evaluation to be made of its financial position and any proposals to be made to relevant creditors.

Access to all relevant information

- The debtor should allow relevant creditors and/or their professional advisers access to all relevant information required by them to assess the financial position of the debtor and to enable them to evaluate any restructuring proposal prepared by the debtor.
- The debtor should provide reliance on information and prepare it in advance to be capable of due diligence by external professional advisers. The debtor should also accept that external advisers review the accuracy and underlying assumptions of accounts, projections, forecasts and business plans prepared in relation to the restructuring proposal. Professional advisers also estimate the impact on the business of the refusal of the restructuring proposal by relevant creditors.

Restructuring proposal

- The nature and complexity of restructuring proposals vary based on circumstances in each restructuring process.
- The restructuring proposal may include:
  - Provision of temporary additional liquidity; and/or
  - Write-off of outstanding debt balances by relevant creditors; and/or
  - Debt to equity conversion; and/or
  - Asset for debt exchange.
- During the process of assessing the financial situation of the debtor, relevant creditors will also want to be reassured that their relative positions will not be prejudiced by the proposals made by the debtor.
- Depending on the content and nature of the restructuring proposal either contractual arrangement has to be concluded between the debtor and the relevant creditors alone or a court sanction is needed to enter such an agreement into force. In the latter case the parties have to ensure that the most likely outcome of any formal court procedure is as far as possible known in advance.

Sixth principle

Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

Restructuring proposal

- Relevant creditors gather information, perform due diligence and evaluation processes in order to evaluate the debtor’s current financial position, to assess restructuring proposal prepared by the debtor and to ensure that all relevant creditors receive equitable treatment.
- Based on individual assessment and/or upon given professional counsel, relevant creditors usually compare the received restructuring proposals in light of expected outcome of a formal insolvency procedure and other available options.
- External professional advisers often base their advice on insolvency models taking into account certain legal and accounting assumptions. Insolvency models are based on information gathered through the due diligence process and take into consideration all relevant claims and rights which would be counted in any formal insolvency procedure. Insolvency models are also used for identifying all claims relevant creditors have against the debtor and estimating recovery of each relevant creditor’s claim.

Seventh principle

Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, be treated as confidential.

Confidential information

- The same information and all restructuring proposals prepared by the debtor should be distributed among all relevant creditors. It also should be applied in case of different proposals are prepared for different constituencies within the relevant creditor group.
- In case of relevant creditor group is formed by financing banks only, the same information should be made available for all of them at the same time. When a co-ordinator is assigned it usually has the task to first process the information and put it into a form suitable for assessment by each of the relevant creditors.
- Even though banks are obliged to maintain bank secrecy, formal agreements are customary to ensure that price-sensitive information received during the Standstill Period is held confidential.
- In case creditors cannot are not subject to express or implied duty of confidentiality or cannot accept confidential information due to its effect on debt trading (e.g. bond holders and other debt traders) an ad hoc group (e.g. legal counsel) restricted from trading should be formed by them to evaluate confidential information until such information is published or distributed to potential investor(s). This method also supports risk mitigation related to confidential information disclosure since such information is transferred to the decision making bodies of relevant investors either when the restructuring proposal has been fully formulated or when the information is simultaneously made available to all the market participants.
- In case of the relevant creditor group comprises only financing banks and they intend to keep the restructuring proposal confidential and avoid any formal procedure, they should set out in the standstill agreement a precise mechanism on debt trading during the Standstill Period.

Debt trading

- Enabling relevant creditors to trade debt has the benefit of providing an exit opportunity to those who decide not to take part in the restructuring process. However, trading debt also has the possible disadvantage that number of and change in the identity of creditors may increase resulting in a more complex situation.
- Treatment of issues around debt trading (e.g. increasing complexity, disclosure of confidential information, etc.) is not regulated by the INSOL Principles, therefore relevant creditors can agree upon the resolution of such issues.

Eighth principle

If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as practicable, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

Additional funding

- The debtor in financial difficulties often require additional funding during the Standstill Period and/or during the restructuring which relevant creditors wish to provide when it is absolutely necessary for the turnaround of the debtor and repayment is assured sufficiently.
- Additional funding can be provided in form of additional loan facilities or any other increase in exposure levels (e.g. derivative or contingent facilities).
- Due to higher risk profile, generally additional funding has priority in terms of repayment and/or collateral enforcement compared to other debt elements in case of the restructuring process is failed or formal insolvency of the debtor is initiated. The priority of additional funding is usually ensured by granting first rank security over assets of sufficient value.
- In some cases negative pledges can block the provision of security for additional funding. There are various possible techniques to manage this issue:
  - Asset purchase agreements;
  - Sale and leaseback agreements;
  - Placement of certain assets into a newly established and ring-fenced borrowing entity;
  - Loss sharing arrangements between relevant creditors.
- Since relative position of relevant creditors at the Standstill Commencement Date should be preserved as set out in the Standstill Agreement, relevant creditors have to take it into account when providing additional funding. The simplest way to preserve relative positions is when all relevant creditors participate in the provision of additional funding on a proportionate basis.
- Financing banks and other financial institutions may be able to provide additional funding directly but other relevant creditors may only be able to provide it to a limited extent only and not to increase their outstanding exposure. However, they can support the provision of additional funding by subordinating their debt elements to its repayment. In any case, provision mechanism for additional funding should be negotiated between relevant creditors.
- In some jurisdictions after the petition for liquidation or bankruptcy has been lodged providing additional funding can be subject to court approval since (i) certain relevant creditors may be prohibited to lend to any debtor facing potential liquidation or bankruptcy issues or (ii) additional funding will not be recoverable in a subsequent liquidation or bankruptcy procedure.

EY

Overview

Introduction

- EY conducted a high level overview of insolvency and OOCR frameworks in selected countries of Central and South-Eastern Europe (hereinafter: “CSE”). Countries Subject to this comparative study are Austria, Slovenia, Czech Republic, Croatia, Serbia and Romania (hereinafter: “CSE countries”). These countries were selected due to their geographic proximity to Hungary and/or due to similar issues regarding the adoption and use of out-of-court restructuring principles.
- Information, research materials and specific practical market insights were provided by respective EY local teams.
- As significant divergence in the nature, type, speed and quality of insolvency and restructuring procedures can be observed across the CSE countries, we tried to understand Hungarian framework in a context relative to other countries, to provide recommendations which would also be based on regional best practices.

Restructuring frameworks across the CSE

- Understanding the basic functioning of the Insolvency legislation in each country is important as legislative characteristics often define the effectiveness of out-of-court restructuring procedures.
- An enabling legal framework which provides for a swift and efficient approach to insolvency and clearly distinguishes between companies eligible for formal procedures and those where an alternative approach can be applied is seen as a prerequisite for a functioning out-of court restructuring regime.
- Apart from the formal bankruptcy procedure, all of the CSE countries provide for an in-court restructuring procedure for an insolvent debtor. Such a procedure is most commonly a debtor-in-possession regime usually resulting in 40-70% haircut of unsecured claims while secured claims tend to be recovered in full.
- Upon conclusion of an in-court restructuring procedure companies either restore their long term financial viability or subsequently enter into a formal bankruptcy, therefore the percentage of successful in-court restructuring procedures generally reflects the overall soundness of the legislative framework.
- Additional, less formal variants of procedures, aimed at financial and operational restructuring of solvent debtors in financial distress were adopted in Slovenia, Romania and Austria. In Serbia, an out-of court restructuring procedure where the Serbian Chamber of Commerce and Industry has a central role of a mediator and facilitator is also governed by law. However, companies have remained relatively passive regarding the application of such procedures.
- Formal procedures in majority of CSE countries have proven to be inefficient in dealing with the growth in volume and complexity of situations, where multiple financial institutions are simultaneously exposed to large and often systemically important companies in financial distress.
- While the process of adopting informal guidelines for out-of-court restructuring in CSE was divergent in terms of involvement of domestic and international organizations, out-of-court restructuring principles in CSE countries were adopted as an alternative to costly and lengthy insolvency procedures and are aimed at promoting a coordinated approach to distressed debt situations while seeking to maximize value for stakeholders.
- Apart from the Czech Republic, where out-of-court restructuring principles have not been developed, all of other countries subject to our analysis have adopted some form of out-of-court restructuring principles in the 2010-2015 period, which serve as restructuring guidelines defining roles of relevant stakeholders as well as preferred action patterns to be adhered to during a restructuring process and are predominantly derived from INSOL principles adapted to local specifics of each respective country.
- Further awareness-raising initiatives aimed at enhancing negotiation culture in the CSE countries are needed to increase the effectiveness of out-of-court procedures and result in more frequent application of such principles in practice.

Key challenges pertaining to out-of-court restructurings in observed CSE countries

- The prevailing method for resolving distressed debt situations in the majority of CSE countries is through court driven procedures.
- Due to the inefficiency of the judicial systems in most CSE countries, out-of-court solutions are typically a preferred option when creditors seek to maximize their returns. However, out-of-court restructurings in CSE countries remain characterized by several collective challenges, from both the creditors' and debtors' perspectives:
  - Complex multi-creditor financing structures mostly lead to lengthy negotiations and limit possibilities for optimal solutions, which would allow for maximizing value and ensure long term viability of debtors.
  - Lack of proactivity on both creditor's and debtors' side; with distressed companies appointing external advisors very late in the process, when the company is already on the verge of insolvency.
  - Limited involvement and cooperation of shareholders.
  - Limited capabilities of debtors to prepare a credible and robust restructuring plan.
  - Conflicting positions and limited cooperation between creditors. In general recovery rates in out-of-court procedures are higher than in formal restructuring procedures. However, secured creditors often lack incentives to engage in out-of-court restructuring processes where the outcome of the procedure is less predictable.
  - Insufficient levels of provisions in the banks' balance sheets in certain CSE countries, which lead to over ambitious expectations regarding recoverability of claims and limits manoeuvring space for debt restructuring.
  - Lenders predominantly focus on short-term solutions and mostly take an "extend and pretend" approach, rather than taking an approach of cooperation in comprehensive restructurings (including financial, operational and strategic restructuring measures) or opting for an early "sale and exit" strategy.
  - Limited appetite and/or legal possibility of banks to enter into the ownership structure of the debtor in the process of restructuring
  - Several creditors holding larger portfolios of NPLs across the region are subject to state aid or have a limited life span (HETA, BAMC, etc.), which imposes additional restrictions to debt restructuring options.
- All of the above has led to a number of unresolved (or re-emerging) issues, which could remain on banks' balance sheets in CSE countries for a longer term if not promptly dealt with.
- Recent AQRs (asset quality review) combined with tighter banking regulations, such as Credit Requirements Directive (CRD IV directive) and strengthened supervisory standards as a part of the European Banking Union (EBU), reduced the risk appetite of regional banks and emergence of non-traditional providers of funds such as hedge funds, private equity and leveraged funds, looking to provide debt financing to corporates or acquiring non-performing or non-core loans and have resulted in an increased level of restructuring activity and NPL disposals across the CSE region.
- An increase in out-of-court restructuring activity has led to a need for the development of out-of-court restructuring principles (OCRPs) in most of the CSE countries. In practice, we observe that the frequency of OCRPs use is not only dependent upon the quality of these principles but predominantly depends on the quality of the overall restructuring framework which significantly differs across CSE region and is on a country basis burdened with country-specific issues.
- In the following sections of the report we present an overview of restructuring framework and key challenges identified for Hungary and the CSE countries: Austria, Slovenia, Czech Republic, Croatia, Serbia and Romania.
- Each of the following country profiles is divided into six sub-sections. The first sub-section is a high-level assessment of the business environment in a country; the second sub-section is a brief overview of insolvency and restructuring legislation in a country, while in the third sub-section we describe the implementation of in-court restructuring solutions in each country. The fourth, fifth and sixth sub-sections pertain to out-of-court restructuring practice. The fourth sub-section generally describes the out-of-court restructuring environment in a country, while out-of-court restructuring principles adopted in each country are listed and described in the fifth sub-section if applicable. Key issues pertaining to out-of-court restructuring processes in each country are described in the sixth sub-section.

Restructuring practices in observed CSE countries - Summary of findings

	Austria	Slovenia	Croatia	Czech Republic	Serbia	Romania
Existence of OUC restructuring guidelines	YES - Austrian Restructuring Principles or "Grundsätze der Restrukturierung"	YES - The Slovenian Principles of the Financial Restructuring of Corporate Debt	YES - Croatian Guidelines on Out-of-court Corporate Debt Restructuring	NO	YES – INSOL Principles Serbia	YES - The Corporate Debt Restructuring Guidelines
Basis for principles	INSOL principles	The Bangkok approach, the London approach	INSOL principles	n/a	INSOL principles	INSOL principles
Year of introduction	2013	2011	2015	n/a	2015	2010
Issuer/ form	Erste Group Bank AG, Raiffeisen Bank International AG, Schoenherr Rechtsanwaelte GmbH / guide	Slovenian Managers' Association, Slovenian Banking Association / guidelines	Croatian government - Ministry of Justice / set of guidelines	n/a	Association of Serbian Banks (working group – representatives of 7 banks) / guide	Ministry of Justice / set of guidelines
Other stakeholders included in drafting/ amending	Other Austrian banks, credit insurers, leasing companies	Bank of Slovenia, Ministry of Finance	/	n/a	/	National bank of Romania (endorsement), Ministry of Finance (endorsement), the World Bank
Application in practice	Commonly used	Commonly used	Rarely used	n/a	Rarely used	Rarely used
Existence of other guidelines	YES – Guidelines for restructuring concepts (Leitfaden fűr Forbestehensprognosen)	YES - Guidelines for Restructuring of Micro, Small and Medium enterprises	NO	NO	NO	NO
OOC restructuring provided for by law/use	NO	NO	NO	NO	YES – Consensual Financial Restructuring procedure/ sometimes used	NO
Supportive legal framework	Formal insolvency is advantageous (e.g. Withdrawal rights, staff cuts, no universal succession clauses, etc.), otherwise strict and relatively supportive legislation. Possible seniority of bridge loans, required substance of restructuring concepts)	Insufficient (e.g. Out-of-court restructuring measures such as change in priority are avoided under subsequent formal insolvency or in-court restructuring procedure, unfavourable tax treatment)	Insufficient (e.g. unfavourable tax treatment, no incentives for early entry into OUC restructuring as bankruptcy legislation allows for fraudulent behaviour of debtors)	n/a	Considerable (e.g. Law on Consensual Financial Restructuring procedure facilitated by Serbian Chamber of Commerce and Industry, however, poor bankruptcy legislation, lack of appropriate judicial personnel)	Several insolvency procedures - from strictly regulated lengthy, rigid and complex proceedings to less comprehensive non-binding proceedings lacking restructuring tools accompanied with unfavourable tax treatment of debt write-offs
Main issues	Lack of observance of key financial covenants by the companies (esp. SMEs)	Minimalistic approach to restructuring (e.g. Operational restructuring is seldom carried out, restructuring measures are most commonly debt rescheduling)	Case-by-case approach to restructuring by banks, lack of involvement of relevant stakeholders (e.g. Banking sector)	n/a	Poor negotiation and restructuring culture, minimalistic approach to restructuring	Banking sector is passive regarding use of principles, lack of involvement of relevant stakeholders (e.g. Banking sector)

Austria

High level assessment of business environment in Austria

- Bank lending to non-financial corporations in Austria has been sluggish due to the tighter lending standards of Austrian banks as well as due to weak domestic demand for credit. Extremely strict avoidance rules in insolvency procedures where claw-back periods can be as long as 10 years demand for the Austrian lenders to be cautious with regards to extending loans to companies in financial difficulties. (source: BMI)
- Deleveraging in the CSE and measures taken by Bank of Austria have had a positive impact on the soundness and stabilization of Austrian banks. Private debt level has decreased from 133% of GDP in 2010 to approx. 127% of GDP in 2014. However, during that period the percentage of NPL's in total loans rose from 2.8% in 2010 to 3.6% in 2015. (source: Eurostat)
- The Austrian business environment is characterized by good payment discipline as adequate tools (e.g. expedited execution procedures) are provided to deal with late payment issues therefore, companies in financial difficulties can be timely recognized and promptly dealt with. Furthermore, strong incentives have been put in place to ensure an early start of insolvency procedures.

In-court restructuring procedures in Austria

- The Austrian Insolvency Act (Insolvenzordnung) recognizes the debtor as insolvent if permanently unable to service debt or when debtor's assets cannot cover all creditors' claims (latter only applicable for legal entities and registered partnerships). The Insolvency Act provides for two different procedures with different envisaged outcomes. After filing for insolvency, the procedure may be continued either as Reorganisation proceedings (Sanierungsverfahren) or as a Bankruptcy proceedings (Konkursverfahren) whereas the aim of the first procedure is to restructure debt and the aim of the second procedure is orderly winding down of the company.
- Austrian rules governing commencement of the insolvency procedure are stringent as non-filing for insolvency by the management within 60 days upon the occurrence of the insolvency situation results in criminal offence and personal liability of the company's directors. In the 60-day-grace-period the company's management must either try to restructure business or decide that business cannot be salvaged without the assistance of the insolvency framework.
- In order for the Reorganisation proceedings (Sanierungsverfahren) under the Insolvency Act to commence, the debtor must file the restructuring plan to be confirmed by the creditors. The majority of creditors can confirm the restructuring plan which must offer a quota of at least 20% of a debtor's claims to be repaid in 2 years without the Debtor-in-control regime applied or 30% of debtor's claims with the application of the Debtor-in-control regime. The provision is similar to recently abolished provision in Slovenian Financial operations, Insolvency proceedings and Compulsory Dissolution Act (FICD) which required 50% of the claims to be repaid in 4 years but was considered too demanding for the debtor.

Implementation and application of in-court restructuring procedures in Austria

- The Bankruptcy proceedings governed by Insolvency Act are usually swift as its average duration is approx. 1.9 years (incl. full liquidation cases) with recovery rates at close to 80% in 2010-2015. Bankruptcy administrator is appointed and creditors are in power to choose whether the debtor should remain a going concern or be liquidated; however, the recovery rates of unsecured creditors are usually low, therefore pre-legal action which is conducted by expert advisors remains the preferred practise for debt restructurings.
- In the first year after the introduction of the new law in 2010, 21% of all the insolvency procedures were Reorganisation proceedings; however, this percentage has been falling steadily to only 18% in 2015. This is in line with the general trends as number of insolvency situations has fallen with CAGR of 3% between 2013 and 2015 (16% in Jan-Jun 2014 compared to Jan-Jun2015) due to the efficient judiciary and mitigated negative effects of the financial crisis.
- The possibility of starting a less formal court mandated Reorganization process was also introduced in 1997; however, it was used only once in 16 years and therefore the effect of the introduction was minimal.

Out-of-Court Voluntary Restructuring Process in Austria

- According to a study conducted by leading Austrian banks (Unicredit, Raiffeisen International, and Erste) more than 61% of restructuring cases are resolved via out of court restructuring process.
- The high percentage of out-of-court restructurings reflects the awareness of Austrian stakeholders in out-of-court restructurings that more value is created in such proceedings *vis-à-vis* in-court procedures. High quality of loan documentation and observant banking sector ensure that most of out-of-court restructurings are initiated at an appropriate time.
- Out-of-court restructuring procedure is initiated by the debtor with the main creditor (covering the majority of debts) usually being behind such decisions. The main creditor takes the lead of the "lenders meeting" and the restructuring steering process after the needs of the debtor are identified. It is quite common that lenders require the debtor to hire external advisors and interim managers in order to support in providing the creditors with transparency of the debtor during a standstill period which is decided by the majority of the creditors.
- In order to facilitate the procedure it is crucial for the debtor to provide the lenders with evidence that conditions to initiate insolvency procedure (i.e. impending or actual inability to pay debts or over-indebtedness) are not fulfilled.
- The key document is the restructuring concept (Fortbestehensprognose), which includes a primary statement on short-term viability (a primary statement for the next 12 months) and a secondary statement on strategic, operational, financial, capital measures, which need to be undertaken to ascertain a sustainable turnaround. Austrian guidelines for restructuring concepts are of relevance as they provide minimum standards on the substance of a restructuring concepts
- Key frameworks to be applied to restructuring concepts governing their substance are the Austrian guidelines for restructuring concepts (Leitfaden für Fortbestehensprognosen) as issued by the Austrian Chamber of Public Accountants and Tax Advisors and the Austrian Economic Chamber as well as the German IDWS6 as issued by the German chamber of accountants (IWP) with the latter being required by the lenders in bigger cases only. Austrian guidelines for restructuring concepts are of relevance as they provide standards on the substance of a restructuring concepts which have to be prepared by debtors in restructuring cases. The Austrian guidelines for restructuring concepts (Leitfaden für Fortbestehensprognosen) are currently being amended and expected to be published in 2016.
- In recent years, a substantial number of alternative debt providers (e.g. hedge funds) have entered into the Austrian debt market. Such players have on one hand provided new liquidity in in-court and out-of-court restructurings but have on the other hand hampered non-binding procedures with their aggressive approaches, which are mainly aimed at short-term profit maximization. The number of such players participating in the Austrian market is expected to further increase.

Out of court restructuring principles (OCRPs) in Austria

- Apart from the Austrian guidelines for restructuring concepts which govern the majority of the restructuring process, The Austrian Restructuring Principles or ("Grundsätze der Restrukturierung") Austrian OCRPs mostly applying to the procedural part of the out-of-court restructuring process have been developed.
- Austrian OCRPs were drafted in 2013 by the law firm Schönherr in cooperation with the three largest banking groups in Austria; Raiffeisen Bank, Erste Bank and Unicredit. The principles are non-binding and aim to serve as objectives and guidelines, independent of interests of individual stakeholders and case-by-case characteristics.
- Since their introduction, the Austrian Restructuring Principles are commonly used in practice and were recently applied to several large restructuring cases such as Zielpunkt (2015, ended in formal insolvency), Baumax (2013-2015, ended in formal insolvency), ASAMER Holding (2013), Wietersdorfer Group (2013-2014), DiTech (2013), Sport Eybl (2013, now Sports Direct) etc..
- The Austrian OCRPs address larger (total to-be-restructured debt volume of around EUR30 million or more) multi creditor (at least 3 bank creditors) restructuring cases and predominantly deal with the first phase of restructuring processes – throughout which it is to be established whether the debtor should continue as a going concern. The final goal of such a phase is to reach a restructuring agreement.
- Austrian OCRPs are norm-based and closely follow INSOL International's eight "guidelines for a global approach for multi-Creditor restructurings taking into account some relevant local specifics.

- Austrian OCRPs comprise 8 principles which are of the same wording as the INSOL principles. Supplements to INSOL International's principles address several local specific aspects such as bank secrecy ("Bankgeheimnis") and written restructuring concept ("Fortbestehensprognose") - requirement governed by the Austrian insolvency law and set guidelines regarding the envisaged support of external advisors, freeze of all conditions due to finance agreements, who is in lead of the steering committee, aspects of restructuring agreements between creditor and debtor, seniority of restructuring bridge loans, etc.

Challenges related to out-of-court restructuring in Austria

- Although in Austria, a large portion of restructuring cases are addressed through out-of-court process the enforcement of such deals in practice is often difficult and time consuming. This especially applies to cases with large numbers of creditors, whereas formal insolvency has a lot of advantages that might facilitate a sustainable and quick restructuring (e.g. withdrawal rights, the employee cutting, no universal succession clauses, etc.).
- Stakeholders such as creditors or credit insurers could easily prevent or hamper a restructuring plan in an out-of-court restructuring situation. Thus, perfect stakeholder management is crucial for a successful restructuring process. However, as distressed situations are particularly challenging for management, banks usually require the debtor to engage an external advisor to support management – amongst others - with stakeholder management.
- Furthermore, restructuring plans prepared by the debtors are often of a questionable quality. In practice, Austrian guidelines for restructuring concepts do not ensure that all restructuring plans put forward by the debtors are sufficiently robust to be successfully put into implementation. However, it is expected by the practitioners that the ongoing amendment of the Austrian guidelines for restructuring concepts will provide solutions to make plans more robust by providing for clearer provisions and recommendations on the substance required for an acceptable restructuring plan.
- Lack of observance of company's key financials is often an issue which undermines the possibility to get a clear enough view on a distressed situation to be able to reach informed decisions. Especially small entities do sometimes have absolutely insufficient management accounts (sometimes trial balances only), lack of analysis of budget variances and insufficient planning (sometimes on yearly basis only and/or profit and loss only).
- The Austrian restructuring landscape is characterized by a large number of small boutiques that are not able to provide 360° support (i.e. operational, legal, financial support) however, and banks are becoming more prone to engage reputable advisors who can provide a holistic review of the business model of the debtor.

Slovenia

High level assessment of business environment in Slovenia

- Corporate debt levels in Slovenia are among the highest in the EU with an average debt EBITDA of non-financial sector at around 3.5 in 2014. The main problem arises from debt being concentrated in approximately 30% of the companies with debt to EBITDA ratios exceeding 5, whose combined debt amounts to approx. 80% of total financial debt (Source: IMF, Bank of Slovenia).
- One of the primary reasons for high levels of non-performing corporate loans (NPLs) is poor corporate governance in state owned banks and poor banking supervision. In years following the financial crisis, banks did not promptly monitor relevant debtors, had insufficient credit files and inadequate risk management systems, which did not follow guidelines issued by Bank of Slovenia.
- While average bank capital adequacy ratio has improved to almost 18% due to the deleveraging of the banking sector and stringent banking supervision in recent years, this has had an adverse effect on credit growth as banks have been reluctant to extend further credits to the private sector, which *inter alia* has had a negative impact on providing new money in corporate restructurings (Source: IMF).

In-court restructuring procedures in Slovenia

- Slovenian insolvency legislation provides for several in-court procedures: (i) Bankruptcy procedure, (ii) Compulsory settlement procedure, (iii) Simplified compulsory settlement and (iv) Preventive restructuring procedure.
- In Slovenia, management of the company must come up with a Report on Measures for Financial Restructuring within 30 days after the company has become insolvent. Apart from a description of restructuring measures which are to be taken, the report must also include an opinion of company's management if there is at least a 50 percent possibility for a Compulsory Settlement to be successfully conducted. If such an opinion is negative, than the company must enter into a Bankruptcy procedure for it to be liquidated.
- A Compulsory settlement and Simplified compulsory settlement are in-court procedures aimed at restructuring of unsecured creditors' claims based on a Report on Measures for Financial Restructuring put forward by the debtor and confirmed by such creditors. The difference between procedures is that the simplified procedure is designed for small and micro companies while the full-scale procedure only applies to medium and large enterprises.
- Claims of secured creditors remain unchanged while subordinated claims are written off during such a procedure. All unsecured claims must be treated equally while commonly applied restructuring tools in such a procedure are debt reschedulings, debt write-offs and in certain cases debt-to-equity swaps.
- A new insolvency framework was enacted in December 2013 introducing a new type of procedure, a pre-packaged Preventive restructuring for viable large and medium-sized companies which are in danger to become insolvent within the period of one year. It is a type of court mandated hybrid procedure where debtors can initiate the procedure with consent of creditors holding at least 30% of financial claims.
- The process of Preventive restructuring is simple with regard to initiation and termination of the standstill (30% of financial claims) while the role of the court in the procedure is fairly limited with no court administrator appointed in the proceeding. However, the court has an important role of enforcing decisions of majority creditors on dissenting minority creditors (cram down) which is a major difference in comparison to out-of-court restructurings.
- The goal of the procedure is to provide sufficient time to the debtor to negotiate debt restructuring. The maximum duration of the procedure for large enterprises is set at 5 months with a possible 3 month extension while the maximum duration for medium enterprises is 3 months with a possible 2 month extension. New financing provided during a Preventive restructuring procedure is granted priority status in a subsequent Compulsory Settlement or a Bankruptcy procedure.

Implementation and application of in-court restructuring procedures in Slovenia

- Poorly conducted insolvency procedures often starting far past the point of a company's financial viability have led to lengthy proceedings and low recovery rates, which are usually at around 50% of the assets. In the observed period of January to October 2015 the recovery rate in in-court debt restructurings (incl. Compulsory settlement and Simplified compulsory settlement) was approx. 37% of non-secured claims with an average repayment period of 4.41 years for micro and small and 6.14 years for medium and large enterprises (Source: Slovenian Ministry of Justice).
- Since the enactment of the Preventive restructuring which is the closest approximation to the out-of-court proceeding in December 2013 only 8 such restructurings have been successfully finished with an average duration of 135 days (Source: Slovenian Ministry of Justice). Such statistics indicate that debtors rather seek to restructure debts in more flexible arrangements through out-of-court negotiations or delay the initiation of less formal proceedings while engaging in potentially fraudulent behaviour and enter into a bankruptcy procedure when financial difficulties become insurmountable.
- Although improved, the insolvency legislation is still provides incentives for the debtor to use delaying tactics as creditors are less willing to enter into an insolvency procedure giving the debtor a better bargaining position.

Out-of-Court Voluntary Restructuring Process in Slovenia

- Length, complexity and inefficiency of the formal restructuring proceedings in Slovenia had created the need for the development of out-of-court restructuring practise.
- In the Slovenian environment, financial and operational restructuring of a company is agreed upon between the debtor and the creditors without the involvement of the court and legal framework. The process is completely voluntary and is in practise usually managed by a professional advisory firm.
- The grounds for initiation of the out-out court restructuring may be several. In practice, distressed situations are being addressed relatively late in the process when the debtor is likely to become insolvent if financial and operational measures are not undertaken.
- Financial and operational restructuring measures are defined and agreed upon in restructuring agreements, which have to be signed by all parties participating in the restructuring (debtor and creditors), but do not have to be approved by the court.
- None of the stakeholders are bound to agree with the conditions set in the proposed restructuring agreement without their consent as the procedure is of voluntary nature. Therefore, to reach a consensus between multiple creditors with different positions and the debtor many times represents the key challenge and results in lengthy negotiation processes managed by an external advisor.

Out of court restructuring principles (OCRPs) in Slovenia

- Numerous complex multi-creditor distressed situations have led to a need for the development of guidelines for multi-creditor approach to out-of-court restructurings. The underlying set of guidelines is the Slovenian Principles of the Financial Restructuring of Corporate Debt (the Principles or Slovenian OCRPs) which were initially prepared by the Manager's Association of Slovenia in 2011.
- Slovenian OCPRs comprised 16 principles in its initial form, while in 2014 principles were supplemented by the Slovenian Banking Association (SBA) in cooperation with the Ministry of Finance (MoF) and the Bank of Slovenia (BoS) to better serve the diverse needs arising from complex situation in financial industry and broader Slovenian economy. An additional 17th principle on confidentiality of information was added in that process.

  Additional accompanying documentation was drafted together with the Slovenian OCRPs and includes draft documents (e.g. agreement on appointing a coordinator, meeting minutes of next steps to be taken and a sample SSA agreement) and indicative time schedule of OUC restructuring process. The time schedule recognizes that duration of an OUC restructuring procedure can differ case-by-case. Nonetheless, it sets out an indicative timeframe for various steps in an OUC restructuring process and an indicative overall duration of a process, which should generally last 180 days from the initial meeting of key creditors and the debtor until signing of a restructuring agreement.

- Apart from being involved in the process of drafting the principles, the role of the MoF was also to act as an intermediary for coordination with the Bad Asset Management Company (BAMC) which was set up by the government to tackle high corporate NPL levels, therefore it was of essence to ensure its general adherence to the principles.
- BoS actively cooperated in the process in amending the principles and endorsed the final document by issuing it in form of several recommendations. Furthermore, BoS prepared a list of systemically important debtors which were eligible to undergo an out-of-court restructuring process.
- Based on both “the London Approach” and “the Bangkok Approach” the Slovenian OCRPs strive to minimise losses of all the relevant stakeholders by encouraging a coordinated approach to restructuring while trying to avoid bankruptcy of companies without prior analysis of the situation.
- The Principles are non-binding and define the approach that should be voluntarily complied with in the financial restructuring of companies with a large number of creditors.
- According to Slovenian OCRPs, the debtor should upon coming into financial difficulty initiate the negotiations with the creditors who are obliged to react promptly and prudently and should not take unnecessary action without consideration. A collective decision of the creditors on whether or not to engage in an out-of-court debt restructuring should be based on comprehensive examination of the relevant information (which should be reliable and shared among all creditors) while a suitable solution for sale of their claims should be offered by the creditors opposed to restructuring.
- Slovenian OCRPs are often used in practice, especially since they were supplemented and endorsed by most important and relevant stakeholders in the field of financial restructuring in Slovenia. In recent years, there were several large financial and operational restructuring cases which were carried out in relative compliance with the Slovenian OCRPs (e.g. Trimo (2013), Hidria (2014) Mercator (2014), Unior (2013), Pivovarna Laško (2014), Perutnina Ptuj (2015) etc.). The abovementioned is a confirmation of successful development and implementation of Slovenian OCRPs as well as a reason for confidence regarding their future application.
- In this paragraph we summarize 17 principles which constitute Slovenian OCRPs:
  1. Any corporate debt restructuring must consist of business as well as financial restructuring.
  2. Measures to re-establish the profitability of the creditors' claims are considered a priority.
  3. All phases of corporate debt restructuring must be carried out in an organized manner without unnecessary delay.
  4. If the debtor's management provides complete and reliable information, a moratorium (a Standstill Agreement) shall be granted by the creditors.
  5. Success of financial restructuring depends on active co-operation of the management in the debt restructuring process.
  6. A leading institution must be selected out of the creditors as soon as possible and shall appoint an authorized person who will actively manage the restructuring process.
  7. A creditor committee where interests of all creditors are represented shall be appointed for major restructuring cases (as a rule, the creditor committee shall consist of the creditors with the largest exposure).
  8. Decisions must be adopted on the basis of complete and reliable information as to ensure the necessary transparency and credibility of the process.
  9. If auditors, lawyers and other consultants need to be appointed, they are to have the necessary knowledge, experience, available staff and means.
  10. Even though the debtor is usually required to assume all costs of professional consultants, leading institutions and creditor committees must strive to help the company control and manage such costs.
  11. The existing rights of the creditors arising from collateral under credit arrangements must stay in force.
  12. New financing (‘New money’) aimed at enabling the debtor to do business during the restructuring, shall have priority (Status of super seniority) over other claims and should, where possible, be secured by an appropriate form of first rank collateral.
  13. The creditors should strive to reduce their risks and thus increase the probability of repayment.

14 Selling debt is acceptable; however, the creditor selling receivables must ensure that the buyer does not obstruct the debt restructuring process.

15 The encumbrances from restructuring shall be distributed fairly applying the principle of absolute priority which is among the basic principles used in international practice.

16 The creditors shall maintain strict confidentiality of debtor's restructuring related information made available to them while communication with the media should be kept to a minimum. Relevant business partners should only be provided with information regarding the usual course of business.

17 The creditors shall keep the right to independent business judgment and goals but shall strive towards the common goal, namely to support the restructuring of an indebted debtor. Any actions of individual creditors to the detriment of other creditors or actions improving creditor's relative position will be treated as causing damage to creditors.

- Additionally, "Guidelines for Restructuring of Micro, Small and Medium enterprises" were developed by the Bank Association of Slovenia. These Guidelines are in organizational and procedural sense adapted to dealing with smaller specific restructuring cases where profit and loss levels tend to fluctuate more by nature of businesses, number of financial creditors tends to be smaller and debt-to-equity swaps tend to be less attractive due to concentrated ownership structures whereas appointment of external advisers can represent a substantial financial burden for the company.

Challenges related to out-of-court restructuring in Slovenia

- Out-of-court restructurings in Slovenia can be very lengthy while the business plans put forward are often not comprehensive enough for the banks to provide new money to such partially restructured companies which cause persistence and eventual reoccurrence of similar problems.
- Creditors approach to restructuring is often minimalistic as they are trying to minimize the haircuts and maintain soundness of their balance sheets and therefore have little interest in ensuring long term viability of the restructured company through alternative arrangements.
- In recent years, Slovenian distressed debt situations have been characterized by the presence of non-banking institutions such as bad banks (HETA, BAMC) or banks in controlled wind down procedure (Probanka, Factor banka), which have a limited time horizon and a different business focus than commercial banks and are thus often unwilling or unable to cooperate in a restructuring process.
- Out-of-court restructuring measures (e.g. change in priority) are avoided under subsequent formal insolvency or in-court restructuring procedure.

Czech Republic

High level assessment of business environment in the Czech Republic

- As compared to the other CSE countries, the Czech Republic's banking sector is relatively healthy with the loan-to-deposit ratio at 79.6% at the end of the Q32015. Bank liquidity is considered adequate and the corporate sector dealt well with the adverse post-crisis shocks as percentage of NPLs to total loans fell from 9% in December 2010 to 5.4% in February 2016.
- Credit growth is picking up and rose to 8.1% y-o-y in November 2015, reflecting loosened credit standards for household loans and the low indebtedness of the corporate sector which slightly exceeded 40% of GDP in 2014.

In-court restructuring procedures in Czech Republic

- Czech Insolvency legislation provides for a multi-option insolvency procedure with three possible procedural options. Two of them, Reorganisation procedure (post-insolvency restructuring) and Bankruptcy procedure are applicable to legal persons.
- In contrast to the Bankruptcy procedure, the in-court Reorganization procedure is aimed at restructuring a company as a going concern. The procedure can be initiated by both creditors and/or debtors. However, the debtor remains in charge of day-to-day operations of the company (debtor-in-possession) under the supervision of creditors' committee and the court appointed insolvency administrator.
- The role of the court is important as it provides for formal supervision of the debtor during the restructuring process, disbursement of the raised funds to the creditors and enforcement of creditors' decisions (cram down). Shareholders' retain the right to elect the management of the company with approval of the creditors. However, if the procedure was initiated by the creditors, shareholders may be stripped of this right entirely.
- Reorganization plan is to be prepared by the debtor or by the creditors in they initiated the procedure. The plan is subject to review and approval by both creditors and the court. After the plan is accepted, compliance to the terms set out in the plan can at all times be inspected by the creditors. An important element of corporate restructuring under Reorganization procedure is the possibility of new money provision which is granted *parri passu* treatment compared to other secured claims in case the court and/or creditors' committee approve such financing.

Implementation and application of in-court restructuring procedures in the Czech Republic

- Since the introduction of the new Insolvency act in 2008, there have been cases where the value of the company has increased in the Reorganization procedure through usage of various restructuring techniques. Application of alternative techniques has led to higher satisfaction of unsecured creditors. However, the number of such successful restructurings is relatively low due to high cost of such procedure, lack of creditor's experience with such proceedings and insufficient creditor protection. Furthermore, issuing complex high-yield corporate debt instruments often used in such restructurings is still implausible in the Czech financial market.
- The main problem of Insolvency procedures in the Czech Republic is however not the inefficiency of the system but rather the state in which companies enter the formal proceedings. The vast majority of companies enter into formal insolvency procedures at a stage, when the value of their assets has been depleted resulting in low recovery rates at around 25% of secured and between 0-5% of non-secured claims.
- Secured creditors have strong incentives to enter into Bankruptcy procedure, as recovery rate of secured claims is higher in Bankruptcy procedure compared to Reorganization procedure. Additionally, new money provided in Reorganization procedure can deplete the funds provided for repayment of secured claims of the creditors creating incentives for a minimalistic approach by the secured creditors.

Out-of-Court Voluntary Restructuring Process in Czech Republic

- No special characteristics apply to the Czech out-of-court voluntary restructuring processes. The process is completely voluntary and might be managed by a professional advisory firm or by the management of the company. Duration of such procedures is commonly between 3 and 12 months.
- Restructuring is usually covered by a standstill agreement and a support agreement, which have to be agreed upon unanimously by both creditors and the debtor.
- Out-of-court solutions for restructuring should follow the main principles of in-court Reorganization procedure to assure that the agreements reached in out-of-court restructurings are not contested in a subsequent formal insolvency procedure.
- The basic restructuring principles applied in practise dictate that absolute priority rule should be applied at all times, receivables should be treated equally (within classes of claims) and profits obtained in the process should be distributed fairly. Additionally, the unanimity rule should apply to decision making in out-of-court restructurings in order to prevent the risk of criminal liability of directors in the case of granting special terms to certain creditors under flexible arrangements.

Out of court restructuring principles (OCRPs) in the Czech Republic

No such principles have been developed in the Czech Republic.

Croatia

High level assessment of business environment in Croatia

- The Croatian economy has been recovering after the financial crisis. The banking sector dominated by foreign banks is resilient as capital levels in all the major banks have been increased pursuant to the Asset quality reviews (AQRs) conducted by the European central bank in 2014.
- Loan to deposit ratio of the banking sector has fallen from approx. 110% in 2010 to 85% due to weak demand and deleveraging of the banking sector, resulting in an increase of bad assets as percentage of NPLs to total loans rose from approx. 11% in 2010 to over 16% in 2015. With the exception of some sectors of the economy, further deleveraging is not seen as a policy priority.
- Corporate debt in Croatia is highly concentrated in capital intensive industries as well as in the largest companies thereof. On average, more than 50% of the total financial debt is held by 5% of the largest companies. The situation is even more problematic in transportation, communication and information sectors where debt concentration in the 5% of biggest companies is as high as 75% whereas high risk debt is largely concentrated in construction, real estate, wholesale and retail sectors. (source: European Commission)

In-court restructuring procedures in Croatia

- Classic bankruptcy procedures in Croatia are rather complicated and fraught with inefficiencies. Such procedures often lacking transparency as duties of insolvency administrators are not clearly defined while their activities are sometimes in conflict with the envisaged outcome of the procedure.
- In addition to the Bankruptcy procedure, Croatian law provides for the possibility to voluntarily enter into Pre-bankruptcy settlement proceeding (PBSP or ”Predstečajna nagodba”), an in-court restructuring procedure which was introduced into Croatian law in October 2012.
- PBSP can be initiated by the debtor or by the creditors with debtor’s consent and aims at reaching an in-court Pre-bankruptcy settlement based on the restructuring plan prepared by the debtor and confirmed by the majority of creditors, which are simultaneously given the possibility to come up with a competing plan. With the amendment of the Financial Operations and Pre-bankruptcy Settlement Act introduced in September 2015, the administrative part of the procedure ceased to be overseen by Croatian Financial Agency (FINA) and is thereafter overseen by the Commercial court in its entirety.
- PBSP is a debtor-in-possession regime under the supervision of an appointed administrator (pre-bankruptcy trustee) while the court can also impose majority decisions on the dissenting creditors (cram down). Debt haircuts of up to 70% can be applied in the procedure while new money is not given seniority status if not unanimously confirmed by the creditors. Due to stay of enforcement action of the creditors, a standstill agreement is not necessary for this procedure.
- PBSP is an expedited proceeding which needs to be completed in 120 days upon its commencement with a possible 90 days extension. However, it has been noticed that some of the procedures can last considerably longer.

Implementation and application of in-court restructuring procedures in Croatia

- Since the introduction of the PBSP into Croatian law in 2012, more than 9000 companies have initiated PBSP with the average recovery rate of unsecured claims being approx. 54% between 2012 and 2014. However, in only 20% of the initiated procedures parties actually concluded a pre-bankruptcy settlement.
- It has been noticed, that debtors remaining in control of the business tend to present creditors with either:
  - A very conservative forecast of their capacity to service overall debt in order to decrease leverage of the company as much as possible, or
  - An overly optimistic forecast where the business is not sustainable in the long term.
- Furthermore, business and restructuring plans put forward in PBSP procedures are often of low quality. Plans are partial with no envisaged long-term strategy or expansion strategy. The focus of the plans is not on further development of the company, adaptation and optimization or enhanced go-to market approaches but rather on cost cuttings and debt write offs.
- Insolvency legislation in Croatia has frequently been subject to amendments which hampers the functioning of already inefficient court system.

Out-of-Court Voluntary Restructuring Process in Croatia

- No special characteristics apply to out-of-court restructuring procedures in Croatia. Such procedures differ from PBSP in sense that they are voluntary and cannot impose obligations, which debtors are not willing to accept. Agreements reached in out-of-court restructurings do not negatively impact of otherwise jeopardize debtors' rights and/or debtors' relative positions.
- Due to inefficient in-court procedures in Croatia, the need was recognized to enhance cooperation between the creditors in multi-creditor restructuring cases. Cooperation between the creditors has thus far been based on established relations, therefore broader unification of standards would likely result in increased efficiency in out-of-court debt restructurings; however, such would require substantial efforts of relevant stakeholders as there are several issues which need to be addressed (see Challenges paragraph below).

Out of court restructuring principles (OCRPs) in Croatia

- As Croatian Government has been striving to foster growth, increase competitiveness of domestic economy and balance the economy as one of the goals set out in the 2015 National Reform Programme the Government was also the main driver of adoption of the Croatian out-of-court restructuring principles.
- Aimed at triggering a timely reaction by enterprises to prevent financial problems in the future conduct of the business, Croatian Guidelines on Out-of-court Corporate Debt Restructuring (GOCDRs) were prepared by the Government and issued by the Ministry of Justice in October 2015.
- The Preamble of the GOCDRs acknowledged the increasing need for the development of out-of-court restructuring principles due to deteriorating business environment in years following the financial crisis. Seeking to increase cooperation and combined value for all the stakeholders GOCDRs specifically inform and educate entrepreneurs, enterprises and creditors on the principles that should apply to multiple-creditor out-of-court restructurings.
- GOCDRs are based on INSOL principles and consist of 8 principles with accompanying commentary:
  1. Debt restructuring is a compromise between the Debtor and the Creditors and it should be carried out in good faith.
  2. Unique approach, coordination and supporting Creditors interests (All phases of debt restructuring must be carried out in an organized manner; both the Creditors and the Debtor should restrain themselves form acts that could violate the agreement in a manner to disable the Debtor to finish restructuring process or cause Creditor settlement to be les possible).
  3. If the debtor's management provides complete and reliable information the creditors will grant the debtor moratorium (a Standstill Agreement).
  4. Transparency and information availability (The Debtor must provide all of the information about business operations, assets and liabilities to all Creditors).
  5. Confidentiality (all of the information provided must be treated as strictly confidential).
  6. A new financing to enable the debtor to do business during the restructuring shall have priority before other claims through an appropriate form of collateral.
  7. Restructuring plan should be prepared by the Debtor and confirmed by Creditors.
  8. Restructuring plan should reflect the applicable law and must be based on all of the rights of the Creditors and on the amount of liabilities outstanding on the day the moratorium is agreed.

Challenges related to out-of-court restructuring in Croatia

- As GOCDRs have recently been adopted, it is yet unknown whether implementation of GOCDRs in practise will be successful. Although the involvement of the Croatian government (and the Ministry of Justice) in the development of principles is welcome, important stakeholders such as the Croatian central bank and the Croatian Banking Association were not partaking in the process which might in practice result in non-compliance with the principles by the banking industry. Furthermore, while the issuing of GOCDRs by the Ministry of Justice is sensible, it is unclear whether or not all technical and economic aspects of out-of-court restructurings were adequately taken into consideration.

- Croatian banks currently use a case-by-case approach to corporate restructuring which could be unified if the newly developed guidelines for debt restructuring are successfully implemented in practise. Since GOCDRs were only issued in October 2015 to our knowledge, there are currently no out-of-court restructuring processes carried out in adherence to GOCDRs.
- Companies undergoing a comprehensive restructuring are often SMEs lacking capital for a stable future operation while alternative debt providers are not likely to enter into such (small-scale) arrangements.
- Croatian banking sector is dominated by foreign banks which have strict internal procedures and need to get an approval of their mother company in all high-exposure restructurings, especially for decisions on new financing. Such banks are more likely to delay decisions to initiate restructuring processes and tend to wait until it is too late for companies to recover easily. Banks are mainly focused on debtors meeting their current financial liabilities and not on long term debtors' prospective.
- Tax treatment of debt forgiveness is inadequate to foster successful corporate restructurings. Creditors are still less willing to write off their claims since write-offs are considered non-deductible tax expenses while debt write-off is considered an income of the debtor, meaning that Banks and Companies pay full income tax regardless of the recoverability and actual existence of the funds. Such does not apply to PBSP, but only to out-of-court procedures.
- One of the problems emphasized regarding the development of the out-of-court restructuring practice in Croatia is promotion of timely entrances into out-of-court restructuring procedures by companies. In Croatia, creditors tend to enter into any kind of restructuring procedure late which commonly results in complex procedures and low recovery rates. Such problems are dampened by poor payment discipline and inefficient execution procedures. Furthermore, the bankruptcy framework is not enabling enough as to provide for sufficient incentives for companies to initiate an out-of-court restructuring process as they rather seek debt forgiveness under a PBSP.

Serbia

High level assessment of business environment in Serbia

- As of December 2015, gross loans to the non-financial sector in Serbia amounted to EUR 6.9b with EUR1.6b being NPLs which results in the highest corporate NPL ratio in the region at 23.6%. Furthermore, the NPLs to total loans ratio exceeds 29% in the category of companies, not including entrepreneurs.
- NPLs have increased from 21.4% in 2013 partially due to currency volatility as approx. 70% of all corporate loans are denominated in foreign currency. However, NPLs are largely limited to manufacturing, construction and trade sectors. (Source: Serbian bank association, National bank of Serbia)
- In order to tackle the high level of NPLs, the National Bank of Serbia adopted a NPL resolution strategy, which *inter alia* aims to improve regulatory treatment of restructured loans and distressed asset management.
- Recovery rates of NPLs are low at approx. 30%, as usually no comprehensive approach is taken to better manage the distressed debt.
- While liquidity is not an issue, foreign banks have reduced their exposure in the country from 44% of GDP to 38% of GDP in the years following the financial crisis. Furthermore, credit growth been stagnating in recent years, which has had a negative effect on private sector growth, especially on the growth of Small and Medium Enterprises (SMEs).

In-court restructuring procedures in Serbia

- Restructuring of companies in financial difficulties in Serbia is governed by two laws. In addition to the Law on Bankruptcy, which also provides for a Pre-packaged Reorganization Procedure (PRP) there is also the possibility to restructure debt through a completely voluntary Consensual Financial Restructuring (CFR) procedure governed by the Law on Consensual Financial Restructuring (LCFR) and administered by the Serbian Chamber of Commerce and Industry (SCCI).
- The Bankruptcy procedure in Serbia is considered inefficient and lengthy which together with low recovery rates creates an unfavourable solution for the creditors.
- The PRP is a hybrid procedure where decisions are made by the majority of relevant creditors and can be enforced by the court (cram down). A restructuring plan negotiated between the debtor and creditors needs to be put forward to be confirmed by the court in order for the procedure to commence. The court takes a limited yet important role of examining the procedural issues as well as the substance of the restructuring plan. With an average duration of 4.7 months the procedure is relatively efficient.

Implementation and application of in-court restructuring procedures in Serbia

- Since the PRP was introduced in 2010, a large number of large corporations has opted to initiate such procedure with total liabilities which were to be restructured exceeding EUR2.5b. Success rate of the PRP procedures was not substantial as a large part of the companies which had undergone PRP subsequently declared bankruptcy.
- Business plans prepared by the debtors in the PRP procedure are often partial, inadequate and aimed at achieving write offs while not providing for long term solutions.
- Furthermore, due to limited reliability of plans and lack of judicial control, creditors are reluctant to extend new money to companies and often take simplistic approach to restructuring, where debt rescheduling is the preferred yet inappropriate solution.
- The number of restructuring options being offered by the legislation seems sufficient. However, an issue may be the ‘saturation with provisions’, as all the possibilities are not adequately supported by the expertise of judicial personnel. Additionally, amendments to the laws are often only partial solutions which take place too often and put additional pressure on the judiciary. With regards to the in-court procedures, the “less is more” approach whereas less well-designed procedures rather than more partial solutions are provided for by the law should be considered.

Out-of-Court Voluntary Restructuring Process in Serbia

- The voluntary Consensual Financial Restructuring (CFR) procedure was introduced in 2012 as an alternative to in-court debt restructuring in PRP.
- The CFR procedure is governed by the Law on Consensual Financial Restructuring (LCFR) and is largely reliant on the application of INSOL principles. Decision to govern the procedure by law is aimed at increasing usage, transparency and credibility of the procedure.
- Three main goals were put forward to increase the use and quality of CFR procedures:
  - Improving administration of cases
  - Capacity building, mediator and SCCI staff training
  - Raising awareness among business subjects and creditors in Serbia of the possibilities and benefits of such procedures
- The CFR procedure provides for a mediation-based voluntary consensual financial restructuring of the company which could find itself at risk of insolvency if prompt financial and operational measures are not taken. The role of facilitator and mediator in the CFR procedure is undertaken by the SCCI.
- The process is intended to facilitate negotiations between financial creditors and the debtor in order for them to reach a CFR Agreement. However, non-financial creditors are not excluded from the process.
- Both the debtor and creditors are entitled to initiate the process while the necessary precondition for the CFR procedure to commence is that at least 2 banks must participate in the capacity of creditors. Financial Restructuring Contract has to be signed by all parties involved and submitted by the debtor within 2 days to the Registry of Business Entities.
- Upon reaching an agreement to enter into such procedure, parties can negotiate a moratorium or a Standstill agreement (SSA). Practise has shown, that creditors are reluctant to enter into such agreements due to fear that standstill of their obligations could cause for the non-participating creditors to improve their positions.
- There are several restructuring principles included in the Law on Consensual Financial Restructuring:
  - Voluntariness - financial restructuring is a voluntary process for which a written consent between the debtor and its creditors is required while the outcome of the procedure is implemented with the assistance of an institutional intermediary (SCCI).
  - Going concern - financial restructuring should only be performed if the business is viable and can continue to operate in a sustainable manner.
  - Good faith - all negotiations should be conducted in good faith aimed at applying case-specific suitable solution;
  - Coordinated approach – all creditors should cooperate. The appointment of professional advisers should be considered. Creditors may appoint one person to lead the negotiations (generally the creditor with the largest exposure)
  - Equality of creditors' – creditors' rights are proportional to the size of their receivables if not agreed otherwise.
  - Transparency and Confidentiality - debtors should provide creditors and/or advisers with full access to all the relevant information related to their businesses. Creditors and institutional Intermediaries are obliged to treat all the received information as confidential.
- The timeframe for different restructuring steps carried out upon reaching a CFR Agreement is usually between 1 and 18 months:
  - Business turnaround (12-18 months)
  - Financial restructuring (8-12 months)
  - Working capital optimization (1-12 months)
- In four years since the introduction of the CFR procedure, only 37 procedures have been initiated with 11 of them successfully concluded. 8 out of 11 of the successfully concluded cases resulted in a CFR (MRA) agreement and 3 of them in separate bilateral agreements. Most of the companies that underwent the CFR procedure were SMEs (Source: Serbian 2015 "NPL resolution strategy").

- Albeit the requirement that at least two banks as creditors must participate in CFR procedure, only approx. 40% of creditors in CFR procedures are banks and other financial institutions. Such low percentage of participating financial institutions indicates that companies rather enter CFR procedure to restructure their non-financial obligations or restore their long term liquidity.

Out of court restructuring principles (OCRPs) in Serbia

- In addition to the CFR procedure, 'National Guidelines for Banks' Actions in the Process of Client Restructurings' officially named 'INSOL principles Serbia' were adopted by the Association of Serbian Banks (ASB) in 2015 to assist banks in CFR procedures as well as in other informal multi-creditor restructuring procedures.
- INSOL principles Serbia are based on Austrian Principles and are therefore an adapted version of INSOL principles. They were prepared by a working group comprising legal and business representatives of 7 Serbian banks.
- The document consists of 8 principles adapted to national specifics:
  - Standstill period
  - Restraint on claims enforcement
  - Client cooperation
  - Coordination committees
  - Timely access to Relevant Information
  - Coherency of legal documents
  - Information confidentiality
  - Additional funding – "New money"
- INSOL principles Serbia may lead to frequent use of a coordinated approach to distressed debt management in the biggest restructuring cases in the country. They are primarily intended to increase awareness regarding the out-of-court restructuring possibilities among the major players in the financial sector.

Challenges related to out-of-court restructuring in Serbia

- At this time, Serbia has a rather underdeveloped negotiation culture which will take time to be improved. Combined with improving the institutional and judicial systems the negotiation culture is seen as an important component of a timely and effective debt restructuring.
- The number of restructuring options being offered by the legislation is certainly sufficient; however, an issue may be the 'saturation with provisions', as all the possibilities are not adequately supported by the expertise of judicial personnel. Additionally, amendments to the laws are often only partial solutions which take place too often and put additional pressure on the judiciary. With regards to the in-court procedures, the "less is more" approach whereas less well designed procedures rather than more partial solutions are provided for should be considered.
- CFR procedure often starts past the point when it could still have the desired effect. This is mainly due to insufficient awareness of the debtors regarding the possibilities and advantages of such procedure.
- Generally, meaningful debt restructuring is rare in Serbia. Although the array of restructuring tools and procedures is wide, the minimalistic approach with minimal exposure is the predominantly the preferred solution. Most common restructuring techniques are loan extensions, covenant modifications and sometimes asset divestments. A comprehensive turnaround is thus rarely achieved.

Romania

High level assessment of business environment in Romania

- As a result of the financial crisis credit growth in Romania has tumbled from pre-crisis levels of 30-50% y-o-y to approximately -4% over the 2012-15 period.
- Romania has seen a reduction in NPLs from 22.6% of total loans in February 2014 to 11.6% of total loans in November 2015. The decrease followed substantial write-offs as envisaged by the 2014 Plan prepared by the National Bank of Romania. However, the level of NPLs in non-financial companies still hoovers at around 20% of total loans.
- The Romanian market was one of the most active markets in CEE regarding the sales of non-performing loans which exceeded EUR2b in 2014-15.

In-court restructuring procedures in Romania

- The Romanian Insolvency Act governs several insolvency procedures. In addition to the bankruptcy procedure, a Restructuring plan can also be submitted in the insolvency procedure by creditors holding at least 20% of company's claims. The company's business under the Restructuring procedure is managed by a court appointed administrator under the control of a judicial administrator. The average length of the process is 3 years with a possible 2 year extension and has low recovery rates.
- Additionally, pre-insolvency arrangements exist in Romanian legislation since 2009. With the purpose of preventing negative stigma surrounding formal insolvency proceedings, the confidential '*ad hoc* Mandate' and Preventive Scheme of Composition (Concordat preventif) can be initiated by the debtor who has found himself in financial difficulties.
- The difference between the procedures is that '*ad hoc* Mandate' is less comprehensive and has the purpose of reaching a settlement thorough court administered negotiation between the debtor and at least one creditor.
- 'Concordat preventif' is a hybrid debtor-in-possession procedure which is also based on court administered conciliation with the aim of reaching an agreement between the debtor and the majority of creditors. The court has a monitoring and enforcing role as if ratified by the court, the restructuring plan prepared by the debtor is binding on all the creditors when supported by the creditors holding at least two thirds of the total value of the unchallenged and accepted claims (or 80% of total value). Day-to-day business of the creditor is monitored by a court appointed insolvency administrator.
- Minority creditors can be bound in 'Concordat Preventif' if their claims do not surpass 25% of total value of claims.
- In this strictly regulated procedure, a restructuring plan must be carried out within a year with a possible 1 year extension and may include business restructuring and/or financial restructuring and/or sale of assets.

Implementation and application of in-court restructuring procedures in Romania

- Due to its non-binding effect and lack of effective restructuring tools (no standstill, no cram down, no stay of enforcement action, disposal of assets by the debtor not regulated), the '*ad hoc* Mandate' is currently not functional.
- Compared to the '*ad hoc* Mandate' which is considered *laissez-faire*, the 'Concordat preventif' is considered lengthy, rigid and complex however not ensuring priority status of new money, which hampers effectiveness of the proceeding.
- Authorities are often not able to cooperate in restructuring cases due to lack of legal capacity and potential conflicts with European State aid rules. Furthermore, unfavourable tax treatment of debt write-offs does not incentivize a comprehensive approach to debt restructuring.

Out-of-Court Voluntary Restructuring Process in Romania

- Out-of-court debt restructuring is common practice in Romania. The most commonly used restructuring technique is debt rescheduling while other commonly used tools are asset sales and non-judicial foreclosures. In exchange for improved financing arrangements banks usually require imposition of stringent debt covenants.
- In order to tackle the issue of more complex restructurings, The Board of Directors of The Romanian Banking Association (RBA) issued several press releases in 2009 recognizing the need to support businesses in financial distress. Furthermore, a set of restructuring schemes and solutions applicable to distressed SMEs was put forward by the RBA to facilitate a less costly approach to distressed asset management of such companies.
- The out-of-court restructuring process is initiated when difficulties occur in the debtor's ability to meet its obligations due to mismatch between needs and resources or inefficient resource allocation.
- An out-of-court restructuring procedure in Romania usually lasts between 6 and 18 months during which companies most commonly pursue a business turnarounds and financial restructurings.
- Creditors can be bound on collective terms (bilateral, multilateral) – any new money provision or other restructuring tool applied is negotiated and mutually agreed upon by creditors and the debtor. The aim is to provide the debtor with the necessary financial support as well as to distribute the risk among its creditors and to provide for the common commitment not to commence or continue formal proceedings against the debtor.

Out of court restructuring principles (OCRPs) in Romania

- Introduction of the out-of-court restructuring principles into Romanian business environment was recommended by the World Bank which resulted in drafting of The Corporate Debt Restructuring Guidelines (CDRGs) known as “the Bucharest approach”, by the Ministry of Justice, followed by endorsements by National Bank of Romania and the Ministry of Finance in 2010.
- Out-of-court restructuring process represents one available option to be exhausted prior to entering into the insolvency procedure. It is defined as an “informal workout” where both creditors and debtors agree upon a private arrangement that adjusts the debt repayment, allowing:
  - Viable businesses to continue to operate and emerge from financial difficulties.
  - Financial institutions and other creditors to reduce their losses.
  - Positively impact third parties involved in the company’s operational cycle (clients, suppliers, employees, investors) as the company continues its activity.
  - Provide financial support to surviving businesses.
- Romanian principles are based on INSOL principles and address the following concepts:
  - Good faith;
  - Confidentiality;
  - Commitment of the lenders during a Standstill period;
  - Commitment of the borrower during a Standstill period;
  - Full disclosure;
  - Fresh funding;
  - Restructuring plan supported by reliable, reasonable and viable statements;
- Principles developed by World Bank Group team were presented to the representatives of Romanian financial institutions in a workshop that took place in 2011 in order to familiarize relevant stakeholders with the provisions.

Challenges related to out-of-court restructuring in Romania

- Analysis performed by the World Bank has shown that the usage of Principles in Romania is low (source: Report on the observance of standards and codes - Insolvency and debtor regimes, World Bank, April 2014). In contrast to other countries (e.g. United Kingdom, countries of South-East Asia, Slovenia) where a more proactive role by the central bank has been undertaken to support out-of-court restructurings, the role of the National bank of Romania was limited to endorsement of the Principles. A more active approach with the National bank of Romania in the role of facilitator and administrator should be taken to promote the use of Principles.
- Foreign banks are often reluctant to enter into out-of-court workouts and seek to minimize losses due to prudential requirements of the mother company rather than engage into any complex restructuring processes. Furthermore, debt-to-equity swaps are rare in Romania as banks often lack turnaround and management capacity to monitor such procedures.
- Insolvency is still a preferred approach to companies in financial distress but is widely inefficient. Additionally, it lacks the “going concern” priority which would enable recovery from difficult financial situations.
- Insolvency legislation provides for no incentives to restructure debt out of court, therefore amendments to the legislation aimed at encouraging early entrance into an out-of-court proceeding should be considered. Furthermore, usefulness of several different proceedings provided for in the legislation should be examine.

Glossary

BRG	Budapest Restructuring Guidelines
CoCom	Coordination Committee
CSE	Central and South-Eastern Europe
HBA	Hungarian Banking Association
MNB	National Bank of Hungary
NPL	Non-performing loan
SME	Small and Medium-size Enterprises
OOCR	Out-of-court restructuring