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## 2020 International Insolvency Forum

# Emerging from the COVID-19 Disruption: The Need for a National Emergency Restructuring Entity

Presented by the International Insolvency  
Institute (III)

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## EMERGING FROM THE COVID-19 DISRUPTION: FUNDING & RECAPITALISING VIABLE BUSINESSES DURING THE CRISIS

The need for a National Emergency Restructuring Entity (ERE)

### Outline of Presentation

1. Introduction of International Insolvency Institute
2. Outline of IMF's three phase approach to addressing the COVID-19 disruption
3. Why consider introducing an ERE?
4. Relevant considerations in establishing an ERE
5. Key considerations for successful implementation of ERE
6. SME specific considerations for ERE
7. A focus on Brazil

Appendix A – The Japanese Experience

## International Insolvency Institute

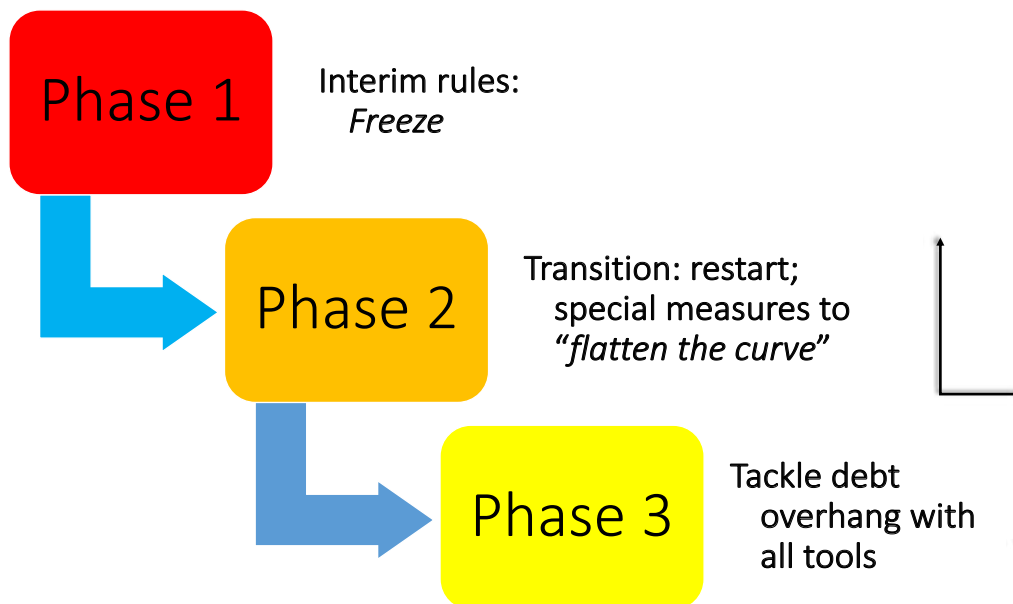
- The International Insolvency Institute (III) is:

- An invitation only membership of the world's most senior, experienced and respected practitioners, academics, judges and financial industry professionals
- Awarded special consultative status to United Nations Agencies
- Continually studying, analyzing and providing solutions to insolvency and restructuring problems
- Dedicated to improving international cooperation and advising on international best practice in the insolvency field

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### IMF Framework for Insolvency Measures in the COVID-19 crisis



## The IMF Framework (cont)

- **First phase – Interim/emergency measures**
  - Prevent social disruption
  - Breathing space for debtors – fiscal and financial support measures
  - Limited insolvency activity
- **Second phase – Transition**
  - Withdrawal of “first phase” emergency measures
  - Prevent overload of the court system
  - Evaluation and planning stage
  - Evaluate
    - Is system “fit for purpose” to address pandemic induced debt overhang?
    - Is there sufficient institutional capacity?
    - Is there a triage process that is “fit for purpose”?
    - Is there sufficient access to liquidity and capital for viable enterprises
  - Then plan and implement any necessary measures. For example:
    - Insolvency law reform to implement best practice (eg SME insolvency)
    - Bolster institutional capacity
    - Establish emergency restructuring entity

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## The IMF Framework (cont)

- **Third phase – Fighting debt overhang**
  - Insolvency law now fit for purpose. For example:
    - Efficient triage process
    - Effective process to rehabilitate viable enterprises
    - Swift liquidation of unviable enterprises
  - Institutional framework ready to facilitate recovery. For example:
    - Judicial capacity enhanced
    - Emergency restructuring entity (ERE) operational and funded

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## The IMF Framework – Key takeaways for EREs

- Evaluate NOW whether likely to be shortage of liquidity and capital available to enable viable enterprises to re-emerge and prosper
- Evaluate NOW whether ERE is needed
- If so, take steps NOW to establish and fund ERE
- If ERE considered necessary, it must be ready when “Phase 1” emergency measures are withdrawn

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## Why consider introducing an ERE?

- **Two policy imperatives**
  - Ensuring **viable** businesses can re-emerge and grow
  - Building an economy for the future, not recreating the past
- **Addressing Covid-19 headwinds**
  - Stabilisation strategy will not be sufficient
  - Rent, debt service and other obligations have continued to accrue; revenues have been substantially reduced/eliminated
  - As a consequence, many enterprises' capital has been depleted/eliminated
  - In a Covid/post-Covid world, capital and/or liquidity will be essential requirements for success in enterprises re-emerging /growing

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## Why consider introducing an ERE? (cont)

- Addressing Covid-19 headwinds (cont)
  - Capital and liquidity are required for prudent lending/investment into large, medium and small enterprises that could not otherwise access it
  - Investment required in tandem with restructuring and insolvency processes that serve to address existing debt overhang
  - For some countries, courts may lack capacity or specialisation, or legal framework may not be sufficiently robust or efficient to accommodate recapitalisation or liquidity support
  - Private sector will likely not have sufficient capital to invest, or their risk intolerance may make pricing unviable. Banks and other financiers and investors bring a different frame of reference to the issue. Their focus is on their own balance sheets, not the policy imperatives identified above, and may decline to lend/invest or limit their investment.

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## Relevant considerations in establishing ERE

- Different approaches for large, medium and small enterprises
- Sector-specific focus (eg aviation) will support government policy
- Critical issue will be manner of identification of enterprises with sustainable business plans, capable of profitable future
- Must be guided by clear government economic policies
  - Support essential industries
  - Support SME sector as lifeblood of most economies
  - Build economy of the future
- Enable only viable business to re-emerge and prosper/employ
  - Assessment of viability will be challenging
- Identify commercially sensible ways to lend, or invest in capital structure, and (ultimately) obtain return of the invested capital

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## Key considerations for successful implementation of ERE

- ERE must have internal operating/investing criteria
  - Criteria for funding/investment request to be evaluated
  - Conditions for finance to be provided
  - Criteria for assessment of capital to be advanced/invested, and manner of investment
  - Funding non-viable businesses could damage ability of viable businesses to compete, and is a misallocation of scarce capital
- ERE must have qualified restructuring professionals on staff
  - Evaluation of applications against criteria requires expertise; particularly in assessment of the viability of business plan to ensure future success, the amount of the investment, the manner of investment, and the means for repayment
  - Ongoing review of investment, and securing return of investment
  - Acting expeditiously requires expertise for decision making and absence of bureaucracy

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## Key considerations for successful implementation of ERE (cont)

- For smaller enterprises
  - Provide SME with access to restructuring professionals
  - Provide “template” solutions where applicable (eg cafes)
  - Simpler, more streamlined interaction. Formal processes only as last resort.
  - Use of structured ADR (eg mediation) to build stakeholder consensus
    - Main creditors likely to be banks and government
- For large enterprises
  - Must work in tandem with a formal restructuring process to ensure success. Eg US auto industry in 2009/2010, where government appointed taskforce sanctioned capital investment conditional on implementation of restructuring plan through formal bankruptcy proceedings

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## Key considerations for successful implementation of ERE (cont)

- Enterprise (large or small) must:
  - Demonstrate existence of viable business plan and restructuring plan
  - Specify the amount of funding requested
  - Specify the uses to which the funding will be deployed
  - Demonstrate that if funding provided, enterprise will most likely be viable and sustainable
  - Identify the manner and timing of return of funding to the ERE
- Sunset date for ERE important – ERE is temporary, and the pathway to return/disposal of all investments must be identified
- ERE must have ability to expedite regulatory approvals and address other impediments to swift action

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## SME-specific considerations for ERE

- Localised solution important
- Must be efficient and inexpensive
- Access to restructuring professionals to assist SME in identifying business plan and restructuring plan
- Triage essential – must ensure only viable SMEs are supported
- Preparation of template plans helpful, as is a streamlined administrative process (instead of a court process) to implement debt restructuring
- Use of ADR processes such as mediation to build consensus among key stakeholders

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## A Focus on Brazil

- An ERE could be established as a new government-controlled entity, or just as effectively by the establishment of funds by the Brazilian National Development Bank, funded by several players, as suggested below. Our recommendation is that the BNDES create three new funds (Funds).
- The Funds would target respectively large, mid-sized and small companies.
- The Funds would be managed professionally, as stand-alone funds, in order to be able to act with the expedition required by the current crisis.

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## A Focus on Brazil (cont)

- Resources for the Funds could be contributed by the BNDES, Banco do Brasil, Caixa Econômica Federal and the three large Brazilian privately held retail banks, namely Bradesco, Itau and Santander, and also with resources raised in the capital markets, possibly with the assistance of the Federal and the Bank Guarantee Funds. Participation of multilateral institutions such as the IDB or IFC should be encouraged.
- IIR members could act as advisers to the investment committees of the Funds if so requested.

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## A Focus on Brazil (cont)

- The Funds would determine initially which companies are viable and deserve to receive investment and/or financing (i.e. the triage). Co-financing should be encouraged, with the participation of stakeholders.
- Focus would be on restructuring activities, not to benefit equity holders (other than in SME sector), although if equity holders are valuable to the activity either by providing funds, expertise and/or relationships, they could participate in the rescue.

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## A Focus on Brazil (cont)

- Insolvent small companies should be liquidated speedily when necessary and the assets should be used to satisfy creditors to the extent possible. Financing should only be provided to allow worthy entrepreneurs to rescue their companies or have a second chance to start over where a viable business case is demonstrated.
- Insolvency filings should be avoided to the extent possible, except if free and clear sales of businesses and assets are required.

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## A Focus on Brazil (cont)

- Mediation should be used whenever necessary.
- Consider whether funds disbursed should prime all other guarantees encumbering future cash flows.
- The vibrant Brazilian stock market could be a valuable alternative, especially for the large companies.

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## Appendix A – The Japanese Experience

### ERE in Japan

1. REVIC
2. SME Revitalization Support Councils
3. INCJ
4. Japan Finance Corporation


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## Appendix A – The Japanese Experience

### 1. REVIC -Successor of IRCJ

Scope: large and medium sized companies

IRCJ (2003-2007) 

ETIC (2009-2013) 

REVIC (2013-Present)

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## Appendix A – The Japanese Experience

### 1. REVIC

#### Key Features:

- Funded both by the Japanese government and by Japanese financial institutions.
- Financially distressed companies referred to REVIC by their main banks.
- Inject capital to restructure the distressed companies.
- Support debtor company in drawing up the restructuring plan.
- Establish funds specialized in supporting regional rehabilitating companies with other regional banks.

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## Appendix A – The Japanese Experience

### 1. REVIC

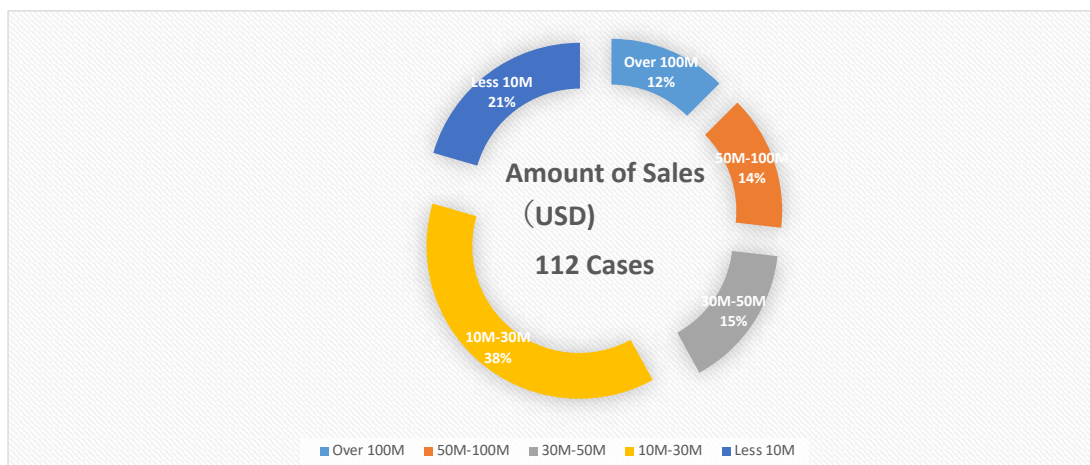
#### Key Features (con't):

- Retain various professionals including financial experts, tax accountants, certified public accountants, lawyers and restructuring consultants.
- Deploy restructuring professionals:
  - 1) to the debtor companies (hands on) or
  - 2) to regional banks which lack experience in restructuring distressed companies.

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## Appendix A – The Japanese Experience



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## Appendix A – The Japanese Experience

### 2. SME Revitalization Support Councils

Scope: Small and medium sized companies

- Located in every prefecture of Japan.
- Formed to support business rehabilitation (e.g. drawing up business rehabilitation plan, negotiating with banks)
- Under the supervision of the Small and Medium Enterprise Agency of Japan.
- Experts retained by these councils include tax accountants, certified public accountants, lawyers and business turnaround consultants
- No capital injection but coordinate with banks to finance the distressed companies.

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## Appendix A – The Japanese Experience

### 2. SME Revitalization Support Councils

Measures for Covid-19



New scheme entitled “Covid-19 Special Rescheduling”

- Making “tentative cash flow plan” for 1 (one) year term
- Requesting banks to lend money to the distressed company
- SME RSC support the company to negotiate with the banks
- Expecting to make rehabilitation plan after Covid-19 (late 2021)

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## Appendix A – The Japanese Experience

### 2. SME Revitalization Support Councils

(Data)

- ✓ Total number of advised distressed companies is 46,083 until 30 March 2020.
  - 15,672 of the above companies completed making rehabilitation plan and confirmed by financial creditors.
  - Over 70% of the above plans includes reschedule plan without hair cut (debt forgiveness).

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## Appendix A – The Japanese Experience

### 2. SME Revitalization Support Councils

(Data con't)

- ✓ Total number of advised companies under “Covid-19 Special Reschedule” is 2754 until 30 September 2020.
  - 52% of the companies are between USD 1 M and USD 5M regarding amount of sales.

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## Appendix A – The Japanese Experience

### 3. INCJ

Scope: Very large, blue chip companies

- Funded by the government
  - Mandate to continue with investment activities for "Value Up" initiatives such as overseeing additional investments and milestone investments
- In reality also involved in restructuring distressed companies

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## Appendix A – The Japanese Experience

### 3. INCJ

Between 2011 and 2020 (July)

- The number of the cases in which INCJ injected capital for restructuring is 12 of 144 cases (8%).
- The amount of capital injected for restructuring is 7.8 billion USD (58%) of all the cases (13.5 billion USD).

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## Appendix A – The Japanese Experience

### 4. Japan Finance Corporation

Scope: small and medium size companies

- Public corporation wholly owned by the Japanese government
- Unique features

Special subordinated loan for companies suffered by Covid-19

- ✓ Loans are treated as investment on its balance sheet
- Easy for debtors to borrow new money
- Total amount of the loan between March and September 2020 is USD 100 billion

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## Appendix A – The Japanese Experience

### 4. Japan Finance Corporation

Unique features (con't)

- ✓ Need to pay interest monthly but pay back principal at the end of the term (balloon type)
- ✓ Support to draw up rehabilitation plan; monitor the plan (like a consultant)
- Reason of consulting function by the JFC is to keep the loan alive (not to fall into NPL)

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### **Reform of the Law on Judicial Reorganizations**

For many diverse reasons and in many different areas, the year 2020 will certainly be remembered as historic. And in the field of corporate insolvency, it will be no different. The deep economic recession caused by the Covid-19 pandemic has posed serious challenges to companies and the already fragile Brazilian economy and, more than ever, has highlighted the need for reform in our bankruptcy legislation.

It was in this context that, over the course of the year, the initiative to reform Law No. 11,101/2005 gained traction, under the leadership of Deputy Hugo Leal. After some to and fro, the bill was approved by the Chamber in August, and is currently being considered in the Senate under No. 4,429/2020, where it is expected to be voted on very soon.

But what should we expect from a reform of insolvency legislation in the current scenario? The expectation is that more than simply changing certain legal provisions, there will be an acceleration of the cultural evolution in dealing with insolvency in our country.

One of the ideas that motivates the current reform is that of expansion: expanding the options and paths available for debtors, creditors, and investors to protect their interests. Experience shows that, although apparently antagonistic, the interests of these different players are intertwined, and can - and should - undoubtedly coexist.

The key to this harmonious coexistence is found in another idea, that of efficiency. Improving the efficiency of procedures and reducing the degree of litigation is perhaps the best way to protect the interests of everyone involved. The winner is the national economy itself, formed by the interaction between creditors and debtors and all those who benefit or depend on the existence of the company - of all companies. More than simply protecting them, one must keep in mind the protection of the business phenomenon.

In view of this scenario, the Bill proposes new and valuable instruments to modernize and increase the efficiency of insolvency proceedings, such as the possibility of replacing lengthy face-to-face meetings with virtual procedures, or the possibility for the judge to end judicial reorganization as soon as the plan is approved, eliminating the costly (and in most cases useless) two-year inspection period imposed by current legislation. Mention should also be made of stimulating mediation and conciliation, valuable instruments to reduce conflicts and save time and money - scarce resources in the context of insolvency proceedings, as well as the correction of some of the distortions that permeate tax legislation. One of its more positive features is the enactment of the Uncitral Model Law for Cross Border Insolvencies.

Liquidation in bankruptcy, so neglected these days, is one of the main beneficiaries in terms of efficiency. The quick liquidation of assets and the return of the entrepreneur to activities (a fresh start) were included as express objectives of the legislation, with the presentation of an organized liquidation plan and the consummation of all sales within a period not exceeding 180 days after the declaration of bankruptcy, a period that today can take decades. There is also a provision for the immediate termination of the bankrupt's obligations along with the closure of the bankruptcy, dispensing with the current and unreasonable minimum period of five years after the closure of the bankruptcy, allowing the return of the entrepreneur to entrepreneurship.

The Bill also greatly expands the restructuring and investment options available, especially through the creation of concrete rules for the granting of credit to companies in recovery - the so-called DIP

loans- and the foreseeable possibility of selling the company, already with the debt properly restructured, for an apt investor interested in pursuing such activities. Also noteworthy is the guarantee that any assets disposed of by judicial authorization will give the buyer the assurance that he will not be liable for debts and contingencies of the recovering company - a guarantee that is currently extended only to the so-called "UPIs"(isolated productive units).

However, not everything is rosy, and there are parts of the reform that have been the subject of controversy. The broad powers granted to the Tax Authorities (including that of filing for the debtor's bankruptcy if tax obligations are not settled), the expansion of judicial interference during negotiations and the possibility of imposing a plan prepared exclusively by creditors represent paradigm shifts, the latter being very favorably viewed by foreign investors, represent paradigm shifts. In any case, practice will certainly take care of trimming the rough edges, just as it did with the original law in 2005.

A very important part of any efficient economic system is knowing how to deal with its own shortcomings, and we hope that the current reform of Law No. 11,101 constitutes an important step in this direction.

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