

CREATING VALUE THROUGH CORPORATE DEBT CONTRACTS RESTRUCTURING

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ABSTRACT

The purpose of this article is to analyze the possibility of financial restructuring, featuring changes to the structure of the debt contracts. The firms being restructured are unprofitable or overleveraged. The theoretical findings are compared with restructuring possibilities applicable in Czech Republic. The analysis concentrates especially on the legal environment of the country, possibility to provide debt restructuring under the court supervision. The paper includes statistics on application of the new Insolvency Act. No. 182/2006 Coll., valid from January 2008. The paper empirically analyzes companies which were subject to the Insolvency Act. and in case of their reorganization determines how much the value of the company was increased.

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KEYWORDS: financial restructuring, debts, company's value.

INTRODUCTION

Restructuring is a process for the purpose of increasing company value. The company usually implements restructuring steps when financial or operational problems have occurred, resulting in poor profitability or even financial distress. Kocenda and Lizal (2003) define three reasons for company failures. The first, based on a neoclassic approach, indicates failure is the result of improper and ineffective capital allocation. Bankruptcy is the proper restructuring tool in this case. The second reason for a company's failure is a short term problem with its cash position. This might result in bankruptcy, although it might not be the best restructuring tool in this case. The third reason for failure is bad management. A change in management is understood to be a better restructuring tool than bankruptcy in this case.

With respect to characteristics of a company's problems, different approaches to restructuring should be applied. In general it is understood that either operating or financial restructuring can be provided. Operational restructuring concentrates on fixing the operating process of the company; this action is provided with the purpose of increasing its operating cash flow. The aim of financial restructuring is to improve the financial position of the company, thus optimizing its capital structure. This action should either improve the cash flow of the company or decrease the cost of capital. Financial restructuring covers the restructuring of equity or debt contracts.

The concrete steps in a particular restructuring process are always influenced by the present financial, legal and social environment, but it is understood that the aim of all approaches is to increase the company's value. This article focuses on shareholder value. The purpose of this article is to analyze the financial restructuring possibilities of companies in financial distress as a result of their over-leverage, focusing on changing the structure of the company's debt contracts.

The remainder of the article is organized as follows: The topics of the first analysis include the reorganization possibilities based on theoretical findings from the literature, including analysis of their applicability in the Czech Republic. Next the analysis introduce the statistics of debtors' recovery. Recovery rates are compared for Czech Republic firms to Europe and US firms. The Insolvency Act No.

182/2006 Coll., which enables restructuring under court supervision has been on the books for more than two years, hence the study of its effectiveness is presented as well. Special attention is given to the description of successful restructuring provided under the new Insolvency Act. Comparison of value of the company before and after the restructuring is provided.

LITERATURE REVIEW

A comprehensive discussion of restructuring possibilities can be found in Gilson (2010). The author presents a number of restructuring case studies of companies operating in the US. The cases are divided into three modules: financially distressed firms that restructure their debt contracts, cases where equity contracts were restructured, firms that restructured their employee contracts to control labor costs. Information garnered from the first module is used in this article.

Gilson etc. (2000) compare the market value of firms that were reorganized in bankruptcy and their value based on management's published cash flow projections. The authors found that different methods of valuation can significantly influence the estimated value of a restructured company.

The range of financial instruments available in the capital market is a significant factor in restructuring possibilities. Specifically, the possibility to issue high yielding capital, which can be used to pay back mature debts, plays a significant role in this situation. This approach is usually done only in more developed capital markets. The interested reader is referred to Chemmanur and Fulghieri (1994). The topic of analysis and investment in distressed debt is broadly presented in Altman (2006). The possibility of issuing junk bonds as a form of high yielded capital is investigated e.g. in Gilson and Warner (1997).

Another favorite tool of equity or debt restructuring is emission of hybrid securities. Chemmanur et al. (2003), Carlin et al. (2006) and Jiranek, P. (2005) found that emission of those securities might decrease the cost of capital under given circumstances and thus increase the value of the company. The emission of hybrid securities might be useful tool of restructuring of financially distressed companies.

Restructuring of firms operating in Czech Republic has been the subject of a wide range of research studies. Particularly at the time of the Czechoslovak economy transformation from central planned to free market based economy (in 1990s). Extensive findings from research on this topic are stated at Kocenda and Lizal (2003) and Estrin et al. (2009). Restructuring became a popular subject for research again, after the new Act No. 182/2006 Coll. – Insolvency Act. - which enabled restructuring under court supervision, took effect. The topic was discussed in a number of on-line articles. Their findings are discussed in this paper (Creditreform.cz (2010ab) and Regiony24.cz (2010)).

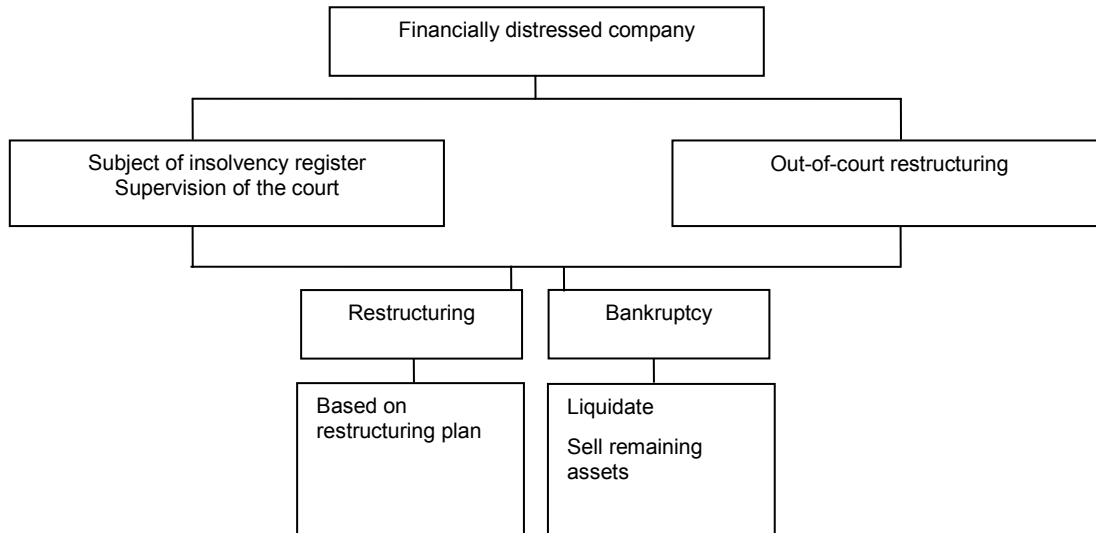
RESTRUCTURING DEBT CONTRACTS

When a company becomes financially distressed and is unable to service creditor claims, it has several options for rectifying the situation (see Figure 1). Legal, accounting and tax issues must be considered. The existence of possible court protection against creditors plays an especially significant role if the financially distressed company is to be restructured without the protections afforded by bankruptcy.

Economic and social development in the region of Central and Eastern Europe (CEE) has led to implementation of a law that enables a company to remedy its insolvency by means other than bankruptcy. The first legislative support for restructuring the company, to be provided in case of its insolvency, has been in place in the Czech Republic since January 1st, 2008. Act No. 182/2006 Coll. – the Insolvency Act – replaced the former Act No. 382/1991 Coll., which solved only bankruptcy cases. The new insolvency law can, in a way, be compared to Chapter 11 and Chapter 7 of the US Bankruptcy Code. The law defines what insolvency is, who registers the proposals to remedy the insolvency, and it offers

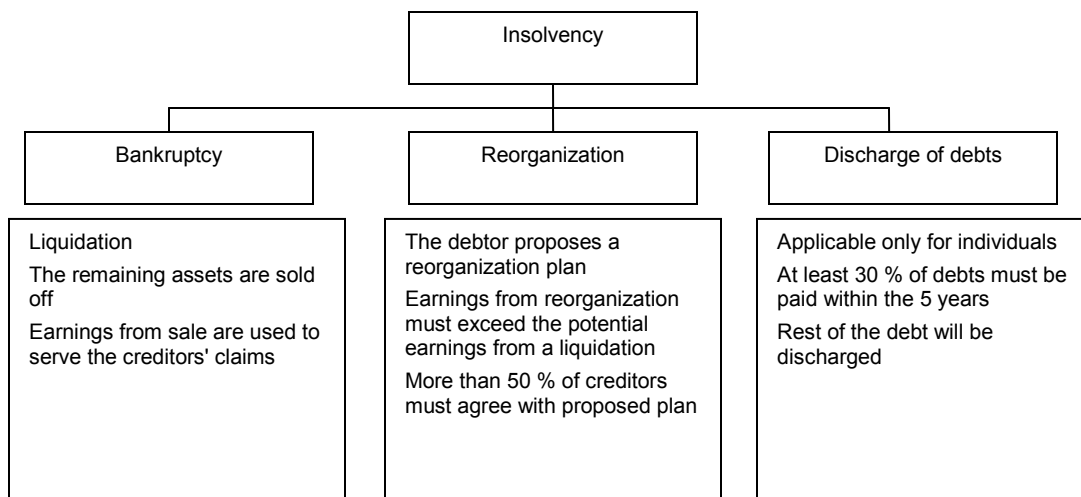
possible insolvency solutions (see Figure 2). The act doesn't exactly define reorganization possibilities. Based on findings from the literature (e.g. Gilson (2010)) the financially distressed company has several options for restructuring its debt contracts, although each of them has its limitations (see Table 1).

Figure 1: Debt Contracts Restructuring



This figure shows that companies can either be restructured under the supervision of the court or outside the court. In the US, the restructuring of an insolvent company is the subject to Chapter 11 of US Bankruptcy Code, whereas a complete liquidation bankruptcy is accomplished using provisions of Chapter 7 (Gilson, 2010). In the Czech Republic, the restructuring and liquidation is the subject to Act No. 182/2006 Coll.

Figure 2: Insolvency Solution Possibilities



The figure displays the feasible solution of company's insolvency under the Czech Insolvency Act, No. 182/2006 Coll. Individuals as well as businesses are subject to the Insolvency Act. This article deals mainly with business entity cases. The restructuring is defined as reorganization and thus, this term is also used in the following text.

Table 1: Reorganization Possibilities and Their Application Limitations

Reorganization Possibility	Limitation
The basic solution of reorganization is to run the business under present conditions. The creditors would agree to a revised debt repayment calendar, while the part of the debts will be forgiven. In such a case, the law enables the company to take advantage of tax benefits resulting from reorganization. Forgiven debt is not subject to income tax on the debtor's side and the creditor is allowed to include this amount as a tax deduction. Moreover, no income will be the taxable to the debtor.	This solution would probably be acceptable only for the creditors with unsecured claims and only if the amount gained from the repayments would exceed the gains from the sale of the assets in the case of liquidation.
Another possibility of reorganization is to sell part of the company's assets or transfer the profitable activities and necessary assets to a new entity. The creditors might be offered ownership shares in the new entity or they might gain some financial means from the sale of shares to new investor(s).	This solution would be the most acceptable one for companies operating in the Czech Republic due to the fact that the biggest creditors are usually banks, whose claims are secured by part of the company's assets and thus the banks prefer to sell these assets.
Investor exchanges the debts for ownership shares in the debtor's business.	An investor will probably be willing to buy the shares of an insolvent company only if he is able to take advantage of possible synergy effects (e.g., when the investor is from the same or a similar industry segment)
Issue of high-yield debt securities (e.g., junk bonds).	This possibility is primarily applicable in countries with highly developed capital markets in which investors might be inclined to buy these securities (this type of investor is sometimes called a <i>financial vulture</i>). No evidence exists in the Czech Republic for a case in which reorganization of the company's debt has been accomplished by issue of new debt securities.

The entrepreneur environment in Czech Republic suffers from a lack of capital available for financially distressed firms. The possibility of reorganization under court supervision exists since January 2008 (Act No. 182/2006 Coll.). Those factors have significant influence on number and quality of debt contracts restructuring cases provided since country's transformation to free market based economy (1989).

DATA AND METHODOLOGY

At the present time, e-government in the Czech Republic is being provided in an extensive volume. Due to this, it is possible to gain considerable information (e.g., register of companies, including their financial statements, foundation deeds and articles of association, insolvency are registered including all related documents and court decisions, etc.) from e-government web portals (e.g. Justice.cz (2010)).

The analysis here focuses on effectiveness of the new Insolvency Act No. 182/2006 Coll., based on the comparison of frequency of enabled restructurings by court and frequency of restructurings provided in real. Data are taken from public sources Justice.cz(2010), Doingbusiness.org(2010) and Creditreform.cz(2010ab).

Studies available at Doingbusiness.org(2010) contain data from different countries. To make the data comparable, several assumptions were made - only limited liability companies are taken in account, they are 100% domestically owned, they have minimum of 201 employees and 50 suppliers and they were granted bank loans. The studies include statistics about the recovery rate (cents on the dollar recouped by creditors through the bankruptcy, insolvency or debt enforcement proceedings) across 183 economies. Rates for selected economies are used in this paper in order to compare the development of indicators in Czech Republic in the years 2006-2009 to other countries.

More data about the development of insolvency in the Czech Republic are available in studies at Creditreform.cz(2010a). The portal enables access to an on-line database of European and Czech business reports. Data used in the article - numbers of insolvency proposals and selected firms with the highest turnover, that were subject to insolvency proposals - were taken from free studies available at Creditreform.cz(2010b). The statistics are enlarged with information searched and gained from e-government web portal Justice.cz (2010).

Information about restructuring provided within the given case study is taken from the reorganization plan available at e-government web portal (e.g. Justice.cz (2010)). Also the estimated values of the company before and after reorganization are taken from the given reorganization plan. The values might be biased by the valuation method used (Gilson et. al, 2000).

RESULTS

One of the outcomes expected from the application of the new Act is to increase the ratio of insolvency claims that are paid back in the Czech Republic. The country's ranking has been poor when compared on an international scale as shown in Table 2.

Table 2: Average Percentage of Claims Paid Back in Case of Debtors' Insolvency (Recovery Rate)

	2006	2007	2008	2009
Great Britain	85.3	85.2	84.6	84.2
Denmark	67.2	70.5	87.0	86.3
Spain	77.8	77.6	76.9	73.2
USA	80.2	77.0	75.9	76.7
Portugal	74.7	75.0	74.0	69.4
Italy	63.3	39.7	61.8	56.6
Germany	52.7	52.9	53.1	52.2
France	47.6	48.0	47.4	44.7
Switzerland	46.9	47.1	47.1	46.8
Bulgaria	33.5	34.4	32.4	32.1
Slovakia	38.6	48.1	45.2	45.9
Hungary	35.7	39.7	38.4	38.4
Poland	26.5	27.9	27.8	29.8
Czech Republic	17.8	18.5	21.3	20.9

This table shows that economically more developed countries, where possibility exists of remedying the company's insolvency through reorganization and thus enabling its future existence, provide an environment that is more effective for satisfying the creditors' claims. The position of the Czech Republic is also poor among other countries in the CEE region. Even the possibility to provide reorganization with legislative support since January 2008 has not yet been reflected in improvement of recovery rate. The data are taken from Doingbusiness.org (2010)

Slight improvement of the value of index is recorded in 2006-2009, but a significant increase is necessary to improve the entrepreneur environment in Czech Republic. The results achieved so far from the new law are shown in Table 3 and Table 5. Although the Insolvency Act became effective more than two years ago, the number of reorganizations provided (total 28) is quite small (less than 0.2 % of insolvency proposals). The reasons why the results are so poor are summarized in Table 4. The limitations of financial reorganization presented in Table 1 affect solution possibilities in cases of big companies, that results in little or no reorganization activities among big companies (see Table 5).

So far the only relevant case of a company reorganization is the company Kordarna, a. s. (here a. s. means the joint stock company (Czech transl. *akciová společnost*)). The company is a producer of technical fabrics for the rubber industry. It is a member of the KORD group which operates within the CEE region. On May 14th, 2009, the company was found by a judge to be insolvent. After the proposal of a reorganization plan and the agreement of most creditors, the court enabled resolution of the company's insolvency by its reorganization. The principle of reorganization was based on founding a new Special Purpose Vehicle (SPV) - Kordarna Plus, a. s. to include the main assets and activities of the former company. The creditor claims would be paid from the sale of 100% of the shares of SPV and sale of the remaining assets which were not to be transferred to the new entity. No debts of the former Kordarna were transferred to new Kordarna Plus. The process is illustrated in Figure 3.

Table 3: Number of Insolvency Proposals in Years 2008-2009 and the First Quarter of 2010

	2008	2009	Q1 2010
# of insolvency proposals	5,354	9,492	33,339
# of enabled reorganizations	6	16	6

Less than 0.2 % of insolvency proposals are allowed by court decision to provide reorganization. Data come from Creditreform.cz (2010a).

Table 4: Reasons of Low Number of Enabled Reorganization According to Act No. 182/2006

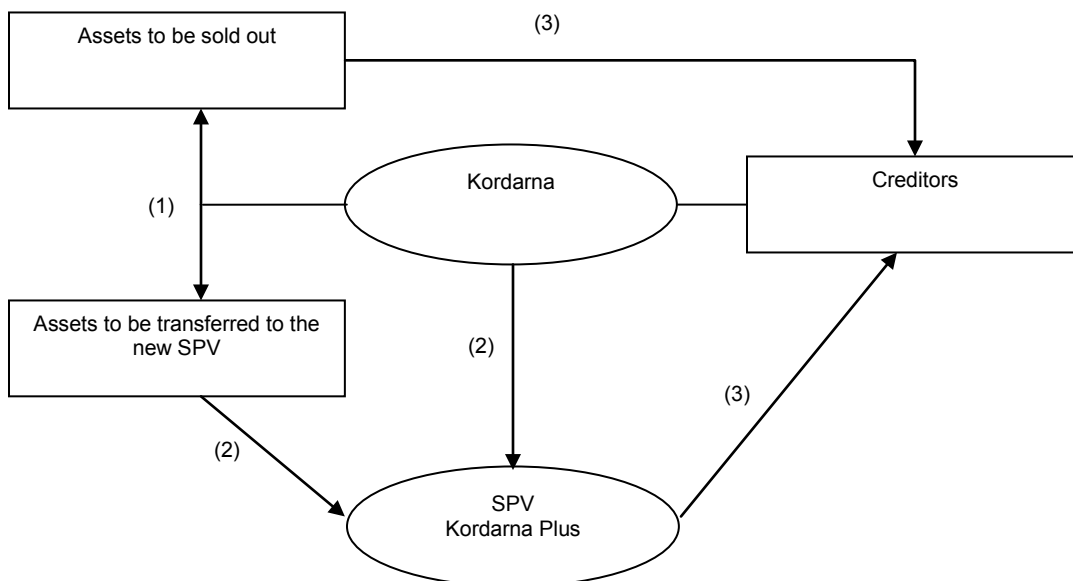
Reason	Explanation
Late registration in insolvency; hence restructuring is almost impossible to implement.	The companies avoid becoming the subject of an insolvency proposal because they would be found as insolvent by most of the creditors and banks would stop extending credit, which would make the company's operations impossible.
Reorganization is expensive and very difficult to implement; the conditions which need to be fulfilled are very difficult or impossible to meet.	The company (debtor) must propose a restructuring plan approved by more than 50% of the debtors, no later than within 15 days after the court renders a decision about its insolvency.
Reorganization is based on agreement between the debtor and the creditors and can be implemented only if more than 50% of the creditors agree with the suggested plan of reorganization.	This is difficult, especially in a time of financial crisis, when the creditors try to reduce their risk and prefer cash from the sold assets of the company rather than bearing the cost of company's reorganization. The most relevant creditors are usually banks, whose claims are secured by assets of the company, and it is very difficult to persuade the banks to concede to the agreement ("Standstill Agreement") about the reorganization of the company. Because they hold secured claims, banks prefer liquidation of the company.
Creditors are reluctant to agree with a proposed restructuring plan due to the lack of experience with company reorganizations in the Czech Republic.	The creditors are wary of the information gap which can arise between them and the company's activity during the reorganization. There are no or very few historical precedents of successful reorganizations, so investors do not understand what the company can provide.
The present definition of the Insolvency Act does not enable sufficient protection against the creditors during the reorganization process.	All the liabilities incurred during this time must be paid on time.
The lack of the capital instruments on the market, e.g., the issuance of high-yield (junk) bonds, is still implausible on the capital market of the Czech Republic.	If the company is in the insolvency register, the possibilities to gain new capital of a debt character and pay back the old debts, are closed.

Table 5: Insolvency Proposals in 2009, Firms with the Highest Turnover

Company	Last known Turnover (mil. CZK)	Turnover Year	Number of Employees	Subject of Activity	Month of the Court Decision	Insolvency Solution
Moravia energo	3,250	2007	25	Energetic	March	bankruptcy
Bohemia crystalex trading	3,000	2008	160	wholesale of glass and white pottery	March	bankruptcy
Kordarna	2,745	2008	538	textile industry	August	reorganization
PA export	2,711	2008	180	deliveries of investment complexes	September	bankruptcy
Karimpex	2,704	2007	60	wholesale of combustibles	August	bankruptcy
Olsanske papirny	1,571	2007	660	paper industry	February	bankruptcy
PK oil	1,500	2007	17	running fuelling stations	September	bankruptcy
Slezan Frydek Mistek	1,432	2007	1,869	textile industry	February	bankruptcy
GSMobile Group	1,427	2007	34	sale of mobile phones	March	bankruptcy

The table displays the company with the highest turnover, which were the subject to Act No. 182/2006 Coll. and their insolvency solution; based on Creditreform.cz (2010b) and Justice.cz (2010). The only one important case of reorganization proposed by the court decision in Czech Republic is the case of the Kordarna company

Figure 3: Reorganization of the Company Kordarna



- (1) The assets of the company are divided into two parts - the first to be sold out and the second one to be transferred to the new SPV.
- (2) The new SPV Kordarna Plus is founded. Main parts of activities and the assets of the former company are transferred to the new SPV.
- (3) The claims of creditors are served from the earnings gained from the sale of 100 % of shares of SPV and the remaining assets.

Liquidation value of the company before the reorganization was estimated by expert opinion at 519 mil. CZK. Liquidation value of assets delegated to Kordarna Plus, a. s. was 484 mil. CZK. The value of the remaining assets to be sold out was 35 mil. CZK. Values are taken from Kordarna (2010). The average exchange rates in 2009 by the Czech National Bank: 1 USD = 19.057 CZK, 1 EUR = 26.445 CZK.

The value earned during the reorganization process, to be used for serving old debts, was estimated to exceed 820 mil. CZK, as stated in Regiony24.cz (2010). The amount gained from the sale of 100% of shares Kordarna Plus, a. s. was 795 mil. CZK. The higher percentage of repayment of creditors' claims in comparison with bankruptcy (see Table 6) was the condition under which creditors agreed with the reorganization plan.

Table 6: Comparison of Percentage of Repayments of Creditors' Claims - Bankruptcy Vs. Reorganization

	Bankruptcy	Reorganization
Group 1 - secured creditors	10.98-11 %	15.2 %
Group 2 - unsecured creditors	1.98-2 %	8.17 %
Group 3 - contingent claims	0 %	0 %
Group 4 - other claims	0 %	0 %

The table displays that the creditors are divided in the groups, what is also required by the Act No. 182/2006 Coll. Calculations are based on information from Kordarna (2010).

The total cost of reorganization was estimated to be 40 mil. CZK. The amount of wages paid to the insolvency administrator, that are the substantial part of total costs of reorganization, is the subject of Section 38 of Insolvency Acts No. 182/2006 and 313/2007 Coll.; Kordarna (2010), p. 22). It represents 5 % of the value earned from the reorganization process (compare to 15% average cost of reorganization in Czech Republic as stated in Doingbusiness.org (2010).

CONCLUDING COMMENTS

Financially distressed companies may restructure their debt contracts either with court supervision or independent of the court. The goal of this paper was to examine the restructuring possibilities of companies operating in Czech Republic. The study is built on publicly available data accessible from internet sources especially those provided by government (Justice.cz). Special attention is given to presentation usage statistics of the Insolvency Act No. 182/2006 Coll., which enables restructuring under court supervision and which is available for more than two years at the time of this writing.

The restructuring possibilities in Czech Republic are limited due to lack of capital available on the capital market especially for financially distressed companies. Debt is offered almost exclusively from banks, which are reluctant to face the risk of investing in companies that are restructuring. The possibility to restructure debt contracts under court supervision exist since January 2008 and so far less than 0.2% of insolvency proposals used the reorganization. From those only one company really followed the whole process of reorganization.

The case of the Kordarna company is a unique example (see Table 5) of a successful reorganization performed under the new Insolvency Act. It is the "pioneer" of insolvency solutions. This reorganization enabled the reorganized company to carry out the existing company activities. Most of the employment contracts were kept and the level of creditor's claims to be served was higher than it would have been in the case of bankruptcy. As a result of the reorganization, the value of the company was increased by more than 300 mil. CZK.

Limitations of the analysis include that it is based only on publicly available data, which might suffer from errors. The case study illustrates that reorganization resulted in increase of company value, but it is possible that estimated values might be biased because of the valuation methods used as stated in Gilson (2000).

Case studies of restructuring inquire about questions which have public policy implications, but can significantly influence the process of company restructuring. Should the managers, when making restructuring decisions, focus more on the increase of shareholders' or stakeholders' value? It is possible that implementation of the Insolvency Act, which guarantees the court's protection for the restructured company, creates a competitive disadvantage for companies with no insolvency problems. Another interesting question is if managers ethically responsible when restructuring the company? Moreover, research examining the extent to which the interest of the company's community be taken into account?

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