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PROGRAM FOR BANKRUPTCY PILOT CASES

SELECTION CRITERIA

USAID FOSTERING AN INVESTMENT AND LENDER-FRIENDLY ENVIRONMENT (FILE)

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BiH NEW BANKRUPTCY AND LIQUIDATION LAWS

Program for Bankruptcy Pilot Cases: SELECTION CRITERIA

INTRODUCTION TO THE 26 SELECTION CRITERIA

From numerous business, financial and legal factors which are potentially applicable, the 26 listed below have been designated as the appropriate "Criteria" to be used, at the present time and under existing circumstances, to assist in the selection of appropriate demonstration, or "Pilot," cases, that will lead the way toward effective implementation of the bankruptcy system under the new Laws on Bankruptcy Proceedings of the Federation of Bosnia and Herzegovina ("Federation") and of the Republika Srpska ("RS"), respectively, as well as their respective new Law(s) on Liquidation Proceedings (collectively, the "New Laws").

Given the overall *economy*-oriented goals of the FILE Project, we have tended to prefer economic over legal factors in selecting these Criteria, although both have been given due consideration.

We also have given due attention to the prior experiences of other donor projects. In this respect the experience of the USAID Bank Supervision Project with bank liquidations and restructurings has been especially instructive.

These bank liquidations presented situations analogous to those we are likely to confront when applying the New Laws to business corporations. One critical lesson learned from the Bank project's cases is that time is of the essence. With respect to the realization of assets, whenever liquidation proceedings are tedious or protracted, asset values such as a bank's booked loans (which are analogous to a business corporation's accounts receivables), will drop precipitously. Similarly, when everything has to be laid out in creditor-approved plans negotiated after the fact, there are likely to be many changes between the start and finish of the process, with a resulting decrease in values.

Another lesson from that project is that the use of flexible supervisory powers is essential to maximizing creditor recoveries. The Bank Regulators actually had to seek the establishment of these discretionary powers, because they did not exist in the law at the time the project began its work. Insofar as bankruptcy implementation is concerned, the FILE Project is fortunate in that appropriate discretionary powers, for the most part, already have been incorporated into the New Laws. Nonetheless, the use of these powers to administer the assets of debtor companies in flexible and practical ways is critical. Accordingly, we have been watchful in structuring these Criteria so that Pilot Cases are likely to be initiated in which the appropriate flexibility can be demonstrated.

The influence of these lessons learned is notably present in Criteria 4, 6, 7, 8, 13, 21, and 25, below.

In reviewing the Criteria as a whole, note that some of them point towards appropriate liquidation Pilot Cases, while others point to potentially appropriate reorganization Pilot Cases. Others will help us identify cases which could belong in either or both categories. The first 12 of the Criteria are in this last group.

Criteria Applicable to *All* Potential (Liquidation *and* Reorganization) Pilot Cases.

Overriding practicalities and Project considerations indicate that the first 12 Criteria which follow should apply to all potential Pilot Cases, whether viewed as potential liquidations or potential reorganizations:

1. Would the process of adjudicating the proposed case serve as a good example, which would reinforce our training plans and other implementation activities?

2. Specifically, consider whether the *process* would provide a good learning experience that would benefit, especially, the trustees, bankers, and business professionals involved.

3. Would an adjudication of the proposed case ultimately have a *significant* and positive enough impact to help build confidence in and encourage a broad implementation of the bankruptcy system?

4. Can the case be a "government/government" Privatization? (That is, is it a state-owned company ("SOE") where the *controlling* creditor interests are also government held, i.e., debts owed to the government itself, *and* the SOE is a suitable candidate for private investment.)

5. Whether dealing with an SOE or a company that is already privately-owned, a threshold test is whether there are sufficient liquid assets and/or assets with realizable fair market values sufficient to pay the costs of the proceedings, including the professionals' fees likely to be incurred, pay the priority and secured creditors, and still allow for the payment of a dividend or transfer of other consideration to the general creditors.

6. Can the case be adjudicated under a pre-packaged Plan? (This applies to both liquidation and reorganization cases, because pre-packaged *liquidation* Plans can be devised relatively easily, although prepackaged Plans of reorganization are more difficult.)

7. If a pre-packaged Plan is impracticable, are deadlines/time schedules flexible and favorable? (Note, if creditors already have filed against the company and hearing and other deadlines are coming up shortly, the company is simply not a good candidate because the deadlines set in the statute will become procedural stumbling blocks. Further, if the filing took place under the old law, it simply cannot be a Pilot Case, because the old law still applies to its adjudication. On the other hand, if a filing is anticipated but has not yet happened, the company may be a good candidate. Among other things, its management may be likely to be cooperative.)

8. Irrespective of whether or not a pre-packaged Plan is feasible, it is necessary to consider whether the proceedings can be executed in a timely and efficient manner so that a final adjudication and asset or dividend distribution and/or Plan consummation can be accomplished within six to 18 months of the initial filing date (assuming that there is adherence to the statutory deadlines set in the New Laws).

9. Does the debtor Company meet an appropriate insolvency test (preferably the liquidity test, where the debtor's present, *or prospective*, inability to pay its debts as they fall due is evident)?

10. Whether debts owed former or redundant workers for wages and social contributions are likely to be a significant or, perhaps, even an insuperable obstacle to an orderly liquidation or reorganization (consideration should be given to (i) the ages, attitudes and sophistication of the workers and their representatives and (ii) whether there is likely to be future employment for them).

11. Whether the debtor company's assets are heavily liened, either due to unpaid taxes or on account of other mortgages or liens, and whether or not it has been or will be able to service these secured obligations.

12. An adjudication of the company does not present any other unavoidably sensitive complications which would overburden the proceedings (including such things as politically sensitive matters, companies with conflict of interest problems, underworld connections, and the like).

Criteria Applicable, Specifically, to Potential Liquidation Pilot Cases.

Criteria 13 through 15, which follow, have specific application to potential liquidation cases, where a reorganization of the Company, for one reason or another, is not viewed as a likely or desirable outcome at the outset of the case.

13. Whether the assets can be liquidated in a practical and efficient way, realizing net proceeds reasonably commensurate with their fair market values, so that there will be sufficient funds to pay the costs of the proceedings. (That is, the "transaction costs" or expenses of the asset liquidation process, itself (i.e., selling off of unwanted assets), will be reasonable; and the assets themselves can be disposed of without selling them at very deep discounts.)

14. If an SOE which is not suitable for reorganization/Privatization is to be liquidated, consider especially whether the liquidation of its assets can be done in a fair and transparent manner.

15. Whether after paying the costs of the proceedings, including professionals' fees, there will be sufficient funds to pay the priority and secured creditors in full (or as agreed), and still allow for the payment of a dividend of at least 10% to the general creditors. (After applying initial screening Criteria 5 and considering Criteria 13 where the case is contemplated as a *liquidation* case, one still needs to examine the likely costs of the

proceedings and resulting payouts more rigorously. To be a good Pilot Case, it should be one in which a not insignificant dividend is actually paid.)

Criteria Applicable to Potential *Reorganization* Pilot Cases.

For potential *reorganization* cases, consideration first should be given to the fact that such cases are by their nature more difficult. Accordingly, a more rigorous application of the first 12 Criteria is appropriate. Further, when dealing with an SOE rather than a business which is already privately owned, additional emphasis should be given especially to the application of Criteria 1, 3, 4, 5, 6, 10 and 12 to the potential Pilot Case.

With that in mind, Criteria 16 through 26, which follow, appear to have specific application to situations where a reorganization of the company (including a reorganization/Privatization) is viewed as especially desirable.

16. Whether there is reliable data on which to base an adequate analysis (are there good books and records, are the debtor's accounting practices sound; is extraneous data available to support projections concerning future performance).

17. Whether the company is presently a going-concern business. (As a general rule, only companies still doing business should be considered for reorganization. It is simply impractical to revive a dormant business through a bankruptcy reorganization proceeding -- such cases should be considered for liquidation-type proceedings only.)

18. Whether the debtor company provides a product or service for which others are able and willing to pay (or can be made to pay) enough to generate future revenues well in excess of the costs of producing/providing the relevant product(s)/service(s) in the future.

19. Whether the future enterprise can be identified, defined and separated, if necessary, from other, unprofitable activities of the debtor Company, while still having access to the elements necessary for its continuing operations.

20. Whether debts owed to former or redundant workers, if significant and likely to be problematic, can be "worked-out" in light of the likelihood of future employment for these same workers, or a not insignificant number of them, in the reorganized enterprise.

21. Whether the debtor company's management has a realistic grasp of its situation (where management already has done some restructuring it is likely to be a better candidate) and/or whether a competent management team is, or can on a timely basis be, put in place.

22. Whether financial ratios are favorable to a potential restructuring. (Consider, among other things, whether the company has enough debt to justify use of the bankruptcy procedure to restructure it: e.g., a company which does not have at least as much debt as one year of sales ordinarily should not need this type of debt relief. Alternatively, consider whether the ratio of the existing debt burden to the potential revenue stream presents such a high

multiple that it will simply be impracticable to satisfy both reasonable creditor demands and new investors' and managers' reasonable expectations.)

23. Whether the future enterprise can generate a rate of return sufficient to attract the necessary capital.

24. Whether analysis of the creditor groupings indicates legal rights and/or likely intransigence on the part of the creditors, which will be difficult to overcome.

25. Whether the reorganization process is likely to be especially time-consuming, problematic and/or uncertain.

26. Whether, in light of the foregoing factors, the prospective reorganization process can be rewarding enough to attract the professionals and obtain the cooperation and/or assistance of the other participants in the bankruptcy process.

APPENDIX TO THE SELECTION CRITERIA

PROPOSED METHODOLOGY FOR APPLYING THE CRITERIA TO POTENTIAL PILOT CASES

In applying the 26 Criteria, above, the objective is to identify Pilot Cases where either a liquidation or reorganization under the New Laws:

- Will be complex enough to challenge and educate the stakeholders and professionals involved and demonstrate the efficacy of the system, but not so complex as to be too protracted or problematic;
- Will have significant positive impact;
- Will resolve multiple issues (political, social, economic, business, foreign investment) that will improve the BiH investment environment;
- Will provide a good learning example that could be used in training programs as a case study;
- Can be referred to in handbooks as an example of the use of the bankruptcy system in creative ways to resolve practical problems.

The following procedure is suggested to help identify the actual Pilot Cases which can meet these, above, objectives:

I. Step One – Creation of pool of potential bankruptcy cases:

1. Identify state-owned companies ("SOE"s) where State Public Revenue Institutions hold most of the indebtedness of the company (that is, its "majority creditor").
2. Identify other SOEs desirable for Privatization where privatization by other means has been stalled, for whatever reason.
3. Identify mid- and larger-sized private companies with known financial and/or management problems.
4. Apply Criteria 1 through 12 to the companies identified in Steps 1 through 3, to winnow out undesirable and/or impractical Pilot Cases and to begin to rank the remaining ones in order of their apparent desirability and practicability for the program

II. Step Two – Order the cases by complexity/simplicity and sort them into liquidation and reorganization categories:

5. Identify the factors which are likely to complicate the proceedings and rank the candidates in terms of complexity.
6. Determine a "liquidation value" and a "business value" for each identifiable, independent business unit ("IBU") within the ranked companies.
7. Where the liquidation value clearly exceeds the business value, or the business value is simply uncertain, consider the case only for liquidation. Apply Criteria 13 through 15 carefully to develop a final assessment of the case as a potential, liquidation Pilot Case.

8. Where the business value of one or more of the significant IBUs within the company exceeds the IBU's liquidation value, the company's potential as a reorganization Pilot Case needs full consideration. Accordingly, apply Criteria 16 through 26 rigorously to each of the Company's IBUs to develop a final assessment.

III. Step Three - Selection of Pilot Cases

9. Select at first no more than four to six potential Pilot Cases, liquidations or reorganizations, for the whole of BiH, with at least two coming from each of the Federation and the RS, respectively.

10. On these cases, complete a more intensive, hands-on analysis, making one-on-one contact with all appropriate parties in interest. Then, where appropriate, begin the "pre-filing" process in which the professionals and other actors are lined-up and rehearsed and attempts are made to negotiate pre-packaged Plans with the stakeholders.