Tackling restructuring in emerging markets (part III)

In the last of his three-part series, **Steven Kargman** completes his advice to creditors faced with the insolvency of emerging market debtors

The final part of this series (which included articles in IFLR, December 2002 and July 2003) completes an overview of ten major challenges facing creditors in emerging market restructurings. This article concludes this overview by examining three additional issues facing creditors: deciding whether to pursue a stand-alone or strategic investor-based restructuring; preventing the dissipation of assets during a potentially lengthy restructuring; and assessing whether a consensual restructuring is feasible or whether alternatives should be explored.

Determining whether to pursue a stand-alone or strategic investor-based restructuring

As a threshold matter, the creditors will have to decide whether they will seek a stand-alone restructuring, that is, a restructuring of the debtor *as is* without involvement of a third party, or a restructuring based on the involvement of a strategic investor such as through an acquisition, merger or joint venture. The creditors may not be able to form an opinion on this issue at the very outset of the process because, as discussed in the last article (IFLR, July 2003), they may need to conduct further due diligence to better understand the financial condition and business operations of the debtor. In addition, the mere fact that the creditors prefer one approach as opposed to the other may not mean that the debtor and its controlling shareholders will necessarily agree with the creditors' point of view on this matter. Obviously, however, deciding whether the restructuring will be a stand-alone restructuring or a strategic investor-based restructuring will have crucial consequences for the ultimate contours of any restructuring plan.

In certain circumstances, the creditors may seek the involvement of a third-party strategic investor for various reasons. First, it is possible that the strategic investor may bring highly valued management expertise in the debtor's industry, and the creditors may believe that as part of any restructuring the debtor's management team needs to be bolstered, if not replaced entirely. Second, the strategic investor may also be able to provide a meaningful and/or significant infusion of capital for the debtor, which may be a critical element in any restructuring plan, particularly if the debtor is seriously overleveraged. Third, the strategic investor may have a better track record than the debtor of dealing with financial adversity, which may be reflected in how the strategic investor has addressed prior downturns in the economic cycle. Therefore, possibly based on the strategic investor's prior history, the creditors may believe that, faced with financial challenges, the strategic investor would be less likely to default on its debt obligations than the debtor. Finally, there may be important and useful synergies between the business operations of the debtor and the strategic investor, which the creditors may believe would help improve the profitability of the debtor's operations.

Nevertheless, it is unlikely that the creditors will simply be able to impose the notion of a strategic investor on the debtor and its controlling shareholders. However, the involvement of a strategic investor may be the recommendation of the debtor's financial adviser as the most effective way to address its financial difficulties. A strategic investor may become attractive to the debtor, and particularly its controlling shareholders, for other reasons. For one thing, the controlling shareholders may be seeking a continued role in the management of the debtor and, depending on the circumstances, the strategic investor may be able or willing to provide the controlling shareholders with some assurance that they will have such a role in the restructured company. Whether or not such a continuing management involvement is a major or minor role, as well a substantive versus an honourary role, could be a focal point of discussions between the strategic investor and the debtor's controlling shareholders.

The outcome of this discussion will be of more than passing interest to the creditors. The creditors will want to be comfortable with the management and corporate governance structure of the restructured company. It should be noted that, in certain cases, the strategic investor might only be interested in pursuing its merger, acquisition or joint venture with the debtor if and only if the incumbent management is removed. This may be the case, for instance, if the strategic investor views the prospect of a continued role for incumbent management as a hindrance to the successful turnaround and restructuring of the company.

Alternatively, the controlling shareholders of the debtor may simply be seeking an exit at the *right price* from the company. In that case, the strategic investor may have to offer the controlling shareholders sufficient financial consideration to achieve that end.

If in fact the debtor and its controlling shareholders are amenable to bringing a strategic investor into the equation, the creditors will have to grapple with several important procedural issues. They may have to address questions such as the following:

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- How will potential strategic investors be identified?
- Will the creditors defer to the decisions and recommendations by a special financial adviser employed by the debtor for that purpose (whose role in certain cases may be separate from the debtor's restructuring adviser)?
- Will there be an organized bidding or auction process, or will it be more informal? and
- How long an exclusivity period will a potential strategic investor have?

This last question could be of considerable significance to the creditors since during this period the creditors may continue to be subject to a debt service standstill or moratorium, in which case most of the creditors may not be receiving any debt service payments. Under such circumstances, the creditors may not be interested in permitting the potential strategic investor to have too long an exclusivity period. The creditors may be concerned by the possibility that at the end of such a period, the strategic investor candidate may simply decide to walk away from the deal based on its due diligence or for other reasons. If that happened at the end of a long exclusivity period, the creditors may have lost valuable time in having their debt restructured and debt service payments resumed. Moreover, the creditors may also be concerned that the debtor and its controlling shareholders will use a long exclusivity period as another way to run out the clock on a restructuring solution.

If the potential strategic investor decides to move beyond due diligence and begins to negotiate the terms of its strategic investment, the creditors will then have to consider what their level of involvement in the process should be. Should they permit the strategic investor to engage in bilateral discussions with the debtor and its controlling shareholders, or should the creditors and particularly their steering committee insist on being included, even as an observer, in such discussions? The debtor (and perhaps even the potential strategic investor) may wish to keep the creditors at arm's length while the terms of the strategic investment are negotiated. However, the creditors may have a strong interest in understanding how the transaction between the strategic investor and the debtor will work.

Among other matters, the creditors may well have an interest in understanding any continuing management role for the debtor and its controlling shareholders. In addition, the creditors may have an interest in how much equity the debtor and its controlling shareholders have been promised if there is to be a debt-for-equity swap as part of the overall debt restructuring. Obviously, the creditors will also want to know if the terms of the strategic investment are premised on certian debt restructuring parameters, such as any proposed forgiveness of debt. Furthermore, they may want to understand the terms and scope of any proposed releases from liability that the debtor and/or its controlling shareholders are seeking.

Finally, if there is a strategic investor, the creditors will have to determine how they should negotiate the debt restructuring given that there may simultaneously be continuing discussions and negotiations relating to the terms of the strategic investment. The creditors will need to decide who should be at the negotiating table for the debt restructuring discussions. They will have to consider whether these should be strictly bilateral discussions between the creditors and the strategic investor, or whether there is any role for the debtor and its controlling shareholders in these discussions.

In sum, the prospect or possibility of a strategic investor entering the picture may be attractive for creditors in certain situations, but the creditors need to determine what role they will want to have – and what role they can arrange for themselves with the other parties – in the discussions concerning the terms of the strategic investment. The creditors also need to consider whether the various discussions and negotiations pertaining to both the strategic investment and the debt restructuring should be essentially two-party or three-party discussions. As much as the debtor and the controlling shareholders may try to manage the process on a bilateral basis with the potential strategic investor without the active involvement of the creditors, for their part, the creditors may have a critical stake in how these issues are addressed, including for example how potential bidders are identified and how long any exclusivity period will run.

Preventing the dissipation of debtor assets during a lengthy restructuring process

One of the important challenges facing the creditors may be maintaining the *status quo* while the debtor's financial situation is sorted out during the restructuring process. The debtor and its financial adviser may refer to the need to *stabilize* the debtor's business operations before any restructuring plan can be seriously considered or negotiated. Among other things, the debtor and its financial adviser may argue that, as part of this *stabilization* process, cash flows need to be *normalized* from their present *crisis* levels before reliable cash flow projections, which would underpin any restructuring plan, can be developed for the coming years, including the period covered by the restructuring plan.

The creditors, on the other hand, may have a different concern and priority: they may be concerned that, during the restructuring process, certain assets of the debtor may be dissipated or siphoned out of the debtor, and this could be detrimental to the restructuring process itself and to the fundamental interests of the creditors. Specifically, the creditors may be worried that, if there were to be such a dissipation of assets, there could be less economic value available for the creditors if and when any restructuring plan is ultimately agreed on and then implemented. This could have major consequences for the creditors' ultimate recovery.

Such a concern on the part of creditors is generally consistent with the third principle of *The Statement of Principles for a Global Approach to Multi-Creditor Workouts*, which was developed by the Insol Lenders Group under the auspices of Insol International. This principle states: "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." The commentary accompanying this principle refers to "prejudicial action[s]", such as "transferring assets or value away from the companies to which the participating creditors have recourse…or otherwise running down or shifting value from its business so that the prospects of repayment to the relevant creditors are diminished".

In emerging market restructurings, dissipation of assets during the restructuring process may not be simply an academic or abstract concern. In certain restructurings, creditors have experienced situations where debtors have come to the creditors and reported that funds are supposedly "missing" from the debtor that may total many millions of dollars. In other cases, creditors have been concerned about certain related party transactions and whether value has been transferred from the debtor to non-debtor affiliates for considerably less than arm's length consideration.

Moreover, in some cases, the creditors have been concerned that the debtor may be using available cash to buy back debt in a process that is not necessarily transparent to the creditors. The debtor may buy back debt of its favoured creditors. Or the debtor or certain of its affiliates may buy back debt in the secondary market, particularly if the debt is trading at deeply discounted prices. Among other things, the debtor and its controlling shareholders may view debt buybacks as a way to maximize their chance of retaining equity control, or at least as large an equity stake as possible, of the restructured company. If the restructuring plan involves or could conceivably involve a debt-for-equity exchange, the debtor and its controlling shareholders may calculate that the more company debt that they hold, the more equity that they would receive in any debt-for-equity exchange.

To address such concerns, the creditors may try to exercise tighter control and oversight over the debtor's cash flows. The creditors may try to implement a so-called cash monitoring system for this purpose. Although cash monitoring may be an important element of the creditors' proposals for reforming the corporate governance structure of the debtor post-restructuring, the creditors may also try to institute such a programme during the restructuring process itself. As is the case with the creditors' ability to conduct a thorough and unfettered due diligence investigation, the debtor in particular restructurings may try to sharply curtail or dilute any such cash monitoring programme. Certain debtors may well try to block the implementation of such a programme from the start, and failing that, such debtors may be uncooperative or otherwise try to frustrate the implementation of such a programme.

At its most basic level, in designing a cash monitoring programme, the creditors will be interested in establishing procedures whereby, for example, the debtor's cash receipts and cash disbursements can be closely monitored, preferably by outside third parties such as independent accounting firms. The creditors will have to decide several important and practical implementation issues. Among other matters, the creditors will have to consider whether cash monitoring should apply only to transactions above a certain dollar threshold and, if so, what should be the relevant threshold. Also, the creditors will have to consider whether they are comfortable being advised of covered disbursements only after-the-fact or whether they wish to be advised pre-disbursement. (Obviously, however, to the extent that the creditors seek to go beyond simply receiving reports on cash disbursements and instead seek to exercise actual approval rights over cash disbursements, they will need to be very sensitive to and aware of lender liability concerns under the laws of the relevant jurisdictions.) Of course, all of these implementation matters will have to be discussed and negotiated with the debtor and, as noted above, certain debtors may not be particularly receptive to such proposals.

From the creditors' standpoint, the importance of an effective cash monitoring programme during the restructuring process cannot be easily overstated. Complex emerging market restructurings can easily last for a period of several years. If there is a debt service moratorium or debt standstill in place, the debtor may be effectively "saving" large sums of money that it would otherwise be paying to the creditors in the form of debt service payments. Creditors who are not receiving debt service payments during this period will therefore want to know how the debtor is using its available cash resources. (Notwithstanding the existence of a debt service moratorium or debt standstill, certain creditors preferred by the debtor, such as possibly some of the local creditors, may receive debt service payments during this period.)

As noted above, certain debtors and their controlling shareholders may find various ways to siphon cash out of the debtor. That is why cash monitoring can be so important to the creditors. Cash monitoring may provide the creditors with an important check on the debtor's ability to use cash resources in ways that are not consistent with the interests of the creditors. Cash monitoring may also help the creditors determine whether the debtor is meeting its financial targets during the course of the restructuring process itself.

But the creditors should not expect the debtor and its controlling shareholders to accept the principle of cash monitoring without a fight, and even if the creditors are ultimately able to put some type of cash monitoring programme in place, certain debtors and controlling shareholders may do everything they can to dilute the effectiveness of such a programme as it is carried out and implemented. Nonetheless, while the creditors may push hard in the restructuring negotiations for an effective programme of cash monitoring that would be instituted post-restructuring, the creditors may also not wish to overlook the need to make cash monitoring a priority item to be implemented in some form during the restructuring process itself.

Assessing whether a consensual restructuring is feasible

At a certain point in the restructuring process, depending on the facts and circumstances of the particular case, it is possible that the creditors may become deeply disenchanted and frustrated with the lack of progress. The creditors may reach this stage if the restructuring process has lasted for several years, as have several large emerging market restructurings in recent years. The creditors may begin to have serious doubts about whether a consensual restructuring solution is in fact achievable in a reasonable period of time or whether, in their view, the debtor appears to be simply interested in delay and obstruction. The creditors may wish to perform this type of reality check on a fairly regular basis if the restructuring process appears to be proceeding far less smoothly than the creditors can reasonably expect under the circumstances. Nonetheless, it may not always be easy to make a clear-cut or definitive determination on this issue since the debtor and its controlling shareholders may be sending mixed signals, perhaps even deliberately so.

On certain matters, it may be abundantly clear that the debtor is not cooperating at all with the creditors. Such might be the case if the debtor does not deliver financial or business information that is requested as part of the due diligence process, or if the debtor prevents the creditors' financial adviser from having meaningful and relatively unimpeded access to relevant information during the due diligence investigation. Such a lack of cooperation may also be evident if the debtor does not follow through on drafting or providing comments on the restructuring documentation in agreed timetables.

However, on other matters and perhaps even at the same time, the debtor may be making certain positive gestures or statements, or at least going through the motions of appearing to cooperate in reaching a consensual restructuring. For example, the debtor and its legal team may even work on producing drafts of certain major restructuring documents, but then may not follow through on producing other documents or may delay finalizing other key arrangements, such as finalizing the filings and/or security agreements that will be necessary to implement new security arrangements under the restructuring. In some cases, therefore, the creditors may be faced with a debtor that appears to take one step forward and two steps back.

However, if the creditors eventually conclude that the consensual restructuring process is stalled and that the reason is the debtor's apparent lack of good faith or cooperation, then they need to decide what course of action to take. Specifically, they will have to decide whether they should abandon the consensual restructuring path altogether and take a more aggressive and even adversarial stance *vis-à-vis* the debtor. Nonetheless, even in the face of clear evidence of the debtor or controlling shareholders' lack of cooperation, it may not necessarily be an easy decision as a practical matter for the creditors as a group or individually to abandon the consensual restructuring process and take a harder line.

Some creditors may believe that they have already invested so much time, money and resources into the consensual restructuring process that it may be better to simply stick it out and try to reach the best restructuring plan possible with the debtor, as imperfect and flawed as such a plan may be. Among other motivations, these creditors may be anxious to close a restructuring deal, whatever its shortcomings, so that they can put their loans back on accrual as soon as possible. Also, in some restructurings, certain creditors, particularly those creditors that were previously unsecured, may have a certain level of comfort if they have received security as part of the overall restructuring package, which the creditors will look to in the event of a subsequent borrower default. Some creditors may also be concerned that the alternative to the consensual process may not necessarily produce a more desirable economic result than the consensual restructuring plan that is then on the table.

This raises the fundamental issue of whether the creditors, in abandoning the consensual restructuring process, are doing so solely or principally to maximize their recovery of principal and/or whether they are also doing so for reasons of broader principle. As to the latter, the creditors may expect restructuring plans to meet certain minimal standards with respect to financial terms, corporate governance issues, and so on. Of course, it may not necessarily be a mutually exclusive choice in seeking to maximize recovery on the one hand and seeking to vindicate certain broader principles on the other hand. For example, it is possible that taking a tougher stance towards the debtor, including on issues of fundamental principle, may bring the debtor back to the negotiating table at which point the debtor may be prepared to negotiate a better economic deal for the creditors. That may be the hope of the creditors, but there is certainly no guarantee that it will be the result of such an approach.

Other creditors, however, may have lost their patience with the debtor and its controlling shareholders and thus may be fully prepared to consider alternative courses of action. Again, as a starting point, such creditors may wish to consider whether the local insolvency law provides any avenues for forcing a solution on the debtor. Among other options, the creditors will need to consider whether they can commence an involuntary insolvency proceeding *vis-à-vis* the debtor. As noted in the first article in this series, it will be important for the creditors to understand not only what the local law provides by way of statute but also how that law is in fact applied in practice. Therefore, the local insolvency law may expressly provide for the possibility of seeking the involuntary insolvency of the debtor. But as a practical matter, depending on the jurisdiction, it is conceivable that such an effort may rarely be successful. As noted in the first part of this series, local counsel can provide important and useful guidance on such matters.

Of course, even if the creditors do prevail, for instance, in achieving a court order for the involuntary reorganization of the debtor, the debtor and its controlling shareholders may still attempt by various means to frustrate the implementation of a plan developed in an involuntary insolvency proceeding. For example, in certain cases, the controlling shareholders of the debtor have mounted a series of collateral legal challenges that have had the effect of tying up the creditors and/or their representatives in local courts. Similarly, in certain cases, the controlling shareholders have even had criminal charges brought against the creditors and/or their representatives or used administrative processes, such as challenges to immigration visas or work permits, to prevent the creditors' representatives from performing their court-approved functions.

Home advantage

As is often the case, the debtor and its controlling shareholders may have a significant *home court* advantage that should not be discounted or overlooked by the creditors. This advantage may even be more pronounced if some of the largest creditors to the particular debtor are foreign financial institutions (for example, commercial banks, bondholders, export credit agencies, and international financial institutions), which is not unusual in a number of large emerging market restructurings. Obviously, foreign creditors may not necessarily be seen as the most sympathetic parties in the debtor's host country and, recognizing this dynamic, the debtor and its controlling shareholders may not be timid about playing a nationalist card in the local press and in any public discussions of the specific restructuring case.

In a multi-jurisdictional restructuring, in evaluating their available legal options, the creditors may wish to consider whether the laws (and legal systems) of one jurisdiction are more favourable and/or fairer for the creditors than the laws (and legal systems) of the other relevant jurisdictions. As a general matter, the creditors will have to consider their options under the relevant insolvency laws as well as in pursuing debt recovery actions, and they will need to consider the impact of any pending insolvency proceedings on their non-insolvency options. In some cases, although it may potentially be time-consuming, complex and costly, creditors have attempted to recover assets that they believe may have been improperly diverted from the debtor, possibly by its controlling shareholders. Obviously, creditors considering any of these litigation-oriented options should consult with counsel to review and analyze their options in depth.

In short, creditors need to continually evaluate whether the consensual restructuring process is leading them to a desirable or even minimally acceptable outcome. If not, they need to consider whether such the process should be abandoned in favour of a more adversarial, litigation-oriented approach *vis-à-vis* the debtor and its controlling shareholders. In considering whether to pursue such an approach, the creditors will need to thoroughly analyze and review their legal options, as well as the likelihood of success, across perhaps several jurisdictions. They will also need to consider the interplay discussed above between recovery of principal and the pursuit of broader principles. In certain cases, creditors may opt for litigation, whereas in other cases creditors may decide that their litigation options are not overly attractive and that therefore they have to remain with the consensual restructuring process as unsatisfactory as that may be. ▮