Tackling restructuring in emerging markets (part II)

Steven Kargman continues his series of articles advising creditors and debtors on managing debt restructurings outside of developed insolvency regimes

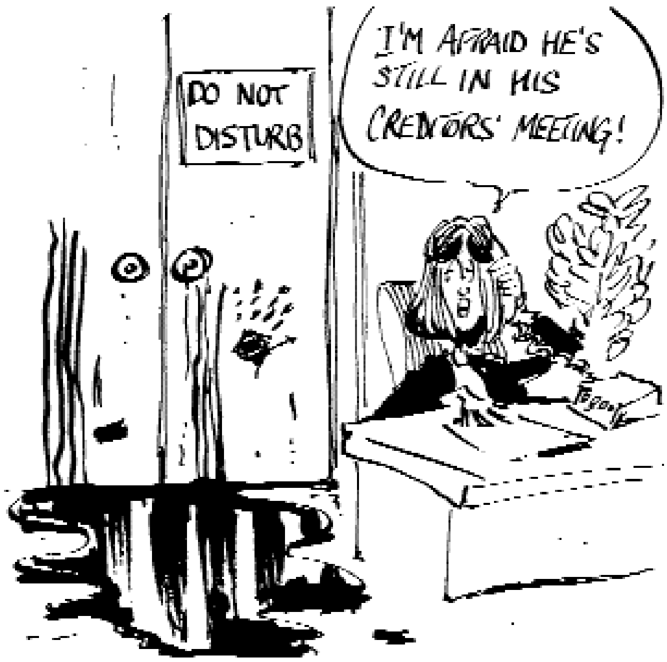
In a previous article (IFLR, December 2002), we examined four central challenges in emerging market out-of-court debt restructurings: organizing the creditor body; trying to make timely progress in the restructuring process; navigating the local legal framework and the local insolvency law; and determining the role of the controlling shareholder in the restructured company. In this article, we will look at three more challenges in emerging market restructurings: managing the resolution of intercreditor negotiations; setting the financial parameters for a restructuring; and establishing realistic creditor recovery expectations.

Managing the process for resolving intercreditor issues

The creditor body of any given debtor may be characterized by various competing creditor interests and claims that will be the subject matter and focal point of any intercreditor discussions and negotiations that take place during the course of the restructuring process. In the first place, in any given creditor body, there may be the usual tensions between secured and unsecured creditors. Although out-of-court restructurings do not necessarily have strict priority rules, secured creditors may well seek some preferential treatment in any plan that is ultimately agreed. However, in certain restructuring situations, before unsecured creditors agree to give preferential treatment to creditors claiming to hold security interests in the restructuring plan, the unsecured creditors may ask creditors claiming a security interest to demonstrate or prove, albeit in an out-of-court context, that as a legal matter they actually have the security interests that they purport to have.

If the debtor has a corporate group structure, creditors to subsidiaries with putatively stronger cash flows may seek more favourable financial terms than creditors to subsidiaries with putatively weaker cash flows. To be sure, the relative cash flow positions of such subsidiaries may change over time, even during the course of the restructuring process itself. This may be the case

Steven Kargman is counsel with the Export-Import Bank of the US in Washington, DC. The views expressed in this article are solely the personal views of the author and do not necessarily represent the views of the Export-Import Bank or the US government.



if, for example, the restructuring extends over a long period of time and the respective subsidiaries of the debtor are involved in different lines of business with different cost structures for their inputs and/or different prices structures for their products.

Also, creditors to operating companies of the debtor, whose debt is to be serviced by the cash flows of these operating companies, will have opposing interests to those creditors at the holding company level whose debt is serviced by the proceeds from dividends from the operating companies. Nonetheless, even though the holding company creditors would normally be seen as structurally subordinated to the operating company creditors, in certain cases, the holding company creditors may still seek some benefit from the cash flows of the operating companies as part of any restructuring solution. Among other things, the holding company creditors may seek some value for any inter-company loans that the holding company has made to the operating companies. As a result, in such situations, the holding company creditors and the shareholders in the holding company may seek, for example, to have so-called *management fees* paid up to the holding company level.

Whether or not the holding company creditors will succeed in such efforts will depend on the facts and circumstances of a given restructuring. Obviously, however, the operating company creditors will likely resist and try to minimize any special deals for the holding company creditors and, to the extent possible, will try to maintain the structural subordination of the holding company creditors. Nonetheless, it is possible that the debtor in such a holding company structure and its controlling shareholders will not want to close a restructuring with the operating company creditors alone unless the concerns of the holding company creditors are also addressed. Thus, even if the debtor has satisfactorily addressed the concerns of its operating company creditors, the debtor and its controlling shareholders may not wish to consider the restructuring process as having successfully reached closure if the debtor continues to face unrestructured debt claims from the holding company creditors.

Creditors face the question of when and how they should attempt to resolve difficult, and even potentially divisive and contentious, intercreditor issues

Creditors whose debt has one set of economic terms (for example, shorter repayment periods, or debt payments that are amortizing as opposed to being payable in one payment at maturity) may take a different view of issues from creditors whose debt may have less favourable economic terms. Similarly, creditors who have potentially more favourable legal rights and remedies (for example, shorter time periods for accelerating debt and otherwise exercising creditor remedies) may take a different approach from those creditors who have less favourable legal rights and remedies. These divergences of interest may be even more prominent in smaller restructurings involving fewer creditors where the interests of individual creditors are likely to receive greater attention.

Timing

Meanwhile, creditors face the question of when and how they should attempt to resolve difficult, and even potentially divisive and contentious, intercreditor issues. One approach is to first reach a deal with the debtor and then attempt to resolve intercreditor issues. Another is for the creditors to begin intercreditor discussions either before or at the same as the creditors begin negotiations with the debtor on an overall restructuring deal. There are advantages and disadvantages to each approach, and the decision on which approach to pursue is usually not made in isolation but rather is affected and shaped by the facts and circumstances of a given restructuring.

On the one hand, deferring intercreditor discussions can have the positive effect of focusing the creditors' attention on what they may view as the main game, namely reaching an acceptable restructuring deal with the debtor. To the extent that the intercreditor discussions are likely to be contentious, deferring such discussions until later in the process may enable the creditors to present a more unified front to the debtor in restructuring negotiations. It may also eliminate what may become a needless internal distraction among the creditors as they begin the process of negotiating with the debtor.

Furthermore, to the extent that the intercreditor issues are driven by considerations of economic value, it could be argued that deferring intercreditor discussions might make sense from a practical standpoint. By this reasoning, the creditors may first want to know what will be the overall value that they will be receiving from the debtor in the restructuring deal and only then decide how they plan to divide and allocate such value among the various creditor interests.

On the other hand, deferring intercreditor discussions until an overall restructuring deal is reached with the debtor could possibly lead to an even more protracted process than would otherwise exist. It may mean that the implementation of the restructuring itself will have to be delayed until the intercreditor issues are resolved. In some restructurings, this can take a long time as the various creditor interests and constituencies negotiate among themselves, which can become a messy and divisive process. Under such circumstances, this may be a good reason to initiate such intercreditor discussions sooner rather than later.

If the intercreditor discussions begin in earnest only relatively late, any resulting delay in implementing the restructuring deal may play directly into the debtor's hands. This may be the case if the debtor is not firmly committed to the deal and is seeking a reason not to move forward with it. To the extent that the debtor becomes aware of intercreditor disputes, it may seek to exploit the situation by playing one creditor constituency off against another. Such a *divide and conquer* strategy on the part of the debtor may also lead to further delay in implementing any restructuring plan.

Nonetheless, in certain cases, the creditors may actually prefer that the debtor become directly involved in intercreditor issues and serve to mediate intercreditor issues between the various creditor constituencies. However, the decision to engage the debtor directly in intercreditor discussions will depend on the creditors' perception and judgment as to what type of debtor is involved. The creditors may seek such a role for the debtor only in those circumstances where the creditors have some confidence in the debtor's desire to close a restructuring deal in a timely and reasonable fashion. In particular, the involvement of the debtor in intercreditor issues may be viewed as necessary if the disparate creditor constituencies are having a difficult time working out such issues on their own without involvement by a third party.

Although the creditors may try to carefully sequence the intercreditor discussions, sometimes events drive the timing of the intercreditor discussions relative to the timing for the development and negotiation of the overall restructuring plan. For instance, it could be the case in a particular troubled loan situation that upon the occurrence of specified events of default, certain secured creditors may have the right to trap cash in designated offshore collateral accounts and may choose to exercise that right. This could put the debtor in a precarious financial position if, without access to the cash trapped in the collateral accounts, the debtor becomes short of cash to continue its normal operations.

In such circumstances, these secured creditors will be in a position to influence how the restructuring process unfolds, including the process by which intercreditor issues are addressed. These secured creditors may not be willing to release the cash, or they may release it only sparingly, unless and until their intercreditor concerns are addressed to their satisfaction. The unsecured creditors as well as the debtor may be faced with relatively limited options. To keep the debtor operating as a going concern, the unsecured creditors and the debtor itself may need to make key concessions to the secured creditors who are trapping cash.

Finally, in some restructurings, the creditors will try to resolve intercreditor issues among themselves and negotiate a restructuring deal with the debtor at the same time. The creditors have to decide whether, in light of the particular circumstances of a given case, such an approach will permit progress to be made on both fronts or whether the process of trying to accomplish both will unduly complicate matters, possibly limiting progress on either or both fronts.

In short, managing the process for resolving intercreditor issues is not at all an inconsequential element in the overall restructuring process. Unless handled properly, the intercreditor issues, particularly if these issues are divisive and pit important creditor interests against one another, can have the potential to disrupt or sidetrack the overall restructuring negotiations between the creditors and the debtor. Unlike other important aspects of the restructuring process, intercreditor issues and the process by which they are resolved tend to be within the control of the creditors. But the creditors need to consider how these issues can be addressed in an orderly and effective manner without unnecessarily distracting or dividing the creditor body as it engages in possibly difficult negotiations with the debtor.

Establishing financial parameters for a deal

Restructuring plans cannot be drawn up in a vacuum but instead are generally based on a number of key financial and economic assumptions. Fundamentally, both the creditors and debtor will be grappling with the issue of what is the company's level of so-called sustainable debt. This is generally understood to be the amount of debt that the company can comfortably service going forward. The creditors and debtor may have differing views on what is the appropriate level of sustainable debt. The debtor usually will push for a lower figure since this will mean that it will have less outstanding debt to service in the future. The creditors, by contrast, normally will push for a higher figure since this will limit, for example, the amount of debt write-offs (so-called haircuts) or debt-for-equity swaps that they may be forced to accept. Yet, in a number of cases, even the creditors may not want an unreasonably high level of sustainable debt, since they would not want to be faced with the need to work through another debt default by the company at any time in the near future.

Determining the level of sustainable debt is not a precise science. As part of the analysis and as part of any broader assessment of the company's future financial viability, the parties may find it necessary to make certain assumptions. These assumptions may include: the cash flow projections for the company; pricing trends for the company's inputs and outputs; industry trends (locally, regionally and even globally) affecting the company, such as competition and consolidation; the effect of government policies such as import restrictions or tariffs; and perhaps general macroeconomic conditions that may have an important impact, for example, on demand for the company's products. Also, it is not uncommon for parties involved in a debt restructuring to consider the debt service coverage ratios for comparable companies, if any, as a means of ascertaining what is the sustainable debt for the debtor undergoing the restructuring. Many of these matters are likely to be reflected, directly or indirectly, in any financial models developed by the financial advisers to the creditors and the debtor, including in the assumptions underlying any such financial models.

Some of these matters will be clarified in the creditors' due diligence investigation of the company's business operations and financial condition, which is a process that is often conducted by the financial adviser to the creditors' steering committee. That is why the due diligence process is so critical to the interests of the creditors. It is also why it is so important for the creditors to draft and negotiate a scope of work for the financial adviser conducting the due diligence investigation that has a sufficiently wide berth so that the financial adviser can look at relevant company records and information, historical and projected, and develop an assessment of the company's business and prospects that is as complete and accurate as possible.

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Perhaps not surprisingly, debtors in certain cases try to negotiate a narrow scope of work and thereby limit the financial adviser's ability to examine certain areas of the company's business or certain categories of information. For instance, although the debtor may not say so expressly, in certain cases the debtor may not want the creditors and their financial adviser to have free rein to examine historical transactions. In such cases, there may be some transactions that are possibly of questionable validity or otherwise embarrassing to the debtor, including for instance certain types of related party transactions that may not have been entered into on arms-length terms. In other cases, however, the debtor may simply be trying to control the costs of the due diligence investigation or trying to agree upon a scope of work that can be completed in a reasonable period of time.

Yet, apart from those matters that are susceptible to due diligence of the debtor's operations, other matters may require the creditors and debtors to make educated guesses concerning important financial or economic issues, and there may be differences of opinion. This can affect how the two sides view the economic parameters of any restructuring deal.

There is one area where it would appear that creditors and debtors should not have much difficulty in agreeing on a key financial parameter: the amount of all outstanding debt of the company. Yet from time to time this issue, too, becomes embroiled in controversy. Again, the debtor may seek to keep this figure as low as possible and may therefore challenge the validity of various creditor claims, while each individual creditor will be seeking to have all amounts due it recognized for purposes of the restructuring. The creditors and debtor will ultimately have to come to some agreement on a procedure for recognizing outstanding creditor claims. Nonetheless, there may be much wrangling about how this process should be conducted, whether a third party should be engaged for this purpose, and who has the final word on which debts are recognized and for what amounts.

In any such out-of-court proof of claims process, the creditors will want to exercise caution in submitting their claims. The creditors must be careful that any submissions they make will not prejudice any claims that they later file in an insolvency proceeding or other court proceeding, such as a debt recovery action. Of course, the creditors may be able to protect themselves by inserting appropriate disclaimers and reservation-of-rights language in any submissions that they make to the debtor, and creditors should consult with their counsel on such matters.

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There may also be issues involving questions of legal interpretation and analysis. For instance, the valuation attributable to original issue discount (OID) bonds under the law governing such bonds may differ significantly from the insolvency principles or laws of the jurisdiction of the debtor. Indeed, local law may not even clearly address the matter. How such issues are resolved can make a difference in determining the amount of outstanding debt for purposes of the restructuring.

Once these financial and economic parameters have been determined, they provide the critical underpinnings for designing a restructuring plan. But to the extent that the creditors believe that some of the cash flow assumptions underlying the plan are conservative or even speculative, they may try to incorporate an *excess cash* mechanism into the restructuring. Such a mechanism is generally designed to allow the creditors to benefit, by paying down debt or otherwise, from cash flows generated in excess of certain pre-determined baseline amounts. Nonetheless, excess cash mechanisms are necessarily not self-executing but, absent for example changes or reforms to the debtor's corporate governance structure, may depend on implementation by the debtor's management and therefore may be only as strong or as weak as the debtor's management itself. That is why in certain cases creditors may try to ensure that excess cash mechanisms are coupled with overall corporate governance reforms of the debtor, such as outside or third-party oversight or involvement in the debtor's financial operations including the possibility of instituting cash controls.

Establishing realistic creditor recovery expectations

The creditors in general and their steering committee in particular will be interested in seeking a restructuring solution that maximizes the recovery prospects of the creditors. As a corollary, creditors generally seek to minimize the amount of debt write-offs. Nonetheless, the creditors need to be realistic in establishing recovery expectations or otherwise 'the perfect can easily be the enemy of the good'. In certain restructurings, creditors may expect a very strong recovery (well into the 80% to 90% range), whereas in other restructurings, creditor recovery expectations may be rather modest (below, and sometimes well below, 50%). Expectations will turn on many factors, such as whether the debtor can reasonably expect to generate strong cash flows and what type of market position the debtor will be in relative to its competitors.

In certain cases, based on recovery expectations, creditors may hold out for desired improvements in a proposed restructuring plan that the creditors believe will improve their recovery prospects by a certain incremental percentage. But it is possible that the creditors may be striving to obtain changes in the restructuring plan that, for whatever reason, the debtor may never agree to. By seeking or even insisting on such changes to the restructuring plan, the creditors may jeopardize the very plan that is then under consideration.

In assessing whether proposed changes to improve a restructuring plan are likely to be accepted by the debtor and its controlling shareholders, it is important for the creditors to understand how the local insolvency law shapes the debtor's incentive structure. The debtor may have little incentive to consider or accept improvements to a restructuring deal proposed by the creditors if the local insolvency law does not pose much of a threat. This may be the case if there is no reasonable prospect or likelihood under the local law that the debtor can be placed into an involuntary insolvency proceeding. The creditors may also face a relatively unmotivated or uncooperative debtor if the debtor is able to seek the protection of the local insolvency law to keep the creditors at bay for an extended period of time. Under the old Mexican suspension of payments law (which was replaced in May 2000 with the *Concurso Mercantiles* law), it was not unusual for debtors to remain in suspension of payments for a number of years.

It may also be difficult to gauge how long the negotiations will take to arrive at the creditors' preferred result, assuming it can be achieved at all. Even if the debtor and its controlling shareholders ultimately agree to certain creditor-proposed changes that may be designed to enhance recovery rates, this may be far from the end of the process. For one thing, in certain cases, the debtor and its controlling shareholders may agree to certain deal points on a term sheet basis and then take various actions to frustrate that agreement as the parties move to documenting the deal. Or the debtor may simply revisit and re-open points that had been previously agreed on in the term sheet. Furthermore, some structures, however desirable from the creditor perspective, may be very difficult to implement as a practical matter. For instance, the more complex the restructuring terms are, the more intricate the restructuring documentation is likely to be, and this may create opportunities for continued dispute and disagreement between the debtor and the creditors as the restructuring documentation itself is negotiated. In addition, in some cases, certain elements of the restructuring plan may raise regulatory concerns, whether anticipated or not, specific to the host country jurisdiction.

As much as creditors tend to focus on recovery percentages during the negotiations, they should bear in mind that these are essentially notional amounts based on projections and various financial and other assumptions. There can be much uncertainty as to certain factors that go into determining recovery rates, such as any value assigned to the equity if there is a debt-for-equity swap as part of the restructuring plan. In addition, different creditors involved in a restructuring may have divergent views on fundamental economic issues that go into a recovery rate calculation, such as what is the appropriate discount rate to arrive at a present value calculation or how to treat accrued but unpaid interest.

Finally, not all creditors will look at recovery rate issues the same way. In particular, creditors that were original lenders to the debtor will likely have a very different perspective from creditors that purchased their debt in the secondary market at a deep discount. In certain large emerging market debt restructurings, bondholders may hold a significant portion of the outstanding debt. Some of the bondholder participants, such as so-called vulture funds, may have purchased their debt in the secondary market at distressed debt prices. They may look at recovery-related issues from the perspective of whether they are coming out ahead, and by how much, relative to the discounted cost at which they purchased their debt in the secondary market.

This perspective of purchasers of distressed debt may affect how these creditors view the acceptability of any restructuring plan. It may also affect their decision whether to hold their debt until the closing of a restructuring or to trade out of their position in the interim if in the meantime they can find a relatively attractive price compared to their purchase price in the secondary market.

Original lenders to the debtor, on the other hand, may measure their recovery against a baseline of their original loan, that is, how they are faring against a recovery of 100 cents on the dollar as would be the case under their loan agreements. Yet, original lenders may also be keeping an eye on how their recovery under any restructuring plan compares to how much they have had to reserve against or write down their existing loans during the course of the restructuring process.

In sum, creditors need to be careful about allowing their negotiating posture to be driven solely or even principally by recovery projections, and these projections and their underlying assumptions need to be carefully analyzed before they are given undue weight. Recovery projections may be one element to be considered in evaluating the acceptability of a proposed restructuring plan, but they are not the only element by any means. Moreover, creditors need to remember that recovery projections are notional amounts and do not yet "represent money in the bank". Any restructuring plan, for example, could have significant implementation risks associated with documenting and then executing the final restructuring deal post-closing, and these complications could render recovery projections much less useful than might appear evident at first glance. ∎

The final part of this series of articles will appear in the August issue of IFLR.