

# Restructuring and Insolvency – an international perspective

Most corporate structures need to review their business focus and structure on a regular basis to keep them as efficient as possible and ensure that business segments continue to be viable. This often results in the realisation that restructuring is necessary and can be done on an operational basis in terms of selling off underperforming assets or consolidating operations for efficiency. It can be done more extensively focusing on different revenue streams or new industries, creating greater or more sustainable profit margins.

There is also usually a need to reorganise the capital structure of the business, to rebalance debt and equity and keep debt servicing at a sustainable level. Operators often look to create the right mix of working capital via various debt or equity products. All these decisions are made in an effort to keep a corporation healthy and avoid insolvency.

During an economic downturn the use of conventional bank debt, either to simply sustain operations or pursue expansion, often becomes more difficult as the debt markets become restricted and lenders put pressure on existing borrowing by tightening covenants and raising margins in many instances. Liquidity in the capital markets dries up and other forms of finance such as bond issues or securitisations such as Commercial Mortgage Backed Securities (CMBS) become more difficult to access.

When such conditions prevail, there is an increased emphasis on utilising a talented and creative professional adviser to help companies or investment vehicles to overcome these difficulties and get the right financial structure in place to ride out an economic downturn or recession.

The sophistication of financial markets and insolvency systems differs from country to country and the complexity of the task increases if the organisation or investment vehicle in distress is multi-jurisdictional in nature. Challenges include conflicting insolvency laws, arguments over COMI (centre of main interest) and the application of overarching models such as UNCITRAL.

## An increase in financial restructuring

Financial restructuring is a buzz phrase at present as many organisations find that pre-downturn levels of leverage are unsustainable. One classic example of financial restructuring en masse is the Icelandic banking system, which was one of the first to collapse in the downturn.

The collapse of the financial system in Iceland in October 2008 caused a dramatic domino effect on the business environment in Iceland. Those companies holding large stakes in the financial sector saw their entire portfolio value disappear overnight.

Heiðar Ásberg Atlason partner with Reykjavik law firm LOGOS, says that other Icelandic companies, not holding direct stakes in financial companies, were also affected.

He said: "Many large and mid sized companies have foreign debt, but income in Icelandic currency. The devaluation of the Icelandic Krona has thus increased the credit exposure of many companies, in addition to the effects of inflation. Hence, this great market disruption in Iceland has resulted in a high increase in financial restructuring of companies, across basically all sectors in Iceland. Most of this restructuring process has cross-border connections, but our work is mainly focused on Iceland. However, the back up of the London and Copenhagen offices has been a great asset in the entire process."

The Canadian economy has been more robust than many others and,



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as such, the need for significant restructuring has been less. Despite this there has been a need for creditors to implement restructuring programs with debtors in order to mitigate potential losses.

Wayne Myles, senior counsel with law firm Benson Myles, says that his restructuring work has been focused on the traditional industries in Newfoundland and Labrador.

He said: "More often than not we act for lenders, I would say our work load was around two thirds lenders and one third debtors. The Canadian economy has been robust and a lot more stable than other parts of the world. Restructuring has focused on the resource based economy with oil and gas, mining, minerals and other energy sources. Some clients have been selling off underperforming assets and expanding in areas with better performance, or, in some cases, diversifying into another industry. One client has removed some investment from its fisheries and diversified into telecommunications, which is an industry without the same cyclical impact."

The economic downturn hit Europe hard as its more advanced financial markets meant that many companies were highly leveraged or burdened by complex capital structures.

The UK's heavy reliance on the financial sector has seen its economy hit worse than many others, as highly leveraged investment vehicles and hedge funds based in London fell into distress.

Restructuring such vehicles can be complex as they are often cross-border in nature and involve special purpose vehicles in various jurisdictions, including offshore.

Adrian Harris, European Head of Restructuring with Chadbourne & Parke in London, has experience working with a broad range of clients active in distressed situations.

He said: "We can get involved in a wide range of situations, acting for accountants appointed in formal insolvencies at one end, to some quite tricky stuff with hedge funds that are either looking to get involved in a distressed situation or are already involved and need to extricate themselves at the other."

The Spanish financial sector is generally held up to have done better than other European countries such as the UK because lenders were more conservative, however there are still high profile examples of restructuring.

Mr. Javier Díaz-Gálvez, from Madrid law firm Roca Junyent, says that he has observed, and participated in, several cases of a trend regarding the restructuring of Spanish Parent Companies by the means of an orderly liquidation of their subsidiaries in Mainland China and/or Hong Kong.

He said: "These orderly liquidations were executed through the termination of the subsidiaries, following the liquidation procedures in accordance with the relevant law and regulations of Mainland China and Hong Kong, with a prior arranged sale of all the remaining assets, such as viable production equipment, facilities or stock to third Chinese parties. Once the liquidation was successfully concluded, the Spanish parent company could continue to operate and in some cases avoid further restructuring, due to the new financially healthier situation."

Russia was affected quite badly by the downturn and many of its large commodity-based industries found themselves in a situation when they became unable to service and repay debt when the market environment changed and commodity prices dropped significantly.

Karsten Heilemann, director with KPMG Russia in Moscow, has acted on either the borrower's or the lender's side in several restructuring cases.

He said: "We have been involved in the largest debt restructuring cases in Russia and the CIS with total debt amounting to around USD46 billion. We have worked and still work with well known companies in metals & mining, automotive, retail, finance and real estate, some of them leaders in their industries by size. Restructuring, especially in a

distressed situation, is a very complex process and the proposed solution must be adapted to the specific debtor as the case might be."

He added: "The choice of a specific technique/approach depends on the complexity, cost and time available for implementation, as well as the interest of stakeholders and the loan recovery strategy of the lenders in multi-bank deals. The first priority is to manage successfully through short-term liquidity difficulties in order to buy time and facilitate a rebuilding of trust with stakeholders that enables the company to put in place a long-term restructuring solution."

"Debt restructuring by itself cannot revive a distressed business and should necessarily be followed by efficiency improvements, therefore financial and operational restructuring measures should come together rather than be seen as alternatives."

The Turkish market is less sophisticated than the Russian market and most restructurings involve new investors moving in to inject new capital, one of the big problems in Turkey is banks abusing the vulnerable state of their debtors.

Zafer Karaca, partner with Karaca & Associates in Istanbul, says he works with several companies in financial turmoil.

He said: "We have worked with companies with too much debt which have been drawn into distress. In some cases new investors have bought the business fully and injected capital, some have obtained credit for extra investments to generate new business."

He added: "Restructuring with Turkish banks is very expensive as the banks immediately abuse the situation with higher interest rates. They will often insist on higher interest rates before extending the term of loans. Banks will not release collateral and security given to them, so companies have no other recourse but to work with the same bank under a high interest rate."

## Alternative methods of fundraising and a lack of liquidity

A desperate need for alternative and creative refinancing solutions across all global economies has led to some interesting solutions. Many structures are trying their best to refinance out of bank debt to give them more flexibility.

Long-term restructuring in Russia is more focused on financial then operational restructuring. Financial restructuring techniques employed include deleverage in the form of debt for equity swaps, new share issues and the buy-out of debt holders. There are also various forms of new debt considered such as payment in kind (PIK) loans, or rolling of debt.

Karsten Heilemann, from KPMG Russia, says that choosing the modalities of restructuring depends on the concrete situation of the debtor, the degree of indebtedness and the ability to generate cash flow.

He said: "The first priority is to manage successfully through short-term liquidity difficulties, in order to buy time and facilitate a rebuilding of trust with stakeholders that enables the company to put in place a long-term restructuring solution. Debt restructuring by itself cannot revive a distressed business and should necessarily be followed by efficiency improvements, therefore financial and operational restructuring measures should come together rather than be seen as alternatives."

One of the problems with finding alternative methods of refinancing debt is a lack of liquidity in the capital markets. Banks are not disposing of loans or structured paper and the demand isn't necessarily there for bonds or securities unless interest rates are attractive.

Adrian Harris, from Chadbourne & Parke, says that distressed investors are finding that there isn't as much product out there as the distressed investor community had expected at this point in the cycle.

He said: "The banks are working through a lot of their problems internally with the help, in some cases, of vastly expanded workout teams. However, there are only so many times that it's sensible to kick the same can down the road and repeated covenant resets are not the answer long term. The banks will probably get to a point where they have to sell to



distressed investors even though that will mean crystallising a loss.”

Wayne Myles Q.C, from Benson Myles, says that he has successfully completed a bond issue for a major client recently allowing them to pay down some debt and achieve more flexibility in their business strategy.

He said: “We did a \$US450 million bond issue to help one client exit a fairly substantial chunk of bank debt which had become somewhat difficult and restrictive in terms of implementing management’s operational and growth plan. There has been a tightening of credit, conditions and flexibility even in the better performing industries (ie telecoms). The bond issue helped them to take out much of their restrictive bank debt and gave them more flexibility in terms of more successfully operating and growing their business in the markets in which they operate in the USA and Caribbean and Latin American Regions during the next few years.”

Mr Myles says the bond market has loosened up during the last three or four months and appears to be at the front edge of the redevelopment of the conventional debt market.

He said: “We achieved a high B rating for these corporate bonds from two rating agencies, which made the pricing quite attractive. Our client was able to issue five year bonds at par with fairly attractive pricing on the interest. In recent months we have seen a number of people able to do new bond issues and take advantage of that market, with much better conditions and respectable pricing than the alternative of bank debt which is tight and restrictive, and these are grounds for cautious optimism, given where the markets have been during the downturn.”

This optimistic view of the capital markets is not shared by Bernd Richter, director at Ernst & Young in Hamburg, Germany.

He says that a lack of liquidity is still hampering any attempts to replace bank debt, meaning more dialogue with lenders.

He said: “We do a lot of restructuring work with mezzanine lenders because these programmes will be due to be repaid in 2010/11 and nobody really knows how they will be replaced. Securitisation of assets or bond issues to replace debt is not really an option because that would require liquidity; to my knowledge the market is not very liquid for any asset based lending at present. The bond markets may improve next year, but, so far I don’t see consistent signals which would indicate that we really have a positive trend in this regard.”

He added: “On top of this, it is harder than in the past to convince banks to put in new debt structures, the first challenge is to keep banks in play with their current exposure. They are keen to decrease their risk and exposure, we very seldom see them increasing their exposure, so they try to compensate their exposure and share the risk by doing more club and collaborative deals.”

### Subordinated creditors

Subordinated lenders are facing many new challenges in the downturn as valuations for companies and investments fall rapidly. In the case of insolvency many subordinated lenders find themselves without any power to influence the administration process and are often left completely out of pocket as secured creditors swallow up the entire asset value of the business.

The case of IMO Carwash in the UK provided a watershed judgement for subordinated creditors when the court ruled against mezzanine lenders who argued that they were disadvantaged by schemes of arrangement.

Adrian Harris, from Chadbourne & Parke, says that the IMO Carwash case is dead centre on this issue and is very concerning for subordinated creditors.

He said: “If you are in a subordinated position as a creditor, you may be faced with a tough call. The strength of your valuation methodology is going to be key where you are perceived to be below the water line in the capital structure, once asset prices start to rise, it shouldn’t be so much of a problem, but for now, on new deals, subordinated creditors want a higher return because of the increased risk following the IMO decision.”

This is a danger also highlighted by Bernd Richter at Ernst & Young. He believes that this persecution of mezzanine lenders could create a gap in the market for a crucial element of deal financing, meaning mezzanine will only be available to supplement senior debt and equity as very high prices.

He said: “It is important to realise that these subordinated creditors do not have the same rights with the administrator as others, even if they have the biggest stake on the debt side. They are usually not invited to committees or don’t have first hand access to information, they are last in line and that’s a pity because it doesn’t have to be the case. We see far more asset deals due to a different transaction rise compared to share deals, which would keep the legal entity and accordingly the rights of the subordinated lenders, however to get rid of issues linked to the legal entity such as tax, or other legal claims, an asset deal will be preferred by potential buyers.

Risk premiums are therefore higher than for mezzanine lending, meaning we could have a lack of financing in the market.”

The situation is very similar in China where judges tend to favour secured creditors in any action.

Ma Hongli, from Beijing law firm Jun He, said: “The situation in China for mezzanine lenders is even more difficult, typically because of the judges’ lack of experience in the area and the confusing practice of judicial liens. For example, in representing unsecured lender/creditors, we found that not only did the secured creditors take most of what was left in liquidation, but also the

chances for our client to get any repayment became pretty slim as local courts in regions where some of the assets were located rushed to post judicial liens for other unsecured creditors.”

In Russia advisers are developing a proactive approach to help lenders to spot these dangerous situations developing and extricate themselves from a subordinated situation before insolvency.

Karsten Heilemann, from KPMG Russia, assists banks with their distressed loan portfolios, as Russian banks not only lack the expertise of dealing with non-performing loans especially in a crisis situation but also do not have the structure and processes in place around workouts.

He said: “We help banks to develop a strategy and apply the core restructuring principles from the beginning to avoid repeating cases and increasing delinquencies. We also assist with improving the monitoring systems at bank workout departments and help to structure SPVs for the transfer of distressed loans. Additionally we assist with valuation and sale of distressed loan portfolios, but such deals have not been very frequent in the Russian market yet.”

### International insolvency regimes

#### Iceland

Insolvency regimes differ significantly across jurisdictions and can affect the way cross-border insolvencies are dealt with depending on where assets and businesses are based.

The Icelandic insolvency system was tested by the collapse of three major banks, Landsbanki, Glitnir and Kaupthing in October 2008.

The banks were taken over by the Financial Supervisory Authority in Iceland and a special Resolution Committee (ResCom) was established for each bank. ResCom took over the powers of the Board of Directors of the banks and there was even a change to the Act on Financial Undertakings in April 2009, so that a special Winding-Up Board (WUB) could be appointed by the District Court of Reykjavik for each of the banks.

Mr Heiðar Ásberg Atlason from LOGOS said that his firm has been highly involved in the aftermath of the collapse:

He said: “We have played a very active role in the entire process. LOGOS has been working for a number of creditors in all sorts of workouts with the banks and their ResComs and WUBs. The legal difficulties have been quite extensive and the unique circumstances around the collapse and takeover of the banks by the government have created a lot of legal uncertainty which we have been focusing heavily on since October 2008. There is not much case law on certain aspects of the insolvency process and the legal framework is not designed to capture a total collapse.”

### Spain

The insolvency system in Spain is under development with an emphasis on changing the negative reputation of insolvency.

Mr. Javier Díaz-Gálvez from Roca Junyent in Spain believes that many Spanish companies make the mistake of waiting too late to ask for protection under insolvency law because of the reputational issues.

He said: "Spanish insolvency law, although fairly new (2003), is under revision. This is mainly because continental Europe still considers insolvency as a bad reputation and honour problem, and that's why the decision for asking the protection of the law is always made too late. Also, because the crisis situation in Spain is so deep that there has not been enough time to make the wet run in practice of the new scheme.

We are sure that the reform of our Bankruptcy law will address those issues under a much more business-oriented point of view."

Roca Junyent has been involved in several major insolvency cases in Spain acting as receivers or on behalf of creditors or debtors.

He said: "Currently the Spanish insolvency law is under revision in order to improve its performance. As a matter of example, protecting DIP refinancing is an issue now and the future amendments to the law are trying to protect this kind of refinancing. As an example, the turnaround of a stock listed company in the USA, 58% owned by one of the biggest bankruptcy procedures in Spain, with over 200,000 creditors has been a successful one. In this case all assets were protected and in some cases, such as the investment in the US, improved."

### China

The problems experienced in Europe are at a more advanced stage than the issues with insolvency found in China, where the system has only been in place for two years and has not evolved to be a readily available mechanism for resolving distressed operations.

Ma Hongli, from Jun He, said: "As the Chinese insolvency system is copied from the Western system, it should work if used correctly, but it is likely to take a few more years for the Chinese society to appreciate the options and mechanisms offered in insolvency law and for individuals and businesses to rightfully use the system to resolve insolvency situations orderly and rationally and for court judges to be experienced and skilful enough to rule in insolvency proceedings."

Both the highest legislature and the Supreme Court have taken note of the UNCITRAL model law and there are examples in the Chinese judicial system of its influence.

Ma Hongli added: "We believe that, if China is willing to try to use the UNCITRAL model law in cross border insolvency matters, it may attempt to first apply these rules in a specialised regulation to resolve cases among the mainland, Hong Kong, Macao and Taiwan. We do not, otherwise, see how cross border insolvencies may be made easier by the UNCITRAL model law as it applies to China in the near future."

## Legal issues of businesses in distress, operating on the Bulgarian market



**With the world financial crisis affecting the credit market in Bulgaria, many transactions that were initiated prior to the crisis have been adversely affected mainly by lack or stopping of financing.**

The restructuring practice of Dinova & Rusev shows that, as a general rule, clients experiencing troubles with too much debt are scarce. Due to the specifics of the financial market conditions, businesses, as a general rule, were not exposed to many types of financing but rather dependent of banking finance for their projects. The Bulgarian credit market is not as developed as in the UK for example and alternatives to banking financing like debenture issues, derivatives and securitization are not as accessible. Iliya Grozdanov, senior associate with Dinova & Rusev, says that the major issues the firm has observed are clients who have fallen in distress due to issues with the main financier of their projects (mainly banks). He said: "Two major deals from our portfolio have been seriously affected by the crisis and deserve mentioning here. In the first case, the financier for the primary debt of a real estate transaction has refused extending financing that lead to default under the contractual agreements of our client. Subsequently, mezzanine financiers initiated litigation and the company fell in distress. With our active participation, a settlement was negotiated that was in effect, implementation of out-of-court insolvency of a the company via settlement that has reached the effects of insolvency avoiding liquidator's fees and timely court proceedings."

He added: "The other involved a local subsidiary of a major European construction company that has started development in Bulgaria. In this case, the financing bank refused to extend the major part of the financing basing its refusal to extend the agreed financing on open administration proceedings for the parent company located

in another member state. The project was suspended and part of the mezzanine debt swapped for equity. This helped the company to avoid opening of insolvency proceedings, renegotiate the agreement with the main financier and put other creditors at bay." General observations on the Bulgarian market from Dinova & Rusev are that most of its major clients are restructuring and/or refinancing their debts.

Consolidation of assets, minimization and optimization of management by corporate restructuring is also a development and a general trend in the large-scale businesses operating on the Bulgarian market. All this is supplemented with the increased rate of take-over transactions and increase in the demand for EU financing. Businesses related to the EU ETS are also trying to actively trade with EU allowances as alternative to short-term financing by banks.

With the crisis stepping in Bulgaria, banks have increased interest rates, security and introduced burdensome administrative procedures. All this opens cluster for private equity, whose market share is increasing in all market sectors starting from consumer credits to M&A and renewable projects.

Mr Grozdanov said: "As a general comment, there are only a handful of Bulgarian businesses with operations outside the country. Regulation EC 1346/2000 ("ERIP"), is directly applicable and has priority over the national insolvency legislation which has only several general provisions related to cross-border insolvency. Our research has not shown any precedent, where Bulgarian courts have dealt with the issue of shifting COMI of Bulgarian businesses to another jurisdiction by rebutting the presumption set out in art.3 (1) and Recital 13 of the ERIP."

## Both the highest legislature and the Supreme Court have taken note of the UNCITRAL model law and there are examples in the Chinese judicial system of its influence

### Turkey

An underdeveloped insolvency system is also a feature of the Turkish system which can be a difficult process because of court interventions, and a lengthy process.

Zafer Karaca, from Karaca & Associates, said: "Turkey has not yet implemented EU regulations in national law and therefore the main rule is that the independence of each legal entity survives. If a Turkish business is taken into insolvency, but has got separate operations, then those operations will be treated as assets of the Turkish parent company and, depending on the organic relationship with the parent company, all operations may be affected."

He added: "Turkish insolvency is an expensive and lengthy procedure from the creditor's point of view, the restructuring of a company is the preferred method, but if it does not work then the insolvency process is launched and the bad credit is registered as a loss in the company books."

### Canada

Canada has an interesting dual law system in place that has different benefits for debtors and creditors and can offer a similar level of flexibility to the US system with its debtor in possession Chapter 11 regulations.

The Bankruptcy and Insolvency Act and the Companies Creditors Arrangement Act (CCAA) are two pieces of legislation giving the full range of options.

Wayne Myles Q.C, from Benson Myles, said: "Restructuring under the Bankruptcy and Insolvency Act is more formally controlled and efficient, while the CCAA is far less structured and therefore more fluid and offers a lot more room for creativity. Sometimes you want the structure, other times the flexibility, and yet other times a combination of the two. It can be a balancing act between creditors and debtors."

The US Chapter 11 system provides protection for debtors and the combination of the two Canadian Acts can generally match what is available under chapter 11. Having said that, I think the US system is more mature and clearly developed on the restructuring side and there is more latitude for displacing or repositioning the status and standing of certain creditors and their security."

Equitable subordination is a US concept, infrequently considered or used in Canada, which allows a judge to alter the priority of creditors in certain circumstances.

Mr Myles said: "We had a recent case in Newfoundland and Labrador (involving the Hiland Insurance and related JJ Lacey insolvencies) where one of our judges made a ruling based on the adoption and application of the US concept of equitable subordination. Usually the creditor first in time is first in line and given the senior position. Under chapter 11 the courts may say that because of the conduct or structure of the creditor or its security, the court may displace the position and subordinate the security to another claimant, or class of creditor, even an unsecured creditor. It can depend on how, and under what circumstances, the security was put in place and the conduct of the creditor, at the time it was put in place or even after the fact."

### Germany

The German insolvency system is a good example of one that is more court orientated than the UK system and provides advantages and disadvantages to debtors.

One big difference from the UK system is that administrators are court appointed and can't be appointed by debtors. This means that debtors don't have the opportunity to appoint a preferred administrator that might give more preferential treatment when dealing with creditors.

Mr Richter said: "The major difference between the UK and the German system is that the court picks the administrator in Germany. This has resulted in some firms attempting to move their Centre of Main Interests (COMI) from Germany to the UK. This development is potentially difficult for Germany, but it has been cooled down recently due to the fact that the cost related to such a move is astronomical."

He added: "Despite these negatives for debtors, Germany is not the worst place for insolvency as we also have a three month period after entering insolvency when the Government will pay employee salaries, to give the entity a chance to exit insolvency."

