

The Distressed Debt Market: Where Are We Heading?

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Background

Upon reviewing trends in domestic insolvency law regimes around the world, one point is strikingly clear: many insolvency laws have recently been amended or are currently under review. The main reason: a political reaction to addressing, for the interests of various parties, the financial and economic cycles that give rise to some unforgettable crises (e.g. the Asian crisis of 1997 and Argentina's external debt default in 2001 and its banking crisis in 2002). It is also a response to a global impetus focused on avoiding liquidation of troubled companies as well as to the adoption of UNCITRAL's cross border insolvency Model Law.

As stated by Stone, corporate restructuring on a large scale is usually made necessary by a systemic financial crisis.¹ This is defined as a severe disruption of financial markets that, by impairing their ability to function, has large and adverse effects on the economy. The episodes of Enron, Parmalat, Yukos and Worldcom are helpful to remind us that developed countries are no strangers to the need of restructuring, although restructuring is more frequent in developing states. What are some of the key characteristics of recent legislation?

Time is money: the 'expedited' insolvency laws

Since corporations doing business in countries undergoing crises are not exempt from the turmoil, it can be argued that recently amended insolvency laws are aiming for expedited debt restructuring procedures. Clear examples are the recently amended laws of Argentina (2002), Turkey (2004) and Brazil (2005), all of which included or streamlined an expedited debt restructuring procedure similar to the US Chapter 11 pre-packaged deals or pre-negotiated plans. The difference between the pre-packaged deals and pre-negotiated plans is the moment of solicitation of the creditor's consents. As clearly stated by Jacoby,² the difference lies in whether it

is 'pre-voted' or 'post-voted', assessed as of the moment that a court approval (homologation) is requested by the debtor. The key element of these expedited mechanisms is that by giving limited intervention to the court, the debtor has the chance to 'cramdown' the dissenting minorities, thereby solving the ever-feared problem of the holdout creditors.

The intervention of the court is limited in the sense that its role would be limited to: (1) ensure that certain principles (equity, fairness, etc.) have not been violated by the debtor and that the required restructuring threshold has been achieved; and, (2) to homologate the approved plan/agreement making it mandatory to the dissenting minority. If we are facing a pre-negotiated plan, the court will also have to summon creditors to vote the plan under the auspices of the court. However, it is worth noting that the debtor would not request the court's approval if it has not yet – as its name indicates – pre-negotiated the creditor's consent. It should be borne in mind that there are some countries where such proceedings do not even involve a court and where the overseeing authority is an administrative entity (e.g. Peru or Bolivia).

Other countries, like Japan or Malaysia, have created specific bodies to deal with the restructuring of their corporations on an expedited basis. These restructuring bodies have their own budget to acquire the debt of distressed companies. More examples of the expedited trend in restructuring can be exemplified by soft law codes for certain types of debt, as is the case in India, Italy or Japan (e.g. the Revised Guidelines on Corporate Debt Restructuring (CDR) Mechanism issued by the reserve Bank of India in 2001 as amended and restated in 2005; the *Codice di Comportamento tra Banche per Affrontare i Processi di Ristrutturazione atti a Superare le Crisi di Impresa* issued by the Italian Banking Association in 2000; or the Guideline for Multi-Creditor Out of Court Workouts established by the Japanese National Bankers' Association and other relevant organisations in 2001). The initiative of codes of conduct is simply

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- 1 Mark Stone, 'Corporate Sector Restructuring: The Role of Government in Times of Crisis', International Monetary Fund, Economic Issues No. 31, June 2002.
- 2 Melissa B. Jacoby, 'Prepacks and the Deal-litigation Tension' (2004) 23-2 ABIJ 34.

the well-known London approach coined in 1976 as result of Zaire's payment problems.

Importantly, the substance of the new 'expedited' bankruptcy laws is that they provide a signal to creditors that they may be better off engaging in swift, voluntary and less cumbersome restructurings than actual bankruptcy proceedings.³

During periods of economic stability – such as we are now experiencing – corporations invest and try to expand. During recessive periods, corporations try to maintain their market share and develop new lines of business. In both cases, corporations recourse to different financing techniques to raise the required capital to achieve their objectives. Subject to their debt-to-equity ratio, corporations have to decide if they are going to finance themselves with debt or with equity.⁴

As noted in the editorial of the previous issue of this journal, all time low default rates in the past couple of years have pushed non-bank financial institutions into new areas in order to extract value during a period of excess cash and low returns which in turn has enabled arranging banks to structure ever bigger and more complicated debt packages comprising tranches of senior debt, second lien, mezzanine and sometimes junior mezzanine.⁵ This de-equitisation trend, based upon the lower cost of debt, excess liquidity in banks due to their tradability in the secondary debt market and CDO repackaging, has made bond debt (as well as loan debt) relatively more attractive in certain markets vis-à-vis equity.

Role of converging investment funds

It is also important to refer to hedge funds and private equity firms, two very important financial players, since the line dividing their activities is blurred. Hedge funds are typically active in the distressed debt market acting on a short-term basis and providing important returns to their clients. On the other hand, private equity firms operate on a long-term basis, obtaining loans and buying companies to turn them into profitable entities and sell them for a difference in the acquisition price.⁶

In the boom period that we are experiencing, hedge funds and private equity firms co-exist peacefully, but the negotiation skills or aggressiveness (depending on your view) of certain hedge funds and the fact that they started overlapping in the same business opportunities

(although on different sides of the negotiation table) have made them recourse to new techniques. Some private equity firms have requested their lending bank to have the right to know the holder of the loans on a name-by-name basis, aiming at avoiding being faced with hedge funds; and others, by means of side letters, have even barred certain hedge funds from voting in the event that the latter have acquired the debt in the secondary market.⁷

Debts grant their holders a right to collect monies. Therefore, the corporation is obliged to repay the agreed sums of money and the fulfilment of this obligation can be enforced by courts, eventually leading to a bankruptcy. In the case of equity, technically there is no liability. Holders of equity have a residual right over the assets of the company.

Opportunities for international arbitrage

Since corporations usually have an international presence in different markets, they are able to take advantage of obtaining finance from other financial markets in a foreign currency with better terms, resulting in lower costs. On the other hand, if a corporation does not have international presence and it tries to obtain financing abroad, which means – in the case of developing countries and some developed countries as well – the debt would be denominated in a strong foreign currency in order to avoid risks (financial, currency, political, etc.). In both cases, corporations would end up being indebted in a foreign currency and its income is normally denominated in the local currency of the country of said corporation.

If the economies of the countries of these indebted corporations are going through a recessive period, they are faced with low rates of return. In the event of a crisis, currencies of legal tender are usually devaluated, resulting in even lower rates of return. While the income of corporations is reduced, the burden to pay principal and/or interests of the corporation's indebtedness in a foreign and 'strong' currency increases. This mismatch has in many cases ended in restructuring episodes. As Rieffel stated, a sharp depreciation of the domestic currency in the course of a crisis causes companies to default on their loans from domestic banks as well as from foreign creditors, rendering a large segment of the corporate sector insolvent.⁸

Notes

- 3 This observation was stressed by Dr. Guira (Warwick) on early discussions on the topic.
- 4 See Jack S. Levin, *Structuring Venture Capital, Private Equity and Entrepreneurial Transaction* (Aspen, 2000).
- 5 See S. Patel and M. Fennessy, 'The Changing Nature of Stakeholders in Restructurings' (2006) 5 *International Corporate Rescue* 266.
- 6 There is some criticism that private equity firms are now more focused on getting their risk-free adjusted returns up-front in the way of fees, and not waiting for the back-end so much, but this is another tale, beyond the scope of this piece.
- 7 See Henny Sender, 'Debt Buyers vs. The Indebted – Showdown Between Hedge Funds and Private Equity May Be Inevitable', *The Wall Street Journal*, 17 October 2006.
- 8 Lex Rieffel, *Restructuring Sovereign Debt: The Case for Ad-hoc Machinery* (Brookings Institution Press, 2003) 43-44.

The use of pre-packs – a debtor-driven approach – allows debtor and creditors to negotiate the terms of an agreement in a shorter period of time than traditional reorganisation procedures, avoiding the problem of hold-out creditors, long and costly procedures, full disclosure of information, bad press, etc.

As the recent Argentine crisis has proven – not only with the sounded *Multicanal* case trialled in New York but with many other Argentine companies that recently had restructured their debts⁹ – pre-packs are essential in facilitating reorganisation procedures. Highly indebted corporations have been able to ‘wash’ their balances over a short period of time with the collaboration of their creditors gaining a solid credit ratio. Although we would expect, as it is common, increased business activity in the debt market, that may not be the case since trying to block a restructuring to obtain better terms might become too risky.¹⁰ *In lieu*, buying shares of a distressed company upon an event of default (when non-qualified investors usually try to get rid of their shareholding or qualified investors sell their shareholdings due to a liquidity problem as a result of the crisis) might provide the possibility to buy shares of a highly indebted company at low cost. Actually, this is what hedge funds started doing: trading. Hedge funds have the added value of their expertise in the distressed debt market.

The table below reflects the return that a hedge fund can obtain trading in the distressed debt market. Examples like these can be replicated in different markets.

Thus – over a short period of time – by means of a pre-pack, the default would be cured and a big portion of the company’s liabilities would have disappeared from the balance sheet. Consequently, a pre-pack contributes to the viability of the company and could increase the value of the shares that were bought at steep discount after the default. The example of Telecom Argentina S.A. can be used to demonstrate the decrease experienced in the price of shares of a highly indebted company upon financial distress and its increase upon achieving a successful restructuring.

In summary, we are heading towards an environment where

- (1) traditional players (e.g. Investment Banks) are losing terrain with hedge funds (e.g. Silver Point represented the creditors in the Chapter 11 restructuring proceeding of Tower Automotive *in lieu* of Morgan Stanley);
- (2) hedge funds and private equity firms are starting to face each other on opposite sides of the table;
- (3) the use of expedited debt restructuring mechanisms, as the codification of private workouts, would start to be seen more often (the term codification is used as the mechanism of becoming part of the norms of each jurisdiction);
- (4) a much more complex restructuring environment will arise as a result of the sophistication of international financing and globalisation.

Fluctuation of the price of shares of a restructuring company undergoing a pre-pack deal (Telecom Argentina S.A.)

Date	Status of the Restructuring	Value of the Share (ARS)*
02/10/2001	Six months prior to default	1.60
02/04/2002	Announcement of moratorium on principal	1.40
24/06/2002	Announcement of moratorium on interests	0.61
21/10/2004	Filing of the pre-pack with the court for homologation	6.18
04/02/2005	Noteholders’ meeting endorsing the pre-pack	7.05
04/03/2005	One month after achieving the restructuring	8.42

* There are other factors that might also impact on the price of the share (i.e. country risk, company’s performance, etc.)

Notes

9 Among others, Acindar S.A., Autopistas del Sol S.A., CTI Holdings S.A., Metrogas S.A., Química Estrella S.A.C.I, Sideco S.A., and, Telecom Argentina S.A.

10 Moreover, it should also be borne in mind that most of the companies undergoing reorganisations – at least from the Argentine experience – are utilities companies or service providers, which in the case of liquidation do not have many assets to liquidate.