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EDITORIAL

An Update on Current Restructuring Issues and Trends in Europe

Alain Le Berre, Managing Director, The Huron Consulting Group, London, UK

There can be no doubt that we are witnessing an unprecedented restructuring cycle. Neither the industry-specific 2001 tech bubble burst, nor the Asian or Russian crises of the late 1990s, nor the 'traditional' recessions of the early 1990s and of the early 1980s – not even the oil-price driven shocks post 1973 and post 1979 can compare to what we are seeing now. Many pundits (and more than a few statistics) point at the fact that nothing of the sort we are experiencing has been seen since the end of WWII, and that it should only be benchmarked against the crisis in the 1930s. Of course, in the summer of 2009 we are not (yet?) seeing collateral damages of the magnitude and importance of the Great Depression. But there is no doubt that it is in reference to this period and to its dramatic mid-term consequences that governments all around the globe, regulatory authorities and private-sector decision-makers have embarked on corrective measures of an unprecedented scale (such as the USD 700 billion TARP and all other recovery plans over the globe), nature (letting large banks go bust or effectively nationalising them in countries such as the USA or the United Kingdom) and long-term consequences (overlooking the creditors' priority rankings in the Chapter 11 at GM and Chrysler, doubling the size of the Federal Reserve balance sheet and hitting a 13% budget deficit in the US, to name but one country). Hopefully the unprecedented speed and coordination of the response efforts around the globe will help keep the credit markets meltdown and accompanying economic crisis somewhat in check before secondary and tertiary effects spin out of control. It remains to be seen whether this hope will be fulfilled, or whether the effects of these hastily conceived responses soon come back to haunt the economies and the social spheres. Either way, there is no arguing that this cycle is in many ways the cycle of a century.

This uniqueness does not only apply to the macro events around us, but also to the restructuring market, its environment, its characteristics, the tools and methodologies which are widely used or at the disposal of its leading players. In many ways, it is fair to say that this cycle is like no other previous cycle and that while experience is key, the winning solutions and techniques this time round will not be the old and tested ones that got us out in the previous cycles. In this article we will quickly review some of the most striking characteristics of the current restructuring issues, which we believe are: the lack of liquidity, the increasing complexity and costs of restructuring processes, and the increasing international dimension of restructuring processes.

1. The lack of liquidity

If 2008 can be arguably considered 'the Year of the Covenant Breach (Cured)', then there is no doubt that 2009 is 'the Year Liquidity is King'. At the same time last year, many breaches were being dealt with by covenant waivers, usually accompanied by chunky margin increases and consent margins, equity cures whenever possible, excess cash sweep clauses, etc. No write-offs were necessary in the books when no one (whether debt-side or equity-side) was keen to take any in the horrible 2008 financial year, and the problems were, well … if not solved, at least swept under the carpet for some time. If you can't cure the disease, why not at least break the thermometer and look the other way? Monty Python's Brian wouldn't have disapproved …

How time flies … It wasn't long in 2009 before the same or other debtors were coming (back) to the table crying out for cash. Whether overindebted LBOs, struggling Corporates, CDOs or other structured vehicles: the liquidity crunch is now what carries the day in today's restructuring arena. How long ago do the times in 2007 and beyond now look – when just about any restructuring situation could be met with a simple refinancing (often only storing up more trouble for later, but that's another matter and it was not recognised at the time). In the environment of mid-2009: banks are not able or not willing to lend or to refinance; the high yield markets are pretty much closed down; same for the syndication markets; private equity sponsors are trying to provide limited cures but are often faced with internal issues can be limited in the nature and scope of the solutions they can provide; hedge funds are also busy dealing with internal issues such as redemptions, and equally importantly see a better use of their funds in more liquid credit markets rather than in compromised stressed and distressed situations; finally, valuations and valuation prospects remain very uncertain – leading all liquidity providers to ponder whether they are

risking to 'catch a falling knife'. It is truly a very tough market environment.

This new phenomenon has many unintended consequences: in the UK, the drying up of the traditional operational turnaround market (for lack of appropriate funding options) and the prominence of Pre-Packs, together with a tendency for 'good companies with a bad balance sheet', exactly those which always used to secure a solvent restructuring solution, to have to file for insolvency and sometimes even liquidation (see TMD Friction) as a result of a lack of adequate liquidity in the restructuring process. In the USA, increased recourse to bankruptcies, the increased likelihood of conversions to Chapter 7, a lower appetite to provide DIP financing and the lenders' increasing need to defensively bid for assets (and/or to rollover their debt, even senior secured tranches), can be mentioned.

Current solutions are slowly emerging in the form of: equity cures and debt buy-backs performed by existing shareholders; combinations of debt haircuts and debt-equity swaps on the one hand, and of the arrival of new money providers on the other hand, the latter usually then seizing control stakes and driving the agenda; the increased complexity of deal structures and financial instruments necessary to make any solution sufficiently palatable to many different stakeholders. The future will tell us how sustainable the currently preferred solutions are going to prove.

This increased complexity is compounded by the difficulty to accurately assess or agree upon what the ultimate causes driving the liquidity needs are, currently and going forward. Root causes usually range from (and usually include) operating losses, one-off operational restructuring costs, inability to meet principal repayment/refinancing deadlines or even inability to carry the interest costs of the existing debt burden. This article can't possibly expand on each of these root causes – but suffice it to say here that each call for different remedies and that this simple fact is sometimes overlooked or too quickly brushed aside in the rush for a consensual solution that provides at least some liquidity in the short and medium term. However, it would be preferable to realistically assess the root causes of the problems and to drive sufficiently realistic sensitivities about the market environment and intrinsic issues of the debtor – in order to come up with a solution that would prove more appropriate and above all, more sustainable.

2. The increasing complexity and costs of restructuring processes

Another key difference from previous cycles is that we are entering this one with an unprecedented level of complexity level as regards most balance sheet structures. Where we used to have Senior Debt, perhaps some Junior Debt or Bonds and Equity, we are now blessed with TLA, TLBs, TLCs, All Bullets or delayed amortisation tranches, 2nd Lien, Mezzanine, PIK instruments, Secured Bonds vs. Unsecured Bonds, Convertibles, Hybrid instruments and Quasi-Equity. Needless to say, each of these instruments have their own documentation, their own schedules and their own issues in any given restructuring situation.

Moreover, any and all of these instruments are held by an increasingly complex group of constituents. Indeed, it is sometimes difficult to know who actually owns what. The secondary market is an important source of liquidity and efficiency in the debt markets, but coupled with a taste of some for unlimited sub-participations it has sometimes led to rather opaque ultimate ownership ... and agenda.

Credit instruments are now routinely held by either banks (typically a long list of them), junior tranches investors, CDOs/CLOs, secondary traders or prop desks, institutional investors and/or retail investors in the case of public instruments. Each of these stakeholders have different objectives, a different agenda, different reflexes, different mindsets, and different constraints. Each of them can do certain things but won't consider other things. Some mark-to-market and some don't. Some have cash and some don't. Some are leveraged and may face margin calls. The credit crisis has made matters even worse, as limitations on new investment capabilities and/or on the acceptable level of write-offs have brought on frequent cases where the objectives and the possibilities of different stakeholders are completely at odds with each other. And this is all before even mentioning the impact of CDS (credit default swaps) which can bring on an additional level of complexity and obscurity. Especially when the (undisclosed) holders of these instruments become incentivised to favor the failure of the restructuring process if they stand to gain more from their CDS exposure than from their exposure to the underlying credit instrument.

Successfully maneuvering through restructuring processes in the wake of this increased complexity is not easy. Restructuring processes have accordingly become more complex and dynamic, with more frequent twists and turns and more frequent surprises. They typically take more time than they used to, the need for experienced and canny professional advisers has increased and it is important to chose those who will actually spend time actually steering the processes rather than waiting for events to unfold and for their success fee to become due. Unsurprisingly, this also results in markedly increased advisory costs for the restructuring processes. But in the wake of restructuring processes which have become more complex and more unpredictable than ever, beware the avaricious and those who usually prefer to 'DIY' their restructurings, as they will find that they need to invest very significant time and internal resources into processes and may find themselves faced with very bad surprises if they try to 'low cost' their restructuring ...

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3. The increasing international dimension of restructuring processes

Yet another dimension in which the current cycle widely differs from previous cycle is the increasingly international dimension of issues and processes. Not only have debtors become increasingly more global, with assets and businesses scattered around the globe. Also creditors are increasingly international, partly as a result of the frenzy for syndications and securitisations in the last few years before the crisis. Financing lines have also been arranged on a global basis, sometimes featuring securities on international assets or according to international jurisdictions. Even when the documentation was set-up to follow England and Wales or New York State jurisdictional frameworks, enforcement implementation can be tricky (or indeed impossible) in certain jurisdictions and under some circumstances.

Conversely, solution providers have also become global. Lenders have built-up global products and global business lines; they have bought foreign operations which have invested in various places and debtors. With their often increased size has come increased geographical coverage and increased foreign exposure. Secondary investors, mostly out of the USA or out of the UK (even if there are notable exceptions) have also often taken a keen interest for less mature markets with less fierce competition for deals. They have often ventured far away from their home bases (and from the jurisdictions they knew well). Lastly, equity investors have also either built-up foreign offices (for the largest GPs) or have been happy to invest outside of their natural geographical boundaries.

In the wake of the credit crisis we are starting to witness the emergence of a new dimension in this internationalisation, namely the increased importance of emerging market investors. The most visible have been Middle East as well as Chinese sovereign funds or high-net wealth individuals and families, followed in specific sectors and regions by Indian or Russian investors. These new entrants have a very wide variety of objectives, strategies and financial means. It is outside the scope of this article to discuss this further, but suffice it to say that, while some emerging market investors have attracted more market or media attention than others, they are all set to become increasingly relevant as the West struggles to deal with the unfolding of the credit and economic crises and of their longer-term consequences.

This means that stakeholders in restructuring processes, whether primary investors, secondary-market investors or new money investors, are typically both much more international and also faced with much more international debtors, assets and issues. This is already having, and will increasingly have, major consequences on restructuring processes and how to lead them successfully – from a legal perspective, from the perspective of financial restructurings and even from the perspective of operational restructurings. While we can't cover these topics remotely exhaustively in this article, we will at least try to mention some of the most important aspects in these three dimensions:

The legal consequences, to start with them, could fill entire libraries. Therefore, we will barely scratch the surface here – and still a few key points can be made. When the USA are involved as well as Europe, for instance, it will be interesting to see how the dividing line between Chapter 11 and Chapter 15 is going to be set: at the moment it is still pretty much a work-in-progress with too little experience and case law available but these are quite different processes indeed. Even in the case of the more tested Chapter 11, whether international affiliates can or should be dragged into the process, or put in some sort of a local process, or indeed restructured out-of-court is also an interesting question; another interesting one is the discussion of what should or could happen to them when they stay out-of-court.

In Europe, the national legal frameworks for insolvency and out-of-court restructurings have recently been considerably revamped in a number of key jurisdictions (notably France, Germany, Italy and now also Spain). It typically takes several years to build a solid basis of case law to test these new procedures and processes, so it is understandable that in many respects we are now in very partially chartered territory only. Yet it is fair to say that, while these changes are still as far as ever from providing an homogenous framework for European restructuring processes, they have all very significantly improved the efficiency and professionalism of the tools and processes at hand in each of their jurisdictions: one only needs to think (amongst others) about the Safeguard process, the New Money priority under Conciliation or Fiducie and the new possibility for accelerated Pre-Packs in France; about the possibility to escape the straightjacket of the 21-days rule and about the recent possibility to file a Group in just one court and propose an administrator in Germany; or about the several new ways to reach out-of-court settlements in Italy.

Moreover, it is common knowledge that the European Directive has created the very real possibility for efficient Forum Shopping inside the European Union. Over the past several years, it has been considerably clarified and solidified by an increasingly comprehensive set of case law – admittedly still work-in-process too in some respects, but with already considerably more predictability and certainty than just a few years ago. Many well-publicised cases (Eurotunnel, Schefenacker, Autodistribution to name but a few) have shown that these new possibilities can indeed be made to work in practice, too.

Financial Restructurings are also significantly impacted by this growing internationalisation. We have already pointed at the consequences of vastly more complex and fragmented capital structures – a matter often made worse by the growing international

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complexity of the assets, businesses, financing lines and stakeholders. Equally interesting is the emergence of a forum competition amongst different forums within Europe where financial restructurings can be conducted. In the previous cycle, no European country could seriously compete with the UK when it came to proposing a tested, predictable and well-oiled financial restructuring toolbox and scene. This is changing fast. For one, the regularly heard argument that financial restructurings could only be professionally conducted in the UK always smacked of oversimplification: the fact that waterfalls might not be respected or that debt-equity swaps might be tricky to execute also simply reflected the fact that typical UK methods collided with some aspects of local laws or usages, while financial restructurings were indeed successfully conducted under these local laws or usages – just differently from how UK-based actors were used to do them, but not always necessarily less efficiently (and often significantly cheaper too).

Moreover, both the increased COMI flexibility under the European Directive, as well as the significant improvements made in several key continental European national jurisdictions, have considerably changed the restructuring landscape. It is fair to say that professionally conducted financial restructurings can now routinely be implemented in a number of different continental European jurisdictions, and/or in cross-border European processes. Examples abound in several countries and would be too long to list here. Conversely, it is equally fair to say that some recent UK processes have been less than straightforward or quick (McCarthy and Stone, Four Seasons to name just two).

Overall, it is key to recognise that successfully devising and implementing cross-border financial restructurings call for cultural sensitivity and for a keen understanding of local frameworks, local business usages and local attitudes. Oversimplification (or colonial attitudes) have recently led to, and likely will increasingly lead to, bad surprises. This should be factored in when considering strategies as well as the choice of advisors.

Finally, operational restructurings are also very significantly impacted by this growing international complexity. First because businesses that span a variety of different markets, distribution channels, brands, pricing structures and consumer attitudes or perceptions are more complex to fix than simpler ones; and because international sourcing and production networks also create additional issues that make operational restructuring more complex. A simple, top-down analysis of a consolidated P&L as can be seen in some Integrated Business Reviews (IBRs) falls far short from providing with the necessary insights to determine what are the most promising, or indeed feasible, ways to fix a troubled business.

Moreover, cultural and national legal frameworks are also paramount for operational restructurings. Everyone knows that you can't shut down a plant or lay-off workers as easily in Continental Europe than is possible in the UK or in the USA. This simple fact is however often overstated and it is not rare to hear that 'it is impossibly costly and impossibly lengthy to restructure operations on the Continent'. Nothing could be further from the truth. In my experience, those who have had very bad experiences were mostly those who were trying to apply their pre-existing UK or US methods or concepts on a continental European situation with an unrevisited mindset. It is not an opinion, but a matter of experience and fact that closures and lay-offs can be successfully implemented even in places such as France, Germany or Southern Europe – and sometimes at a far lower cost than initially expected. The difference between success and failure often resides in careful planning, deep cultural knowledge and cultural sensitivity, skilful management of all stakeholders (including trade unions, employees representatives or local authorities) … and good process management ! There again, it is key to select advisers with the relevant experience and cultural background. Even though most business leaders now speak decent English, an ability to speak with them and with other stakeholders in their native language will be very helpful to get under the skin of some subtleties that may loom large if they go unnoticed.

4. Conclusion

The considerations above have clearly not exhausted the subject matter of the current difficulties and intricacies in European restructurings: one should also speak about how to conduct business valuations in an increasingly volatile environment, characterised by an unprecedented lack of visibility; this is particularly important for valuation of mildly or seriously distressed assets and businesses. Equally, the blurring of out-of-court and in-court restructuring solutions is another important and interesting trend that differs from the experience in previous cycles. But it would take more than we possibly can deal with in the context of this short article.

The topics covered above, however briefly, should suffice to give a feel for the fact that whether from a legal, financial or operational perspective, restructuring processes are very different in this cycle. Actors, room for manoeuvre, priorities, contexts have all evolved considerably. The growing internationalisation is a one-way street and there will be no turning back; an international mindset and genuine cultural awareness are paramount, as well as a team of advisors who understand local issues and are experienced internationally. Processes are more complex than ever, they can typically be longer and considerably more costly, as well as more uncertain. But first and foremost, they fundamentally call for new solutions and new attitudes. We are living through particularly interesting times.

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International Corporate Rescue

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