

Restructuring Offshore PRC Debt

Skadden

06/24/15

If you have any questions regarding the matters discussed in this memorandum, please contact the following attorneys or call your regular Skadden contact.

Dominic McCahill

London
44.20.7519.7018
dominic.mccahill@skadden.com

Alec P. Tracy

Hong Kong
852.3740.4710
alec.tracy@skadden.com

This memorandum is provided by Skadden, Arps, Slate, Meagher & Flom LLP and its affiliates for educational and informational purposes only and is not intended and should not be construed as legal advice. This memorandum is considered advertising under applicable state laws.

Four Times Square
New York, NY 10036
212.735.3000

skadden.com

As the growth of the Chinese economy (and the real estate sector in particular) slows, we are seeing stress in an increasing number of issuers of offshore noninvestment-grade People's Republic of China (PRC) bonds. It seems likely that some of these issuers will be unable to continue to meet scheduled payments of principal and interest and the debt may need to be restructured. Below, we discuss some of the challenges both issuers and bondholders face when restructuring debt and highlight the principal components that are key to achieving a successful outcome.

Overview

Historically, it has been impractical for foreign bondholders to obtain meaningful security over assets in the PRC. As a consequence, offshore bonds commonly have been issued by an offshore holding company (often a Hong Kong-listed issuer incorporated in the Cayman Islands, the British Virgin Islands, Bermuda or Hong Kong.) The proceeds typically are passed down to the PRC operating companies via a combination of intragroup loans and/or equity investments.

The bonds typically are guaranteed by the group's offshore subsidiaries, and the obligations of the issuer and the offshore guarantors often are supported by pledges of the shares of the group's offshore subsidiaries. The onshore group companies usually are not obligors in respect of the bonds and typically are not parties to the indenture or other transaction documents. In most cases, the indenture governing the bonds permits the incurrence of significant onshore debt by the group's PRC entities. All such debt, which is typically short term and often secured, is structurally senior to the bonds. Since the onshore entities normally are not parties to the bond documents, it is not uncommon for such entities to borrow in excess of the stated limits, particularly if the group comes to face liquidity problems.

Challenges to a Successful Restructuring

Restructuring offshore bonds poses a number of complications, many of which are driven by the multijurisdictional nature of these instruments.

First, the lack of onshore obligations typically means that the onshore creditors are in a much stronger position. If there is insufficient value onshore to satisfy the onshore creditors' claims, offshore bondholders can expect little or no recovery. Where possible, onshore insolvency proceedings should be avoided, as offshore creditors are likely to have little or no influence over or visibility into such proceedings.

Second, the group's offshore structure usually will include obligors incorporated in a range of different jurisdictions, including the Cayman Islands, the British Virgin Islands, Bermuda and Hong Kong. Consequently, consideration needs to be given at an early stage as to how a compromise with bondholders can be implemented in a manner that is not vulnerable to attack in the courts of other jurisdictions where the issuer or subsidiary guarantors are organized or hold assets.

Third, a further complication arises where the bonds are governed by New York law. A common method of restructuring New York-law governed bonds is through an exchange offer or tender offer. In an exchange offer, a bondholder agrees to swap its original bond in exchange for a different security — for example, a new note with a later maturity date or equity capital. In a tender offer, a bondholder agrees to give up his bond in return for an immediate cash payment, usually for significantly less than the face amount of the bond. These offers are framed so that they only become effective if a specified majority of the bondholders accept the offer. However, outside a U.S. bankruptcy process, it is not possible to force a bondholder to accept a lesser amount or delay payment of principal and interest

Restructuring Offshore PRC Debt

without that bondholder's consent. Inevitably, some bondholders will refuse to accept the company's offer in the hope that they will have to be paid out in full. If too many bondholders adopt this strategy, the restructuring may well fail unless these holdouts can be "crammed down" through an insolvency or other court process.

The most common method of imposing a restructuring deal on holdout creditors in this context is through one or more schemes of arrangement, which are a common tool for restructuring under English company law and in jurisdictions which follow the English law tradition (including the main offshore jurisdictions). A scheme of arrangement is an arrangement or compromise entered into between a company and its creditors or members. Under a scheme, the court is asked first to call the requisite creditor meetings. At this first hearing, the court also will consider whether the class or classes have been properly defined (it is in the company's interest to have only one or as few classes as possible, because each class must separately approve the scheme if it is to be approved). At the meeting, the scheme is approved if (1) a majority in number representing (2) at least 75 percent of the claims of those present vote in support of the scheme. A second court hearing follows, at which the court will sanction the scheme if it is satisfied that it is fair in all the circumstances. Unhappy creditors have the ability to object in court, but if the scheme is ultimately approved, each scheme creditor will be bound.

Since a scheme is not an insolvency process, embarking on a scheme does not give the issuer or other obligors in the group automatic protection against creditor actions. Indeed, the act of proposing a scheme may constitute an event of default under the group's finance agreements. If necessary, the relevant companies may seek the appointment of provisional liquidators upon the presentation of a winding-up petition. The appointment of provisional liquidators gives rise to a stay of creditor claims while the scheme process continues. Following approval of a scheme, the provisional liquidators are discharged and the winding-up petition is dismissed.

An alternative or additional source of protection may be had through a filing in the U.S. Bankruptcy Court under Chapter 11 of the Bankruptcy Code. A Chapter 11 filing gives rise to a worldwide automatic stay. Financial and other creditors that have dealings in the United States should be reluctant to risk being held in contempt of the federal bankruptcy courts and therefore may refrain from seeking to enforce their claims. By way of a recent example, in 2014 Skadden filed for U.S. bankruptcy protection for Bermuda-based shipping group Nautilus Holdings, which held container ships through Hong Kong limited companies. No proceedings were commenced in Bermuda or Hong Kong. The group recently emerged from Chapter 11 after reaching an agreement with key creditors.

If the bonds are governed by New York law, it will, in the absence of a Chapter 11 proceeding, be necessary to have a scheme recognized

in the U.S. This is done by commencing an ancillary bankruptcy process under Chapter 15 of the U.S. Bankruptcy Code. This is a relatively straightforward process which can be completed quickly. If it is necessary to have more than one scheme, for example in Cayman and Hong Kong, then the schemes will be substantively identical and each scheme will only become effective if the other is also sanctioned by the relevant court.

Key Elements for Success

As a result of these and other factors, restructuring offshore PRC debt can be challenging, and success cannot be assured in all cases. However, the following approaches will increase the odds of success:

Start Early. The earlier a company realizes it has to address its offshore debt, the better. Reaching an agreement with creditors and implementing one or more schemes normally will require a number of months. Bondholders are unlikely to react well to pressure to quickly reach decisions. Moreover, viable restructuring options often will include related transactions such as assets sales or equity investments by new or existing shareholders. Negotiations among these parties can be interlinked and inevitably take longer than is initially hoped.

Be Transparent. A company should, to the greatest extent possible, provide transparency in its dealings with creditors in order to build the necessary trust around which a deal may be struck. Professional advisors have a major role to play in this respect. Moreover, the absence of current information about the company's financial and operating position and prospects will make it difficult for bondholders to evaluate or commit to any restructuring proposal.

Provide a Credible Nonconsensual Alternative. While a fully consensual deal is almost always the optimal outcome, the company should be prepared to act on a credible nonconsensual alternative. For example, in the context of offshore bonds, it may be helpful to bondholders to have access to a liquidation recovery analysis prepared by a professional advisory firm.

Offer Fairness. A related concept is to ensure that the plan is fair to all stakeholders. Fairness in this sense means fairness relative to what rights and entitlements the creditors have and their likely recovery in the absence of a successful restructuring. Bondholders are less likely to support a transaction if they do not feel that their sacrifice is appropriate and proportionate to their position in the capital structure.

We anticipate that an increasing number of offshore bond issuers will need to restructure their debts in the coming months and years. The hope is that these can be successfully achieved and that the restructured issuers will be able to continue with their businesses and, in due course, return to the debt capital markets.