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# Insolvency

Introduction

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2018

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## Contributing Editor

**Mark S. Chehi** focuses on negotiated and litigated workouts and out-of-court restructurings, 'prepackaged' and prearranged bankruptcies, and traditional Chapter 11. He represents public company debtors, creditors, shareholders, lenders, acquirors, creditors' committees, committee members and board special committees in various matters, including international and cross-border situations and related litigations. Mark advises officers and directors on governance and fiduciary duty matters, and represents companies confronting mass tort liabilities. He is a member of the Turnaround Management Association, a member of INSOL, a member of the ABA Business Bankruptcy Committee Liaison to INSOL, co-chair of the subcommittee on Business Transactions, and of the ABA Business Bankruptcy Committee.

## Introduction

This 2018 Insolvency Global Practice Guide is a guide for legal and non-legal professionals to the differing legal regimes that apply to business restructurings, reorganisations, rehabilitations, insolvencies and liquidations in the 33 countries covered by this publication.

The contributing firms and authors are well-versed in the restructuring and insolvency practices and laws of their respective jurisdictions. They provide concise, high-level summaries of country-specific creditor rights and legal alternatives (statutory and non-statutory) for the restructuring and resolution of financially distressed and insolvent businesses. The contributors also provide all-important professional insights into current trends and developments in their local markets.

The information and summaries in the Guide are not provided as legal advice or opinions of any kind, and should not be relied upon as such. Readers should consult the contributors or other qualified legal and non-legal advisers when seeking to identify and understand what rules and practices might apply in particular situations and jurisdictions.

**Evolution and State of Financial Restructuring Market**

The Guide summarises legal regimes that often reflect an evolution towards current best restructuring and insolvency practices. Local laws and related practices that apply to creditor rights, financial restructurings and business insolvencies are typically unique, complex and jurisdiction-specific. Such laws and practices may be long-standing or reflect recent changes and global trends. While it is difficult to generalise about global trends, the following observations may be of interests:

**Globalisation of Practice**

Best practices in financial restructuring and insolvency-related practices have evolved over several decades to address the globalisation of business, financial markets and debt-trading. Legal regimes in many jurisdictions have adapted and changed in response to: cross-border M&A activity and private equity investments; the immense growth in distressed investing and secondary loan trading in international debt markets; and the development of cross-border and international restructuring and insolvency laws, treaties, regulations, organisations and best practices.

The international nature of today's capital markets and business enterprises requires that legal, judicial and professional practices recognise and resolve cross-border issues arising when a company's domestic and foreign investors, creditors and operations are impacted by an insolvency or financial restructuring. Differing foreign legal rules, regimes and policies may apply simultaneously and must be harmonised.

Thirty years ago, few restructuring professionals and firms were known to have significant international restructuring contacts, capabilities and expertise needed to navigate cross-border insolvency situations. Since then, the cross-border restructuring and insolvency practice has grown and matured. The International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL) and the Turnaround Management Association (TMA) both are worldwide associations of thousands of restructuring professionals focused on international capabilities and best practices for cross-border situations.

Uniform laws and practices for cross-border insolvencies and financial restructurings have been advocated by professional associations and enacted in various jurisdictions. INSOL formulated the INSOL Global Principles for Multi-Creditor Workouts. In 1997, the United Nations Commission on International Trade Law (UNCITRAL) established the Model Law on Cross-Border Insolvency (Model Law). The Model Law has been enacted in many countries. It provides that a country's national courts must recognise insolvency proceeding that have been commenced in another country. For instance, in Europe, the Model Law was originally enacted by Council Regulation (EC) 1346/2000 on insolvency proceedings (Insolvency Regulation), which automatically applied to all EU Member States in the European Union, excluding Denmark. The Insolvency Regulation of 2000 was replaced by Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings that, as recast, provides for recognition of pre-insolvency rescue proceedings.

There is continuing need for laws that foster business rehabilitations rather than liquidations, because rehabilitative and "rescue" regimes preserve jobs and the going-concern value of insolvent companies. For instance, after nearly 100 years of only permitting liquidations, Panama recently enacted legislation that allows for companies to reorganise. Also, Singapore recently enacted new corporate bankruptcy laws to promote international debt restructurings. The Singapore Companies (Amendment) Act 2017 enacted the UNCITRAL Model Law on Cross Border Insolvency into Singapore law. The Act also makes significant changes to Singapore's schemes of arrangement and judicial management processes by borrowing from some of the prominent features of Chapter 11 of the US Bankruptcy Code.

**New Participants and Competition**

Over the last two decades, there has been fundamental change in who typically holds "debt for borrowed money" in financially distressed company situations: traditional, institutional commercial bank lenders have been replaced by hedge funds and other strategic, private distressed debt investors.

In years past, the senior creditors of an insolvent company often were its relationship bank lenders. Banks predictably continued to hold distressed debt through work-out or other restructuring or insolvency negotiations and proceedings. Over time, new and different types of strategic and opportunistic investors, including hedge funds, entered restructuring markets to acquire distressed company debt from banks and other traditional lenders.

The impact of hedge funds and other non-traditional investors on financial restructuring and insolvency processes was mixed. On the one hand, they often made restructurings more complicated and litigious as well as unpredictable and sometimes more difficult because such investors often sell and assign (or acquire) their debt positions during a pending restructuring, thereby potentially upsetting restructuring negotiations and agreements between a company and its creditors. The practice of using "restructuring support agreements" and "lock-up agreements" was developed to manage risks posed by debt trading: such agreements bind a debt-holder and its successors and assigns to restructuring terms agreed to by the debt-holder, thereby providing certainty to those who negotiate and reach restructuring agreements, and flexibility for debt-holders who may want to trade their claims freely.

On the other hand, hedge funds and other non-traditional investors brought money, speed and sophistication to the restructuring landscape. They are creative investors, particularly well-suited to driving restructurings to conclusions, and have the wherewithal to invest new money to expand the solutions to a distressed company. They provide liquidity to a market that may otherwise be constrained.

Sophisticated US hedge funds and other strategic investors who previously focused primarily on distressed US company debt (using the US Chapter 11 process to achieve outsized returns and debt-to-equity conversions giving them equity control of reorganised companies) have expanded the scope of their investment activities and strategies to target financially distressed foreign companies worldwide. While many non-traditional investors remain focused on debt of North American companies because distressed debt markets there are more developed than in other jurisdictions, opportunistic investors are now active in non-US jurisdictions where distressed debt markets are less mature. In recent years, major debt funds have been raising significant capital earmarked for deployment in Europe and elsewhere globally in anticipation of expected economic changes and foreign financial distress situations that will present opportunities for such investors.

It is important to note that the increased numbers of non-traditional restructuring and distressed debt-market participants have increased competition for sometimes limited investment opportunities. As a result of such competition, risk is sometimes underpriced when distressed debt is acquired.

**Pre-Negotiated Processes**

Thirty years ago in the US, distressed companies often commenced traditional chapter 11 bankruptcy cases under the supervision of a federal bankruptcy court without any pre-negotiated outcomes or reorganisation plan terms in mind at the outset of a case. In traditional Chapter 11 cases, it typically took a year or much longer to negotiate and confirm a possible reorganisation plan. Over the past three decades, more efficient, speedy and less expensive Chapter 11 bankruptcy case strategies have developed. There is now a general trend in favour of consensual strategies negotiated out of court for efficient in-court resolution of financial distress, in place of lengthy, formal, non-consensual judicial proceedings. A company and its lenders and other major stake-holders may employ a "pre-packaged" or "pre-negotiated" chapter 11 case strategy to achieve relatively rapid case progress milestones and deadlines, and outcomes that in the past might take several years to accomplish in a traditional Chapter 11 case. Restructuring professionals, companies and major financial stake-holders often prefer out-of-court workouts and "pre-packaged" or "pre-arranged" restructurings - - instead of disorderly, uncertain and often litigious bankruptcies, liquidations or receivership-type insolvency proceedings that may result in high professional fees, delay, unnecessary litigation and loss of going-concern values.

**Increased Litigation**

With the entry of non-traditional distressed debt investors and other opportunistic participants, litigation has become a much more common strategy for achieving or negotiating recoveries in insolvency and restructuring proceedings. When there is uncertainty about available value or who is entitled to it, valuation litigation and inter-creditor disputes may dominate insolvency proceedings, as they have in the litigious Puerto Rico insolvency cases. Likewise, avoidance actions and litigation claims against third parties (including former owners, management and auditors) may represent meaningful sources of recovery. The settlement or assignment of complex litigation claims during a proceeding may be the basis of a plan of reorganisation or liquidation. Moreover, creditor litigations against governmental authorities and regulators may materialise in connection with regulated financial institution insolvencies, as has happened in the wake of Santandar's acquisition of the assets and senior liabilities of Banco Popular Espanol. The frequency of litigation may increase as specialised investment funds who are focused on insolvency-related litigations become more active; they invest in and fund litigations in return for a share of litigation proceeds.

**Sales of Financially Troubled Businesses More Common**

Sales of all or substantially all of an insolvent business's assets as a going concern "free and clear" of liens, claims and encumbrances are now common in Chapter 11 cases and other formal proceedings when a stand-alone reorganisation or rehabilitation of a business is impractical or impossible. Proposed sale transactions may be market-tested and negotiated before formal insolvency proceedings are commenced. In the US, a pre-negotiated sale process for an insolvent business may be proposed and effectuated quickly with court approval following commencement of a Chapter 11 case, especially when a sale has affirmative support of senior secured creditors. Senior creditors often provide funding for a pre-planned Chapter 11 sale case in order to preserve a business's going concern value that may be lost in the absence of such funding. After a court-approved sale, a Chapter 11 company and its creditors may negotiate and seek bankruptcy court approval of a liquidating Chapter 11 plan that distributes sale proceeds to creditors.

**What May Lie Ahead**

As reported by many Guide contributors, there is currently a lower incidence of business restructurings and insolvencies in many jurisdictions. The lower incidence is attributable in part to an abundance of private-sector liquidity, continuing record low interest rates in many major markets, and recent economic strength worldwide.

In the US, after keeping the federal funds rate at an unprecedented floor of zero to 0.25% for seven years, the Federal Reserve only recently has begun increasing the federal funds rate. Likewise, the European Central Bank has only recently began dialling back its monetary stimulus after years of ultra-low interest rates and bond purchases; the Bank of England's main policy rate was cut last year to 0.25% - the lowest in the Bank's 300-year history; and the Bank of Japan has continued to keep ten-year government bond yields around 0%.

Global economic strength contributes to current lower levels of financial distress. For instance, the Eurozone economy remains on course for its strongest year since 2010, although it may be slowing slightly towards year end 2017. Since 2016, the US economy has experienced strong growth (over 3% in Q3 2017) and lowered unemployment levels. Lower US business taxes are expected to further increase US economic growth in 2018 and beyond.

However, history shows that significant financial restructuring cycles always lie ahead. Sudden events causing a tightening of credit markets or leading to economic slowdowns may trigger increased restructuring activity. Even without precipitous events causing financial distress, continuing economic growth in the US and Europe may lead to higher interest rates that necessitate financial restructurings: as major economies grow, wage and price pressures may lead to inflationary trends that, in turn, lead to interest rate increases.

US corporate debt levels may signal the next cycle of financial restructurings. US corporate debt is at its highest level relative to US gross domestic product (GDP) since the financial crisis began in 2008-2009. Approximately US USD9.5 trillion of corporate debt maturities (including USD2.3 trillion of junk-rated debt and USD418 billion of junk debt rated B- or lower) will come due through 2020 - - with US USD2.1 trillion of debt coming due in that year alone. Some commentators believe high-yield and leveraged credit markets may be approaching bubble territory. In the United States and Europe, junk yields are hovering around all-time lows – signalling a high level of complacency in the financial markets.

Another possible sign of future financial distress is the trend in recent years towards weakened borrower covenants in debt securities and instruments. In 2011, Moody's Investors Service developed a covenant quality index for high-yield bonds that evaluates and scores various covenant protections in new bond offerings and then converts these scores into an index value. This methodology, which considers a full array of borrower covenants, recently produced the lowest monthly score since the index's inception. While companies may negotiate "covenant-lite" borrowing terms from yield-hungry lenders, the prevalence of "cov-lite" loans and non-investment grade bonds may reflect the underpricing of risk and become a wave of borrower defaults without advance covenant breaches when economic conditions change.

As for industries that are most likely to experience financial distress in the near future, contributors and other analysts expect insolvencies and financial restructurings in the following sectors: oil & gas; retail; maritime/shipping; healthcare; commercial real estate; minerals and mining; financial services; and sovereign debt.

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