CLIENT NOTE

WHEN PANDORA BOX IS OPENED - IS IT A DISASTER OR ONE CAN MANAGE IT?

OVERVIEW

When trouble pops-up, it often comes unannounced. Business giants are not insured against unexpected trouble. Lenders and investors of troubled companies should sit and chew their nails though. There certainly is a significant arsenal of tools to handle mayhem. Just know how.

It is quite often that your investment does not go exactly the way it was planned. Such circumstances may be due to both internal (operational issues, lack of proper governance framework etc.) or external factors (change of legislation, change of market conditions, adverse political developments etc.). Some tend to look at this as the end of the world and tend to say that Pandora box is opened! You may think that in such a case the only thing that's left is a hope (as it was in a famous myth of Pandora in Hesiod's Works and Days). However, life has taught us that there is more than just hope - this is just the beginning of a new life under new conditions, where, you need to have a plan - a plan how to handle the crisis and unexpected troubles that come out of the box.

The purpose of this note is to discuss the key steps that the creditors (and more specifically lenders) should take to manage that crisis and get the most out of this. We will particularly discuss 4 various solutions to this crisis - out-of-court workouts, hybrid procedures, financial recovery (rehabilitation) and liquidation. Clearly each option offers set of advantages and disadvantages. Situation gets more complicated when the regulatory policies are not clear and where stakeholders do not share the same vision. Timing is a separate enemy, because you should realize that not everyone affected by the trouble is willing or able to wait. It therefore takes a tremendous amount of effort and coordination to control the troubles that come out of the box and agree on a solution that hopefully is the best for everyone.

It seems obvious that whatever solution is finally implemented, such solution should resolve the trouble quickly, and to the extent possible, retain the value of the enterprise as a going concern and reassure creditors that the value of their claim will not be overly diminished. Moreover, if you are not just a lender, but, for example, a development institution, then of course you realize that a wide scale corporate distress can impact broader financial stability of the market.

WHO OPENED THE BOX?

Prior to initiating and implementing any form of workout or a liquidation, it is important to understand the cause of the trouble. There should be something that opened the box and unless you have a clear understanding of such cause, the risk of overall failure increases. As mentioned above, such causes are various and depending on the nature of such cause the toolkit that has to be applied varies.

Analysis of the debtor's real financial and economic situation is imperative to determine the viability of the business.[1] It is therefore recommended to conduct a quick, but at the same time thorough analysis of the current status of affairs and address such aspects as the group structure (especially when such structure doesn't formally exist), business and assets that are being used in the value chain, management, financial information, cash flows, key contracts and partnerships (both formal and informal), financing (e.g. interrelationship between different forms financings and providers), existing securities and guarantees, pending and potential litigations etc. This will enable you to both have a better understanding of the current standing, as well as to reveal the enemy that you are fighting against. In out-of-court workouts this is typically done through the use of information rights available by virtue of contract (e.g. financing agreement, shareholders agreement etc.) or statute (e.g. right to access to information as a shareholder, board member etc.).

[1] It is however rightfully perceived that insolvency proceedings are better equipped to analyze full in the finances of the debtor, especially when there are serious controversies regarding creditors' rights.

Stakeholder analysis is equally important. The main and obvious participants in any restructuring scenario are the debtor company and its creditors. An important aspect of a workout is to have a balance between the different interests of the stakeholders, as well as between the broader social, political and policy considerations that can impact the implementation of the plan. Some of the creditors can be flexible, but some may have limitations.[2] However, when the debtor is facing trouble from Pandora, there are number of other stakeholders (not necessarily participants in the negotiation) that may be interested in the development and success of the workout process. Such stakeholders might include the Central Bank (if the default of the debtor can have a significant hit on the financial industry), employees (when a company's operations are the only means for the employees living in certain regions for bringing home the bread), suppliers (when the debtor was playing a vital role for sustaining small suppliers such as farmers) and of course the Government (when the company plays a critical role in the economy). As a result, unless you have a good understanding of how to manage these interests, your plan may fail, and you may be blamed for killing the wrong animal.

MANAGING THE TROUBLE COMING OUT OF THE BOX

As mentioned above, in international practice, there are four ways of containing the trouble:

(a) out-of-court restructuring (contractual workouts);[3]
(b) hybrid procedure;[4]
(c) formal reorganization (financial rehabilitation);
(d) formal insolvency (liquidation).

The relations between the different processes can differ considerably: generally formal insolvency proceedings can act as an alternative, as a complement or as part of a sequence to out-of-court debt restructuring. As the basic preconditions for a restructuring are practically the same as those for a formal insolvency procedure, a restructuring may well be an alternative to a formal insolvency procedure. But restructuring can be complemented by a formal insolvency proceeding where the out-of-court restructuring cannot, for various reasons, completely solve the debtor’s financial problem, formal insolvency procedures can act as a complement to achieve the restructuring goals.

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[2] For example, Armenian tax legislation does not enable tax authorities to negotiate and enter into separate agreement whereby the payment of certain accrued taxes can be postponed or somehow structured. in our practice this has been needed on many occasions where having such a possibility would enable the other creditors to approve the proposed out-of-court plan.

[3] Out-of-court debt restructuring involves changing the composition and/or structure of assets and liabilities of debtors in financial difficulty, without resorting to a full judicial intervention, and with the objective of promoting efficiency, restoring growth, and minimizing the costs associated with the debtor's financial difficulties.

[4] Hybrid procedures refer to all procedures where the involvement of the courts or other authorities is an integral part of the procedure but is less intensive than in formal insolvency proceedings. Hybrid procedures are, essentially, private restructurings completed by minor judicial or public interventions and incorporating some elements of formal insolvency proceedings. One of the most widespread hybrid procedures is the "prepackaged plan", which, despite numerous recommendations of a number of interested groups has not been incorporated into the existing regulatory framework. Other hybrid procedures are those that allow the debtor to negotiate with its creditors while the court enforces a stay on creditors' actions.

Clearly, there are advantages to the out-of-court workouts:

(i) Flexibility and ease of adaptation to the specific needs of the debtor's business. An informal workout, allows creditors and the debtor to reach agreements with a wide variety of contents;
(ii) Ease of negotiations. A workout is less confrontational than formal insolvency proceedings and therefore provides a better environment for negotiations, both between creditors and the debtor among creditors themselves. Procedural rules are extremely light or non-existent, so engagement among creditors and the debtor and the creditor may take any form that the parties decide to choose;
(iii) Timing issues. In many instances of corporate financial difficulty, time is of the essence to avoid liquidation of the business. Workouts are also typically shorter processes compared to formal insolvency procedures (on the average takes more than two years), where the intervention of the judicial system subjects the negotiation process to considerable delays;
(iv) Confidentiality. Workout is much more private process than a formal insolvency procedure and, possibly, less prone to unwanted publicity and speculation;
(v) Less stigma than formal insolvency. Workouts are perceived to cause less reputational damages and carry less stigma than formal insolvency processes;
(vi) Continuation of the debtor's business. It is also clear that the discretion associated with a workout makes it easier for the debtor to continue its business, than a formal insolvency procedure, where loss of goodwill tends to be very substantial;
(vii) No changes (or partial changes) in management. In a workout, the debtor's management retains place and there are no formal controls of their activity. This is especially important when the operation of the business depends on the informal partnerships and ties that have been established by the senior management;
(viii) No court involvement. Workouts avoid the intervention of the judiciary, whose pace may be too slow in the face of the emergency of financial difficulties;
(ix) Lower costs. Formal insolvency procedures are costly in terms of time, money, and reputation. Workouts are generally less costly, even in cases involving numerous advisors and creditors to coordinate.

There are of course disadvantages of workouts vis-a-vis formal procedures. The basic disadvantages of out-of-court restructurings as opposed to formal insolvency are the following:

(i) Punishment of fraudulent behavior. From a public perspective, formal insolvency procedures are better suited to deal with fraud and criminal conducts connected to insolvency;

(ii) Avoidance actions. A formal insolvency procedure is necessary to investigate antecedent transactions- such as undervalue transactions and preferences - and potentially avoid them;
(iii) availability of different remedies. In workouts, it is not possible to use some extraordinary remedies e.g. subordination of certain claims, availability of right of action against managers and shareholders in case they were aware of the insolvency criteria;
(iv) Lack of unanimity requirements. Workouts can be quite flexible regarding the contents of the restructuring, but they can be extremely rigid in their approval procedure, as they typically require unanimity of creditors;
(v) No requirements of debtor's consent. Because of the contractual nature of the workout, the debtor's consent is required, whereby in formal insolvency procedures it is possible to act without the debtor's consent.

There are additional disadvantages that need to be taken into consideration, such as difficulties of multi-party negotiations, issues related to the director's liability in case of failure for mandatory filing, existence of a formal reorganization (rehabilitation procedure) etc.

CONTRATUAL WORKOUTS

There are a variety of explanations for the widespread use of informal contractual workouts, but the need for flexibility, as opposed to the relative rigidity of the formal insolvency proceedings, is probably the most important one. Several features of the process attest to the flexibility of informal workouts:

(a) contrary to most formal insolvency procedures, the debtor and the creditors can initiate workout negotiations without having to submit evidence of financial difficulties;
(b) the parties are free to negotiate among themselves, without applying the rules of formal insolvency;
(c) there are no limits for solving financial difficulties (e.g. certain rate of recovery for creditors, or a time limit for a moratorium).

As the term provides, these workouts are purely contractual and basically the workout plan is converted into an agreement which is entered into by all the creditors (or such a number of creditors, that is big enough to manage to prevent the filing for insolvency by other "small" creditors). The agreement should inter alia address such issues as the standstill/forbearance terms, coordination/voting among the creditors and rules on dealing with dissenting creditors, access to information, management and governance, the contents of the restructuring plan (e.g. asset sales, provisions regarding debt restructuring, etc.).

HYBRID PROCEDURES

As it was mentioned above, hybrid procedures incorporate some elements of formal insolvency proceedings in an attempt to eliminate the problems that arise in the context of the informal workouts. Generally, there are many options, available for the regulation of hybrid procedures, with varying degrees of court intervention. The degree of court intervention should depend, in turn, on the court's preparation and availability and on the nature of the problems that informal workouts encounter in any given jurisdiction.

Armenian insolvency legislation provides for a regulation of a "danger of insolvency" as a permitted hybrid procedure. Particularly, in 2016 amendments were introduced into the Bankruptcy Law, introducing the concept of danger of insolvency. Chapter 2.1 of the Bankruptcy Law allows the debtor to seek a temporary stay from the court subject to the approval by the court of the financial recovery plan satisfactory to the judge. Upon deciding to entertain a petition for a danger of insolvency the court appoints the manager (Art. 15.2.(2)). The approval of the petition on the danger of bankruptcy is coupled with an approval of the financial rehabilitation plan, which should either (i) be approved by all the creditors or (ii) by the creditors holding 60% of the claims against the debtor and there is an agreement between the manager and the debtor that after the implementation of the financial rehabilitation plan the dissenting creditors will receive as much as they would have receive as a result of the liquidation of the debtor (Art. 15.3.(3)). The approval of the financial rehabilitation plan under the insolvency danger proceedings also triggers the entry of an automatic stay (e.g. suspension making payments to creditors other than as provided under the plan, prohibition on filing of court claims against the debtor, suspension of accrual and payment of interests, taxes and fees etc.). Pursuant to Article 59 (2) of the Bankruptcy law, the duration of the financial rehabilitation plan should be up to 36 months (extendable for additional 12 months with a total duration for the plan not to exceed 72 months (Art. 66)).

FINANCIAL REHABILITATION

Financial rehabilitation is a regulated process aimed at restoring debtor's financial condition (solvency) to avoid the liquidation. Financial rehabilitation is only possible after the declaration of insolvency within the framework of the Bankruptcy Law.

Chapter 8 of the Bankruptcy Law regulates the process. Financial rehabilitation plan can be produced and submitted for the court's consideration by the debtor, secured creditors holding 1/3 against the debtor, unsecured creditors holding 1/3 of the claims against the debtor or shareholders holding 1/3 of the shares of the debtor. However, in practice, preparation of the financial rehabilitation plan requires a close cooperation with the administrator both in terms of getting access to the information about the company and the efficiency of the process (i.e. especially in case of debtors representing systemic value for the economy in a multi-stakeholder environment).

Financial rehabilitation plan has to be submitted before the 1st meeting of the shareholders. The creditors' meeting on the voting of the financial rehabilitation plan (unless rejected by the court on the grounds of incompatibility of the plan with the requirements of the law) has to take place within 20 days from the filing of the plan to the court. The plan shall be then submitted for the approval of the court in the event a majority of the creditors votes in favor of the plan.

Bankruptcy Law provides for the possibility of the party proposing the rehabilitation plan to request the court to prevent the foreclosure and "extraction" of certain key assets from the debtor's estate pledged in favor of the creditor. In such an event, Article 41 of the Law requires to make available an adequate protection for such secured creditor (e.g. making payments to the secured creditor for the depreciation of the collateral, increase of the volume of the collateral, full satisfaction of the claims of the secured creditor etc.).

The implementation of the plan has to be carried out under the administrator's control and the operation of the debtor should fully comply with the financial plan. The compensation of the administrator in case of the financial rehabilitation should be provided under the plan but should not be lower than 5% of the satisfied claims. The plan can provide for a bonus in case of successful implementation of the plan.

As mentioned above, the duration of the plan shall be 36 months, extendable by 12 months, with a total duration not to exceed 72 months.

LIQUIDATION

In the event no financial rehabilitation plan is submitted, approved or successfully completed the debtor shall proceed to the liquidation. At the liquidation stage the creditor's claims shall be satisfied in line with a rank order provided in the Law (Article 82). Unless the secured creditors chose to opt-out from bankruptcy proceedings and satisfy their claims via realization of the collateral, their assets will become part of the debtor's estate and will be realized in accordance with the Bankruptcy Law. The process is carried out by the administrator and the control over the process is actually exercised by the court.

CONCLUSION

It is traditionally perceived that the distress of the debtor is a situation very close to a lose-lose status. Indeed, there are and will be losers, but the opening of the Pandora box should not necessarily result in a total loss for everyone. As discussed above, getting out of this situation as a "winner" requires cooperation, collaboration and control. There is certainly a significant chance of success should all the creditors agree that keeping the debtor as a going concern increases their chances of recovering the investment.

Unfortunately, not in all cases the workouts or rehabilitation happen. However, this also requires from the creditors to frame their vision (and have a clear plan) that should fit within the existing regulatory apparatus.

HOW CAN WE HELP?

Our team has extensive experience in helping the creditors to navigate in such critical environments and design and successfully implement a realistic and at the same time effective plan in line with the existing regulatory environment. So please, do get in touch when you want to get sophisticated advice.

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