

# RESTRUCTURING IN ROUGH SEAS:

## AN OVERVIEW OF THE DYNAMICS FOR WORKING OUT TROUBLED LOANS IN AN UNCERTAIN GLOBAL ENVIRONMENT

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**I**n the best of times, complex corporate debt restructurings can be a very challenging process. But in the current environment, in the midst of a global financial crisis and a slowdown in the global economy, such debt restructurings are likely to become even much more vexing. The global financial crisis will mean that companies in need of refinancing may not be able to find such financing, and this lack of financing could push certain companies into debt restructurings or insolvency proceedings. In the ensuing debt restructurings or insolvency proceedings, the parties may not be able to rely on readily available financing necessary to keep troubled or insolvent businesses operating. Moreover, the global economic slowdown may mean that there can be no short-term assurance of steady or strong demand for services and products provided by companies undergoing debt restructuring.

The shipping industry has not

been immune from these forces buffeting the global financial and economic system. Over the past few years, the shipping industry has vastly increased its capacity, but in the current environment, this could make shipping companies vulnerable as demand for shipping capacity drops given falling economic activity around the globe. Also, in recent years, in order to finance the purchase of new vessels, the shipping industry has taken on large amounts of new debt. But how difficult will this new debt be to service in a seriously constrained economic and financial environment?

For shipping companies with large debt service burdens that they are unable to meet now or in the foreseeable future as well as for creditors with exposure to such companies, it may make sense to think through ahead of time what would be involved in an out-of-court debt restructuring process. Otherwise, if the financial condition of such

companies spirals downward and leads to debt defaults on different debt instruments (e.g., bank loans, bonds, etc.), the affected companies can soon enter into a free fall with possible cross-defaults being triggered and lenders rushing into to exercise remedies to protect their individual positions, often at the expense of finding a more constructive common solution.

In this article, we will provide an overview of certain restructuring dynamics and considerations that are relevant in the international debt-restructuring context, particularly in debt restructurings involving the emerging markets. At the request of the editors, the observations in this article draw upon the author's experiences in international restructurings involving various industries outside of the shipping industry, and the article therefore does not purport to provide shipping industry-specific analysis.

Even though many debt restructurings are often conducted in an ad hoc manner with important decisions made on the fly, debt restructurings fundamentally require careful planning and a sound strategy if they are to proceed in a timely manner towards an outcome that the various stakeholders will find acceptable. To be sure, no one party to the restructuring is likely to be completely satisfied with the final terms of a debt restructuring, since each party may be called upon to make sacrifices in the interests of finding a mutually agreeable solution for all of the parties.

For parties entering a debt restructuring, they need to bear in mind that debt restructurings consist of several distinct but interrelated dimensions: financial, business/economic, legal, and strategic. Each of these dimensions must work in sync in order to achieve a successful debt restructuring. However, not infrequently,

parties to a restructuring concentrate on just one or two of these dimensions without taking the other dimensions into account, and that can be a very serious mistake.

On the financial front, parties need to have a thorough and comprehensive understanding of the company's existing debt burden and how that debt burden needs to be reconfigured in order to allow the company to move forward on a sound financial footing. Fundamentally, this requires an analysis of what constitutes the company's "sustainable debt." Is the company's debt burden too high, and does some debt have to be written off (a worst case scenario for lenders) or exchanged for equity? Do certain debt maturities on the company's debt need to be pushed out further into the future, i.e., rescheduled? Does the interest rate structure on the company's debt need to be adjusted?

However, this type of analysis brings us to the business/economic dimension of debt restructuring: the parties cannot undertake a meaningful sustainable debt analysis unless and until they have a firm grasp of the company's future business prospects. This will allow the parties to gain a better understanding of the company's future revenue streams that will provide the company with the means to service its future debt service obligations.

Thus, with respect to the business/economic dimension, the parties to a debt restructuring must launch a serious due diligence investigation of the company in order to better understand, among other issues, the company's operating history, its cost structure, its revenue streams, the identity of its key customers, any cyclicity in the business, its track record on receivables, and so forth. The creditors in a debt restructuring will often hire an outside advisor to conduct such a due diligence investigation.

Nonetheless, for such an investigation to be productive and yield useful information, the creditors will require the active and good faith cooperation of the debtor in this effort. In some restructurings, the creditors will encounter resistance from the debtor as they try to conduct a full-blown due diligence investigation of the debtor, and this can present a serious roadblock to achieving a successful restructuring.

The parties must also factor in how the company is situated in its industry and among its peer group. For instance, if the company has lost its competitive edge, is there any possibility for the company to regain its competitiveness in its industry? What will the competitive pressures from other similarly situated companies mean for any pricing strategies going forward? But there also may be larger business and economic issues to

take into account. Will national governments, for example, impose policies that will either disadvantage or advantage the company, such as trade policies?

Furthermore, there are various macroeconomic factors that may well affect the company's prospects. For example, if a particular shipping company is heavily dependent on shipping raw materials such as iron ore from Brazil to China and assuming that demand for iron ore from China declines due to a slowdown in China's steel sector, when can that shipping company reasonably expect China's demand for the raw materials from Brazil to pick up again?

Such an analysis may require a finetuned understanding and assessment of the dynamics of the Chinese economy. In addition, it may even require the parties to make projections and/or assumptions regarding global supply and demand trends for the commodity in issue as well as for the demand requirements of industries that depend on that commodity as an input.

On the legal front, the parties may confront a myriad of issues from the relatively simple to the very complex. Yet no debt restructuring of any complexity can be carried out without the involvement of lawyers, and such lawyers may be engaged separately on behalf of the debtor, its lenders, and other

parties to the restructuring. To the extent that the existing debt structure has an international component (e.g., debt instruments issued under US, UK or other foreign law), international lawyers are likely to be involved.

Furthermore, to the extent that the debt restructuring is likely to implicate issues of local law (e.g., how one executes on security in a local jurisdiction, what are the insolvency options in a local jurisdiction, etc.), the parties are likely to engage local counsel in the foreign jurisdiction in question. Although it is sometimes an afterthought for parties to a restructuring, the role of local counsel should not be overlooked as such counsel can play a crucial role in the restructuring process.

The legal issues in a debt restructuring are likely to surface at virtually every stage of the restructuring process. For example, at the outset of the process, the parties will want to evaluate the lenders' rights and remedies in the case of a borrower default, and this will require a thorough review by counsel of all of the relevant loan and security documents. Throughout the process, the parties will want to keep in mind the options and avenues that are available under the applicable insolvency law. As is often stated, out-of-court restructurings occur in the "shadow of the insolvency law." Depending on how the out-of-court restructuring process is

progressing, a range of insolvency law options and considerations, such as whether to put the debtor into an insolvency proceeding or how to gain approval for a restructuring plan, may or may not assume greater relevance as the process moves forward.

Furthermore, as the parties are negotiating a deal structure for any proposed restructuring, they will want to ensure that the deal structure is feasible and can be executed from a legal standpoint. For instance, among the many issues to be considered, is any debt-for-equity exchange that the parties are considering permissible under the laws of the relevant jurisdiction(s), and are any government approvals required for such an exchange? Do any proposed corporate governance reforms proposed for the borrower comport with securities law or other legal constraints in the relevant jurisdictions? Or will any bond exchanges that are contemplated as part of the restructuring require approval by securities regulators in any of the relevant jurisdictions? In short, there are likely to be many structuring issues that will require the careful analysis and input of legal counsel.

Moreover, the lawyers will also be responsible for drafting all of the relevant restructuring documentation, which, in many restructurings, can be quite voluminous. There will be the final deal documentation that

should reflect the terms of the agreed upon restructuring deal, and there is usually a full array of legal documents, some of which may be governed by foreign law and some of which may be governed by local law, that comprise the final restructuring package. But there may also be important preliminary agreements that need to be drafted, including confidentiality agreements, engagement letters for advisors, possible

standstill or forbearance agreements, and term sheets.

The final dimension of a restructuring that the parties should focus on is the strategic dimension, and this dimension should not be given short shrift by the parties since in many ways it can provide the unifying framework for the restructuring process. At its core, the strategic dimension involves consideration of whether the restructuring process being followed by the parties will, in fact, contribute to achieving a productive outcome or whether the process is likely to lead to undue delay or a failure to reach a mutually acceptable restructuring deal.

Among other key strategic issues, the parties need to consider matters such as the following: Is there a realistic but ambitious timeline in place to achieve key milestones in the restructuring process, such as completing due diligence, negotiating and agreeing upon a term sheet, producing initial drafts of restructuring documentation, and so forth? Are the parties engaged in constructive and good faith negotia-

tions, or are the negotiations merely a delaying action by one or more of the parties?

Other strategic issues to be considered include: Is there a process in place for resolving intercreditor disputes that may arise among and between different types of creditors (e.g., banks, bondholders, hedge funds, secured lenders versus unsecured lenders, operating company lenders versus holding company lenders, etc.) Will there be a creditor steering committee, and if so, who will be its members and how will it operate? If the borrower has a controlling shareholder such as is often the case in family-controlled companies, is that

controlling shareholder constructively engaged in the negotiations and the restructuring process generally?

In sum, debt restructurings are multifaceted, multidimensional exercises, and the parties to debt restructurings need to focus on all of the different dimensions—financial, business/economic, legal and strategic—if they intend to achieve a successful restructuring. As the shipping industry works through any financial distress resulting from the current global financial and economic environment, its stakeholders should recognize that, to the extent a debt restructuring becomes necessary, the debt restructuring process can be either a friend or foe depending on how the parties to the restructuring manage the process. Finally, the parties should also weigh the pros and cons of pursuing an out-of-court restructuring process versus pursuing a judicially supervised insolvency process.



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