Restructuring lessons learned from the last crisis

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Introduction

This article discusses the debt and equity restructurings that occurred during the last crisis, the global financial crisis of 2007-2008 ('GFC'), its impact on the Gulf Co-operation Council ('GCC') states, the strategies we employed during the same and lessons learned for the projected upcoming new round of restructurings that we anticipate because of the current global Covid-19 pandemic.

In the run-up to the GFC from 2003 to 2008, as legal counsel we witnessed the ease of liquidity in the GCC. It was a time when banks and creditors, both locally, regionally and internationally were providing facilities with little due diligence and very light documentation with respect to terms and conditions.

As a result of the ease of this liquidity during this time we also observed the establishment and development of many investment companies throughout the GCC. These entities, with little up-front capital, were able to draw upon the availability of significant funds from financial institutions to establish large operations composed primarily to invest directly in stock markets, closed companies/real estate and becoming creditors themselves as they lent facilities to smaller corporates and individuals. Unfortunately, many of the investments made by these investment companies were into long-term projects that did not offer quick exit strategies as the underlying shares were not listed on any exchanges nor had ready-made buyers looking to acquire their shares/assets. This illiquidity of the investment companies' assets was matched by the fact that the cash used to acquire the same came from relatively short-term loans made by creditors, which proved to be a disaster in the making.

Initial phase

During the initial phase of the GFC in the GCC, Al Tamimi & Co has had the opportunity to lead many debt restructurings of such investment companies primarily from the creditors' side. In many of these instances, our due diligence revealed the illiquid assets of the debtor versus the plethora of both short-term bilateral and syndicated debt from many creditors that was now due or due soon. In a number of instances, the creditors themselves were shocked at the number of debt facilities granted to the borrower from other local and international lenders. These initial creditors' meetings were generally used to classify the debt and assets and counsel the wayward creditor who wanted to "go legal" instead of restructuring the same as a group. As we did not even have established bankruptcy laws on the books during this era, the litigation front did not make sense especially given the time it takes to secure judgments in many local GCC courts and then eventually attach assets. Hence, we used this initial time to agree to standstill arrangements convincing the creditors to suspend any litigation in consideration for agreements (to be verified) by debtors not to dispose of any assets either to other preferred creditors nor to third parties.

Restructuring phase

In developing a restructuring plan, we had to take into account the goals of the individual creditors and, at the same time, to ensure that the debtor was invested in the process, a plan to keep the debtor company healthy and continuing as a going concern. We also had to weigh the different interests of the creditors themselves, which differed based upon: (i) secured v. unsecured; (ii) bilateral creditors v. syndicated; (iii) conventional v. Sharia complaint; (iv) local (usually local currency debt) v. foreign (usually dollar denominated debt); and (v) lenders v. bond/sukuk holders.

In terms of rolling up all the creditors into one group, we had to be creative in combining the same. First, we drafted loan documentation that had the effect of refinancing all of the bilaterals into three separate tranches of syndicated facilities as follows: (i) conventional local currency; (ii) Sharia compliant local currency; and (iii) US dollar conventional. This ensured that the lenders would act on a pari passu basis. Second, we would ensure (at least with Kuwait restructurings) that this debt was evidenced with a "Declaration of Debt". Under Arab civil law, a Declaration of Debt, if done properly, is essentially a judgment with a right to attach assets as it is a notarised instrument that allows the creditor to attach any assets immediately in the event that the itemised debt is not repaid on the specific date without the need for recourse to the courts. Third, with respect to most of the assets that the debtor companies were holding, the creditors needed to eliminate the debtor as the middle-man and find a way to hold or control them directly. While many of these assets were not liquid, at least they can be used as value until some time in the future where they could be properly dispensed and sold for cash at their highest value.

One of the main techniques used to hold these assets and ring-fence them from any future or non-restructuring creditors or liquidation situations was to ring-fence the same through an SPV. During the GFC, the DIFC and ADGM vehicles were not yet in vogue. And we generally could not use Caymans or BVI offshore entities to hold the same since many of these assets were GCC based and, hence, were required to be owned by a GCC entity. We turned to Bahrain and set up a number of vehicles in that jurisdiction, which were owned by one or more of the creditors in their capacity as security agents/de facto trustees. Depending on the strategy, these Bahraini shares could still remain for the beneficial ownership of either the debtor (to keep the assets technically on their balance sheet) or use the same as a debt for asset swap for the creditors as a group.

A second strategy existed where there were only a few creditors or one large creditor and that was a direct debt for asset swap, wherein the debt would be extinguished, in full or in part, for title transferring the asset (usually shares or real estate) to an individual creditor. Obviously, this was not acceptable where there where many creditors fighting over the same assets.

Finally, as a back-up strategy, we would simply mortgage the assets to a security agent appointed by the creditors and, through the use of an intercreditor agreement, which we developed and that complied with Arab Civil Law, we would be able to dispose of the assets properly throughout time on a fair and representative basis.

As a side note, we did have many instances whereby the true asset was the human capital that the investment company itself held and was used for service-based revenue such as assets under management services or providing advisory services. In these instances, we instituted debt for equity swaps. We normally had a two-step approach: firstly we decreased the capital and hence, the shares and their value to the current shareholder group; and immediately afterwards, we increased the capital solely for the purpose of allowing the creditors to subscribe to the same in consideration for a cancellation of their debt. In many instances, we had to meet with the regulators of the companies in their respective jurisdictions to explain the process. Thankfully, many of the companies' laws in the GCC that were enacted since the GFC now allow shareholders to subscribe for new shares directly for this debt to alleviate any regulatory issues.

One strategy that was used in the later phases in order to secure more valuable assets to swap with the debt was to offer a “hair-cut”, or reduction on the value of the debt that was swapped or remaining. We saw this development in the later stages of the restructuring era when creditors had grown frustrated for not having received any principal back on their debt for quite some time. This “restructuring of debt phase” from the GFC began in earnest in 2009 and lasted through to at least 2014 based upon the number of mandates we received during that time.

Post-restructuring phase

Upon the completion of the restructuring phase, new issues emerged. First, many of the regulated banks (especially conventional ones) in the GCC were not allowed to hold assets on their books indefinitely. Hence, for the banks that took assets directly in their names under debt for asset swaps, there was a big rush to co-ordinate with advisors to locate strategic purchasers, evaluate the assets properly and sell off in a timely manner. With respect to the assets that were ring-fenced into separate SPVs, it still required regular meetings with both creditors and the debtor to check on all plans to find buyers to be used to dispose of the assets in the shortest time period but which gave the highest yield. Finally, with respect to the debt for equity swaps whereby the creditors actually became majority owners of the distressed debtor, significant time was put into looking for the initial shareholders to either buy them out or look for outside buyers to turn their shares over to. It also forced the banks to “manage” these entities in the interim which, in many cases, for which they did not have sufficient time or specialised personnel to do.

Lessons learned from the GFC

There is an old saying which goes: “Generals always fight the last war.” The question is whether our legal knowledge gained from the last restructurings can be applied to the expected new round of restructurings that we expect from the global Covid-19 pandemic. First, we have to look at the differences between then and now. During the GFC in the absence of sophisticated bankruptcy laws, we were forced to implement private restructurings without the assistance of the courts. This meant that one outlier bank had the ability to disrupt the process by refusing to engage and potentially bring lawsuits which would defeat the entire restructuring. Now, while we would still generally prefer the private restructuring mode, if any creditors (or even the debtor itself) refuses to work in good faith on a restructuring plan, at least we have the threat of putting the company into bankruptcy to ensure everyone works together in good faith on a plan.

Secondly, the nature of the distressed debtors has changed. During the GFC, they were mainly investment and real estate companies that held shares/assets in other entities. Because of the nature of the pandemic, we see many “bricks & mortar” companies whether food and beverage, retail or related, in trouble. Other industries affected are those in travel, education, and lifestyle. Hence, the nature of the assets of the current distressed debtors may be more in the area of leases, franchise and licence agreements, know-how and inventory. It will be important more than ever to come up with a restructuring plan that keeps these debtors alive as going concerns as they may be light on “hard” assets. As a positive factor, the development of SPVs in the ADGM and DIFC with English law and Trust law will give us the best of both worlds by allowing GCC entities to hold assets in a manner that is pro-creditor and allows for ease of implementing proper restructuring plans.

Conclusion

In conclusion, we developed a number of legal strategies from the last great crisis that were implemented in the GCC and most likely for the first time. While these strategies existed in common law systems for generations, many of these structures were modified and evolved to fit into our Arab Civil Law systems. We now are on the precipice of a new round of restructurings given the current pandemic crisis that we find ourselves in here in the GCC. We will try to take what was learned from the past, but will need to balance the same against the differences emerging during this crisis.

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