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Six Restructuring Questions for LatAm Investors

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For the first time in five years, investors in Latin American debt are no longer in workout mode, worrying about how to protect themselves from the latest default or scratching their heads over some judicial decision that seems to impair their contractual rights or remedies. In 2008 and 2009, stories of one company after another experiencing financial stress dominated Latin America's headlines. As a result, investors in the region spent much of the last few years dealing with troubled corporate credits whose flaws were exposed by the global financial crisis. However, with the recent settlement of the Vitro litigation, the completion of various Argentine energy sector restructurings and the filing of electricity company Rede Energia's judicial reorganisation proceeding in Brazil, the latest wave of Latin American restructurings has largely come to a conclusion.

Aside from a few sector-specific trouble spots, such as Mexico's housing and telecom sectors, most of the region's distressed companies have been restructured and investors are once again looking to lend. According to a recent JP Morgan report, $94.5 billion of Latin American debt was issued in 2012, a 22% increase over 2011. The first few months of 2013 suggest an accelerated pace of activity, particularly in Mexico.

Notwithstanding the improved outlook, investors are now more keenly aware that credit metrics alone won't reveal how their investments will fare if and when their borrowers experience financial stress. The experiences of the past five years have provided a number of lessons as to what factors are most likely to influence the outcome of any future restructuring. What are these factors and how can investors better protect themselves at the outset? Here are six questions every investor should consider before lending money or acquiring debt in Latin America.

What has been the recent restructuring experience in the borrower's home country?

Following the 2008 financial crisis, many international creditors followed their respective debtors into courts in Mexico, Brazil or Argentina expecting that the relevant *concurso, recuperaçao or acuerdo preventivo extrajudicial* (APE) restructuring proceedings would be largely analogous to proceedings in jurisdictions with more experienced insolvency regimes. To some extent, creditors had reason to be optimistic. In the decade preceding the financial crisis, many Latin American countries had modernised their insolvency laws to incorporate some of the concepts found in these regimes. Bankruptcy codes in Latin America now contemplate reorganisations of ongoing concerns rather than merely the liquidation of failed businesses. In most Latin American jurisdictions, secured creditors are no longer able to disrupt the reorganisation process and creditors are required to approve, by a minimum percentage vote, a court-sanctioned reorganisation plan. Some Latin American jurisdictions have even introduced expedited procedures to speed up the reorganisation process through prepackaged proceedings.

In practice, however, the modernisation of the region's insolvency laws has proven to be a mixed success. In Mexico, the previous in-court restructuring process (*suspensión de pagos*) was susceptible to delays and allowed debtors to remain shielded from their creditors for extended periods. The best example of this was the decade-long restructuring of steel manufacturer AHMSA. In contrast, the newer *concurso mercantil* (the Mexican insolvency proceedings) has proven to be an effective tool to expeditiously (in some cases, in less than six months) implement a plan that has majority support. This was demonstrated by the successful proceedings of *Controladora Comercial Mexicana* (CCM), an operator of supermarkets, banking group *Grupo Metrofinancera* and mobile operator *Grupo Iusacell*, among others.

While the recent changes in Mexican insolvency law have undoubtedly improved the process, it is harder to make the same claims for similar changes in Brazil or Argentina. Many creditors have found the modernised version of Brazil's insolvency law to be almost as cumbersome and flawed as the system it replaced. In the recent *Doux Frangosul* case, for example, a debtor in default was able to lease its entire business on a long-term basis to a third party and deprive creditors of access to their collateral and the debtor's cash flow even though the debtor was insolvent at the time of the transaction. In addition to procedural impediments that frustrate participation in a restructuring process, Brazilian insolvency law permits certain types of creditors – such as parties to a foreign exchange advance contract (ACC) – to be excluded from the proceedings. As a result, the interests of other creditors are often held hostage to demands preferred creditors can make under threat of shutting down the debtor's operations. This has led many foreign creditors to conclude that they do not get a fair deal in a Brazilian restructuring process.

Similarly, in Argentina, a number of companies have sought to avail themselves of the APE proceeding to restructure their debt, only to get caught up in lengthy appeals and uncertainty about the law. As a result, despite the amendments to the bankruptcy laws to encourage in-court proceedings, many creditors in both jurisdictions have come to rely on out-of-court processes – such as exchange offers – for restructurings.

Who controls the borrower?

In trying to predict how a Latin American corporate debtor will react if it experiences financial stress, one of the most important factors is the controlling shareholder group. Unlike in the US, where equity is generally required to be wiped out before there is any impairment of debt, in most Latin American jurisdictions whoever controls the equity of a distressed debtor controls the restructuring process. In fact, in virtually all Latin American countries, a plan of reorganisation of the debtor cannot be approved unless the debtor – and therefore its controlling shareholders – has consented. This fact alone provides enormous leverage to equity holders given that creditors cannot, by themselves, impose a plan on a debtor. Accordingly, creditors are often left with the Hobson's choice of accepting a plan favourable to the equity or attempting to maximise their recovery in a liquidation, where the combination of delays in the process, loss of control, lack of transparency, substantial costs and preferences afforded to tax, labour and other priority creditors in a liquidation can decimate any potential recovery.

Because most Latin American jurisdictions provide equity with so much leverage, who controls the equity and how they choose to use their leverage is critical to the outcome of any restructuring process. In Mexico, creditors in some cases have experienced how the use – or threatened use – of intercompany claims (which allow the debtor's affiliates to vote in favour of a restructuring plan) can change the dynamics of a restructuring process. In Brazil, the recent *Rede Energia* and *Celpa* proceedings provide evidence of the extent to which equity that is out of the money can still control the restructuring process. In both of these cases, the controlling shareholder was able to hand-pick the buyer for the defaulted business and control the restructuring process, with the tacit or explicit support of the government.

Although generalisations only go so far, the more internationally-minded and sophisticated the shareholder group, the less likely they will be to take advantage of an uneven playing field. Similarly, companies that expect to return to the international capital and lending markets often recognise that the short-term benefits that may be gained by taking advantage of the asymmetries inherent in a country's insolvency laws are outweighed by the longer-term adverse reputational impact.

Does the borrower have subsidiaries, assets, revenue or other interests outside its home jurisdiction?

One of the critical factors to a successful restructuring is the nature and extent of the creditors' leverage against the debtor. There is perhaps no greater way for a creditor to exercise leverage than if it has the ability to force the debtor into a bankruptcy proceeding or litigation outside of its home jurisdiction, where the prospect for a more level playing field is greater.

Having this ability largely depends on the extent of the debtor's assets and operations outside its home jurisdiction – particularly in a creditor-friendly country such as the US – and the structuring decisions that are made with respect to these assets and operations.

In assessing its leverage in a restructuring situation, one threshold question for a creditor is whether it has the ability to institute a Chapter 11 proceeding against the debtor. If a foreign debtor has substantial US operations, there is a possibility, albeit remote, that a creditor could file an involuntary Chapter 11 proceeding against the debtor even if it is organised outside the US. Although the likelihood of success in that process will depend on a variety of factors, including the location of the debtor's business and the jurisdiction of the debtor's principal creditors, the threat of an involuntary Chapter 11 filing can be an effective leverage point against the debtor. Similarly, if the debtor has a subsidiary in the US that has guaranteed its debt, a creditor will generally be able to file a Chapter 11 proceeding against the US subsidiary. A creditor operating in a Chapter 11 context will be able to employ techniques traditionally used by creditors to pressure the parent company's equity holders into a meaningful dialogue because, unlike in most Latin American jurisdictions, the equity runs a real risk of being wiped out. The Chapter 11 process will also benefit from creditor protections that are absent in many Latin American jurisdictions, including a formal creditors' committee, avoidance actions, discovery and right to replace management.

Even in those cases where a Chapter 11 filing against the debtor or a subsidiary guarantor is not possible, if the debtor has US assets (such as fixed assets, receivables, trademarks, intellectual property, licences, or bank accounts), it may help level the playing field.

A number of recent Latin American restructurings have involved Latin American companies with a significant US presence. In these restructurings, the threatened or actual use of attachment, foreclosure and other civil remedies by creditors has been an important factor in bringing the debtor to the negotiating table.

It is worth noting that having access to US court processes (through a state or federal court action or a bankruptcy proceeding) with the ability to seek discovery, challenge past transactions and use US-style litigation tactics to disrupt a company's relationships with its customers, vendors and third party financial institutions can often change the dynamics of the restructuring process.

On the other hand, where all of a debtor's assets are located in the debtor's home jurisdiction, creditors often find that the debtor perceives itself to be in (and actually is in) a stronger position. Although certain of these US-style litigation techniques, such as attachment proceedings, may be available in local Latin American courts, they usually are not as effective in creating leverage over a defaulting debtor when used in those jurisdictions. Nonetheless, certain Latin American companies faced with these types of pressures have softened their position or taken action, sometimes by paying off a litigating creditor or filing for bankruptcy protection. Knowing when and how to exercise such leverage is often the difference between success and failure for a creditor looking to recover on its investment.

What type of debt instrument does the investor hold?

The type of debt instrument that a creditor holds largely dictates the path a particular creditor will need to travel in a future restructuring and the options it will have to recover on its investment. The best instrument to hold in the context of a restructuring is a note-like instrument, whether the instrument is governed by New York law, UK law or even the law of the jurisdiction of the debtor (such as a Mexican *pagaré* or a Chilean *titulo ejecutivo*). A note-like instrument generally permits the holder to obtain some form of pre-judgment attachment such as an expedited proceeding before a decision on the merits. Even if the attachment does not permit the creditor to seize and realize on the debtor's assets, it generally will prevent other parties from taking the assets and therefore serves to preserve the status quo.

If the creditor holds a bond or a syndicated loan governed by foreign law, the process will be more cumbersome. Any remedy will require cooperation of other holders – whether for purposes of acceleration or to take action against any collateral in enforcement proceedings. In addition, the remedy cannot generally be sought by the creditor individually, but rather through an indenture trustee or an administrative agent. Getting the trustee or the agent to act can be time-consuming and costly. Most trustees will not act unless their fees and expenses have been brought up to date, and reserves and indemnities have been established for future actions.

If the instrument is a derivative or similar sort of instrument, the process is much more complex and uncertain. In the recent derivative-related restructurings, debtors as well as other creditors raised questions regarding the validity of the derivative instruments. Allegations were made challenging the validity of the derivative contracts (likening them to gambling contracts) and as to whether the debtors had the proper authority to enter into the contracts. The resulting uncertainty under applicable insolvency laws as to the treatment of derivatives, the ability of counterparties to terminate them and net recoveries against collateral they may have held was a significant driver in the negotiations between many debtors and derivative counterparties, and substantially affected the timing and substance of many of the restructurings.

Who are the borrower's other creditors?

Knowing who your fellow creditors will be at the time of a restructuring is an important data point in assessing how difficult (or even achievable) a restructuring process may be if a debtor experiences financial stress. Investors should be aware of the risks associated with complicated capital structures. Companies with operating and holding company lenders, secured and unsecured debt, senior and junior debt, and/or large derivative exposure will have a more difficult time restructuring than companies where creditors share a commonality of interests. The more varied the funding sources and types of instruments, the more challenging the restructuring is likely to be.

Even among similarly situated creditors, differences in approach or need will often affect the timing and outcome of a restructuring. Local creditors often insist on preferential treatment even where local insolvency laws prohibit it. Bank and bond creditors frequently disagree on the type of recovery to be sought, with banks seeking to maintain the nominal value of their debt and bondholders willing to accept haircuts because they are focused on the net present value and liquidity of their post-restructuring claims. Relationship lenders may be willing to accommodate a debtor's desire to retain operational flexibility post-restructuring whereas workout specialists at financial institutions will be less inclined to do so. Bridging these differences and resolving inter-creditor issues alone can take months (and even years), even in situations where a debtor is actually trying to move the process forward.

Further, the type of claim other creditors own can make a significant difference to the restructuring process. In Brazil, tax, lease and chattel mortgage claims are excluded from the judicial reorganisation processes. These claims often form a significant portion of the claims against a debtor, making it very challenging to achieve a successful restructuring. In addition, because creditors holding certain of these claims are not subject to the automatic stay of the court, they can proceed individually against the borrower, giving them enormous leverage.

In Mexico, secured claims do not participate in the restructuring process unless they agree to be treated like unsecured debt. As a result, unsecured creditors are often more influential in the negotiation of a restructuring plan. In addition, in Mexico, the preference given to labour claims has played a significant role in prominent restructurings, including that of the airline Mexicana. The failure of many Latin American insolvency regimes to deal adequately with labour, tax and other trade or contract claims is one reason why insolvency proceedings in the region are rarely used to effect operational restructurings.

Is the government likely to play a role if the debtor gets into financial difficulty?

Investors in Latin American companies generally appreciate the important role that government can play in the success of a company. They are not, however, always as mindful of the critical influence governments can have on a company when it experiences financial stress. In many Latin American companies, government can be and often is a critical stakeholder as a creditor, lender, regulator, customer or shareholder (and sometimes it wears multiple hats). Latin American investors would be well-served to give some thought to what role government may play if a company gets into trouble – and how the government has behaved in the past.

In Brazil, BNDES has played a constructive role in aiding companies that are experiencing balance sheet or liquidity issues, in some cases even equitising a portion of their exposure. However, in a number of recent cases in Mexico, the experience has been different. Government creditors, such as the Mexican Social Security Institute (*Instituto Mexicano de Seguridad Social*), have refused to haircut their claims alongside other creditors, citing laws that prohibit public servants from 'wasting' public property. Likewise, creditors of Argentine companies such as pipeline operator TGN, in which the government pension fund holds significant debt or equity stakes, have found themselves at the mercy of political concerns. In other cases, the government can have conflicting roles. Some creditors believe the liquidation of mortgage company Hipotecaria Su Casita in Mexico was prompted by the conflicting objectives of the government as regulator and as lender to the industry, which resulted in the company not having access to critical funding after it completed its first restructuring.

Similarly, the strategic importance of the debtor can play an important role in fostering or frustrating a restructuring. In the case of Gruma, the political importance of a company responsible for a substantial portion of one of the most important staple goods (tortillas) likely moved the Mexican government to push parties to work out their differences. In some cases, the importance of the debtor is as much financial as it is strategic. For example, the size and importance of Cemex to the Mexican market was such that the government could not allow its financial situation to deteriorate in 2009 into an uncontrolled bankruptcy process. Therefore, the government played a peripheral but important role in making sure that Cemex's primary bank lenders understood what was at stake.

On the other hand, investors have seen other examples where, despite the strategic importance of a company, the government decided to take a hands-off approach. Although the government's cost/benefit calculation may be difficult to predict, it is worth considering whether and how a government is likely to get involved if the debtor gets into financial trouble.

No credit market is immune to the occasional default, and in general Latin American corporate default rates are comparable to those in developed markets. However, once a Latin American company has defaulted on its debt, the experience for the creditor and the factors that will drive its recovery are very different from what an investor might be accustomed to in the US or elsewhere. Considering the questions posed above will not protect an investor from the risk of default, but will enable an investor to: (i) anticipate how a future restructuring may play out; (ii) better assess the risk/reward of the investment; and (iii) push for structural enhancements of the credit to allow the investor to better position itself in the event of a future restructuring.