Corporate Restructuring Including Legal Aspects

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1: The Role of the Loan Workout Team

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Objectives of a Loan Workout Function

3 Key Objectives:

- To manage and mitigate impairment provisioning requirements

- To reduce and manage risk on a case and portfolio basis

- To achieve reductions in the level of high risk and impaired asset portfolios

This was traditionally a bank driven process for its own commercial benefit, but has now become of increasing importance following the Financial Crisis and given the importance of Basel II / III regulations in terms of monitoring potential defaults, as well as other regulatory guidance and implementation of IFSR 9.

High Risk / NPL Processes

High Risk / NPL Case Identification

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Reported as High Risk / NPL

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Internal / External Assessment

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Develop Strategy

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Strategy Implementation

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Monitoring

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Restructured, Repaid, Recovered

Options Available for High Risk / NPL Loans

- The best way to avoid a loss is to devise an effective workout strategy.

- By involving the Bank's Workout team at an early stage, the Relationship team can get full support to determine the best way forward.

- The best results are generally achieved by working consensually with all parties in distressed situations.

- Regulators and supervisors therefore need to check and test that this process if working effectively on a regular basis.

Options Available for High Risk / NPL Loans

- Nevertheless, Bank workout teams will sometimes have to operate in a non-consensual way. They have a number of tools at their disposal in these circumstances, including:

- **Legal/Restructuring Reviews:** Identification of legal and structural issues within the borrower, which might have a bearing on the workout strategy.

- **Independent Business Reviews**: generally undertaken by a firm of accountants and aimed at the key areas of concern in the business.

- **Operational Reviews**: People with specific industrial and commercial expertise who can review operational issues.

Options Available for High Risk / NPL Loans

- **New Management:** Identifying potential new management to go in and work on troubled situations.

- **Receivership:** Receivership is used as a tool to effect change in a number of situations where for example, the relationship with parties have deteriorated to the point where they are acting against the bank's best interests.

- **Other Banks' Workout Areas:** The workout function usually has extensive knowledge of other Banks' workout teams, which can prove invaluable in certain situations. Would also have relationships with secondary markets desk to help sell the debt down if required.

Identifying a High Risk Case

- The bank will have a number of triggers that would result in a loan being classified as high risk or non-performing.

- Often, if the internal or external credit rating falls below a certain level, the loan would be immediately placed on a watchlist and / or moved into the workout team area.

- Some additional criteria include:
  - Low, nil or negative EBIT cover or where trading is appreciably behind budget

Identifying a High Risk Case

- Material increase in Debt:EBITDA ratio – both of these have a clear impact on the ability of the company to service its debt;
- Any suspicion of the integrity of management or financial information
- Regularly exceeding limits – shows poor financial management or that current facilities are no longer sufficient
- Significant discounted asset cover shortfall (DACS) - indication that the bank's security position is at risk/being eroded
- Where knowledge of the market / regulatory environment provides grounds to doubt the future viability
- Where formal insolvency is threatened / imminent - sometimes its out of the bank's hands, other stakeholders e.g. creditors and directors may take insolvency action that would impact on the recoverability of the bank's assets.

Identifying a High Risk Case

Data Sources

- Relationship Managers - critical to get the workout team involved at an early stage – the earlier, the more options available and therefore the greater likelihood of avoiding a write-off.

- Overdraft or Limits exceeded

- Days Past Due Reporting

- Sector analysis

- Others (e.g. economic forecasts; bulletins from consultants; new reports etc.)

Typical Internal Documents on Transfer to Workout Team

Causality Report

- It is accepted that banks operate in a "risk" environment and that not every credit decision will be correct. The purpose of causality reviews is to try to identify ways of improving the credit process so that front line staff and credit officers learn from mistakes if they occur and ensure that they do not recur, thereby minimising avoidable losses.

- This type of report should contain details on the connection, business, debt, risk measures, history and causality – why we are where we are.

Typical Internal Documents on Transfer to Workout Team

High Risk / NPL Report

- This should be completed for each new connection and should include:
    - Security schedule.
    - Asset Cover Calculation (discounted basis).
    - Narrative (strategy formulation and progress).
    - Updated reports should then be completed on a regular basis (e.g. quarterly) going forward.

Restructure Review Template

- This is completed by the Relationship Team. The document provides details of the group structure and secured position and is forwarded to a designated legal firm for the purpose of conducting a security review.

Documents Prepared by the High Risk / NPL Team

- Status Change Form
- Impairment Checklist / Financial Model (provisioning). Previously would have been the IAS 39 template, going forward it will be the IFRS 9 model.
- LGD Template

Assessment - Internal

- Corporate Structure
- Financial (essentially viability, value of business)
- Security / Ranking
- Sector / Market
- Operational
- Management Capability

Assessment - External Investigation

1. Independent Business Review (instructed by High Risk / NPL Team)

- Financial and or Operational - generally undertaken by a firm of accountants and aimed at key areas of concern

2. Legal

- Restructuring Review - Identification of legal and structural issues with the borrower that may have a bearing on strategy. Undertaken by panel law firm.

- Pre-receivership Check

What is an Independent Business Review

- An effective business review provides an informed, objective assessment of a company's existing commercial and financial position.

- It stress tests management's business plans against real commercial, operational, and financial challenges, and evaluates the risks of meeting forecasts and potential upsides.

- Key focus areas include:
  - market prospects
  - customer and product profitability
  - working capital
  - funding structures
  - management skills
  - processes

- The goal is to establish a realistic set of "post-vulnerability" numbers that stakeholders can use to assess future profits and cash flows, from which to develop strategic options and financing options with confidence.

Develop Strategy

Options

1. Status Quo
2. Solvent Restructure
3. Sale of Business
4. Insolvent Restructure
5. Break-up
6. Re-bank
7. Wind-down / managed exit
8. Secondary Trading

Develop Strategy

Considerations

- Corporate Structure
- Capital Structure / Risk & Reward
- Tax / Accounting
- Pension Deficit

Scenario and Outcome Analysis

Strategy Implementation

- Planning

- Approval

  - *Credit Process*

- Negotiation

- Completion

- Provisioning / Write off

  - *Impairment*

Monitoring

- Ongoing High Risk / NPL Reporting

    - via monthly tracker and / or credit submissions

- Quarterly Reports

- Financial information and review

- Customer Meetings

Key Issues for Supervisors to Check

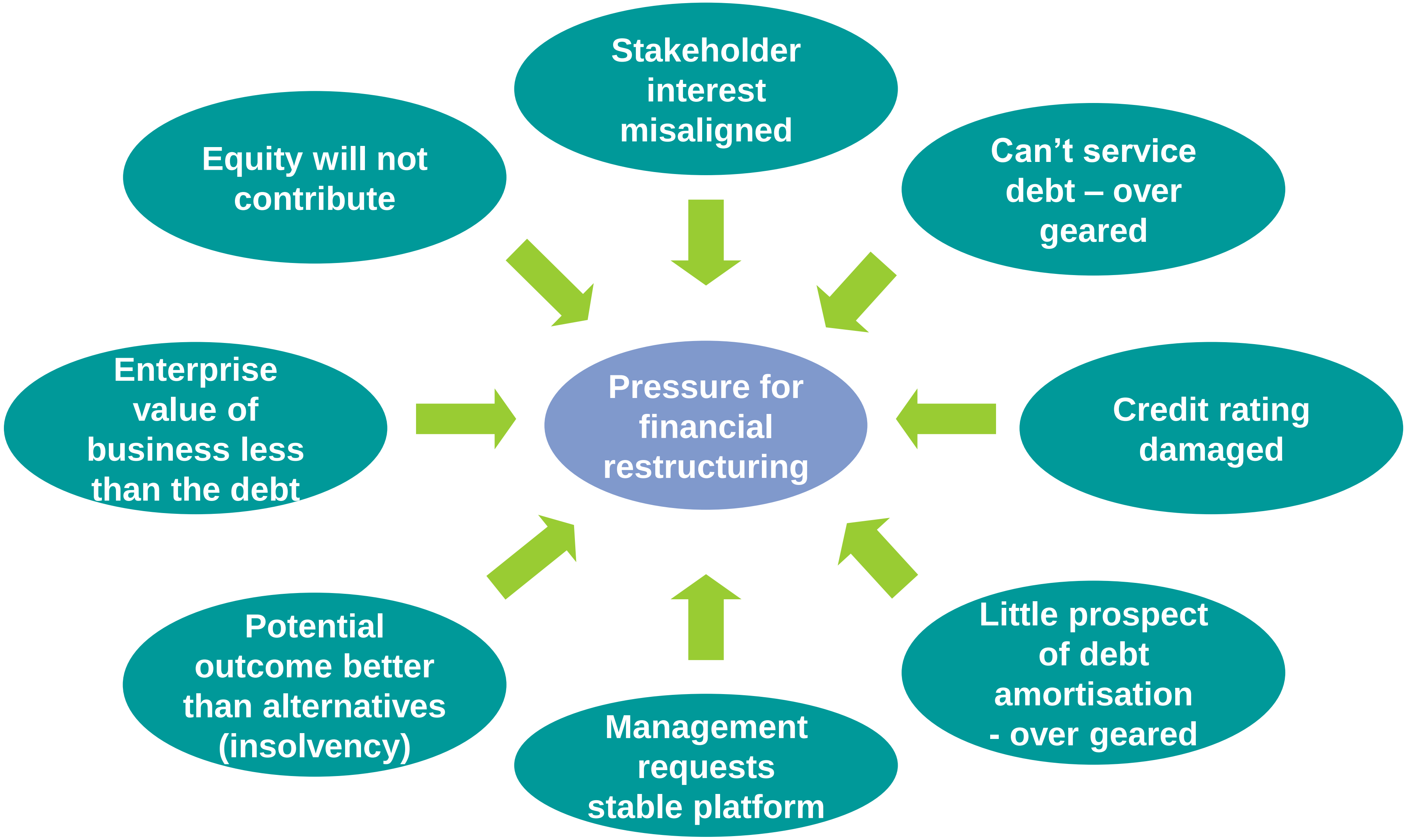
- Early consultation with the NPL / High Risk team. This is key to ensuring that options are maximised and therefore risk minimised.

- Supervisors should be able to evidence a collaborative and supportive approach between the front line and loan workout teams.

- Forbearance and evergreening.

2: Debt for Equity Swaps

1. OVERVIEW: When is a debt for equity swap necessary?



2. PLANNING: Areas to Consider

- **Business**
  - Operating companies
  - Key operational assets
  - Material liabilities
  - Key contracts
- **Debt capacity**
  - Current debt structure
  - Business plan
  - Audit sign-off
  - ‘Stressed’ vs ‘restructured’ profile
  - Performing vs non-performing

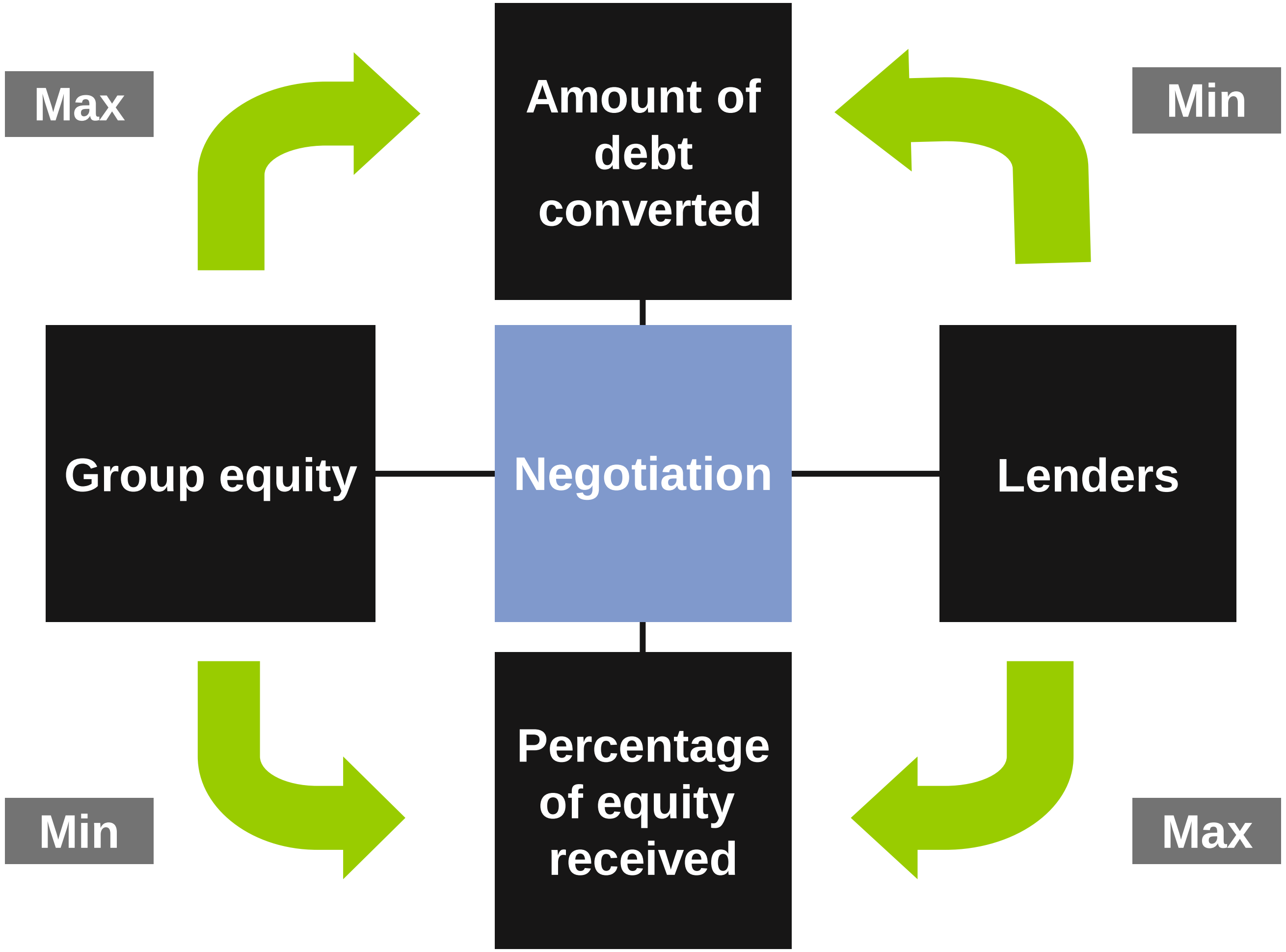
3. STAKEHOLDERS

Shareholders (Public / Private)	Banks & High Yield	Lease & Asset Finance Creditors
Private Equity	Bond Providers (Sureties)	Debt Traders/ Distressed Investors
Credit Insurers	Pension Funds & TPR	Trade Creditors

4. DEAL STRUCTURE: Objectives of Exercise

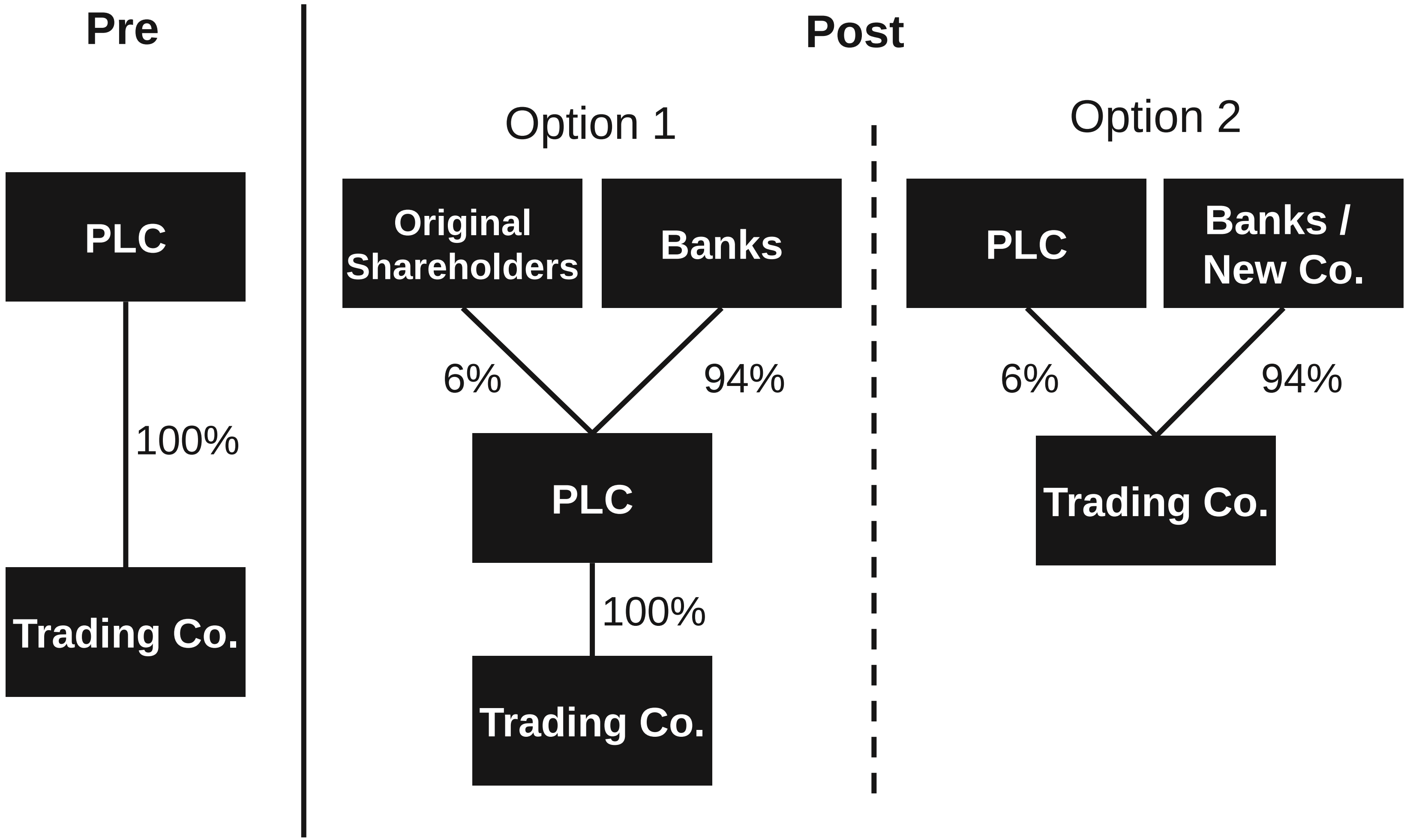
- Requires credible operational plan
- Commercial structure
- Restores confidence
- Restores balance sheet solvency
- Reduces debt to realistic levels
- Recognises value of stakeholders' legal / commercial positions
- Have regard to taxation implications
- Recognise need for management motivation
- Provide / agree a workable exit

4. DEAL STRUCTURE: Amount Converted



4. DEAL STRUCTURE: Structuring

Debt to equity swap can be done at different levels:



4. DEAL STRUCTURE

Issues to consider:

- In the absence of a new money investor, lenders should look to retain virtually all of the economic benefit.
- Need to make it clear to equity holders and other banks that failure to support will lead to insolvency; hence minimal shareholding better than nothing .
- Existing equity being squeezed more with extra stakeholders.
- Consolidation voting / control / management issues.

4. DEAL STRUCTURE: Share Rights

- When determining the Bank's voting rights, balance the desire for control against:
  - Tax consequences
  - Greater disclosure and approval requirements if the company is listed
  - Consolidation or equity accounting requirements

4. DEAL STRUCTURE: Consolidation

Issues to consider:

SUBSIDIARY	JOINT VENTURE
ASSOCIATE	OTHER

4. DEAL STRUCTURE: Control vs. Minority Participation

Issues to consider:

Control	Economic interest
Consolidation	Public perception

4. DEAL STRUCTURE: Managing the Exit

- **Drag Along Rights**
  - Include in the company's articles if the Bank is the majority shareholder
  - Enables the Bank to deliver 100% of the company to a purchaser

- **Tag Along Rights**
  - Minority shareholders likely to request
  - Give the minority shareholders the option to require the Bank to include their minority shareholding in the sale on the same terms as the Bank receives

- **Lock-in**
  - Relevant if quoted vehicle
  - Concert party issues (suspicion that parties who separately invest in a company but have the concealed intention of using their holdings as a single block

5. PROCESS: Timetable

Prior

Planning and liaison re: Takeover Code and/or listing rule issues

Day -14

Liaise with Stock Exchange to clear listing particulars

Day 0

Circular documents posted

Day 21

EGM

Day 22

Trading in shares commences

All Companies

Quoted Companies

PLCs

6. MANAGEMENT/GOVERNANCE: Board Representation

Issues to consider:

- Bank employee on Board
- Right to appoint Board member(s)
- Observer rights
- Lender vs Equity conflicts

CONCLUSIONS

- There must be a credible business plan and hence a business worth saving. Establish through business review process.
- Generally deal should be once and for all.
- Detailed planning is vital.
- Control / disclosure issues are important considerations.
- A credible plan B must be worked up.
- Potentially expensive process, allow for the costs as part of the funding package.
- Minimal equity should be left on the table for existing shareholders.
- Further complications exist if it is a public/listed company.

3: Legal Aspects – Security Issues

What is Security, and why is it Important?

- Creditor's right for a particular debt to be repaid from the proceeds of sale or income generated by a specific asset.

- Gives priority of payment before other creditors.

- Gives control – ability to replace management, influence of running a business.

- Gives leverage against borrower and other creditors.

What Security Have You Got?

- **Who has provided security?**
  - Are these the most valuable companies in the group?
  - Where is the business generated
  - Has the position changed from when the security was taken (new operations commenced?)

- **What liabilities are secured?**
  - Specific debts? All monies? Are future liabilities e.g. facility increase, covered?
  - Where there are cross guarantees – check guarantee obligations are secured
  - Third party security

What Security Have You Got?

What assets are covered by the security?

- Real property;
- Shares – ability to replace management, enforce at holding company rather than opco level;
- Intellectual property rights;
- Contracts (NB termination rights);
- Book debts;
- Other income streams (e.g. rentals);
- Floating charge over all or substantially all of the assets – impact of carve outs

What Security Have You Got?

Perfection

- Was it done originally?
- What further steps can be taken now?
  - Registration
  - Notices to debtors, banks and contractual counterparties
  - Counterparties to act on instruction of bank once event of default has occurred
  - Share security – if full title to shares is to be taken, update share register; take possession of share certificate

What Security Have You Got?

- **How can security be enforced?**
  - Is there a power to appoint a receiver?
  - Is there a power of sale?

- **When can the security be enforced?**
  - On event of default; following acceleration; upon service of notice? Documentation should be reviewed.

- **Overseas Security?**
  - Types of asset over which security can be taken
  - Public auction vs. private sale – issues of timing and control
  - Costs of enforcement
  - Legal risks / absence of precedent

Fixed vs. Floating Security

- **What is a fixed security?**
    - A charge in relation to a specifically identified property that applies immediately to **that** property or as soon as the charger acquires it.

- **What is a floating security?**
    - A charge over a fluctuating class of assets where the charger has freedom to deal with the assets in the ordinary cause of business until the charge takes some steps to intervene.

Fixed vs. Floating Security

Why does the distinction matter?

- A floating charge ranks after statutorily preferred claims (e.g. employee claims) and expenses of the administration and liquidation.
- An administrator can dispose of property subject to a floating charge without the chargee's consent.
- Floating charges are subject to separate avoidance provisions.
- Creating an effective fixed charge:
  - Effective control test
  - Practical issues – viability for a trading business of fixed charges over stock; current account with the bank etc.
  - Book debts

Enforcement of Security

- **Creditor's rights on enforcement**
  - Take (if not already held) or retain possession of asset
  - Receive income generated by asset; power to appoint a receiver
  - Power of sale

- **Liabilities of mortgagee in possession**

- **Enforcement options**
  - Administrative receiver
  - Fixed charge receiver
  - Administrator

Enforcement of Security

- **Administrative receiver?**
  - Is there power to appoint? Security over all or substantially all of the assets.

- **Fixed Charge Receiver**
  - Appoint over specific asset or where security does not cover all or substantially all assets of chargor.

- **Administrator**
  - Must fulfil statutory purpose:
    - Rescuing company (rather than the business) as a going concern.
    - achieving a better result for the company's creditors as a whole than would be likely if the company were wound up.
    - realising property to make a distribution to one or or more secured or preferential creditors.
  - Need a qualifying floating charge to make appointment out of court.

Enforcement of Security

- **Mechanics**
  - **Receiver:** (usually) makes demand; invitation by debtor; secured creditor appoints receiver by deed; indemnity.
  - **Administrator:** (usually) makes demand; can appoint under out of court route but must swear statutory declaration that security is enforceable; indemnity (?)
  - Role of Security Trustee:
    - Act on instructions of Instructing Group
    - Rights to indemnity (particularly in hostile situations)
  - Share security
  - Overseas security and moratorium on enforcement

- **Practical points**
  - Contingency planning and enforcement strategy
  - Due diligence

Priority of Security

- Ranking of different security interests over same asset: contractual priority or first in time

- Ranking of proceeds of realisation of secured assets in insolvency:
  - Fixed Charge asset realisations
    - Costs of insolvency practitioner in preserving and realising asset
    - Fixed chargeholder
    - Unsecured creditors

  - Floating charge asset realisations:
    - Expenses of the administration / receivership
    - Expenses of the liquidation – if incurred
    - Preferential creditors
    - Floating chargeholder
    - Unsecured creditors

Avoidance of Antecedent Transactions

- Specific types of transaction that were made prior to a company's insolvency. They may be reversible by a liquidator or administrator if the company was insolvent at the time they were made, or caused the company to become insolvent at a later date.

- Validity of Security
  - Is security valid for enforcement purposes

- Voidable transactions
  - Transactions at undervalue
  - Preferences:
    - Put an existing creditor in a better place than it would be on insolvent liquidation
    - Desire to prefer has to be demonstrated

- Invalid floating charges

Security in a Restructuring Context

- **What impact do revisions to credit documents have on existing security?**
  - Does existing security secure amended obligations?
  - New security and hardening periods.

- **Security enforcement as a restructuring tool**
  - Enforcement sale of operating subsidiaries.
  - Release of guarantees and security under intercreditor documentation.

Q & A

Thank you

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