Don't assume

There will be hundreds of debt workouts in emerging markets in the next year. The former general counsel of an emerging markets fund explains how to mitigate the problems for lenders

For a brief period, it looked as though some emerging market governments might follow their wealthier G7 colleagues and bail out strategic corporate and bank borrowers burdened with high levels of foreign currency debt. The better-heeled countries like Russia started to use their reserves for this purpose. The less well-to-do looked to the newly-recapitalised IMF to keep private sector borrowers, or at least the more important ones, afloat.

That era is ending fast. Even Russia's large reserves (which approached $600 billion last summer) have proven insufficient for the dual challenges of defending the ruble and bailing the private sector out of its maturing foreign currency debts. This means that we are likely to see hundreds of individual debt workouts by emerging market corporate and banking sector borrowers over the next 12 months. Eastern Europe, Russia and parts of Asia will be affected.

The last time the financial system faced a widespread emerging markets debt crisis was during the Asian and Russian crises of the late nineties. During the intervening 10 years, many of the individuals that handled these workouts have left the market and collective memories have faded. Hard lessons in how to conduct these workouts, painfully learned a decade ago, may have to be learned again. Here are the more important lessons we learned.

Don't assume good corporate governance

It took a long time for the managers of some emerging market companies to realise that they stood to make more money through the appreciation of their company's stock (assuming the company is perceived as well managed) than by pilfering money from their minority investors or defaulting on their debt. Once this sunk in, many purported to embrace principles of good corporate governance.

Don't assume that the dedication to these principles will in every case survive a sharp downturn, particularly when there is little prospect of the markets reopening to some of these companies soon. Once a workout becomes inevitable, the temptation to return to more primitive forms of self-dealing will be strong.

Protective measures: The main risks here are asset stripping by insiders, transfer pricing abuses and similar measures designed to leach value out of the enterprise during the workout period. After all, the insiders may reason, the workout may not succeed and what's left of the company may wind up in bankruptcy. Protection for the foreign lenders may be sought in the appointment of shadow auditors, contractual restrictions on the disposition of assets and related party transactions, and sometimes securing the right to participate in, or review the minutes of, meetings of the board of directors.

Don't assume the agent will protect you

If foreign lenders have taken interests in syndicated loans or similar credit facilities, there will be a tendency to believe, or want to believe, that the syndicate agents will aggressively protect the interests of the syndicate. They may not.

Once a syndicate agent has sold down most or all of its economic interest in a credit, it will lose any commercial incentive to take a stern and unpopular position with the borrower. And because such sell-downs today are often effected through a sale of derivatives (such as total return swaps), other investors may never know the true extent of the agent's remaining exposure.

The contracts governing these facilities are unlikely to be of much comfort to the syndicate. Ever since the late seventies, there has been a remorseless expansion of exculpatory provisions for agents in syndicated credit facilities. The black letter will typically restrict the agent's responsibilities to those expressly ascribed in the agreement, and these will be mostly administrative. Implicit duties, and fiduciary responsibilities of the agent to look after the interests of its flock when things turn stormy, will be lavishly disavowed.

Finally, some of these agents will have large franchises in the debtor country. They may not be eager to place those local franchises in jeopardy by taking aggressive actions against local enterprises, particularly those that are well connected with the government.

Protective measures: Although agents benefit from exculpatory language in the credit agreements (and these provisions are normally enforceable), they still worry about their relationship to syndicate members. Part of this concern is legal liability; the rest is reputational. A syndicate member can often nudge an agent with a sentence like "we bought into this credit, and we stayed in this credit, in reliance on your professionalism and reputation." This may not turn the agent into a sword-wielding paladin, but it should forestall a drift toward pathological passivity.

Don't assume security provisions will go unchallenged

Many of the credit facilities arranged in the last 10 years in emerging market countries benefited from collateral security arrangements, often a pledge by the borrower of receivables or shares in affiliated companies. These are frequently governed by English or New York law and in some cases the pledged assets will be lodged with a trustee outside of the debtor's country. All that legal ingenuity could do to make these security features binding and enforceable will have been done. But ingenuity doesn't mean that these arrangements will not be challenged in a firefight with the borrower.

Here is a sobering example. Last fall, foreign lenders announced that they intended to foreclose on collateral securing a $2 billion credit facility to a Russian borrower controlled by a powerful business tycoon. Within days, a Russian court in the Siberian town of Omsk issued an injunction purporting to stop it. Twenty-four hours later the Russian Government bailed out the company but, for that one day, the mask slipped and the old combat tactics re-emerged.

Protective measures: If the collateral is lodged in the debtor country and subject to the jurisdiction of local courts, there may not be much lenders can do apart from launching a rule-of-law public relations campaign. Where the collateral is outside the country, it may be helpful to place it in the hands of a trustee that does not have a local operation against which retribution could be visited.

It may also be possible to seek from a court in the trustee's jurisdiction an order confirming the propriety of the trustee's foreclosure against collateral. But be warned – corporate trustees, as a species, often fall under the broader genus invertebrate. They are likely to seek an indemnity from the lenders to cover any loss or liability resulting from their defiance of a court injunction, even one from a Siberian court.

Don't assume all creditors are created equal

A borrower is likely to have both local creditors and foreign creditors. Foreign lenders enjoy the leverage that comes with a borrower's desire to maintain its reputation in the international capital markets. Local lenders benefit from a more intimate leverage. They will be around long after the foreign creditors have departed, and the borrower knows it. Local lenders may have close personal connections with management and other business relationships, such as local currency lines of credit. In a word, they are neighbours. When liquidity runs short, therefore, the borrower may experience a perfectly human temptation to prefer its local creditors over Johnny-come-lately foreigners.

Protective measures: Once a default on a foreign loan occurs, the lenders should condition their forbearance in taking hostile actions (such as accelerating the loan or foreclosing on collateral) on the borrower's commitment to refrain from paying its other creditors (other than suppliers and trade creditors necessary to support day-to-day operations) until an agreed restructuring programme is in place. Indeed, as a general proposition, forbearance may be the most valuable bargaining chip the foreign lenders have at this stage; they should use it sparingly but effectively.

Don't assume the efficacy of contractual remedies

Most of these credit facilities contain provisions choosing foreign law and submitting to foreign court jurisdiction or arbitration outside of the debtor's country. In a hostile confrontation with foreign lenders, however, some borrowers may seek succor from their local judiciaries in the form of declarations purporting to invalidate these foreign enforcement provisions or otherwise blocking the foreign lenders' attempt to exercise their contractual remedies. (See, for example, Indonesia declares bonds invalid, IFLR January 2007, page 19.)

The pending litigation between the Norwegian company, Telenor, and the Russian Alfa Group is a good example. The two sides fell out over a shareholders agreement to which they were both parties. Telenor commenced (and won) an arbitration in New York. A mysterious third party (alleged to be affiliated with the Alfa interests) then sought and obtained a declaration from a Siberian court purporting to invalidate the shareholders agreement in general and its arbitration clause in particular. Within hours of Telenor obtaining an order from a New York court imposing contempt sanctions on the Alfa side, the Siberian court handed down an award of $2.8 billion in damages against Telenor, later reduced to $1.7 billion.

(For those readers who may be wondering, the author is unaware of any feature of Siberian jurisprudence that would render its courts a superior venue for challenging contracts between foreign investors and Russian counterparties. Yet the path to Siberia is well-trodden; this is where Russian oligarchs commenced their lawsuits against minority foreign shareholders during the nineties).

Protective measures: As the Telenor case illustrates, there may be little a foreign investor can do once a dispute takes on the character of judicial battling banjos. Extracting contractual promises from the counterparty that it will foreswear any remedies other than those expressly chosen in the agreement will not help, and may even hurt, when the time comes.

For example, Telenor has obtained from a New York court an order imposing contempt sanctions against its adversaries ($100,000 a day for the first 30 days, doubling to $200,000 for the next 30 days, $400,000 for the next 30, and so on until the contempt is cured) that will, a few years from now, result in the Alfa Group owing a sum equal to every US dollar in circulation. So the contempt route may also be unavailing. The final appeals here are to public relations campaigns and diplomatic pressure similar to those now being pursued by the holders of defaulted Argentine bonds.

Don't assume you can vote

Syndicated credit facilities typically enfranchise only the direct participants in the credit — the syndicate members themselves. Holders of beneficial interests in the facility acquire their interests from the direct participants, but only rarely will the documents evidencing their derivative interests give the beneficial owners the right to instruct how the direct participant should vote on important issues such as the declaration of an event of default, the acceleration of the loan or the subsequent workout strategy. Even sophisticated investors often assume (incorrectly) that because they are exposed to the economic risk of a distressed credit, they will naturally have a voice and a vote in how it is managed in a workout.

Protective measures: The best time to think about these issues is when the derivative instruments are being negotiated with the direct participants. In sub-participation agreements and total return swaps, for example, the beneficial owner can sometimes negotiate the right to transform the agreement into a direct assignment of a ratable portion of the credit, should an event of default occur or be in the offing. As an assignee, the owner will be entitled to a seat and a vote at the syndicate table during the workout process. Even if the documents lack such a provision, the direct participant can sometimes be persuaded to transform the arrangement into an assignment before it is contractually bound to do so.

Don't assume bankruptcy is an option

As a consequence of incessant hectoring by institutions such as the IMF and the World Bank, many emerging market countries have revised their bankruptcy laws over the last 20 years to the point that, on paper at least, they incorporate the basic principles of a modern corporate bankruptcy regime: clear distribution priorities, the ability to file claims, supermajority creditor control of the process, no discrimination against foreign creditors and so forth.

But the administration of these new laws in many countries is largely untested. The quality of the law is one thing; the competence and honesty of the local judges is quite another. Moreover, no one can predict what might happen if a sudden credit crisis rendered large segments of the country's corporate sector insolvent overnight.

A functioning, predictable bankruptcy regime plays a much wider role in debtor and creditor relations than is apparent on the surface. Each side's estimate of how things may play out in a formal bankruptcy sets an invisible boundary for that side's position in negotiating an out-of-court debt rearrangement. If the demands being made either by the debtor or the creditor in those negotiations exceed in severity the treatment the other side can expect in a formal bankruptcy, the negotiations will fail. This tends to moderate negotiating demands and thus encourage out-of-court workouts.

Take away any realistic prospect of an orderly bankruptcy, however, and the foreign lender's options quickly boil down to two: pursue legal remedies against the borrower (usually in a foreign court or arbitral tribunal) or accept the restructuring terms that the borrower may offer in a negotiated settlement. The crucial leverage that comes with the threat of forcing the debtor into bankruptcy will be lacking.

Protective measures: Before making any investment in an emerging market country, local counsel should be asked for a candid opinion about whether, in the event of non-payment, partial recovery of the debt in bankruptcy is a realistic option. If the answer is no, the lender should look to other features of the deal (such as taking enforceable collateral security) to replace the negotiating leverage that the looming prospect of bankruptcy ordinarily conveys.

By Elena Daly, the former general counsel of an major emerging markets fund and now in private practice in New York City