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Restructuring in Europe

James Sprayregen, Kirkland & Ellis

Kirkland & Ellis is bullish on restructuring in Europe

James H. M. Sprayregen flew in to London from Kirkland & Ellis LLP's Chicago head office last month to give an American perspective on European restructuring developments to an audience of top insolvency practitioners and turnaround managers.

As partner and international head of Kirkland's restructuring, workout and bankruptcy group Jamie Sprayregen is well placed to comment on the current downturn in the really big bankruptcy cases emanating from the US. He reckons this fall will prompt the leading US bankruptcy practices to look more at the international market and the US domestic mid market.

In 2003 over US$100 billion of high yield debt was issued, a near record. Lots of senior debt was taken off companies' books, with amortisation a few years out. This has not solved problems for these companies. "It just buys them a bit of time", says Sprayregen.

> This doyen of US bankruptcy quoted one of his long-held sayings: "Bad management beats good economy. Its just takes a while."

So in 2005/6 Sprayregen expects lots of high yield offerings to come home to roost.

Likely industries include auto makers, steel and utilities. In utilities Sprayregen has seen what he calls a lot of 'band-aid' deals. As for airlines, "there is a lot of major work to come."

For instance, US Airways came out of Chapter 11 a year ago and has just been forced to restructure the Government loan it received. "Where will they be in a year's time?" he asks rhetorically. The low cost carriers must also be an area of interest.

> "In the US in three to five years' time one, two or three of the major carriers will no longer be here. They will either have merged or closed."

The latest headache: 'Second liens'

Just when you thought capital structures were complicated enough, another obstacle has appeared for restructurings: Second liens on high yield debt. Traditionally, high yield bonds have been unsecured. However, there are now more and more secured high yield bonds, which make things more complicated.

As the Kirkland partner said with admirable understatement, "It's quite complex".

The problem is that second liens over high yield debt can produce tremendous inefficiencies for restructuring US bond indentures.

Sprayregen sees this factor as likely to start creating problems for restructurings in one to one and a half years' time.

Germany

Turning to Germany, Thomas Verhoeven, a German partner working in Kirkland's London office, spoke first about the new German insolvency law which was introduced in 1 January 1999.

The law was first 'enacted' in 1984. Why the delay? To give the insolvency industry in Germany time to adjust, is Verhoeven's sardonic verdict. "The changes require ten years to build up case law in order to get rid of uncertainties."

The law introduced the American concept of Debtor in Possession (DIP) to a jurisdiction traditionally dominated by close links and cross shareholdings between banks and companies. However, says Verhoeven, the German insolvency industry has not picked up on DIP.

Again, why? "The courts believe that the guys that got you into this mess should not take advantage of the rescue," he says.

(Incidentally this is also a widely held view in the UK, where the banks stymied efforts to introduce DIP in the Enterprise Act last year).

The recent Kirch restructuring based in Munich and the Babcock bankruptcy in Dusseldorf both illustrated what actually happens under current German law, that is, that insolvency receivers are appointed as the new management. "It will take five years to see more DIP proceedings," he predicts.

One major downside to German insolvency law is the infamous "21-day rule".

Management has to file for bankruptcy at the latest by 21 days after it has become aware that the company is either 'illiquid' or


Lyndon Norley, Kirkland & Ellis


Thomas Verhoeven, Kirkland & Ellis

'over-indebted'. The fact that directors can go to jail if they get this wrong overshadows every attempt to rescue troubled companies.

For instance, Verhoeven recalls when he was working on Ish, a regional German cable TV company; "the management was scared of this rule. Management preferred to file for bankruptcy early and not take any risks. This meant everything went down. The operating entity was sold. The filing was unnecessary, but there was no time to negotiate with the bondholders."

No covenants

Bank covenants virtually do not exist in Germany. This means that one extremely powerful early warning system that is relied upon by lenders in the US and elsewhere is not available. German banks do not see covenant breaches so they often lack early warning of trouble at debtor businesses.

Coupled with the 21-day rule, this is a potent cocktail for forcing perfectly rescuable companies into bankruptcy. So it is very important to see if loan agreements have covenants, to avoid trouble with the 21-day rule, Verhoeven warns.

Returning to the example of Ish, he says that the high yield bond debt was at the top of the capital structure, at the holding company, and that the holding company's only assets were shares in the operating company. If you are structurally subordinated like this, the 21-day rule no longer applies.

Canny lawyers will already be wondering; can you use the recently introduced European Bankruptcy Regulation to escape the 21-day rule, by moving the case to the UK, where there is no such rule?

Such forum-shopping is much discussed at the moment. Verhoeven quickly pops this balloon however, by pointing out that Germany's 21-day rule is part of corporate law, not insolvency law, so it is not covered by the Euro Regulation. Switching jurisdiction will not help you escape the 21-day rule.

German insolvency receivers have a tendency to sell off a business instead of restructuring it, and then just closing the books, he observes.

In the last two years the Euro Regulation has had a tendency to move cases from Germany to the UK. For instance in the now famous Daisytek decision, Stephen Taylor of PricewaterhouseCoopers was made administrator by the UK court, and therefore under the Regulation also Administrator of all Daisytek's subsidiaries in the EU.

On 24 January the Cologne Court viewed the German subsidiary as filing for secondary proceedings under the Regulation. The Judge approved a Debtor in Possession procedure and put the UK insolvency practitioner, Taylor of PwC, in charge of the German proceedings.

Verhoeven comments; "This was a very good decision. It puts one guy in charge of the whole proceedings."

However, Verhoeven says that many German lawyers are deeply worried at the prospect of cases switching from Germany to the UK for no good reason other than 'forum-shopping'. This is a hot topic for debate in Europe at the moment.

Another thing to watch out for is the German labour laws, he adds. The German Government will pay subsidies for up to 90 days to pay the salaries of employees in troubled companies, up until the filing for bankruptcy. No such subsidy exists in the UK, for instance.

Restructurings in Germany are often implemented by 'employment companies', vehicles for re-education and re-training for the former employees of bust businesses. These employment companies are closed after six months, and also receive subsidies from the Government.

Lyndon Norley of Kirkland & Ellis's London office then gave his predictions for the marketplace.

"Restructurings used to be organised by an insolvency practitioner and his lawyer. That was it. Now you have seniors, bonds, mezzanine, equity. I am sure there are people out there as I am speaking who are busy inventing new forms of capital."

The US influence will grow, he predicts. Some people in London may think that the high water-mark of American influence has been reached with the working out of the telecoms boom and the related bond restructurings, but Norley reckons this is "wishful thinking."

There will also be more complexity and more stakeholders. As is already the case with American restructurings, each one of the army of stakeholders will require their own legal and financial advisers. Complexity is being added to by increased trading in secondary debt right through companies' capital structures. Public instruments mean deals are more public.

Norley notes that the UK's recent Enterprise Act which changed insolvency law, crucially did not introduce an element of the US Chapter 11 'Debtor in Possession' procedures as was originally hoped. It was watered down at the drafting stage.

But there is a change of attitude by senior lenders towards a more consensual approach to restructurings. This fits in with the European Regulation, which did not recognise the old Receivership as a 'rescue procedure' but does recognise the reformed Administration.

> "Armed with these reforms some British advisers are hoping to draw more European cases into London, and make the UK capital the Delaware of Europe."

Pre-pack administration is very difficult to achieve.

One problem with the changes in the Enterprise Act is that the newly reformed administration procedure has a 'cascade' of three priorities; the first priority of any administrator is to try to save the company, then protect the creditors and only then failing that the assets.

So Norley says you have to be quite brave to say you can't achieve the first purpose or the second before going straight to the third, which is what would be required by a 'pre-pack.'

If the court takes a restrictive view of definitions then it could achieve the opposite of the intention of the Enterprise Act; to promote business rescue.

Alan Bloom, Ernst & Young's senior insolvency practitioner in the UK, then commented from the audience why that 'cascade' of aims had been inserted in the Act:

The British government had been concerned that during the last recession a lot of companies were going to the wall and that receiverships destroyed value. Bloom says he thinks this view is misguided, but that nevertheless the new insolvency regime is driving change:

> "Now creditor groups are coming in to take over companies by buying their debt. So creditors are pushing insolvency practitioners away from the rescue of the company!"