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LEGAL INSIGHTS

Corporate Debt Restructuring
Amidst Coronavirus Pandemic

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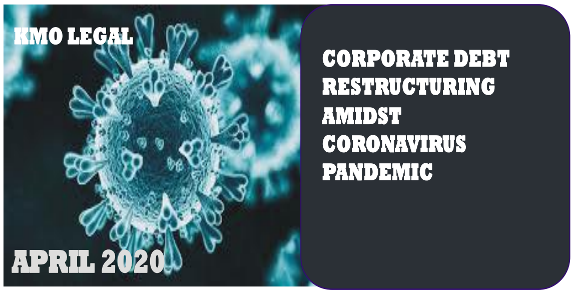
CORPORATE DEBT RESTRUCTURING AMIDST CORONAVIRUS PANDEMIC



By Akorede Folarin

Apart from the high infection and mortality rate that the coronavirus pandemic has left on its wake, several economies and businesses are also feeling the pains. The outbreak is triggering "an economic crisis whose violence is set to exceed anything we have previously witnessed."[1] Aside the disruptive energy crisis it has also caused, the consequent social distancing and work-from-home directives have led to a virtual collapse of economic activities across the globe, with the world now in yet another recession.[2]

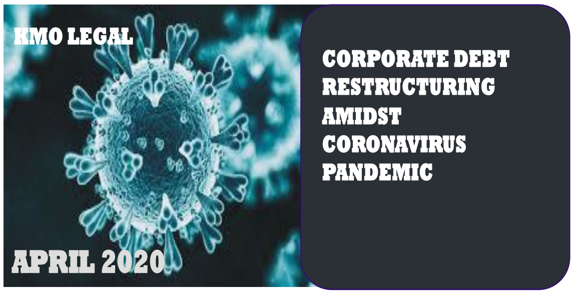
Businesses are seeing their revenue streams thin out. The primary concerns for most companies at this point are their cash flow and liquidity, and how to weather the storm, which are now leading corporations to save cash, cut costs, suspend capital investments and, if things get out of hand, - as they sometimes inevitably do – lay off staff. All over, there is a certain air of inevitability that a lot of businesses will slip into bankruptcy and that even others that are able to scale through (at least in the short term) may do so only by deferring or defaulting on payments.

These unsettling economic effects of the pandemic are already giving businesses serious concern, particularly those relying on credit financing with regards to their ability to meet their debt obligations. Financial institutions are also becoming worried about their own potential to make good their advancements and ensure that non-performing loans stay within manageable thresholds.

Against this backdrop, lenders and borrowers alike will do well to become proactive about protecting and preserving their respective positions in light of the economic downturn and in a bid to ensure liquidity and provide cash flow for companies even if only as far as staying afloat or clearing a path toward viable future operations. One of those options available to both parties and which promises the most convenient and beneficial returns in light of the current economic climate is debt restructuring.

What is Debt Restructuring?

Debt restructuring is a process that allows a company or a sovereign entity facing cash flow problems and financial distress to renegotiate and reduce its delinquent/distressed debts in order to improve or restore liquidity so that it can continue its operations. It is a process of renegotiating troubled debts. It would involve an alleviation of debt liabilities or a favourable variation of payment terms and is usually less expensive than litigation or bankruptcy as means of debt recovery. It is more often than not beneficial to the company at risk of default because



it often results in a significant discount and/or a more flexible repayment schedule.

Generally, due to the inadequate insolvency law regime with regards to business restructuring in Nigeria, any out-of-court restructuring is regarded as an **"informal arrangement/informal workout."** They serve as timely alternative to recovering funds loaned to borrowers without recourse to courts/litigation/liquidation which may not prove to be the most efficient and effective way to preserve value in the present economic climate. The main objectives are to minimize losses to companies, financial institutions and other affected parties by way of coordinated negotiations and concessions; and avoiding unnecessary liquidations of redeemable companies.

Assessing Companies' Financial Standing - What Debts to Restructure?

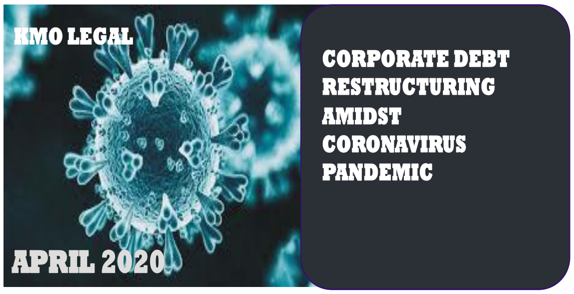
Before agreeing to restructure a credit facility, banks and other financial institutions will usually collect and assess relevant financial information regarding the debtor's business operations and prospects in order to determine its sustainable debt capacity. This review is crucial to both parties because it ensures that only facilities that are viable (i.e. reasonably recoverable) are restructured and that they are not simply deferring the inevitable i.e. bankruptcy and liquidation. By doing this, they will be able to determine what debts are worth restructuring and what debts are not. It can also help to solidify the bank's position on whether or not to fulfill scheduled draw-downs pursuant to loan facilities granted to businesses in jeopardy.

These loans – usually referred to as "problematic loans"[3] - are analyzed based on reliable information on the borrower's business atmosphere and projections and are divided into two major categories:

1) **<u>Viable Credit Facilities (VCF):</u>** These are those loans that can be reasonably recovered after restructuring the terms and conditions of the credit facilities – mostly of interest and principal – in order to provide necessary cash flow to the company and keep it a going concern,[4] and

2) **<u>Non-viable Credit Facilities (NCF):</u>** These are those credits that cannot reasonably be recovered from the cash flow generated in the normal course of the business even if more leeway is provided to the company, thereby raising concerns for bankruptcy and crystallizing the declaration of maturity and foreclosure. In such a case, therefore, the bank's speed of reaction is most crucial as it can mark the difference between the recovery of a bigger or of a smaller part of the due debt.[5]

Debt Restructuring Techniques



There are three major restructuring techniques employed in the restructuring of distressed debts. They are:[6]

1) **<u>Debt-for-equity swaps:</u>** In a debt-for-equity swap, the creditors of a distressed company generally agree to cancel or forego some or all of the borrower's debt in exchange for equity in the company. This kind of restructuring usually happens where the company has a large base of assets and forcing it into bankruptcy has little to no advantage for creditors. Instead, it is deemed beneficial to let the company remain a going concern[7] but allow the creditors to become involved in its operations.[8]

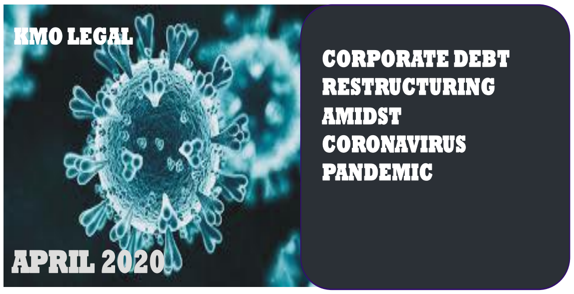
   In this scenario, not only is debt reduced along with interest payments, but equity is also simultaneously increased. For example, a 20% debt-for-equity arrangement conceded to in a $200 million debt restructuring will simultaneously reduce the company's debt by about $40 million and create an equal amount of equity in the process, thereby recapitalizing the company significantly.

   The downside of this restructuring arrangement, however, is that it significantly dilutes the original shareholders' stake in the company and can result in the creditors taking over the company.

2) **<u>Bondholder "haircuts":</u>** Unlike what it traditionally means in mortgage finance,[9] the term "haircut" is used in debt restructuring to denote "a reduction in the value of a troubled borrower's debts."[10] "To take a haircut" would mean for the creditors of a company to accept less than what is owed to them. According to David Parkinson, it is "the market's euphemism for wiping out a large portion of the debt owed to the creditors."[11] A portion of the outstanding interest payments would be written off, or a portion of the principal will not be repaid. It is in essence a debt forgiveness/forbearance whether partially or wholly – although it is more usually partial with the intent that even though the debtor is unable to discharge the entire granted credit, there is the possibility of recovering a considerable part.[12]

   It is important to note that although bondholder haircuts are painful to creditors, they are sometimes bitter-sweet concessions given to debtors with generally good credit reputations whose ability to service existing debts have deteriorated due to drastic events in order to maintain working relationships and to allow them continue operations without necessarily going bankrupt.[13]

3) **<u>Informal debt repayment agreement/variation of terms</u>**: Here, the company meets with its creditors to negotiate lenient repayment terms. This can be done



through variation of payments on principal or of interests by defining a new reimbursement schedule in accordance with the debtor's actual payment capabilities.[14] The creditors may suspend payment on the principal for just amortization of interests and then consequently a "bullet payment" at an agreed date.[15] Or the restructure may take the route of "balloon payment", whereby the debt has the regular interests paid alongside a fraction of expected payments on the principal, until at the end of the tenor there is a balloon payment yet to be paid. It could also be by reducing the interest rate while also increasing the period of time to satisfy the debt by way of moratorium.[16] Generally, therefore, under this technique, there will be an arrangement and compromise whereby credit obligations are spread out over a longer duration with smaller payments in order to provide respite to distressed borrowers.[17]

From the above, we can see that debt forgiveness, debt relief, debt rescheduling, and debt forbearance are aspects of a complex corporate debt restructuring process. All of debt-for-equity swaps, bondholder haircuts and informal debt repayment agreement have their unique benefits and limitations depending on the circumstances and the parties involved.[18]

Conclusion

With the serious downturn in economic activity due to the coronavirus outbreak, the world has been plunged into yet another recession of an unprecedented scale. A great deal of businesses are already facing serious limitations with cash flow and meeting their debt obligations as a result of thinning revenue streams. Also, lenders are getting increasingly concerned about their prospects of recovering loans made to businesses which are likely to be in jeopardy. With the stupendous amount of loan advancements in question, one thing is certain - if nothing proactive is done, all parties may find themselves dragged into a hole of litigation and counter-litigation which might take years to settle and not even offer mutually-beneficial returns.

On that note, restructuring existing debt portfolios can be a win-win for all parties. It can ease the cash flow pressures on distressed borrowers, allowing them to remain a going concern, pay their employees and suppliers, and improve their capacity to service their debt, while also protecting and preserving the interests of financial institutions in the recovery of their facilities. Overall, it can help to preserve jobs, help viable businesses successfully survive the recession and be a driver of economic recovery.

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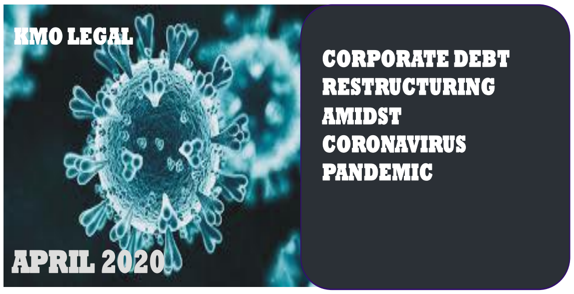

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5 *Ibid*

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12 Dedu, V., Lãzãrescu, S. A. and Niþescu, D. C., *supra* (note 3) P. 29

13 *Ibid.* P. 29

14 *Ibid* P. 28

15 That is, like in mezzanine finance and high-yield debt, only interest will be paid during the agreed time and then a "bullet payment" of the principal will be made at a later date.

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17 Bhadmus, H. Y., "*Bhadmus on Corporate Law Practice*", Chenglo Limited, Enugu, 2017, p. 412

18 It has even been opined that "*while a cut in face value [i.e. haircut] provides direct and instant relief, maturity extensions and/or lower interest rates only unburden a [company] slowly over time.*" Christoph Schröder, '*Haircut Size, Haircut Type and the Probability of Serial Sovereign Debt Restructurings*', Discussion Paper No. 14-126, December 2014, Centre for European Economic Research. Available at http://ftp.zew.de/pub/zew-docs/dp/dp14126.pdf

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